PERSPECTIVE

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Pay Trends in the Financial Services Industry

The financial crisis and recession may be history, but the impact these events have had on the financial services industry remains. Meridian Compensation Partners LLC, a consulting firm that serves clients on executive compensation and governance matters, has a dedicated team that specializes in serving financial services organizations. Susan O'Donnell and Daniel Rodda, partners at Meridian, fielded questions about the issues facing the industry today.

Back row, from left: Jinyoon Chung, Susan O'Donnell, and Dan Kaufman. Front row, from left: Jim Kzirian, Daniel Rodda, and Stephan Bosshard.

How have compensation programs evolved in the past decade?

O'Donnell: Following the recession, compensation program designs underwent a period of significant change, driven in large part by regulatory pressures and economic uncertainty. The Federal Reserve Bank changed the landscape of compensation practices among the largest financial companies, known as systemically important financial institutions (SIFIs). The changes included reduced upside in long-term incentive plans (LTIs), a reduction in the use of stock options, the addition of risk-based adjustments during deferral periods, and recoupment policies such as clawbacks and forfeitures. With the implementation of Dodd-Frank Section 956 incentive compensation regulations currently stalled, financial companies are focusing on reevaluating the competitiveness of their compensation programs, including the mix of equity vehicles and the competitiveness of upside leverage opportunities.

What trends are you seeing with incentive plan designs?

Rodda: First, while a majority of long-term incentives are granted as performance-based awards, a meaningful portion is also granted as time-based restricted stock to support retention, align executives with shareholders, and support ownership goals. We are also seeing target goals for performance-based LTI grants increasing in response to shareholder feedback and the impact of tax reform. Additionally, after previous regulatory pressure to cap upside leverage at 125 percent of target, we now see maximum payouts converging at 150 percent of target. Return on equity has become the most prevalent LTI performance measure, including a significant increase in the use of return on tangible common equity, which is viewed as being highly correlated to shareholder value creation.

How has the industry addressed the need to mitigate incentive compensation risks?

O'Donnell: Risk-related conduct issues in the financial services industry have received increased scrutiny from both media and regulators around the world. Regulators continue to target compensation plans as tools for addressing misconduct, and industry practices continue to evolve. Companies now seek to ensure that their processes incorporate appropriate risk considerations in incentive determinations, encourage appropriate behaviors, and require meaningful portions of incentives to be deferred and subject to forfeiture. Many companies are also reassessing their forfeiture and clawback policies. In addition to ensuring compliance with regulatory expectations, compensation committees want to have adequate tools to take appropriate actions when necessary, while also ensuring that policies protect executives from unlimited uncertainty with regard to award payouts. We anticipate that recoupment policies will expand in prevalence and scope beyond financial services as compensation committees evaluate their programs in light of recent events.

What should compensation committees in financial services companies be focused on moving forward?

Rodda: Since the recession, compensation committees in the industry have had to focus on addressing concerns raised by regulators. While regulator perspectives will continue to be critical, the pendulum is swinging back toward shareholders. Shareholders are focusing on incentive plan metrics and goals, and are assessing whether executive rewards are consistent with their expectations. Compensation committees should ensure their programs are responsive to regulatory and shareholder feedback, support strategic goals, and demonstrate strong alignment of pay and performance.