November 2018

Bank Compensation Trends: What You Need to Know

The end of the year is just around the bend and many firms are already knee-deep in their year-end planning. However, before fully diving in, it's important to evaluate all the changes and resulting outcomes that occurred in 2018 to ensure you have the right reward plans and practices in place. To help this process along, we've used our 2018 Regional & Community Banking Compensation Survey and McLagan proxy database results to share an overview of the major topics and trends that are shaping the sector today and in the future.

From CEO Pay Ratio plan adjustments to declining say-on-pay support, changes in LTI plans, and emerging trends in director and staff compensation, here's what you need to know to set pay with confidence across key rewards elements.

CEO compensation is on the rise

According to our CEO comp-matched sample analysis, which examines year-over-year pay changes at the same bank annually, we are seeing increases across the board. In fact, the rising numbers are at the highest they've ever been for all asset sizes. Specifically, increased cash and long-term incentives are driving the large increases in direct and total compensation. It's important to note that this analysis examines actual compensation paid, and not increases in target compensation. As reflected in the chart below, at the median, salaries increased 1–4%; however, total compensation increased 8% to 13%, reflecting a strong economy and performance for the industry.

CEO Compensation: Matched Sample Analysis (Median Year-over-Year Pay Changes)

	Salary		Cash Comp		Direct Comp		Total Comp	
Asset Size	2017	% Change '16 to '17	2017	% Change '16 to '17	2017	% Change '16 to '17	2017	% Change '16 to '17
$1B–$3.5B	430,916	4%	585,306	7%	688,319	8%	819,406	10%
$3.5B–$7B	611,900	4%	957,331	9%	1,426,433	12%	1,567,274	13%
$7B–$15B	700,000	3%	1,220,000	9%	1,848,382	8%	2,108,443	10%
$15B–$50B	950,000	2%	2,136,800	5%	3,759,894	9%	4,522,912	8%
$50B–$400B	1,000,000	1%	3,675,000	11%	8,238,500	8%	8,688,292	8%

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CEO Pay Ratio

Last year, there was lots of buzz around this topic with predictions that it would be a major focus during the 2018 proxy season. This was not the case, as there were no real surprises to stir heightened attention in the financial sector. However, the business model *did* have an impact on median employee compensation, with decreased median employee pay at retail-focused banks in contrast to more commercial focused entities. As we head into the second year of pay ratio disclosures, deciding whether a new median employee must be identified will be a key question in 2019. Should a company identify a new median employee by mandate or voluntary choice? Using the same median employee is easier and allowed. However, with increases in base salaries due to the 2017 Tax Cuts & Jobs Act or from mergers & acquisitions, a firm may need to update the median employee. The decision will be quantitative and qualitative. We previously published an article that goes into greater detail on the circumstances that might trigger a review of your median employee.

Say-on-Pay

Declining say-on-pay support in 2018 marks a departure from the improvement we saw starting in the 2015 proxy season. During the 2018 annual meeting cycle, there have been five failures, up two from 2017, and a total failure rate of approximately 2%. Perceived quantitative and qualitative pay-for-performance issues are the main drivers of failures and proxy advisory firm against recommendations, followed by perceived egregious contractual provisions. ISS "against" recommendations are also up 3% from last year, reaching 13%. Higher ISS against recommendations for this industry, and the general industry as a whole, largely reflect that CEO pay levels continue to inch up, despite noted investor concerns about overall quantum. Inadequate disclosure around short-and long-term incentive goals, in addition to large one-off equity or cash grants without inadequate rationales, are also factors contributing to these results. The bottom line is that it's much harder to become compliant in today's environment and firms must remain extra cautious and diligent to stay up-to-date with the latest standards and guidelines.

As for ISS, there will be changes effective for the 2019 Proxy season, following its current survey period, where final decisions are made. Adopted policies will be effective for the 2019 proxy season. Click here to view the key potential policy changes ISS is questioning.

Director compensation remains dynamic

As you can see in the chart below, which depicts year-over-year change for average director compensation, increases were often more significant in equity. This is true, regardless of asset size.

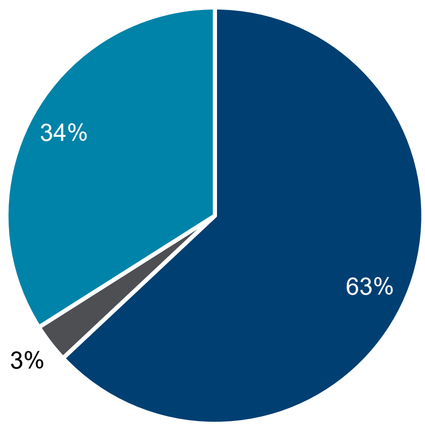
Average Director Compensation: Matched Sample Analysis

		Cash		Equity*		Total	
Asset Size	n	2017	% Change '16 to '17	2017	% Change '16 to '17	2017	% Change '16 to '17
$50B–$400B	17	104,292	-1%	115,000	4%	222,833	2%
$15B–$50B	44	73,252	4%	58,667	17%	141,662	6%
$7B–$15B	51	53,075	9%	43,403	10%	96,765	9%
$3.5B–$7B	63	52,283	4%	31,792	8%	88,558	12%
$1B–$3.5B	140	36,000	3%	20,000	13%	47,484	7%
<$1B	116	25,000	3%	11,216	17%	33,199	7%

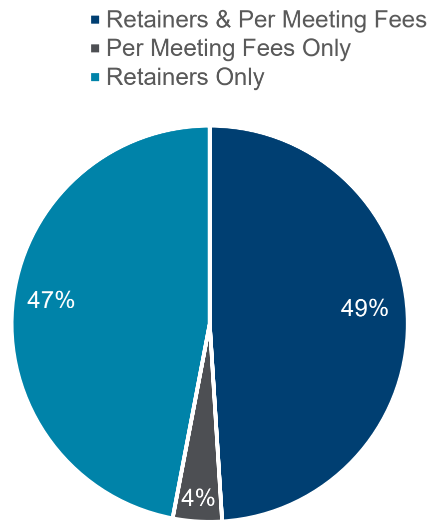
*Equity values are summarized based only on those banks granting equity in 2017.

Another important item to note is that the market has been shifting away from paying directors on a per meeting basis and towards the use of annual retainers only, as depicted in the image below.

2015



2017



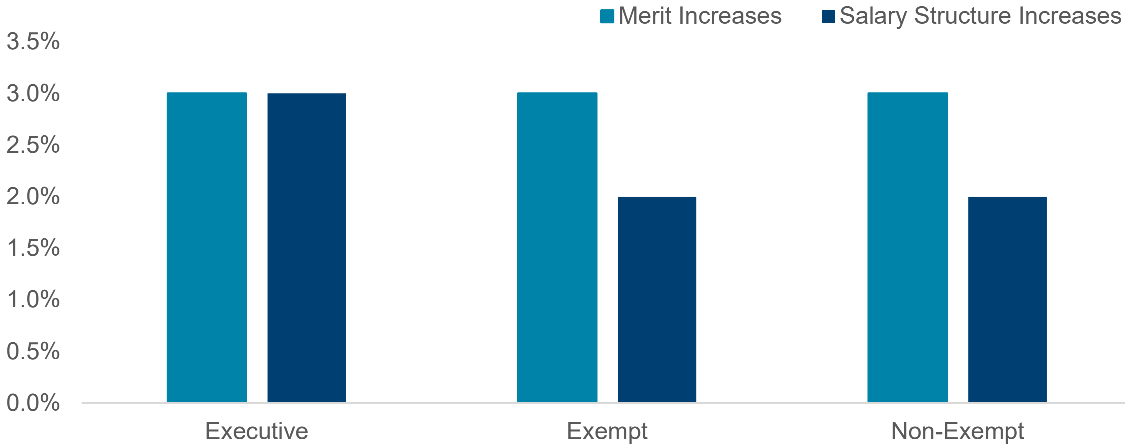
What exactly does this mean? If we look at retainers vs. per meeting fees, we learn that retainers compensate directors for their services rendered, while per meeting fees compensate directors for their time spent. In other words, time-intensive projects lead to increased pay. Firms are beginning to lean towards providing retainers only, given that this approach is easier to budget and administer and does not encourage additional meetings. There are many factors that come into play when determining which method to use, such as firms that are undergoing succession planning and acquisitions. If the current needs and goals of the organization require more meetings, per meeting fees could become the more expensive route to take.

Talent competition will lead to salary structure increases in 2019

Attracting and retaining employees has always been a challenge. This challenge only continues when the unemployment rate is low—and right now it's the lowest it has been in the last 50 years. While this is good and indicates a positive economy, firms must adjust their rewards strategies to remain competitive against the market, especially in financial services.

Close to 60% of banks in our Retail Branch Pay Practices Study indicated that they increased minimum pay rates within the last year. National & Regional banks were quicker to act on increasing internal rates than Community Banks and Credit Unions. In addition, banks often manage different starting pay rates by geography. Holistically, our study found that salary merit increases are planned at 3% for the banking industry. This number has remained steady since 2011. As pictured below, 2019 salary structure increases are anticipated to be at 3% for executives and 2% for exempt and non-exempt employees. Firms should use data analysis to test where their grade structure is relative to market. This not only helps with career progression, but also maintains competitive pay levels.

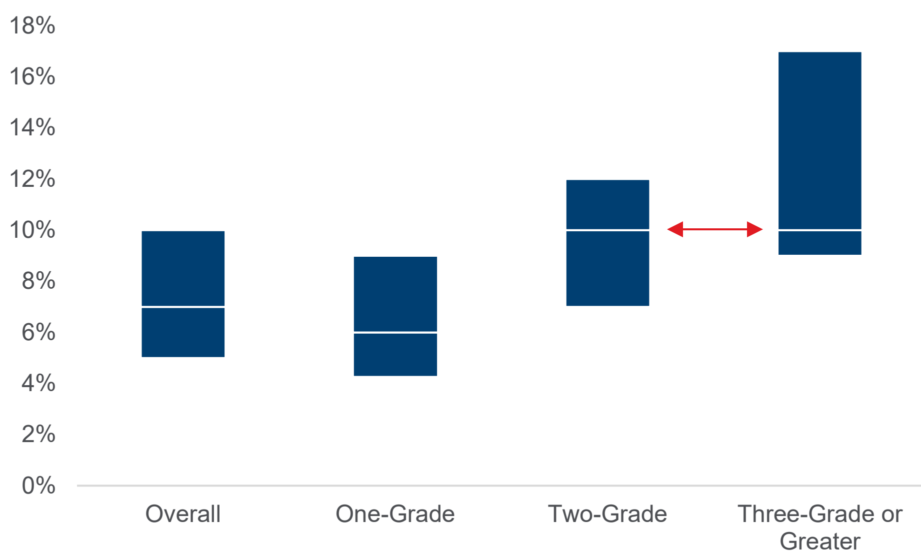
2019 Salary Budget Planning (Merit & Salary Structure)



Source: McLagan 2019 Salary Budget and Turnover Study

In terms of promotional increases, 50% of firms do have a budget for this, with 2/3 reporting their promotional budget is separate from merit. With merit increases remaining low despite low unemployment, promotions are one way to keep up with the market and engage employees.

Average Promotional Increases



Source: McLagan 2019 Salary Budget and Turnover Study

Regulatory check

Historically, the retail sector isn't thought of as being a high-risk area of banking. However, according to our 2018 McLagan Retail Branch Pay Practices Study, the Wells Fargo Scandal of 2016 has caused changes to risk and governance components of retail incentive plan designs for 31% of retail banks within the last year. Reputational and legal risks exist at all banks and credit unions. With this reality in mind, it is critical that retail incentive plans are viewed through a lens of risk identification and mitigation. Here are a few key updates to add to your regulatory checklist.

Sound Incentive Compensation Policies: This remains at the forefront. Established in June 2010, this guidance requires firms to have effective risk processes and internal controls in place, and strong corporate governance, including oversight by the board over of the firms compensation plans.

Non-Employee Director Compensation: In the last few years, Delaware courts have issued several rulings in lawsuits involving complaints of excessive compensation to non-employee directors. The outcome of these rulings state that if an equity plan gives the directors discretion to determine their own compensation, then even if the plan is stockholder-approved, awards granted to directors are subject to the higher "*entire fairness*" review standard.

Dodd-Frank: An executive order was issued asking regulators to look at what's working and what's not, and the uncertain status of several proposals (e.g., incentive compensation, pay for performance, clawbacks, and hedging) remains unchanged.

Executive Order on regulatory efficiency: For every new regulation issued, at least two prior regulations need to be identified for elimination, with the goal of a go-forward, cost-neutral regulation.

IRS Section 162(m)–Transition Relief under Notice 2018-68: On August 21, 2018 the IRS provided guidance that focuses on the following areas:

- Identification of "covered employees"
- Operation of the transition relief
- What constitutes a material modification of a written binding contract (resulting in loss of grandfather rule) by providing 11 examples

The IRS has revised the definition of "covered employee," whose compensation deduction will be limited to $1 million per year without exception to:

- Anyone who is a Principal Executive Officer and a Principal Financial Officer at *any time* during the year
- The three most highly compensated executive officers at any time during the year (other than the PEO or PFO) even if they were not listed as an NEO in the proxy statement
- Anyone who is a "covered employee" in any taxable year beginning after December 31, 2016

This article covers more details on the new definition of a "covered employee," the written binding contract that's in effect, and other changes that are occurring.

Under the current administration, a lot of uncertainty remains. Many regulations that were proposed have not yet been finalized, and it's important to remain diligent and prepare your firm for whatever the future holds. To assess your competitive positioning and gain additional banking compensation insights for 2019 and beyond, please contact our team.

Author Contact Information

Gayle Appelbaum
Partner, McLagan
Aon
1.952.886.8242
gayle.appelbaum@mclagan.com

Katrina Gerenz
Associate Partner, McLagan
Aon
1.952.886.8247
katrina.gerenz@mclagan.com

Todd Leone
Partner, McLagan
Aon
1.952.886.8254
todd.leone@mclagan.com

Bryan Lemke
Principal, McLagan
Aon
1.952.886.8272
bryan.lemke@mclagan.com

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