

# Executive Compensation Governance

## *In a Post-TARP World*

OBA/ICBO Directors & Officers Winter Conference  
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OBA/ICBO Winter Conference – Executive Compensation Governance

## Agenda

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- Legislative/regulatory environment and timeline
- Implications of TARP compensation rules
- Federal Reserve's proposed incentive comp guidance
- Action items for your bank
- Q&A

## The Legislative & Regulatory Environment

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- 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 are determined to “fix” the perceived governance problem post-haste

## The Legislative & Regulatory Environment

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- Early proposals and enactments were applicable only to TARP recipients and/or public companies
  - While a number of small TARP recipients were subjected to onerous rules designed for much larger institutions, the majority of community banks were not initially affected
- Recent proposals have cast a much wider net, impacting thousands of community banks
- The trend suggests that ALL community banks, regardless of size, charter and/or ownership structure should anticipate similar governance and reporting requirements

## The Legislative & Regulatory Environment

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### Question:

If your bank was accused of operating its compensation programs in accordance with sound governance and risk management principles ...

would there be enough evidence for a conviction?

The current legislative/regulatory environment is demanding that banks deliver evidence of sound compensation governance and risk management.

## Legislation/Guidance Timeline

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- **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 and compliance

## Legislation/Guidance Timeline

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- **Apr-09: FSF “Principles for Sound Compensation”**  
([http://www.financialstabilityboard.org/publications/r\\_0904b.pdf](http://www.financialstabilityboard.org/publications/r_0904b.pdf))
  - Developed by an international task force of the Financial Stability Board (formerly Financial Stability Forum)
  - Principles address
    1. Effective governance of compensation
    2. Effective alignment of compensation with prudent risk taking
    3. Effective supervisory oversight and engagement by stakeholders
  - *“To date, most governing bodies (henceforth “board of directors”) of financial firms have viewed compensation systems as being largely unrelated to risk management and risk governance. This must change. While voluntary action is desirable, it is unlikely to effectively and durably deliver change given competitive pressures and first-mover disadvantage. The global supervisory and regulatory infrastructure is an appropriate vehicle for making sound compensation practices widespread.”*

## Legislation/Guidance Timeline

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- **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
  - Applicable to SEC registrants
- **June-09: “TARP Standards for Compensation and Corporate Governance: Interim Final Rule”**
  - Formal guidance for compensation provisions of ARRA
  - Creation of “Special Master” (Pay Czar)
  - “Senior Risk Officer” requirement
  - Extensive PEO, PFO and Compensation Committee certifications related to pay governance and TARP compliance

## Legislation/Guidance Timeline

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- **July-09: Treasury and SEC proposals**
  - Focused on compensation governance & risk management, corporate leadership structure, comp committee independence, shareholder “say-on-pay”
  - Targeted at all public companies (not just financial institutions)
- **July-09: House passed “Corporate and Financial Institution Compensation Fairness Act of 2009” (H.R. 3269, Frank)**
  - Similar in spirit to Treasury and SEC proposals for public co’s.
  - Includes incentive pay governance requirements applicable to all “covered financial institutions” larger than \$1B in assets (depository institutions, credit unions, broker-dealers, investment advisors, Fannie & Freddie)
  - Disclosure to Federal regulator of incentive-based compensation arrangements sufficient to determine appropriateness (focused on risk management issues)

## Legislation/Guidance Timeline

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- **Sep-09: Financial Stability Board Implementation Stds. “FSB Principles for Sound Compensation Practices”**  
([http://www.financialstabilityboard.org/publications/r\\_090925c.pdf](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”**  
(<http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf>)
  - Developed to be consistent with FSB Principles
  - Applies to ALL banking organizations supervised by the Fed (bank holding companies, state member banks, Edge and agreement corporations, etc.)

## Legislation/Guidance Timeline

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- **Nov-09: “Restoring American Financial Stability Act of 2009” introduced in Senate (Dodd)**
  - Vast majority of bill relates to financial services reform
  - Proposed executive compensation rules for public companies are similar to H.R. 2369 (Frank) and S. 1074 (Schumer)
  - Financial Institution Regulatory Agency (FIRA) created under the Act would be required to establish rules for bank holding companies prohibiting compensation practices that threaten safety and soundness (including compensation for directors and non-executive employees)
  - Appropriate Federal banking agency would be permitted to impose higher capital standards for an insured depository institution if its compensation practices pose a risk of harm to the institution

## Key Implications of ARRA & TARP IFR

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- 1) Prohibits paying (or accruing) any “bonus, retention award, or incentive compensation” to most highly compensated employees (MHCE)
  - Applies to as many as 25 MHCEs depending on level of TARP assistance
  - Exception for certain legally binding agreements in effect prior to 2/11/2009
  - Exception for certain restricted stock awards
- 2) Prohibits termination pay (i.e. severance pay) for top 10 MHCEs except payments for services performed or benefits accrued
- 3) Eliminates tax deductions for compensation in excess of \$500,000 paid to top 5 MHCEs – the “Senior Executive Officers” (SEOs)

## Key Implications of ARRA & TARP IFR

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- 4) Prohibits compensation that encourages “unnecessary and excessive risks” or manipulation of reported earnings
- 5) Expands scope and depth of “claw-back” provisions
  - CEOs and next 20 MHCEs (top 25) must repay bonus, retention awards or incentive compensation if found to have been based on materially inaccurate criteria
- 6) Requires adoption and maintenance of policy related to approval of excessive or luxury expenditures, addressing four categories: 1) entertainment or events; 2) office and facility renovations; 3) aviation or other transportation; and 4) other similar items, activities, or events.

## Key Implications of ARRA & TARP IFR

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- 7) Requires annual disclosure and narrative to Treasury and primary regulatory agency regarding perquisites that exceed \$25,000 for the MHCEs subject to the bonus restrictions
- 8) Prohibits tax gross-ups to top 25 MHCEs
- 9) Requires non-binding “say-on-pay” shareholder vote on executive compensation (SEC registrants)
- 10) Requires annual certification of compliance by both CEO and CFO
  - Model language is provided in the TARP IFR
- 11) Imposes new compensation committee requirements

## TARP “Compensation Committee” Rule

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- TARP recipients must maintain a Board Compensation Committee comprised entirely of independent directors for the purpose of reviewing all employee compensation plans
  - Note: Non-SEC registrants receiving less than \$25 million in TARP funds are permitted to have the full board of directors carry out the responsibilities of the Compensation Committee if desired
- The committee is required to meet at least every 6 months with Senior Risk Officer(s) to discuss/evaluate employee compensation plans and assess whether they pose unnecessary risks to the company

## TARP Comp Committee Disclosures

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- At least once per fiscal year the committee is required to provide narrative descriptions to primary regulatory agency (proxy committee report if public) and Treasury identifying each compensation plan and how:
  - SEO compensation plans do not encourage SEOs to take unnecessary and excessive risks;
  - Unnecessary risks posed by employee compensation plans have been limited;
  - Employee compensation plans do not encourage manipulation of reported earnings
- Within 120 days of fiscal year-end the committee is required to provide a narrative description to primary regulatory agency and Treasury regarding the engagement and services of compensation consultants

## TARP Comp Committee Certification

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- The committee is required to make a certification similar to the following to primary regulatory agency (proxy committee report if public) and Treasury within 120 days of each fiscal year-end while TARP is outstanding:

“The compensation committee certifies that:

- (1) It has reviewed with senior risk officers the senior executive officer (SEO) compensation plans and has made all reasonable efforts to ensure that these plans do not encourage SEOs to take unnecessary and excessive risks that threaten the value of [TARP recipient];
- (2) It has reviewed with senior risk officers the employee compensation plans and has made all reasonable efforts to limit any unnecessary risks these plans pose to the [TARP recipient]; and
- (3) It has reviewed the employee compensation plans to eliminate any features of these plans that would encourage the manipulation of reported earnings of [TARP recipient] to enhance the compensation of any employee.”

## Principles of the TARP “Special Master”

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The TARP compensation czar will apply the following principles when reviewing compensation structures and/or compensation payments of TARP recipients:

**Risk:**

- Compensation structures should avoid incentives to take unnecessary or excessive risks that could threaten the value of the TARP recipient.
- The performance measurement and payment time horizon should take into account the risk horizon so that the reward reflects the true contribution to the long-term value of the TARP recipient.

## Principles of the “Special Master” (cont.)

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### **Taxpayer return:**

- “Compensation structures should reflect the need for the TARP recipient to remain a competitive enterprise, to retain and recruit talented employees who will contribute to the TARP recipient’s future success, and ultimately to be able to repay TARP obligations.”

## Principles of the “Special Master” (cont.)

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### **Appropriate allocation:**

- “The compensation structure should appropriately allocate the components of compensation such as salary, short-term and long-term incentives, as well as the extent to which compensation is provided in cash, equity or other types of compensation ...”
- “... generally, in the case of an executive or other senior level position a significant portion of the overall compensation should be long-term compensation that aligns the interest of the employee with the interests of shareholders and taxpayers.”

## Principles of the “Special Master” (cont.)

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### **Performance-based:**

- “An appropriate portion of the compensation should be performance-based over a relevant performance period. Performance-based compensation should be determined through tailored metrics that encompass individual performance and/or the performance of the TARP recipient or a relevant business unit taking into consideration specific business objectives.”
- “... generally a significant portion of total compensation should be performance-based compensation, and generally that portion should be greater for positions that exercise higher levels of responsibility.”

## Principles of the “Special Master” (cont.)

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### **Comparable structures and payments:**

- “The compensation structure, and amount payable where applicable, should be consistent with, and not excessive taking into account, compensation structures and amounts for persons in similar positions or roles at similar entities that are similarly situated ...”

## Principles of the “Special Master” (cont.)

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### Employee contribution to TARP recipient value:

- “The compensation structure, and amount payable where applicable, should reflect the current or prospective contributions of an employee to the value of the TARP recipient ...”

## Fed’s Incentive Comp Guidance

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### Supervisory Initiatives

- Large Complex Banking Organizations (LCBOs)
  - Only 28 organizations currently meet LCBO definition
  - Formal, extensive Fed review of incentive programs
- Community and regional banking organizations (non-LCBOs)
  - Over 6,800 non-LCBOs (approx. 3,000 with assets < \$175M)
  - Fed will review incentive compensation arrangements as part of risk management reviews during the regular, risk-focused examination process
  - *“As with other aspects of the examination process, these reviews will be tailored to reflect the scope and complexity of the organization’s activities, as well as the prevalence and scope of the organization’s incentive compensation arrangements.”*

## Fed's Incentive Comp Guidance (cont.)

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### Supervisory Initiatives (cont.)

*"The Federal Reserve expects all banking organizations to evaluate their incentive compensation arrangements and related risk management, control, and corporate governance processes and immediately address deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in the guidance, do not encourage excessive risk-taking, and do not pose a threat to the safety and soundness of the organization.*

*The Federal Reserve is committed to moving the banking industry forward to incorporate the principles described in the guidance into incentive compensation practices."*

## Fed's Incentive Comp Guidance (cont.)

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### Applicable to Incentive Plans Covering:

1. Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
2. Individual employees whose activities may expose the firm 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 firm to material amounts of risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

## Fed's Incentive Comp Guidance (cont.)

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### Three Key Principles of a Sound Incentive System

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

1. Balance risk and financial results in a manner that does not provide employees incentives to take excessive risks on behalf of the banking organization;
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.

## Fed's Incentive Comp Guidance (cont.)

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### Principle #1 - Balanced Risk-Taking Incentives

#### Examples of Red Flags

- Highly leveraged
  - e.g. 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
  - e.g. 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 organization if they were to be realized

## Fed's Incentive Comp Guidance (cont.)

### Principle #1 - Balanced Risk-Taking Incentives

#### Potential "fixes" suggested by Fed 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 become clear 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)."*

## Fed's Incentive Comp Guidance (cont.)

### Principle #2 – Effective Controls & Risk Management

#### Policies and procedures should:

- Identify and describe role(s) of personnel 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

*"Banking organizations also should create and maintain sufficient documentation to permit an audit of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements."*

## Fed's Incentive Comp Guidance (cont.)

### Principle #2 – Effective Controls & Risk Management

Banks should involve appropriate risk-management/control personnel:

- Review potential risks involved with the encouraged activities
- Analyze risk-taking and risk outcomes relative to incentive compensation payments (forward-looking and backward-looking scenario analyses)
- Assist with monitoring, reporting and revising incentive arrangements as needed if payments do not appropriately reflect risk

The guidance states *“Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.”*

... a difficult task for smaller community banks!

## Fed's Incentive Comp Guidance (cont.)

### Principle #3 – Strong Corporate Governance

- **Active board oversight:** *“The board of directors of an organization is ultimately responsible for ensuring that the organization’s incentive compensation arrangements are appropriately balanced and do not jeopardize the safety and soundness of the organization.”*
- **Regular review and monitoring:** *“... the board should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the design and operation of the organization’s incentive compensation system in providing risk-taking incentives that are consistent with the organization’s safety and soundness.”*
- *“The **organization, composition, and resources of the board of directors** should permit effective oversight of incentive compensation.”*
  - Guidance encourages independent comp committee structure, access to independent outside advisors, etc.

## Actions for Fed-supervised Institutions

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- Identify risk management personnel within the bank that can assist the compensation committee
- Inventory all incentive programs covered by the Fed's guidance
- Perform risk assessments for covered incentive programs and review with compensation committee (see sample assessment handout)
- Make adjustments to incentive plans, as necessary
- Document, document, document

## Actions for TARP Recipients

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- Review model certifications provided in the TARP IFR (published in Federal Register on 6/15/2009)
- Identify Senior Executive Officers (at least 5) and next 20 MHCEs; determine which employees are subject to the various requirements and ensure compliance
- Inventory all SEO and employee compensation plans and gather written documentation of each plan for evaluation by the Senior Risk Officer(s) and Compensation Committee
- Conduct required risk assessments (at least every 6 months) and document findings
- Adjust compensation plans as necessary
- Determine restricted stock strategy for employees impacted by the bonus restrictions
- Prepare for say-on-pay requirements (SEC registrants)
- Ensure disclosure/certification requirements are met

## Actions for SEC Registrants

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- Prepare for eventual say-on-pay requirements (current requirement if TARP recipient)
- In anticipation of expanded proxy disclosure and voting requirements, re-evaluate:
  - Qualifications and independence of outside directors
  - Dual vs split roles of Chair/CEO
  - Independence of advisors to the board
  - Quality of the bank's compensation risk management and the role the Compensation Committee plays in the process

## Contact Information

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