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How Regulators are Changing Bank Incentive Pay

By: *Susan O'Donnell* | JUNE 9TH, 2014

The Federal Reserve's influence on incentive practices at the largest banks is cascading to regional banks. **Although the final Dodd-Frank Act regulations have not been released, many banks are adjusting their incentive programs to respond to regulatory pressure.** A Meridian Compensation Partners review of proxies of U.S. banks with $10 billion to $400 billion in assets confirmed that changes continue to emerge in the following areas:

Decreased stock option use.
While slightly more than half (53 percent) of banks continue to include stock options in their portfolio of long-term incentives, the value of such awards declined 30 percent from 2012. Regulators deem stock options as a more risky form of compensation. Most banks granted two to three forms of equity as part of their long-term incentive program in 2013, with stock options representing the smallest portion.

Increased use of performance-based equity.
In place of stock options, performance-based shares have become the most prevalent stock instrument, used by 74 percent of the banks. Performance shares reward future performance, typically over three years, against measures such as total shareholder return (42 percent of those surveyed used TSR), return on equity (38 percent used), earnings per share and return on average assets (both used by 27 percent). Some banks used multiple measures to determine performance share awards.

Reduced use of relative metrics.
For performance-based equity plans, relative performance metrics continue to be prevalent, particularly due to the challenge of setting long-term goals in today's business environment. Yet, regulators fear overuse of relative metrics leads to risk taking and "chasing" of performance peers. As a result, we are seeing an increase in the use of absolute measures in long-term plans: 17 percent use absolute measures and 46 percent use a combination, while 37 percent continue to use only relative.

Reduced leverage.
Over the last few years, regulators have been pressuring the largest banks to reduce the maximum upside opportunity in incentive awards, particularly within long-term plans. While maximum opportunities of 200 percent of target remain standard in general industry, 125 percent to 150 percent caps are now standard at large banks.

Increased prevalence of forfeiture provisions.
While clawbacks have emerged as common practice despite the lack of final Dodd Frank rules regarding clawbacks, these policies will be challenging to enforce. It is easier to adjust pay before the award or vesting, rather than after pay has been doled out. About 30 percent of banks have forfeiture provisions on incentives prior to award or vest. Such provisions allow for potential reduction of outstanding cash and equity grants in instances of negative earnings, returns, and/or "bad risk behavior." Many banks provide for the adjustment or forfeiture of equity vesting based on an assessment of individual actions (e.g. violation of risk policies).

While some of these emerging trends conflict with the desires of shareholders and other constituencies to reward high performance, they nevertheless represent reality for today's banks. As organizations consider these practices, **it is critical to take a holistic view of the bank's compensation philosophy and programs to ensure they are balanced, support the business strategy, align pay and performance and appropriately mitigate risk.** Incentive plans should:

1. **Be grounded in bank strategy.** Performance measures should clarify and communicate what's important to focus on (short and long-term) as well as the level of performance expected.
2. **Incorporate a balanced portfolio of performance perspectives.** No one measure effectively reflects performance. Annual incentive measures should align with your bank's annual business plan while long-term incentive measures should reflect sustained value creation and shareholder value. Banks should understand the total incentive opportunity (short and long-term) that is allocated to different performance perspectives (e.g. profitability, growth, shareholder return, individual performance) to ensure it reflects the desired mix and focus.
3. **Balance discretion and formula.** While the Securities and Exchange Commission and shareholders like to understand the performance goals and resulting performance to assess pay-performance alignment, regulators prefer discretion, particularly with respect to risk considerations. More banks are using a combination of financial measures and discretion to provide a more holistic review of performance.
4. **Incorporate risk adjustments.** Consider forfeiture provisions that provide for reduced payouts or clawbacks.

Tags: Incentive Pay, Regulation, compensation

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