AMERICAN BANKER

Tug-of-War Over Pay Leads to Small Gains, Changing Incentives

Susan O'Donnell is a partner at Meridian Compensation Partners, an executive compensation consulting firm in Newton, Mass.

Susan O'Donnell
MAY 5, 2014

Bank chief executives had a good but not a great year in 2013, based on an analysis of the pay packages at 35 U.S. banks with assets of $20 billion to $400 billion.

Total compensation — including base salaries, incentives and equity-based pay—rose 3.2%. Base salaries were flat. Cash payouts, which reward executives for meeting annual objectives, averaged 112% of target, indicating that the rewards were modestly above performance expectations. The value of long-term equity grants rose approximately 5% over 2012 levels.

The good news for shareholders is that CEO pay and performance has been reasonably well aligned for the majority of banks, an analysis of one- and three-year total shareholder returns shows. Another notable finding: the continued evolution of the way in which CEOs are rewarded.

Changes in the Way Banks Pay

Behind the changes in pay structure are conflicting external pressures. On one side, bank regulators are seeking to mitigate risk-taking. On the other, shareholders are seeking to closely align CEO pay with company performance.

The biggest changes are evident in long-term incentive pay, which at many banks constitutes the largest component of compensation. During 2013:

- Stock option values decreased 30%
- Time-based restricted stock values decreased 18%
- Shares awarded on the basis of performance increased 35%

Stock options are still a common component of long-term incentives and were found in 53% of plans studied. Even so, the percentage of long-term incentives made up of stock options has decreased in recent years in response to regulators' view that options promote risk-taking. Institutional Shareholder Services, the influential proxy advisory service, also frowns on stocks options, which it does not regard as performance-based—a notion that most companies and many shareholders dispute. Nevertheless, the result has been that many banks have deemphasized stock options as a form of pay.

Time-vested stock, which is granted based on the length of service, was found in half of banks studied this proxy season. Supporters believe it aligns executive and shareholder interests by giving the former group "skin in the game." However, because time-vested stock is awarded for service, rather than for hitting financial targets, it is not considered performance-based.

This explains the emergence of performance-vested stock as the most prevalent form of long-term incentive, with two-thirds of banks offering it to CEOs in 2013.

Regulatory Effects

Bank regulators' influence on pay has over the past year extended beyond the composition of equity-based vehicles to include plan designs. Among the changes:

Reduced Leverage: It has been common practice among banks and in other industries for performance pay to range from 50% to 200% of a pre-set target, depending on performance against metrics like total shareholder returns, earnings per share and return on equity over a defined performance period (typically 3 years). This design is intended to align pay and performance, but bank regulators have criticized the hefty upside of such plans. Large banks have responded by cutting maximum awards to 125% to 150% of the pre-set target. The practice is likely to cascade to the smaller banks in coming years.

Absolute vs. Relative Performance: For performance-based equity plans, it remains common to determine payouts based on how an institution fares relative to others in the industry. Regulators fear this design leads to risk taking and "chasing" of industry rivals. This theory is debatable but has led to increased use of absolute measures along with relative ones or as an additional metric or hurdle.

Forfeitures for Risk-Based Pay: These provisions enable an institution to adjust or recover performance-based pay in the event of negative earnings, returns, and/or "bad risk behavior." Return on Tangible Common Equity hurdles appear to be emerging as a common forfeiture provision.

The Future of CEO Pay

Long-term incentive plans will continue to evolve in response to pressure from the Federal Reserve, proxy advisors and shareholders. As they do, we may begin to see unintended consequences.

Reduced upside leverage in incentive plans, for example, could lead directors to address the concern that CEOs will receive lower payouts for superior performance. Banks may try to avoid such unintended consequences by providing executives with higher target opportunities and /or eliminating targets altogether to avoid leverage maximums. They may also turn to greater use of discretionary pay or lower performance hurdles.

One inevitability appears to be that as regulators seek to reduce risk-taking, bank boards will consider new ways to motivate and reward executive performance.

It remains to be seen whether these cumulative changes will be for the better or worse in terms of creating more sound and profitable financial institutions.

Susan O'Donnell is a partner at Meridian Compensation Partners, an executive compensation consulting firm in Newton, Mass. Her contact information is sodonnell@meridiancp.com or 781-591-5284.