# Shareholders at the Top 50 Are Getting Tougher

**By Jin Lee and Julie Lewis**
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Right or wrong, the public and political perception that undue risk taking and its link to pay was central to the financial crisis has fueled a resurgence in the discussions around executive pay. Those discussions and associated headlines are further stimulated by Dodd-Frank's requirement that shareholders be given their say on the topic. As top banks continue to face higher scrutiny on executive pay, shareholders have not been shy of giving the "thumbs down."

In the second year of Dodd-Frank's requirement that shareholders be given an advisory vote to ratify executive pay, many investors have publicly stated that they felt they were too lenient on companies during the 2011 proxy season, and that they would be tougher on say on pay proposals during 2012. And the results prove it.

At the largest U.S. banks by asset size, Management Say on Pay proposals fared somewhat worse this year than they did in 2011. For the second year, McLagan has analyzed the results of the 2012 Say on Pay votes at 50 of the largest U.S. banks.

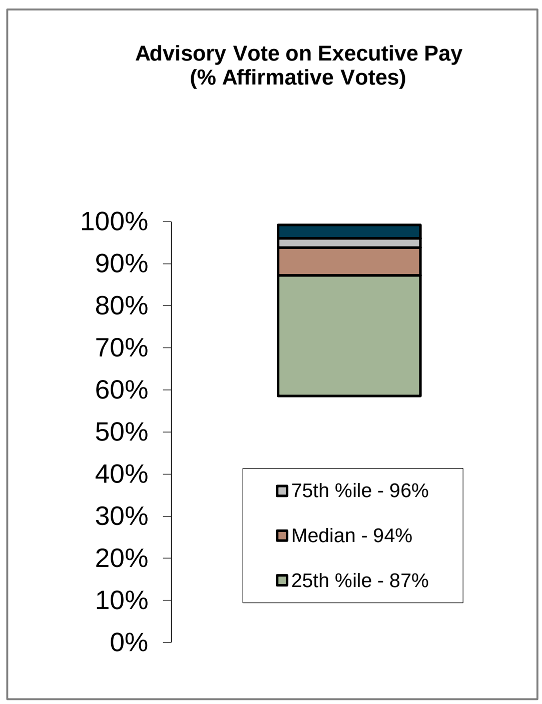
## VOTING RESULTS

A vast majority of the banks used in the 2011 study are included in this year's analysis as only six banks were replaced.

The list of firms in our study is included in the Appendix.

In 2011, our Top 50 study showed that ***100%*** of the banks received approval from shareholders on executive compensation. However, our 2012 study shows a slight decrease in the approval rate with ***96%*** getting the "thumbs up." Two banks failed to receive approval from shareholders on executive compensation in 2012 – both of whom received over 88% shareholder approval in 2011.

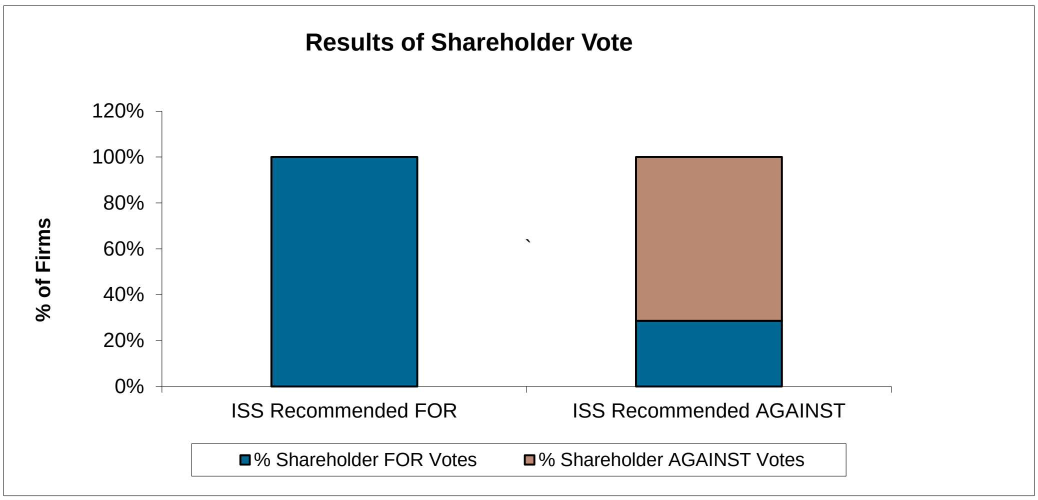
Similar to last year's study, at the median, 94% of bank shareholders voted affirmatively on pay for senior executives. While the lowest affirmative vote was 65% in last year's study, this year shows a decline to 59%.



Twenty-three of the Top 50 banks show a decrease in affirmative votes in 2012 vs. 2011, ranging from -1% to -49%. While the overall average rate of decline was -2% for all 50, among the 23 banks that showed a decrease from the prior year, the overall average rate of decline was -12%.

## ARE SHAREHOLDERS FOLLOWING ISS' RECOMMENDATIONS?

Of the Top 50 banks, ISS recommended against seven Management Say on Pay proposals this proxy season. In two of those cases, shareholders agreed with ISS and shareholders rejected the 2012 proposals.




In contrast, ISS recommended against nine of the top 50 MSOPs during the 2011 proxy season and in none of those cases did shareholders reject the MSOP. In considering ISS recommendations, it is important to note that since the Pay for Performance model only considers CEO pay, individual circumstances can materially skew results.

## WERE THERE FEWER NO'S FROM ISS DUE TO NEW RULES?

Although overall results show that top bank shareholders are continuing to give majority approval on executive pay, it can be concluded that the increased engagement of shareholders in executive pay decision making and the impact of proxy advisory firms on influencing shareholders are creating a more challenging pay environment for companies.

Prior to the 2012 proxy season, ISS considered its vote recommendation by assessing a firm's executive pay practice in two primary areas: "pay-for-performance" and "problematic pay practices." Most companies that received an unfavorable recommendation from ISS, ran afoul of the Pay-for-Performance policy. ISS's Pay-for-Performance policy applied only if a firm's one- and three-year total shareholder return fell below median of an ISS designated group of peer firms. For the 2012 proxy season, ISS implemented a new Pay-for-Performance methodology. The new assessment now consists of three measures of alignment between executive pay and company performance relative to peers:

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**Relative Degree of Alignment**–Measures the percentile ranks of a company's CEO pay and TSR performance, relative to an industry-and size-derived peer group, over one- and three-year periods.
**Multiple of Median**–Measures the prior year's CEO pay as a multiple of median pay of the ISS-established peer group for the same period.
**Pay-TSR Alignment**–An absolute test that compares the trend of the CEO's annual pay and the value of an investment in the company over the prior five-year period.

While there is no evidence ISS's policies produced harsher recommendations for the Top 50, it is clear ISS's new Pay-for-Performance methodology creates a greater degree of complexity for management. Evaluating the potential impact of ISS recommendations on upcoming proxy ballots and engaging shareholders on the specifics of those recommendations is more time consuming and complicated under the new policies.

Active engagement with shareholders and effective disclosure of the policies and processes around pay decision making have been the most effective tools in managing potential issues around the shareholder vote on pay.

As recent incidents of failed Say on Pay proposals have shown, companies must continue to be mindful of the potential impact of the shareholder vote on pay. To avoid these outcomes and prepare for next proxy season, firms can continue to do the following:

- Analyze the shareholder base to determine the level of ISS or other advisory firm influence.
- Monitor changes in each institutional investor's proxy voting guidelines.
- Audit compensation and governance plans and programs for any potential exposure to guidelines of proxy advisor groups and institutional investors.
- Analyze and review 1-year, 3-year, and 5-year TSR relative to your ISS-established peer group.
- Use the proxy Compensation Discussion and Analysis to clearly tell the "story" of executive pay and explain pay and governance decisions.
- Be prepared to engage in meaningful dialog with shareholders.
- Determine whether any problematic pay and/or governance practices exist, and make adjustments as appropriate.

## CHANGES ON THE HORIZON

Companies will see several changes next year to Glass Lewis' model for assessing executive pay. Glass Lewis & Co. is currently the second largest proxy advisory firm in terms of market share in the United States, behind ISS. While their research and recommendations have not historically carried as much weight as those issued by ISS, the level of Glass Lewis influence is often company-specific and dependent on the specific investor constituency. Companies should actively monitor their investor ownership to determine the level of ISS and Glass Lewis influence.

Effective July 1, 2012 Glass Lewis has revised the proprietary Pay for Performance model used to make vote recommendations on director nominees and Say on Pay proposals. Specifically, Glass Lewis has updated its model to change how: (i) named

executive officer (NEO) compensation is evaluated and (ii) peer groups are constructed.

**NEO Compensation Evaluation**–Historically, Glass Lewis has evaluated NEO compensation using the most recent fiscal year compensation totals as disclosed in the Summary Compensation Table. Under the new model, Glass Lewis will now utilize a three-year weighted average of total compensation for a company's NEOs relative to such compensation totals at the newly determined peer group.

**Pay for Performance Peer Groups**–Prior to the updated changes, Glass Lewis utilized four undisclosed industry peer groupings for its Pay for Performance evaluation. The new model utilizes a "market-based" peer group developed by Equilar. The new target peer group universe will consist of no more than 30 companies, and will take into account a company's publicly disclosed compensation benchmarking peers, as well as other peer companies disclosed by the subject company's self-disclosed peer group (with actual peer companies being chosen based on the "strength" of the relationships and connections between that universe of companies and the subject company). It has also been reported that Glass Lewis will identify the peer companies used for evaluation purposes in their reports.

The model examines five financial indicators as measures of relative company performance (change in operating cash flow, EPS growth, total shareholder return, return on equity and return on assets) against relative three-year weighted average total compensation. A weighted-average executive compensation percentile and a weighted-average performance percentile are compared to determine how closely compensation tracks relative performance. Companies with the largest "gap" are identified as having a poor pay for performance link, impacting the assigned performance grade A – F.

Given greater disclosure around the peer group methodology, companies will find it easier to determine likely Glass Lewis comparators and track the pay and performance relationship as Glass Lewis sees it.

On the ISS front, staff members recently solicited feedback from various executive compensation consulting firms and a handful of large public issuers regarding the second season of Say on Pay. The purpose was to gather feedback on the various issues and concerns echoed by corporate issuers during this past proxy season. It was no surprise that attendees had several complaints over ISS's newly revamped CEO Pay for Performance Policy and its underlying methodology (specifically, the lack of realizable pay analysis and shortcomings with the peer group construction methodology).

While ISS listened to advisor and issuer perspectives on the current CEO Pay for Performance peer group methodology and the merits of using realizable pay for CEO compensation evaluation purposes, ISS did state that it was unlikely that their Pay for Performance Policy would be subject to major revisions for the 2013 proxy season. ISS had concerns and questions about being able to establish a uniform realizable pay analysis, and further that such an analysis could cut both ways (i.e., in some years such an approach may not be helpful or beneficial to an issuers pay for performance assessment).

Overall, the tone suggested that ISS is open to making tweaks to its policies, but no significant overhaul is expected now or in the near future.

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Future McLagan alerts will continue to monitor the ongoing impact of Say on Pay and changes in the way advisory firms determine their recommendations.

## ABOUT THE AUTHORS

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## APPENDIX: FIRMS INCLUDED

| Firms | Industry | 12/31/2011 Assets |
|---|---|---|
| JPMorgan Chase & Co. | Bank | 2,265,792,000 |
| Bank of America Corporation | Bank | 2,129,046,000 |
| Citigroup Inc. | Bank | 1,873,878,000 |
| Wells Fargo & Company | Bank | 1,313,867,000 |
| Goldman Sachs Group, Inc. | Broker/Dealer | 923,225,000 |
| Morgan Stanley | Broker/Dealer | 749,898,000 |
| U.S. Bancorp | Bank | 340,122,000 |
| Bank of New York Mellon Corporation | Bank | 325,266,000 |
| PNC Financial Services Group, Inc. | Bank | 271,205,000 |
| State Street Corporation | Bank | 216,827,000 |
| Capital One Financial Corporation | Bank | 206,019,000 |
| SunTrust Banks, Inc. | Bank | 176,859,000 |
| BB&T Corporation | Bank | 174,579,000 |
| Regions Financial Corporation | Bank | 127,050,000 |
| Fifth Third Bancorp | Bank | 116,967,000 |
| Northern Trust Corporation | Bank | 100,223,700 |
| KeyCorp | Bank | 88,785,000 |
| M&T Bank Corporation | Bank | 77,924,287 |
| Comerica Incorporated | Bank | 61,008,000 |
| Huntington Bancshares Incorporated | Bank | 54,450,652 |

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|---|---|---|
| Zions Bancorporation | Bank | 53,149,109 |
| Hudson City Bancorp, Inc. | Thrift | 45,355,885 |
| Popular, Inc. | Bank | 37,348,432 |
| First Niagara Financial Group, Inc. | Bank | 32,810,615 |
| First Republic Bank (new) | Bank | 27,791,801 |
| People's United Financial, Inc. | Thrift | 27,567,900 |
| Synovus Financial Corp. | Bank | 27,162,845 |
| BOK Financial Corporation | Bank | 25,493,946 |
| First Horizon National Corporation | Bank | 24,789,384 |
| City National Corporation | Bank | 23,666,291 |
| East West Bancorp, Inc. | Bank | 21,968,667 |
| Associated Banc-Corp | Bank | 21,924,217 |
| First Citizens BancShares, Inc. | Bank | 20,881,493 |
| Commerce Bancshares, Inc. | Bank | 20,649,367 |
| Cullen/Frost Bankers, Inc. | Bank | 20,317,245 |
| SVB Financial Group | Bank | 19,968,894 |
| Hancock Holding Company (new) | Bank | 19,774,096 |
| TCF Financial Corporation | Bank | 18,979,388 |
| Webster Financial Corporation | Bank | 18,714,340 |
| Astoria Financial Corporation | Thrift | 17,022,055 |
| Fulton Financial Corporation | Bank | 16,370,508 |
| Wintrust Financial Corporation | Bank | 15,893,808 |
| Susquehanna Bancshares, Inc. | Bank | 14,974,789 |
| Signature Bank (new) | Bank | 14,666,120 |
| FirstMerit Corporation | Bank | 14,441,702 |
| Valley National Bancorp | Bank | 14,244,507 |
| Bank of Hawaii Corporation (new) | Bank | 13,846,391 |
| Washington Federal, Inc. | Thrift | 13,649,716 |
| UMB Financial Corporation (new) | Bank | 13,541,398 |
| PrivateBancorp, Inc. (new) | Bank | 12,416,870 |