

Final Regulatory Guidance on Incentive Compensation Arrangements: Immediate Implications for Your Bank

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Agenda

- Review of the June 21, 2010 Joint Release on Sound Incentive Compensation Policies (45-50 minutes)
 - Legislative/regulatory background
 - Executive summary of the final guidance
 - Deeper review of the 3 Key Principles
 - Key take-aways and suggested action items for your bank
- Q&A (10-15 minutes)
 - Participant questions



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Background

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The Legislative & Regulatory Environment

- Legislators and regulators have been extremely active in the area of executive compensation, particularly for financial institutions
- Perception is that poor compensation governance was a primary contributor to the financial crisis
- Significant focus on responsibilities of the Board of Directors and Compensation Committee
- Lawmakers and regulators at all levels seem determined to “fix” the perceived governance problem
- Early proposals and enactments were applicable only to TARP recipients and/or public companies
- Recent legislation and regulatory guidance has cast a much wider net, impacting thousands of community banks

Legislation/Guidance Timeline

- **Oct-08: *Emergency Economic Stabilization Act of 2008 (EESA)***
 - Established TARP and subjected recipients to certain executive compensation restrictions
- **Feb-09: *American Recovery and Reinvestment Act of 2009 (ARRA)***
 - Expanded compensation restrictions for TARP recipients
 - Directed Treasury to publish rules for implementation/compliance
- **Apr-09: *FSF Principles for Sound Compensation***
(http://www.financialstabilityboard.org/publications/r_0904b.pdf)
 - Developed by an international task force of the Financial Stability Board (formerly Financial Stability Forum)

Legislation/Guidance Timeline (cont.)

- **May-09: *Shareholder Bill of Rights Act (S. 1074, Schumer)* Introduced in the Senate**
 - Focused on “say-on-pay,” director nomination and election process, separation of Chair/CEO, establishment of board risk committee
- **June-09: *TARP Standards for Compensation and Corporate Governance: Interim Final Rule***
 - Formal guidance for compensation provisions of ARRA
 - Extensive PEO, PFO, and Compensation Committee certifications related to pay governance and TARP compliance
- **July-09: *Treasury and SEC proposals***
 - Focused on compensation governance and risk management, corporate leadership structure, comp committee independence, shareholder “say-on-pay”

Legislation/Guidance Timeline (cont.)

- **July-09: House passed *Corporate and Financial Institution Compensation Fairness Act of 2009* (H.R. 3269, Frank)**
 - Included House version of compensation provisions that show up in the Dodd-Frank Act
- **Sep-09: *Financial Stability Board Implementation Stds. FSB Principles for Sound Compensation Practices***
(http://www.financialstabilityboard.org/publications/r_090925c.pdf)
 - “Firms and supervisors should ensure the process of implementation is begun immediately and pursued rigorously in their respective jurisdictions.”
- **Oct-09: Federal Reserve’s *Proposed Guidance on Sound Incentive Compensation Policies***
 - Developed to be consistent with FSB Principles
 - Applied to all banking organizations supervised by the Fed

Legislation/Guidance Timeline (cont.)

- **Jan-2010: *FDIC Advance Notice of Proposed Rulemaking Incorporating Employee Compensation Criteria Into The Risk Assessment System***
 - “... the FDIC is exploring whether and, if so, how to incorporate employee compensation criteria into the risk-based assessment system.”
 - Goals considered by the FDIC as measurement criteria:
 - Significant portion of performance-based executive compensation should be comprised of restricted, non-discounted company stock that vests over a period of years;
 - The restricted stock should be subject to a clawback designed to account for the outcome of risks assumed in earlier periods; and
 - The compensation program should be administered by a committee of the Board composed of independent directors with input from independent compensation professionals.

Legislation/Guidance Timeline (cont.)

- **Mar-2010: *Restoring American Financial Stability Act of 2010* introduced in Senate (S. 3217 Dodd)**
 - Included senate's version of compensation provisions that show up in the Dodd-Frank Act
- **June-2010: *Final Interagency Guidance on Sound Incentive Compensation Policies***
 - Effective June 25, 2010
 - Press release: <http://www.fdic.gov/news/news/press/2010/pr10138.html>
 - Full text: <http://edocket.access.gpo.gov/2010/pdf/2010-15435.pdf>
 - Very similar to Fed's October 2009 proposed guidance
 - Applies to all banking organizations regulated by the Fed, OCC, FDIC, and OTS

Legislation/Guidance Timeline (cont.)

- **July-2010: *Dodd-Frank Wall Street Reform and Consumer Protection Act* Signed Into Law**
 - Executive compensation rules for public companies similar to previous proposals by SEC, Treasury, and Congress
 - Say-on-pay and say-on-parachutes
 - Comp Committee independence standards; authority and funding to engage independent advisors
 - Disclosure of 1) pay vs. performance, and 2) CEO vs. non-CEO pay parity
 - Incentive comp claw-backs if financial restatement
 - “Covered financial institutions” with assets greater than \$1 billion
 - Goes beyond banks (e.g. credit unions, broker-dealers, financial advisors)
 - Federal regulators to jointly prescribe rules for 1) required disclosure of incentive compensation arrangements, and 2) prohibition on certain incentive-based payment arrangements/features
 - Not just executives; includes all employee, director, and/or principal shareholder incentive compensation arrangements

Legislation/Guidance Timeline (cont.)

- **Common Themes of the Legislation/Guidance:**
 - Employees will tend to pursue the behaviors that are rewarded – reward the right behaviors, and in the right way
 - Compensation arrangements need to shift the focus from short-term performance/reward to long-term health of the organization
 - No more “heads I win, tails the firm (or DIF) loses”
 - All compensation decisions need to go through the filter of prudent risk management – and the board of directors must lead the way
 - Potential conflicts of interest have been a real obstacle to sound compensation governance – remove them
 - There’s a need for greater transparency – give your constituents the full explanation and then give them a “say-on-pay”
 - Voluntary action is thought to be unlikely, hence the laws/regulations

A photograph of two white dice on a reflective surface. One die is in sharp focus in the foreground, showing the 1, 2, and 3 faces. The other die is blurred in the background. The background is a light blue gradient.

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Executive Summary

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Stated Reasons for Issuing Guidance

- Incentive compensation practices in the financial industry contributed to the financial crisis
- Banks* too often rewarded employees for increasing the bank's revenue or short-term profit without adequate recognition of the risks (short- and long-term) posed to the bank
- Aligning shareholder and employee interests is not always sufficient to address safety-and-soundness concerns
- Poorly designed or managed incentive compensation arrangements can themselves be a source of risk, irrespective of the quality of the bank's risk-management and internal control functions
- "...the Agencies believe that issuance of the proposed guidance is needed to help ensure that incentive compensation arrangements do not pose a threat to the safety and soundness of banking organizations, including small banking organizations."

* For convenience, throughout this presentation we use "bank" interchangeably with "banking organization."

Scope of Application

- Covers all banking organizations supervised by the Fed, OCC, FDIC, and OTS
- Applicable to incentive compensation arrangements for:
 1. Senior executives and others who are responsible for oversight of the bank's firm-wide activities or material business lines;
 2. Individual employees, including non-executive employees, whose activities may expose the bank to material amounts of risk (e.g., traders with large position limits relative to the firm's overall risk tolerance); and
 3. Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the bank to material amounts of risk, even if no individual employee is likely to expose the bank to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the bank's credit risk).

Definition of Incentive Compensation

“... that portion of an employee’s current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income).”

Incentive compensation does not include:

- Compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary);
- Compensation arrangements that are determined based solely on the employee’s level of compensation and does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the bank contributes a set percentage of an employee’s salary).

Supervisory Expectations

3 Groups with Varying Supervisory Expectations

Group 1: Large Banking Organizations (LBOs)

- The largest and most complex organizations, as identified by each respective agency
- More formal, extensive supervisory review of incentive programs
- Must maintain certain policies, procedures, and systems not generally expected of smaller, less complex organizations

Group 2: Smaller Banking Organizations (non-LBOs)

- Covers the vast majority of banking organizations (an estimated 8,700+ which have total assets less than \$175 million)
- Agencies will review incentive compensation arrangements as part of risk management, internal controls, and corporate governance reviews during the regular, risk-focused examination process
- “Reviews will be tailored to reflect the scope and complexity of the organization’s activities, as well as the prevalence and scope of its incentive compensation arrangements.”

Supervisory Expectations (cont.)

3 Groups with Varying Supervisory Expectations

Group 3: “Significant Users” of Incentive Compensation Arrangements

- Subset of non-LBOs (Group 2)
- No clear definition of “significant” provided in the Guidance
- “A smaller banking organization will not be considered a significant user of incentive compensation arrangements simply because the organization has a firm-wide profit-sharing or bonus plan that is based on the bank’s profitability, even if the plan covers all or most of the organization’s employees.”
- Additional governance expectations placed on the board of directors over what’s expected of “non-significant” users

3 Key Principles of a Sound Incentive System

To be consistent with safety and soundness, incentive compensation arrangements at a bank should:

1. Provide employees incentives that appropriately balance risk and reward;
2. Be compatible with effective controls and risk management; and
3. Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.



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Principle #1 – Balanced Risk-taking Incentives



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Incentive compensation arrangements should:

- Balance risk and financial results in a manner that does not encourage employees to expose the bank to imprudent risks
- Consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized
- Utilize modifying features, where necessary, that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes
- Be tailored to account for the differences between employees, as well as between banks
- Effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase (with examples, where feasible)

Principle #1 – Balanced Risk-Taking Incentives (cont.)

Examples of Imbalance:

- Highly leveraged
 - Examples: overuse of options, base pay small relative to incentive potential, “run-away” incentives without caps
- Time horizon mismatches between performance measurement, payout, and potential risk outcomes
 - For example, short performance measurement and payout periods associated with activities that expose the bank to long-term risk
- No link between level of risk and potential payout (no risk adjustment)
 - “As an example, under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially.”
- Potential for encouraging activities that could lead to “bad-tail” risks
 - Low probability of being realized, but would have highly adverse effects on the bank if they were to be realized

Principle #1 – Balanced Risk-Taking Incentives (cont.)

Potential Modifiers Suggested in the Guidance:

- Risk-adjustment of awards
 - “Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.”
- Deferral of payment (with “clawback”)
 - “The actual payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that are realized or become better known only during the deferral period.”
- Longer performance periods
 - “Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes are realized or better known.”
- Reduced sensitivity to short-term performance
 - “The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s).”

Note: The Guidance acknowledges there are no “one-size-fits-all” solutions and each modifier has its own advantages and disadvantages. A combination of modifiers may be appropriate.

Principle #1 – Balanced Risk-Taking Incentives (cont.)

“Golden Parachutes”:

- Significant additional and/or accelerated payments upon departure from the organization or change in control (CIC)
- Banks should carefully consider the potential for “golden parachutes” and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees
- Coordinate any “golden parachute” provisions in agreements (e.g. employment/CIC/severance/retirement/incentive) to ensure they do not encourage imprudent risk-taking in light of the other features of the employee’s incentive arrangements

Additional Expectations of LBOs:

- In designing and modifying incentive compensation arrangements, LBOs should assess in advance of implementation whether such arrangements are likely to provide balanced risk-taking incentives (e.g. simulation analysis)
- LBOs should actively monitor developments in the field and incorporate emerging methods or practices, as appropriate
- More extensive use of modifiers (e.g. longer performance periods, risk adjustments, deferral, clawback)
- “Likely to be better balanced” if a significant portion of the incentive compensation is paid in the form of equity-based instruments that vest over multiple years with clawback features
- Evaluate the impact “golden handshake” arrangements might have on weakening the effectiveness of forfeiture features in deferral arrangements



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Principle #2 – Effective Controls & Risk Mgmt.



Principle #2 – Effective Controls & Risk-Mgmt.

Developments in Controls and Risk Management:

- *Basel Committee on Banking Supervision: Compensation and Principles and Standards Assessment Methodology*
- *Special Master for TARP Executive Compensation – Lookback at AIG Compensation – Concluded 7-28-2010*
- *New IIA Guidance for Review of Compensation Programs*

Final Interagency Guidance on Sound Incentive Compensation Policies:

“... traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced. Rather, a banking organization’s risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.”

Effective Control is a “Top-Down” Process

- **Requires Active Board Oversight** – The board of directors is ultimately responsible for ensuring that the bank’s incentive compensation arrangements for all covered employees are appropriately balanced and do not jeopardize the safety and soundness of the organization

Involve Appropriate Personnel

- Banks (the Board) should adopt policies and procedures that ensure that risk-management personnel have an appropriate role in designing incentive arrangements and assessing their effectiveness in restraining imprudent risk-taking. They might assist with:
 - Reviewing risks associated with the activities of covered employees;
 - Approving risk and/or performance measures; and
 - Analyzing risk-taking and risk outcomes relative to incentive compensation payments (forward-looking and backward-looking scenario analyses).
- Other functions (e.g. control, HR, finance) can also play an important role in helping ensure incentive arrangements are balanced

Minimum Requirements for An Appropriate System of Controls Include:

- **Functional Controls** – Maintain controls to ensure that policies and processes for achieving balanced compensation arrangements are followed
- **Adequate Documentation** – Create and maintain sufficient documentation to permit an audit of the effectiveness of the bank's processes for establishing, modifying, and monitoring incentive compensation arrangements
- **Appropriate Monitoring** – Monitor the performance of incentive compensation arrangements and revise the arrangements as needed if payments do not appropriately reflect risk

Additional Expectations of Large Banking Organizations:

- LBOs should have and maintain policies and procedures that:
 - Identify and describe role(s) of personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive arrangements
 - Identify source of significant risk-related inputs and establish appropriate controls governing the development/approval of inputs
 - Identify those authorized to establish/approve new incentive arrangements or modify existing arrangements
- An LBO should also conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed
- An LBO's internal audit department also should separately conduct regular audits of the bank's compliance with its established policies and controls relating to incentive compensation arrangements, and report the results to the appropriate individuals.

The Internal Auditor's Role

- **Risk Assessment** – Internal audit should evaluate risk related to various aspects of compensation systems, including implications related to program specific requirements under special programs such as TARP, TALF or implications under SEC rules for public companies.
- **Audit Plans** – The internal auditor should include testing of systems implemented to ensure BoD policies and organizational procedures are adhered to; internal audits should be conducted with timing and scope commensurate with the organization's risk levels, but initially no less than annually
- **Audit Reporting** – Reporting over controls which ensure compliance with executive compensation policies and procedures are of particular importance; deviations from these policies should be closely scrutinized by the Audit Committee and BoD.
 - **Appropriate action must be taken should policies not be complied with as intended**

Principle #2 – Effective Controls & Risk-Mgmt. (cont.)

Supervisory Process

- Findings will be communicated to the bank and included in the relevant report of examination or inspection
- Incorporated into organization's risk-management, internal controls, and corporate governance rating components, as well as overall supervisory rating
- Federal supervisors may take enforcement actions based on their findings and/or the bank's lack of prompt corrective response to discovered deficiencies
- "The Agencies intend to actively monitor the actions being taken by banking organizations with respect to incentive compensation arrangements and will review and update this guidance as appropriate to incorporate best practices that emerge."
- Fed/FDIC estimate average time burden on smaller banks to be 80 hours first year (implementation/modification) and 40 hours each subsequent year (maintenance)



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Principle #3 – Strong Corporate Governance



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Active Board Oversight:

- The board of directors (BoD) is ultimately responsible for ensuring that the bank's incentive compensation arrangements for all covered employees are appropriately balanced and do not jeopardize the safety and soundness of the organization
- The BoD (comp committee) is expected to:
 - Directly approve the incentive compensation arrangements (including any material exceptions or adjustments) for senior executives;
 - Closely monitor payments to (and clawback provisions for) senior executives and the sensitivity of those payments (clawbacks) to risk outcomes;
 - Monitor the performance, and regularly review the design and function of incentive compensation arrangements (with support from management and internal audit) for all covered employees; and
 - Seek to stay abreast of significant emerging compensation developments in the marketplace, academia and from regulatory agencies (but don't blindly follow the herd).

Principle #3 – Strong Corporate Governance (cont.)

Organization and Resources of the BoD:

- The board of directors (BoD) should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the bank's activities
 - May be present collectively among members of BoD; may come from formal training; may be obtained through outside advisors
- In selecting and using outside parties, the BoD should:
 - Give due attention to potential conflicts of interest arising from other dealings of the parties with the bank or for other reasons
 - Avoid allowing outside parties to obtain undue levels of influence
- The BoD retains ultimate responsibility for ensuring that the bank's incentive compensation arrangements are consistent with safety and soundness
 - The BoD (comp committee) must take full ownership of the process


Disclosure Practices that Support Safety and Soundness:

- The bank should provide an appropriate amount of information to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for incentive compensation arrangements that encourage imprudent risk-taking
 - Include information for arrangements covering executive and non-executive employees
 - Explain the related risk-management, control, and governance processes
 - Scope of disclosures should be tailored to the nature and complexity of the bank and its incentive arrangements

Principle #3 – Strong Corporate Governance (cont.)

Additional Expectations of Large Banking Organizations AND Significant Users of Incentive Compensation:

- The BoD (comp committee) of an LBO or other “significant user” is expected to be more actively involved, including:
 - Actively oversee the development and operation of the bank’s policies, systems, and related control processes related to incentive compensation;
 - Review the overall goals and purposes, and provide clear direction to management to ensure they are carried out in a manner that achieves balance and is consistent with safety and soundness;
 - Receive and review, at least annually, an assessment by management (with input of risk-management personnel) of the effectiveness of the arrangements in achieving balanced risk-taking incentives consistent with safety and soundness;
 - Receive and review periodic reports that analyze incentive compensation awards and payments relative to risk outcomes on a backward-looking basis (and consider periodically obtaining and reviewing forward-looking simulation analyses)
- If not already in existence, consider establishing a separate compensation committee of predominantly non-executive directors
 - Work closely with board-level risk and audit committees, and report to full board



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Take-Aways and Actions for Your Bank



Key Take-Aways

- This is a serious matter for all banks
- The guidance demands an immediate, thoughtful response
- The board of directors (compensation committee) must own the initial response and ongoing compliance
- Risk management and control personnel can play a meaningful, helpful role in the overall process
- Bank regulators will expect to see evidence (documentation) of:
 - Prompt, thoughtful consideration of, and response to, the guidance
 - Policies and procedures consistent with the 3 principles
 - Internal assessments of existing incentive arrangements, measured against the 3 principles
 - Actions (or plans) to address any found shortcomings
- Supervisory expectations will vary based on scope and complexity of the bank and its utilization of incentive compensation arrangements
- The next few years will be a time of learning and adjustment for banks, their examiners, and their advisors

Actions for Your Bank

- ✓ Educate your board of directors about the Guidance
- ✓ Identify risk management and control personnel within the bank that can assist the compensation committee
- ✓ Inventory all incentive programs covered by the Guidance
- ✓ Perform internal assessments for existing programs and review with compensation committee
- ✓ Make adjustments to incentive plans (including policies and procedures), as necessary
- ✓ Establish a plan to systematically review/monitor incentive arrangements at least annually
- ✓ Document, document, document

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