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Your Bank's Long-Term Incentive Strategy and Surging Stock Prices

AUTHOR

David Seitz
Managing Director

With the Trump administration, investors are anticipating an easing in banking regulations and modest increases in interest rates. Accordingly, the market response to Trump's election sent bank stock prices surging. From election to year-end, the Keefe, Bruyette & Woods NASDAQ Banking Index, which is made up of money center banks, as well as regional banks and thrifts, was up 22 percent, alongside a very strong 7 percent increase in the S&P 500. Full year returns were even better, and they were better for many smaller banks as well. For example, banks with total assets between $1 billion and $10 billion saw returns of 20 percent to 65 percent.

In our experience, large swings in stock prices trigger important design considerations for long-term incentive grant strategies and grant policies.

Long-term Incentive Strategies—Target Value Versus Fixed Share

Long-term incentive strategies among banks typically incorporate the use of full-value awards, such as restricted stock or performance shares, or stock options.

There are two common approaches used to determine the number of shares granted under equity awards—a target value approach and a fixed share approach.

- **Target value approach**: The bank targets a specific award "fair value." Thus, as stock prices surge, the number of shares granted is reduced to deliver the same grant value. Conversely, when stock prices decline, more shares are granted. This is the most common method for determining the number of shares awarded.

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- **Fixed share approach**: The bank targets a specified number of shares. Thus, as stock prices surge, the fair value of the award also increases. The volatility in grant value is one of the reasons this approach is less common.

No matter the approach used, sudden surges in stock prices will result in significant changes in either the number of shares granted or the fair value of the award, assuming no adjustments are made to the grant strategies. For example, the increase in stock prices over the past year for banks with assets between $1 billion and $10 billion will likely result in a 16 to 40 percent decline in shares delivered through a target value approach or a 20 to 65 percent increase in fair values at banks utilizing a fixed share approach.

The advantages in delivering equity through a target value approach include providing tighter controls over the accounting expense of long-term incentive programs, a clearer understanding of the award value to the participant, greater consistency in disclosed compensation values for proxy-reported officers, and maintaining alignment with competitive market compensation levels. However, when stock prices surge, no matter the cause, the resulting reduction in shares under a target value approach may be perceived as a so-called performance penalty by participants. Your participants in the plan might wonder, “The stock price went up and you cut my shares?”

Alternatively, under the fixed share approach the increase in the fair value of the award may result in higher compensation expense, greater variability of disclosed compensation, and compensation levels that are positioned higher relative to the market than the bank’s stated compensation philosophy.

Considerations

In light of the potential variability in grant values or the number of shares issued, banks should thoroughly review the impact of recent stock price changes on their long-term incentive grant strategies to avoid unintended consequences.

Target value programs can be adjusted through an increase in the value delivered or revisions to the approach used to determine shares, or a combination of these two approaches. Generally, an increase in the value delivered would not correspond directly with the increase in stock price, for example award values would increase 20 to 30 percent of the gain in stock price. In adjusting the approach used to determine the number of shares issued, banks can use an average stock price (for example, 90 to 150 days) rather than the price on the date of grant.

Conversely, fixed share programs would be adjusted to reduce the grant value through a reduction in the number of shares issued. For example, shares granted would be reduced by 10 percent to 15 percent of the gain in share price.

In all cases, the impact of adjustments to long-term incentive strategies on total compensation should be evaluated against market compensation and share utilization levels as well as the bank's stated compensation philosophy. Further, the rationale for adjusting long-term incentive strategies should be communicated clearly to program participants.

About the Author

David Seitz is a managing director with Pearl Meyer, located in Dallas and affiliated with the firm's Houston office. He has nearly 30 years' experience in compensation consulting and particular expertise in long-term incentive plan design. Additional areas of concentration include director compensation, performance metrics, and total compensation strategy, among others.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

Pearl Meyer

NEW YORK
570 Lexington Avenue, 7th Floor
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, NE, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
93 Worcester Street, Suite 100
Wellesley, MA 02481
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
3rd Floor
58 Grosvenor Street
London W1K 3JB
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN FRANCISCO
595 Market Street, Suite 1340
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

For more information on Pearl Meyer, visit us at www.pearlmeyer.com or contact us at (212) 644-2300.