Compensation
Advisory Partners

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Revisiting Discretion

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Banks have long used discretion in annual incentive plans as a tool to pay for not only "what" financial results the bank achieved, but "how" the bank achieved those results. Bank regulators expect the responsible use of judgment, particularly related to risk outcomes, and shareholders typically accept the use of discretion when supported by a clear rationale and transparent disclosure. However, proxy advisory firms like ISS have historically favored formulaic incentive plans and criticized plans that are largely discretionary. In July, ISS launched its 2026 policy survey, which will inform ISS' policies for 2027. The survey included a question about whether ISS should look at discretionary plans differently for financial services companies. As of this publication, ISS has not released the results of the survey.

In light of this development and ahead of Q4, we wanted to revisit the "best practices" for applying discretion and raise the questions compensation committees should be asking about the use of discretion as we approach year-end.

Best Practices for Applying Discretion – Use a Structured Approach

Whether your bank's annual incentive program is purely discretionary, like many of the largest U.S. banks, or provides for limited discretion, we recommend using a structured approach when applying discretion to determine executive incentives:

- **Establish the framework upfront.** The bank should identify and define the factors that the Committee will consider when determining incentives before year-end results are known.
- **Let financial results be the primary driver.** The Committee should consider other factors that are critical to the long-term success of the organization such as leadership, people and culture, community engagement, and innovation; however, annual incentives should largely reflect the results achieved in the most recent year to align with shareholder expectations and avoid paying ahead of performance. The Committee should also consider whether financial results appropriately reflect the risks taken to achieve them and whether any risk outcomes warrant an adjustment.
- **Consider relative performance.** Banks should pay for performance, not overpay for performance. The Committee should exercise discipline in determining payouts, considering performance relative to peers and whether the resulting relative positioning of pay is reasonable in that context.
- **Be balanced.** Banks should not use discretion to increase payouts every year, but should instead apply a consistent approach to both headwinds and tailwinds. For example, if the Committee has made positive adjustments to recognize the adverse impact of unexpected rate movements in prior years, they should consider whether benefits from unexpected rate movements warrant a negative adjustment.
- **Document and disclose rationale.** Committee meeting materials should document all of the factors that management and the Committee considered in exercising discretion. In our experience, a well-documented rationale can help write transparent disclosure and mitigate potential shareholder concerns around the use of discretion in annual incentive plans.

Questions Committees Should Be Asking

- Do our financial outcomes align with how management, the Board, and shareholders view performance for the year?
- Were there headwinds or tailwinds that impacted financial results outside of management's control? How have we adjusted for these factors in the past? Would we apply the same discretion if the impact on performance went in the opposite direction?
- Were there adverse risk outcomes in 2026? Should we adjust for these outcomes at the Company funding level or the individual payout level?
- As we think about our 2027 incentive plan design, does our compensation program allow us to exercise sufficient discretion to align pay with performance?