Meridian Compensation Partners

Advising the Banking Industry Through Intense Regulatory Reform

Meridian Compensation Partners is an independent consulting firm advising clients on executive compensation and governance matters. While Meridian serves companies in all industries, a dedicated team of consultants specializes in assisting compensation committees for financial services companies. Meridian's Susan C. O'Donnell and Daniel Rodda fielded questions about the issues unique to this industry.

Meridian Compensation Partners' banking industry specialists (from left): Annette S. Leckie, Shane A. Meredith, Susan C. O'Donnell, Daniel Rodda, and Jinyoon Chung.

DAMIANOS PHOTOGRAPHY

What are the biggest challenges facing compensation committees in the banking industry?

Susan C. O'Donnell: Compensation committees must comply with increased regulations and restrictions, while also responding to the often conflicting perspectives of shareholders. While bank regulators such as the Federal Reserve Board (FRB) seek to mitigate risk by reducing the focus and range of compensation associated with performance, shareholders prefer that a meaningful portion of executive pay varies based on performance. Finding the right balance that satisfies both constituencies is a challenge, particularly since perspectives of "best practice" continue to evolve. For example, in the absence of final rules from the Dodd-Frank Act of 2010, the FRB has developed its own guidance for the largest U.S. banks, and these practices are trickling down to smaller companies and across the industry. While committees have addressed significant changes in response to the financial crisis, there are more changes to come. The pay components, performance goal-setting process, and payout horizon for incentive plans will continue to be areas of focus for committees.

How do compensation practices in the financial services industry differ from other industries?

Daniel Rodda: Regulators have pressured the largest banks to reduce or cap the maximum upside opportunity in incentive plans. While maximum opportunities of 200 percent of target remain standard in general industry, caps of 125 to 150 percent of target are now becoming the norm for U.S. banks under FRB review. This reflects the FRB's concern that higher upside opportunities drive excessive risk taking. In Europe, actual bonus caps have been mandated, limiting the potential for incentive pay altogether. There has also been a significant decrease in the use of stock options, which regulators view as promoting riskier behavior. While the use of stock options has been declining across all industries, the reduction in financial services has been much more pronounced.

What is happening as a result of these differences?

O'Donnell: Banks have made considerable changes to their pay programs in response to regulatory directives. There remain concerns about their ability to continue to attract and retain talent, however. As regulators push banks to reduce the upside leverage within incentive plans, some banks are feeling the pressure to move to more discretionary approaches or increase fixed pay (e.g., salaries). These pressures could lead to unintended consequences as these programs evolve over the next few years.

What can compensation committees do to be most effective?

Rodda: While there may be a temptation to follow the latest trends, committees should first design compensation programs to meet their business strategy, philosophy, talent needs, and culture. Programs can then be refined to ensure they appropriately incorporate regulatory and shareholder perspectives. Simply following what other companies are doing or what regulators believe are best practices can lead to ineffective programs that do not motivate executives or drive performance.