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Are Your Retirement Vesting Provisions Motivating the Wrong Behaviors?

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As more executives near retirement age, many banks are realizing their equity vesting provisions may be motivating unintended behaviors. Do your bank's retirement provisions encourage executives to:

1. Provide advance notice of retirement to facilitate planned succession?
2. Assist in their transition?
3. Remain engaged and motivated through the last day on the job?
4. Remain interested in the bank's success following retirement?
5. Unfortunately, many retirement provisions don't consider these important objectives and in some cases motivate the opposite behaviors.

Current and Emerging Retirement Provisions

Forfeit

Forfeiting all unvested equity may be used as a means to retain executives, but this practice can unintentionally encourage executives to wait around for equity to vest when the executive is no longer fully engaged.

Fully Accelerate

Accelerating unvested equity upon retirement allows executives to announce and retire whenever they want without losing any equity. However, if an executive communicates an intention to retire two months before an equity award, does the company make the award? Not doing so could impede the executive's motivation to provide advance notice of pending retirement. However, full acceleration can limit the retention value of awards once the executive reaches (early) retirement eligibility.

Prorate

Proration provides executives with a portion of unvested equity based on the amount of time the executive has worked during the vesting period, regardless of when the grant was made. The bank may be uncomfortable with executives receiving value from recent grants, while executives may feel that they are forfeiting earned compensation. Below are three potential solutions to this concern which combine proration with acceleration:

1. **Holding Period.** Participant must have received the grant at least 6-12 months prior to retirement in order for vesting to accelerate or performance awards to vest.
2. **Prorated 12 Month Period.** The amount of award that accelerates or vests is based on the portion of time worked during the first year after grant. If a participant works for six months following a grant, he/she would receive value of half the award. This alternative is more generous and does not create as much of a cliff timeline.
3. **Most Recent Grant Pro Rata.** Equity accelerates in full except for the most recent grant (made in the last 12 months) which would vest pro rata based on the full vesting period of the award (e.g., if stock options vest ratably over 4 years, a participant who works for six months during year one would receive one-eighth of the award).

Continue Vesting
Continued vesting is an emerging practice with benefits for the executive and the bank. Continued vesting allows the executive to retire without forfeiting all or a portion of outstanding awards. Instead, the awards continue to vest on the original schedule. This also encourages the executive to leave the bank in sound condition and facilitate transition. Another benefit for the bank is that continued vesting helps reinforce non-compete or non-solicit agreements because the bank can cease vesting if the executive violates the restrictive covenant.

Committee Discretion
Some committees want the discretion to determine retirement treatment on a case by case base. This treatment acknowledges that each executive is different and each retirement situation is unique. However, this approach puts a significant pressure on the committee and may be perceived unfair by executives if the discretion is not applied consistently.

Other Considerations

Retirement Definition
Banks should also review the retirement definition to ensure it remains appropriate. If a bank's retirement age is 65, what is the treatment if an executive is hired at age 64? Some banks define an age plus service definition such as age 65 and 5 years' service or an age and service definition to recognize early retirement (e.g. 55 age plus 10 years' service or age plus service equals 75). For these definitions, banks may want to consider including a "retire from the industry" requirement in their retirement definition.

Performance Awards
Should performance award payout be based on target or actual performance? Awards paid based on actual performance at the end of the performance period could encourage the retiring executive to leave the bank in sound condition.

Vesting Schedule
Finally, the vesting schedule may also impact which type of retirement provision a bank chooses. For example, if time-vested restricted stock vests ratably over three years (i.e. 1/3 per year), a forfeiture provision would not be as detrimental to the executive as if the award was cliff vested.

Choosing the right retirement treatment is a more strategic decision than ever before. Banks should review their long-term incentive plans to ensure they are meeting desired objectives.

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