Susan O'Donnell is a partner at Meridian Compensation Partners.

Daniel Rodda is a partner at Meridian Compensation Partners.

COMPENSATION

Determining Annual Incentive Pay in a Pandemic

For most banks, the impacts of the coronavirus pandemic rendered many of the 2020 annual incentive goals obsolete.

While banks with incentive plans based on formulaic financial goals are particularly challenged, even those with more discretionary plans are asking how to evaluate and reward performance in light of the pandemic. Many compensation committees will need to assess how they might exercise discretion to determine 2020 executive incentive payouts. Here are several questions that committees should ask to inform their decision-making.

How did the bank perform relative to budget and/or goals set at the beginning of the year, and how were those results impacted by Covid-19?

Compensation committees should start by understanding what payouts would be in accordance within the existing plan metrics (and goals, if approved), and any positive or negative impacts that the pandemic had on those results. Lower net interest margins, increased credit provisions and fee waivers to support customers have hurt profitability. On the positive side, Paycheck Protection Program loans created new revenue and customer streams, and low rates spurred a strong mortgage market. While it may be appropriate to use some discretion to adjust results for the impact of the pandemic, committees should also make sure incentive payouts are directionally consistent with actual results.

How did the current expected credit loss (CECL) accounting standard impact our performance?

The CECL methodology requires banks to record expected credit losses at origination, based on a bank's future economic forecast — which became even more challenging to create during the pandemic. Committees should understand how CECL impacted 2020 results and peer comparisons, considering that other banks may not be using similar economic assumptions or accounting approaches. Reviewing pre-provision results, as well as earnings based on actual charge-offs, may provide committees with additional context on performance.

How will shareholders view performance and pay decisions in 2020?

Bank stock prices have lagged most industries in 2020. Committees at public banks will need to consider how shareholders will view performance and pay decisions in light of their lost value and, in some cases, reduced dividends. Providing transparent disclosure of how executives managed the business through the pandemic, the factors the committee considered in making pay decisions, and how pay and performance are aligned will be even more critical next proxy season.

How have we performed relative to our peers?

Relative performance can provide context in evaluating how management executed during 2020, given that the industry faced similar challenges. Committees should compare results to other banks on key financial metrics (e.g. ROE, ROA) and total shareholder return.

What can we afford?

Incentive payouts will be significantly impacted by affordability, particularly in a declining earnings environment. Even where relative performance has been strong, there will need to be consideration for what the bank can afford to pay given its absolute results. One helpful perspective can be the sharing ratio — the percentage of earnings paid out in incentives. Some banks may also consider paying a portion of the annual incentive in unvested equity, spreading the expense over a longer period of time.

How have non-executive employees been impacted?

Shareholders, employees and other observers may pay particular attention to how executives are compensated relative to other employees. Committees should consider the optics of executive payouts relative to how employees have been impacted, including any pay or benefit reductions, expected incentive payouts and/or potential layoffs. In many cases, executives may face a greater proportional reduction from lower incentive pools.

How will the communities we serve react to these payouts?

Whether a bank is public or private, many of the actions the compensation committee takes will become public within their communities, whether through disclosure, employee word of mouth or the media. When making decisions about executive pay, it is important to consider how the payouts may be perceived externally.
It is critical that compensation committees have an understanding of multiple perspectives on performance and the implications of payout decisions.

The answers to these questions can help inform the committee's judgment to determine payouts that balance the bank's performance results, affordability, shareholder outcomes and the performance of management during extraordinary challenges.

As seen in the 4th Quarter 2020 issue of *Bank Director*