

Banks Taking Defection Fear Out of Performance Pay

By Matthew Monks | Tuesday, March 29, 2011

Banks are making sure "pay for performance" doesn't scare off top talent by becoming "no pay for underperformance."

As banks overhaul their compensation to appease regulators and shareholders, U.S. Bancorp, PNC Financial Services Group Inc., Wells Fargo & Co. and other large lenders are tying their pay incentives to safe targets — criteria under which the companies already excel.

With performance pay, executives get paid well when a company does well. If it doesn't, they get paid less, or not at all. The idea is to discourage reckless behavior by delaying more of executives' compensation and making them forfeit it if profits lag.

But that can give executives an incentive to walk if it looks like their pay is in jeopardy. Setting safe performance targets minimizes retention risks; people are less likely to look for a better-paying job when there's a high probability of actually earning big incentives that can't be touched for three to five years, experts say.

Big banks are "still trying to pay people well — this is a ridiculously competitive market," said Donald Delves, president and founder of Delves Group, a Chicago compensation consultancy to banks. "They still have to put a lot of money out there to attract and retain people. You may not like that, but that's the fact. How do they do that in a way that's shareholder-friendly?"

U.S. Bancorp Chief Executive Richard Davis got a \$7 million stock award last year that is contingent on the Minneapolis company's returns on equity, which are exceptional, being above the middle of the pack. James Rohr, PNC's chief, received \$5.8 million worth of shares that depend on the Pittsburgh lender's core capital levels, among the highest in banking, remaining strong. Analysts project that U.S. Bancorp's returns and PNC's capital levels will remain strong at least through this year, so Davis and Rohr have a good shot at collecting the biggest parts of their recent pay.

Spokesmen for U.S. Bancorp and PNC did not return calls seeking comment.

Balancing the risks and promise of performance pay guided how these institutions have gone about overhauling precrisis pay programs in 2010 and 2011. Annual shareholder proxies filed with the Securities and Exchange Commission this month detailed their changes.

Though the specifics vary, they are basically tweaking the mix of the three basic forms of executive pay: salary, yearend bonuses and long-term incentives.

In general, salaries are growing, bonuses are shrinking and long-term incentives are becoming more about performance-related stock that takes years to vest. Performance-related shares carry more restrictions than options, which were popular before the crisis.

These changes will have broad implications for how banks pay executives. In normal times, banks base pay decisions on the performance and pay of close rivals. Since U.S. Bancorp and Wells got out of the Troubled Asset Relief Program in 2009, they are among those setting the new trends for paying bankers. Institutions like KeyCorp, Fifth Third Bancorp and Huntington Bancshares Inc. are just getting around to updating their compensation because they stayed in Tarp longer. They all said in their proxies that they plan to emphasize performance pay in 2011, without going deep into specifics.

Experts say that pay consultants, regulators and shareholders will expect them to follow the cues of the healthier banks.

"The regulators have asked to see most large banks' compensation structures to judge whether it is appropriate and not incenting greater risk-taking," said Kevin Fitzsimmons, a managing director with Sandler O'Neill & Partners LP.

Long-vesting performance pay "is a relatively new thing" that is becoming a "bigger part of the compensation structure than it used to be" because of that pressure, Fitzsimmons said.

Wells Fargo, in moving away from options, said in its filing that the "risks to management of forfeiting all or a significant portion" of their pay is "an effective performance incentive" — as is the promise of earning "additional" money.

Wells Fargo did not return a call for comment.

Banks can structure performance pay in countless ways, but the new shares that Wells and others are now using share common traits, including three- and four-year vesting schedules. Some of the shares can be forfeited entirely if profits suffer. Others are just reduced in value if the company's performance lags, but they can rise in value if it improves.

There's a tax benefit to performance pay, too: It is not subject to a federal tax rule that forbids public companies from deducting certain compensation worth more than \$1 million. To qualify for that bigger deduction, performance pay has to be approved by shareholders, and attached to some kind of performance goal — which can literally be dozens of internal or external metrics. A bank can base it on singular performance metrics, like hitting a goal involving loan losses or levels of nonperforming assets. Or also set relative targets by choosing a group of peer banks to compare its gains in earnings per share or other items against.

Healthy banks — worried about retention — are embracing relative metrics, with the idea that meeting them is good for the company, its investors and employees.

U.S. Bancorp says in its proxy that it "has consistently been among the top in our peer group, and frequently the leader, in the common industry performance measures." It became deeply concerned last year about rivals luring away its well-regarded management team because much of the stock awards they'd been paid in recent years had lost much of their value.

So Davis got a new "special retention" award early last year worth \$7 million designed to encourage him to stick around for five years. U.S. Bancorp said it wanted to eliminate "a significant risk" of other banks' recruiting "key" people. Davis will get that award provided two conditions are met. The first is that he does not leave the company early. The second is the amount of profits the company generates with shareholder equity beat the average of its 10-bank peer group over the next two years. U.S. Bancorp's profits as a percentage of its equity were higher than any of its peers last year, and analysts project the ratio will stay high through at least this year, if not longer.

Rohr got a \$5.8 million stock grant this year that can be forfeited over the next four years only if PNC's core capital falls below 6%; it was 9.8% at yearend, higher than most of its rivals.

Rohr is guaranteed \$4.35 million of that award as long as the company stays well capitalized, and that grant can swell to as much as \$7.25 million if its earnings-per-share growth beats those of a dozen other banks it considers peers. Its EPS growth was higher than ten of them last year, PNC says in its proxy.

Wells, coming off a "record 2010" and good "relative performance versus peers," granted Chairman and CEO John Stumpf \$11 million of performance shares. They largely depend on Wells' beating at least half its rivals' returns on equity over three years. It had no problem on that front last year.

Banks that aren't quite best-in-class say they will not necessarily base their performance pay on how they match up with other banks.

"We set our own standards for performance, but we also consider how we are performing compared to our peers," Huntington, of Columbus, Ohio, says in a preview of its "compensation philosophy for 2011" section of its proxy. "A portfolio of measures will be used to define our success."

Huntington returned its federal aid in December after ending a long string of losses earlier in 2010.