2021 Incentive Plan Design Considerations in Light of Continued Uncertainty

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To say that 2020 was an unusual year would be an understatement. Banks have had to manage through the impact of a global pandemic, historically low interest rates, CECL (Current Expected Credit Loss) implications and a government stimulus program, just to name a few of the challenges. Add a change in government leadership and potential increases in oversight and regulation, continued uncertainty going into 2021 is extremely high.

While the impact on outstanding annual and long-term incentive programs are industry and company specific as well as dependent on the existing plan designs, most banks expect payouts to be significantly below target. Going into 2021, it will be more important than ever for banks to review current programs to ensure they have appropriate flexibility going forward to motivate, reward and retain their executives while still providing performance-based compensation in an uncertain world.

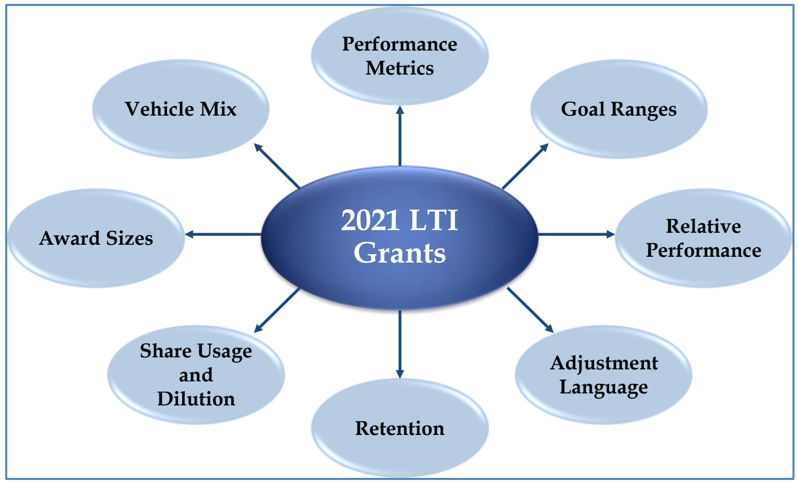
2021 Annual Incentive Plans

Discussed below are several design features that banks may want to consider to ensure 2021 incentive plans remain effective in an environment of continued uncertainty. As with any executive pay change(s), it is important to consider the impact on the annual and long-term programs in aggregate rather than as individual components.

Design Features	Considerations
Performance Metrics	▪ Incentive metrics should support each bank's business strategy and priorities; review whether current metrics remain appropriate or should be adjusted ▪ Even if metrics remain the same, consider whether the weighting of metrics should also stay the same or be adjusted to reflect new priorities
Plan "Gates" and Goal Ranges	▪ Some plans have earnings "gates" or hurdles that must be met for the incentive to "turn on". Gates that are set too high may unintentionally cancel the plan when payouts might otherwise be appropriate ▪ In periods of uncertainty, it may be appropriate to widen the performance ranges, particularly at threshold to allow for downside protection (i.e. provide some payout for reduced performance) ▪ When lowering threshold performance levels, it may be appropriate to also lower payout levels (e.g. 25% of target vs. 50%)
Use of Relative Performance	▪ While relative metrics are not commonly included in annual programs, some banks may consider adding a relative metric and/or consider relative performance as part of a qualitative or discretionary assessment ▪ Requires selection of an appropriate comparator group and a consistent definition of the metric calculation for both the bank and peers
Use of Non-Financial (i.e. Qualitative) Metrics and/or Discretion	▪ Allows the program to reflect a broader view of performance beyond just financial metrics ▪ Can be a weighted component (e.g. 20%) or a modifier (e.g. +/- 20%) ▪ Often incorporates a list of factors/goals that reflect strategic and/or individual performance metrics not reflected in short-term financials (e.g. ESG, transformation, digital growth)

2021 Long Term Incentive Plans

Many banks had multiple outstanding performance-share cycles impacted by COVID-19. Fortunately, for most banks, the use of time-based vehicles and/or relative performance metrics have shielded participants from complete elimination of potential value. Due to the significant accounting and disclosure implications, most banks are not taking action on outstanding equity grant cycles at this time but are considering potential changes to 2021 grants. Many of the alternatives for the long-term incentive plan design are the same as for the annual program (e.g., evaluate metrics, consider relative performance, widen performance ranges, etc.). However there are additional factors that also should be considered when determining long-term incentive awards for 2021.



- **Vehicle Mix**: Shareholders and proxy advisors still expect a majority of executives' equity to be in performance-based vehicles (i.e. performance-vested restricted stock). Those banks that provide a significant majority of long-term incentive value in performance shares (e.g. 65% -100%) may want to consider whether increasing the time-based restricted stock component may be appropriate, especially below the CEO or executive officers. That said, we expect most public companies to retain at least 50% of the long-term incentive value in performance share awards as shareholders will continue to prefer performance-based incentives.

- **Relative Performance Metrics**: Unlike the annual incentive plan which typically focuses on absolute goals tied to the bank's business plan, the use of relative metrics for some or all of the performance-shares is a common practice among banks.[1] Based on our database and industry experience, the most common relative metrics among banks are return on equity, earnings per share and total shareholder return, with most banks using two metrics to provide a balanced perspective. Relative performance is often measured against an industry index to reflect the broader shareholder view and provide a larger sample size. If the current design already uses relative metric(s), consider whether the weighting should be increased or an additional metric should be added for 2021.

- **Retention Concerns**: For banks that have a significant weight on performance shares and/or those using absolute performance goals, the potential for no payouts on outstanding awards can create a challenge for retaining top talent. In response to these challenges, some banks are considering one-time enhanced or supplemental grants in 2021 to support retention and reward objectives. Enhancing the 2021 grants provides an easier mechanism as it does not require identifying new performance measures and may be less likely to receive potential negative external reactions. Retention grants are more likely to receive scrutiny and can be more complex to design and disclose. For publicly traded banks, there could be Say-on-Pay implications and additional disclosures to explain the approach to shareholders.

- **Award Sizes and Share Usage:** Another challenge some banks may face is the additional share usage driven by decreased stock price and/or enhanced (or additional) equity awards. With stock values continuing to be down year-to-date, banks may be using more shares to deliver similar award

[1] Banking Industry Incentive Practices (https://www.meridiancp.com/banking-industry-incentive-practices/)

value which can put pressure on the equity plan reserve. Banks should monitor their share reserves to ensure they understand when a new share request may be necessary. Another approach to assist with stock volatility is to determine the number of shares granted based on an average of a defined number of days (e.g. 30) rather than grant date stock price, to lessen the impact of day-to-day stock price fluctuations.

- **Adjustment Language**: Not surprisingly, many existing performance-share grants did not have language within the plan to account for a global pandemic. As banks look at the design of the 2021 program and potential changes to award agreements, consider whether there is an opportunity to include language which would allow adjustments to performance metrics for similar unexpected situations without the negative implications of award modifications.

As with all compensation-related issues, there is no “one size fits all” approach for deciding on 2021 incentive plan designs. Banks should consider their compensation philosophy, other “protective” plan design features and how any potential changes will be perceived by executives, shareholders and proxy advisors. Banks will need to be cautious of these changes and be mindful of potential consequences. How these changes are evaluated will depend substantially on the disclosed rationale. In the end, it is important that incentive plans properly retain and motivate executives through the uncertainty of the coming years while also aligning with performance and all stakeholders.