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The Crystal Report on Executive Compensation



BANK OF AMERICA'S KENNETH LEWIS: NO GREAT SHAKES

by Graef Crystal

October 27, 2008

So I was watching "60 Minutes" on Sunday, Oct 19. And I sat through a segment featuring Kenneth Lewis, the CEO of Charlotte-headquartered Bank of America Corp. The interviewer was Lesley Stahl. She's wonderful, but I concede to being biased since she did a story on me in 1991, and I was the principal on-air contributor to a second story she did in 1996.

During this interview, Mr. Lewis was treated as the new King of Financial Services, partly because he is one of the few titans still standing but mainly because he became the White Knight rescuer of Countrywide Financial Corp. and Merrill Lynch & Co. Inc., in the process leading his company once again to emerge as the biggest bank in America, a position it held for years when the company was headquartered in its original hometown of San Francisco.

But I sat bolt upright in my seat when Mr. Lewis portrayed himself as an enemy of high executive pay. Listening to him talk, you'd have thought he was the second coming of Warren Buffett, who always pays himself \$100,000 a year (except for a tiny amount of miscellaneous compensation).

So, friends, here's the scoop on Ken Lewis:

- He has been paid plenty of money, though, currently, he is in the middle of the CEO pay pack.
- His performance for shareholders has been spotty and frequently poor.
- Like many CEOs before him, Mr. Lewis seems implicitly to value size over performance – something that many men do.

Lewis' Pay

The first thing you need to know about Mr. Lewis' pay is that it's relatively unvarying. He first became CEO on April 25, 2001. For the years 2002 through 2007, I scored him as receiving total pay of, respectively, \$22 million, \$21 million, \$21 million, \$24 million, \$23 million and \$23 million.

My definition of total pay includes:

- Base salary.
- Bonus for annual performance.
- The value at grant of free shares granted during the year.
- My estimate for the present value at grant (using the Black-Scholes model) of stock options granted during the year. (The terms "present value" and "grant date fair value" are synonymous.)
- The "target" value of prospectively-granted performance shares or units awarded during the year.
- The present value of pension accruals made during the year.
- And, as defined by the U.S. Securities and Exchange Commission, miscellaneous compensation.

It should be noted, though, that pension accruals did not show up in proxy statements until 2006. If I remove the \$3 million of accrual for 2006 and the \$3.2 million for 2007, Mr. Lewis' pay decreases in those two years to, respectively, \$20 million and \$19 million.

You can say two things about Mr. Lewis' pay:

- It doesn't seem small enough to permit him to be bashing executive pay and, at least implicitly, holding himself out as a sort of pay hero.
- Its relatively unvarying size from year to year suggests that either BAC's performance has been relatively unvarying from year-to-year or, alternatively, that his pay is unconnected to his company's performance.

Looking at the size of his pay package:

- I revisited one of my mathematical models covering pay in 2002 through 2004 for hundreds of CEOs. Mr Lewis' average annual pay over the three years of \$21 million positioned him 83 percent above the market, after controlling for differences in company size, three-year total return and pay risk.

- But my pay model for 2007 pay showed he was right on the money. His pay of \$23 million (which included his pension accrual, because pensions were included for every other CEO in that year's study) positioned him only 1 percent above the market after controlling for company size and pay risk.
- So though Mr. Lewis' pay has remained relatively steady from one perspective, it has gone down from another perspective. And that is because his company's revenue growth has been so high (remember that current revenue is a prime determinant of where a CEO will place in the pay pack of his colleagues). Between 2002 and 2007, revenue rose from \$46 billion to \$119 billion, for an increase of 157 percent. And that doesn't count Merrill Lynch or Countrywide Financial.

The Acquisition of Merrill Lynch

There is another aspect here – one which is encapsulated by George Santayana's famous remark that: "Those who cannot learn from history are doomed to repeat it."

Back in the early 1980s, I became the pay consultant to the Bank of America. That was when it was headquartered in San Francisco and headed by Samuel Armacost.

Around that time, BAC acquired a small San Francisco-headquartered discount brokerage called Charles Schwab Corp.

Quite soon thereafter, I was dispatched along with Steve McLin, BAC's brilliant internal strategist, to design a long-term incentive plan for Mr. Schwab.

Our idea was to pay him mainly on his own firm's long-term results and not those of BAC.

Steve and I did, I think, a fine job. Chuck liked it. But Sam Armacost didn't. I will always remember him reviewing the plan and saying words to the effect: "Why, Chuck could make more than I do." Brings to mind Babe Ruth's famous reply when he was asked in the early 1930s how he could earn more than Herbert Hoover: "I had a better year than he did!"

At any rate, the magnificent long-term incentive plan bit the dust, and soon Chuck Schwab was in his full-throated "Let my people go" act.

After a while, he was able to free himself from BAC and to re-establish what became a highly successful independent company.

So now we have BAC taking on Merrill Lynch. Goes to show you that the idea of a financial supermarket does not die easily, even if it may not work.

How long do you think it will be before some hot-shot Merrill investment banker sees his pay bump into the Ken Lewis pay ceiling? Probably longer than normal, since the Wall Street firms are currently on their can. But it will happen.

Will this problem be resolved by Merrill agitating to separate from BAC once the financial storm clouds have passed over? Or will it be resolved by Ken Lewis receiving a monstrous pay increase so the poor slobs under him can make a decent living?

There is, of course, the possibility that Mr. Lewis will accept that some of his subordinates are being paid more than he is. Warren Buffett does. Bill Gates did when he was running Microsoft Corp. But they're worth billions, and Ken Lewis isn't.

Stay tuned.

BAC'S Performance

Now let's take a look at BAC's performance during Ken Lewis' tenure.

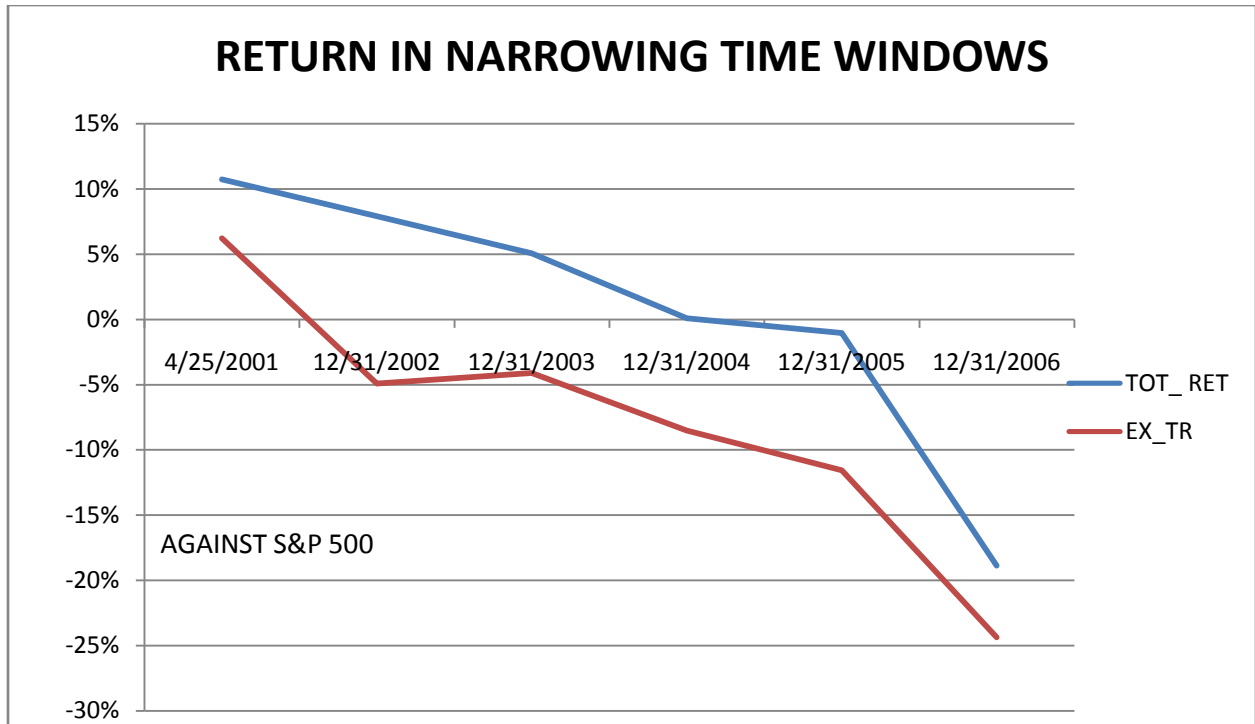
I have four charts to show you here.

Narrowing Time Windows of Total Return

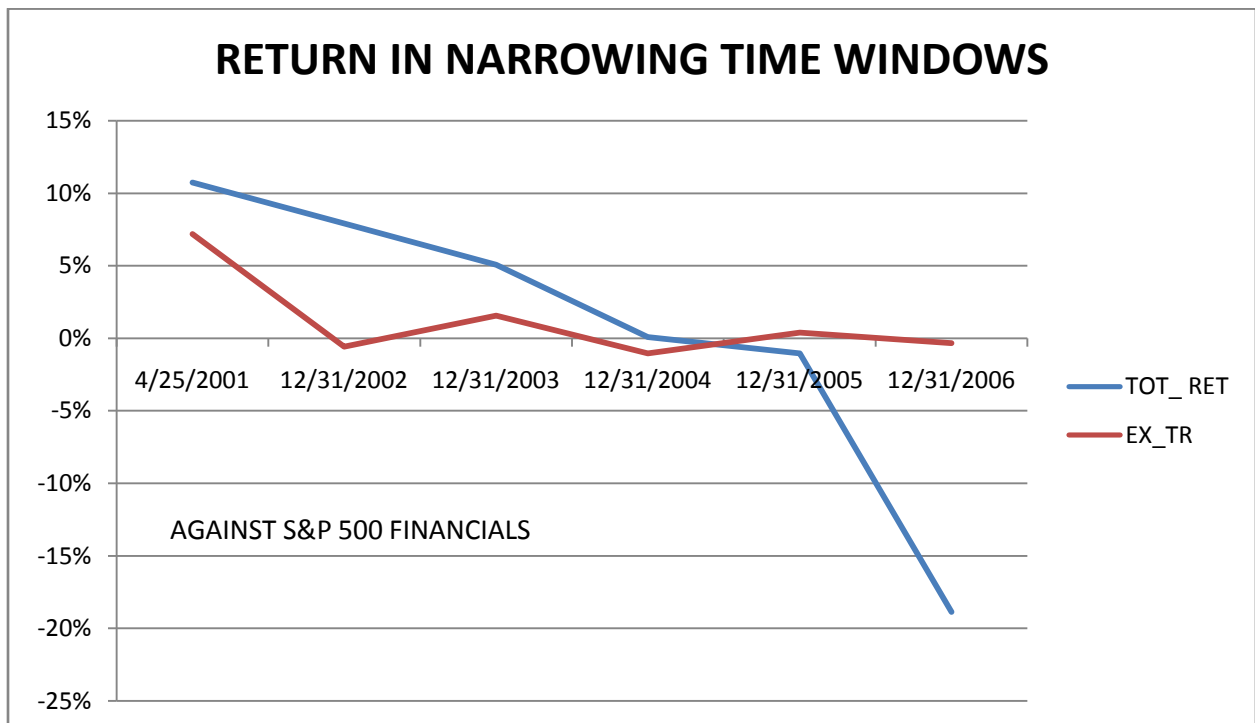
The one immediately below looks at BAC's total return in narrowing time windows. The widest window begins on April 25, 2001, the day he became CEO and ends on Dec. 31, 2007 (because that's where my pay data end). The second-widest window begins on Dec. 31, 2002 and ends on Dec. 31, 2007. Thereafter, the start date of each succeeding window increases by one year. But the end date is always Dec. 31, 2007.

This chart shows two lines:

- BAC's compounded annual total return.
- The amount by which that return is higher or lower than the return on the Standard & Poor's 500 Index. This second line is hereafter referred to as the "excess return".



The second chart repeats the first chart, except that the excess return series is calculated using the S&P 500 Financial Services Index (which currently includes 85 members), instead of the S&P 500 group of companies.

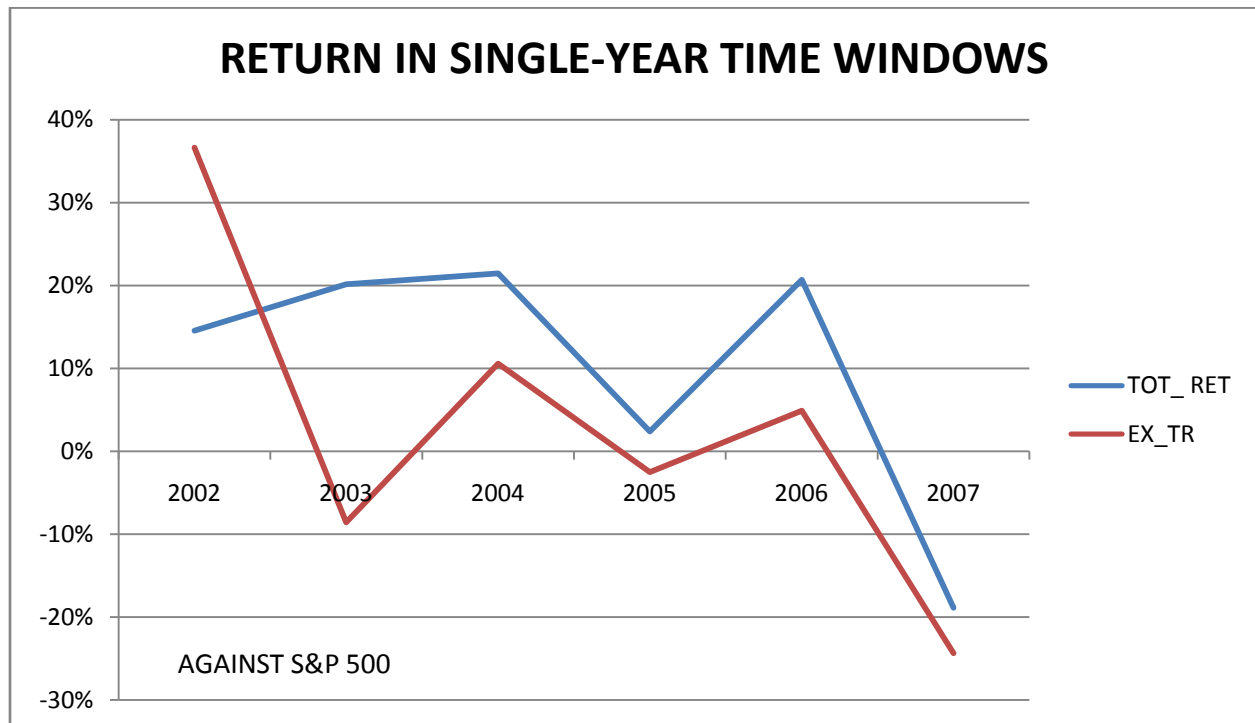


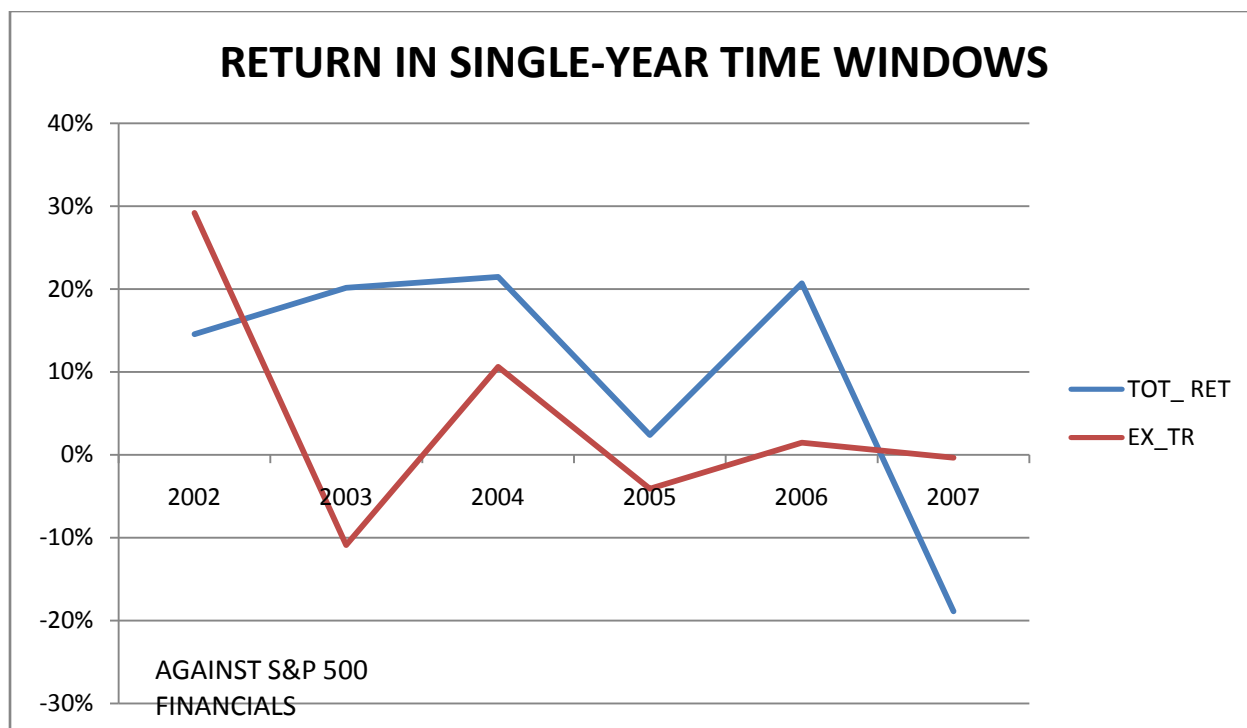
Comments:

- When compared against the S&P 500, BAC outperforms the index in only one of six time windows – the widest one.
- When compared against the S&P Financials, BAC also outperforms the index in the widest time window. In the other five windows, it pretty much breaks even.

Single-Year Time Windows of Total Return

Now we come to two charts that display BAC's annual returns, first comparing to the S&P 500 Index and then to the S&P 500 Financials Index.





Comments:

- In three of the six years, BAC outperformed the S&P 500 index. In the other three, it underperformed the index. The best performance was in 2002, in which the excess return was 37 percent. The worst was in 2007, in which the excess return was negative 24 percent.
- More or less the same pattern prevails when the comparison is made to the S&P 500 Financials Index. But of significance is the fact that where the excess return against the S&P 500 Index was negative 24 percent for 2007, it was 0.3 percent in the same year against the S&P 500 Financials Index.

Performance Past 2007

Looking at total return performance from Dec. 31, 2007 through the close on this Oct. 24, BAC's total return was a hugely negative 46 percent. That performance positioned the company 6.7 percentage points below the S&P 500 Index and 5 percentage points above the S&P 500 Financial Services Index.

Summary

Kenneth Lewis is not a hero – performance or pay -- as some might have seen him portrayed on “60 Minutes”. But, arguably, he may be one of just a handful of major financial services executives who haven’t destroyed their companies.

I have two pieces of advice for him:

- Stop being so enamored about the size of your company and instead concentrate more on performing for your shareholders.
- And in so doing, take a sharp knife, if not a meatax, to your pay for 2008. Given that your company’s EPS for the first three quarters of 2008 fell 68 percent compared to the first three quarters of 2007, you need to feel some substantial pay pain. I hate to be sadistic about it, but that’s the way the system is supposed to work.

Certain of the compensation data for this article were obtained from Equilar, Inc., a leading provider of executive pay data (www.equilar.com).

2009 marks Graef Crystal’s 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley’s Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley’s Boalt School of Law.