Reflecting on Initial Learnings from the 2023 Financial Crises

Events over the last few weeks have sent shock waves through our financial services system, resulting in extreme actions intended to sustain investor and consumer confidence. Silicon Valley Bank and Signature Bank both failed, First Republic Bank received $30 billion of uninsured deposits from its largest competitors, and UBS agreed to buy Credit Suisse. Highlighting the situation's severity, the UBS / Credit Suisse deal is the first merger of Global Systemically Important Financial Institutions (G-SIFIs) since the 2008 financial crisis, and the Federal Reserve Board implemented the Bank Term Funding Program.

These events and actions provide an opportune time for all financial services Compensation Committees — banks, asset managers, insurers – to revisit their executive compensation programs. G-SIFIs evolved their compensation programs and practices in response to the 2008 financial crisis; with a new crisis at hand, this article contemplates three key decision points using G-SIFI practice as a key reference.

1. Does your organization have a comprehensive recoupment policy?

There has been significant discussion over the last few months with regards to the SEC finalizing their clawback policy as required under Dodd-Frank. For G-SIFIs, the SEC rule, focused on Executive Leadership and no-fault provisions related to all accounting restatements, is much narrower in scope than their existing policies. G-SIFI's existing policies typically:

- include clawbacks (the repayment of incentive compensation);
- include forfeiture provisions (the ability to cancel vested shares with holding provisions and unvested awards);
- extend beyond the Section 16 officers to include material risk takers (which can be thousands of employees at some firms).

These features in isolation likely would not have changed recent outcomes. However, enhanced recoupment policies also often go beyond inaccurate financials to include malus provisions that cover the following circumstances:

- Reputational harm
- Misconduct or negligence
- Material failure of risk management
- Material downturn in performance

The regulators believe that these policies have positively impacted behavior at the G-SIFIs. Shareholders will likely expect financial services companies to have a comprehensive recoupment policy in place moving forward, particularly given last month's events.

2. Is the quality of results factored into Incentive Compensation decisions?

A key challenge financial services firms face is that not all revenue is "good" revenue. Risk management strategies and risk adjusted returns are critical components of long-term, sustainable success. Inadequate risk management strategies can lead to disastrous outcomes in the longer term, even if it drives higher revenue in the short term. It is, therefore, prudent for all financial services firms to reevaluate how risk management is incentivized in their compensation plans, even if that means incentive designs that do not meet proxy advisor expectations.

G-SIFIs have enhanced their compensation programs to incorporate risk management, and other financial services firms may be well-served to follow suit. After 2008, regulators pushed the G-SIFIs to incorporate features into their incentive plans that balance risk-taking and financial performance. This required G-SIFIs to not only consider "what" results were achieved, but also "how." In today's model, G-SIFI Compensation Committees ensure appropriate and informed discretion is part of the year-end evaluation process. This process typically involves the Chief Risk Officer/Board's Risk Committee providing direct input to the Compensation Committee. This ensures that boards, and incentive participants are acutely aware of the alignment between compensation, risk taking and related behaviors.

Using judgment and discretion to reflect risk management in incentive plan outcomes may go against proxy advisor preferences. These proxy advisors believe annual incentives should be formulaic with fixed goals and ranges (regardless of exogenous factors). At times they have even been explicit in their criticism of G-SIFI programs, publishing cautionary language such as, 'decisions are determined discretionarily, which raises some concern.' However, these criticisms are generally not sufficient (standing alone) to result in an "against" vote recommendation, let alone a say on pay failure. Companies should be aware of proxy advisor preferences but not dictated by them.

3. Does your organization have a stand-alone stock retention policy?

On their own, stock ownership guidelines and hedging and pledging policies may not be enough to incentivize the correct behavior and optimize public perception. Although not common today, post-vest holding requirements or Hold-Until-Retirement policies could be a beneficial addition at many financial services firms. These policies require executives to retain a portion of the net shares received from all awards until (or in some cases, for a period of time after) they are no longer an executive. Hold-Until-Retirement policies also support prudent and risk-appropriate long-term decision making.

It was reported in the media that executives at First Republic Bank and Silicon Valley Bank sold stock right before the crash of their respective shares. While some of these transactions were related to 10b5-1 trading plan arrangements and therefore predetermined, some were not, and the optics of the sales are poor regardless.
Traditional stock ownership guidelines may have lost some of their utility in the financial services sector. They are often easily achieved and an afterthought among executives and investors, even when supplemented with hedging and pledging policies. Nearly all firms prohibit hedging and pledging of company shares, but the impact can be muted, particularly in a crisis -- selling shares in advance of a market downturn is a form of "hedging." Finally, Stock Ownership Guidelines on their own do not continuously align the Executive Leadership Team with the time horizon of their risks and/or strategic decisions.

Although currently uncommon in the broader market, Hold-Until-Retirement policies are powerful tools and have already been adopted by industry leaders. Based on Meridian's research, while less than 15% of banks currently have a Hold-Until-Retirement policy in effect, they are standard at the largest banks.

The benefits of implementing this type of policy are tangible and have resonated with G-SIFI investors:

- positive optics in both bull and bear markets;
- continuously aligns Executive Leadership Team with (1) investors and (2) the time-horizon of risks; and
- aids in succession management through an Executive's retirement.

Darren Moskovitz is a lead consultant with Meridian Compensation Partners, LLC, is the New York Office Market Leader and specializes in serving Financial Services Companies across the globe. Mr. Moskovitz has over 20 years' experience advising boards and management on all aspects of compensation and governance.

Anthony Bailey is a senior consultant and *Dean Chaffee* is a lead consultant for Meridian Compensation Partners, LLC. Both work with compensation committees and senior management to develop customized executive compensation programs aligned with business strategies and the governance environment.