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# COMPENSATION AND RISK

## The Directors' Responsibility

WHITE PAPER

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*Comprehensive Compensation®*



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## Executive Summary

**B**ank directors today have an increased fiduciary duty to assess and manage the relationship between risk and compensation programs. Regulations resulting from the financial crisis require boards (and their compensation committees) to formally assess and document the relationship between risk and compensation programs for all employees, not just executives. As a result, board members need to be more involved, informed and knowledgeable about the bank's compensation programs while ensuring the programs support sound risk management practices and comply with new regulations. The first step is to develop a process where the roles and responsibilities of management, the board and its committees are clearly defined. Risk assessment findings should address plan design, controls, processes, policies and governance practices. Where the findings identify gaps that could lead to potentially risky behaviors, action plans for improvement should be developed and implemented.

## Compliance Requirements

Banks may have up to four compliance requirements related to compensation:

- **Banks with outstanding funds under the Troubled Asset Relief Program:** Compensation committees must review and disclose how all compensation programs relate to risk and long-term value. Semi-annual reviews are required.
- **All banks and thrifts:** Under Section 956 of the Dodd-Frank Act, all banks will be required to document and report their risk assessment to regulators on an annual basis.
- **Public banks:** Public companies are required by the SEC to disclose where risks are "reasonably likely to have a material adverse effect on the company."
- **Certain financial institutions with consolidated assets of at least \$1 billion:** Proposed rules to enforce Section 956 of the Dodd-Frank Act prohibit incentive compensation arrangements to covered individuals that encourage inappropriate risk by:
  - providing excessive compensation, or
  - creating a potential for material financial loss

Banks with assets greater than \$50 billion have additional requirements:

- mandatory three-year deferral of incentive compensation arrangements for executive officers. Any payouts must be adjusted for actual losses, or for other measures, aspects, or performance that are realized or become better known during the deferral; and
- enhanced internal review and approval of incentive compensation arrangements for other individuals who have the ability to expose the institution to significant loss.

### Enhanced Director Responsibilities

Board members have always had oversight for managing the bank’s risk. Directors today, however, have the additional responsibility for ensuring that incentive compensation programs for all “covered” employees are appropriately designed and have protections in place to ensure the safety and soundness of the institution. Covered employees are broadly defined and include executive officers as well as non-executive employees or groups of employees who in aggregate could expose the bank to material financial loss. For example, lenders and mortgage originators, who individually may not cause significant financial loss, can have an impact. In practice, this means that directors (typically the members of the compensation committee) must understand all the bank’s compensation programs and ensure the structure and administration of the programs do not motivate risky behavior.

The compensation committee’s role should include:

- understanding who meets the definition of “covered employees”
- receiving an inventory of incentive compensation arrangements impacting covered employees
- reviewing data and analysis provided by management summarizing the design features and controls that mitigate risk-taking
- reviewing and approving goal setting and

payment approval procedures for all covered employees

- approving compensation arrangements for senior executives
- interacting with management (e.g. risk, audit, human resources, finance) and other board committees to ensure proper information sharing to fulfill its risk monitoring role
- monitoring ongoing assessments and regulatory compliance, including reports to regulators and disclosure in the proxy statement

Reports on the risk review process will need to be submitted to the bank’s regulator(s) on an annual basis. In addition, board committees should review and update charters as appropriate to ensure proper oversight and governance of the risk assessment and review processes.

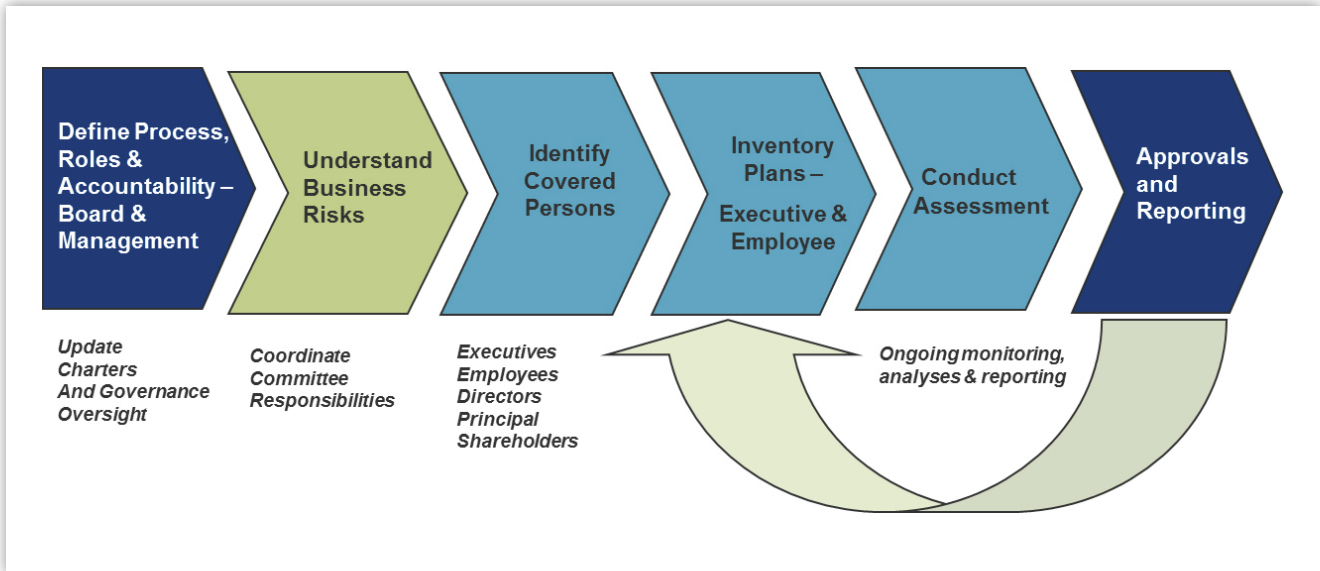
### Risk Assessment Process

The first step is to clarify management and board responsibilities. A common approach is to convene a multi-disciplinary management team involving functions such as risk, human resources and audit to conduct the risk review. The board, typically the compensation committee, then reviews the assessment to ensure incentive compensation arrangements are consistent with sound risk management practices.

The assessment process involves identifying covered persons, inventorying all incentive plans and reviewing risk from multiple perspectives such as financial, credit, market, operational, reputational, competitive, regulatory and legal risk. Not all of these risks are equal—the magnitude or materiality should be significant enough in terms of number of employees, compensation amounts and/or the likelihood of occurrence as to create a material risk to the bank. Materiality is defined by the regulatory authorities in different ways and may vary given the bank’s situation.

The risk assessment itself should:

- review and define company risks from both a historical and prospective viewpoint
- identify covered employees and the potential risks resulting from their functions/roles



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- clarify the time horizon of the risk and ensure incentive payouts are appropriate to the timeframe
- audit design features, controls, processes, policies and governance practices that may lead to increased risk taking or mitigate risk-taking
- identify “gaps” and areas for improvement
- develop priorities and action plans for improvement

Outcomes from the assessment should be provided in a written report and presented to the compensation committee/board of directors in a manner that promotes transparency and identifies appropriate remedies for potential problem areas. Each year, the process should be reviewed and documentation should be presented to the board and regulators. The Dodd-Frank Act requires this for all banks and thrifts.

### Risk Mitigating Strategies – What To Look For

As directors review the risk assessment, they should recognize practices and design features that can exacerbate or mitigate risk. The goal should be to achieve a balance of risk that is appropriate for the bank—promoting safety and soundness while still achieving realistic business objectives. While most banks will not require significant changes to their compensation programs, the new requirements present an opportunity to review practices through new lenses. Practices that may have been “fine” or “acceptable” pre-financial crisis, under today’s heightened focus, could be perceived as potentially risky. For example, programs that exhibit the following characteristics could in the extreme, or in combination with other higher risk features, be perceived as problematic by regulators:

- majority of compensation is incentive-based pay (i.e. high leverage pay model)

- most or all of incentives reward short-term results (i.e. one year or less)
- incentives are based on one (or few) performance measures
- the same performance measures are used for both short and long-term incentives
- there is no cap to awards (i.e. unlimited upside)
- thresholds/targets are set too high
- awards are based on formulaic calculations without any qualitative/discretionary factors
- plans are based on volume with no mechanism for determining quality
- no claw back policy is in place
- no ownership/holding is required
- performance measures are not adjusted for risk or incorporate risk-based metrics
- no centralized process for approving plan designs, goals or payouts
- incentive plans are not documented
- compensation committee does not understand the full range of potential payouts under different performance and risk scenarios

While any one of these features may not be problematic alone, they represent areas where banks should ensure counter balancing mechanisms are in place to mitigate risk taking. Board members need to understand the impact of the plan designs, processes and controls that exist and ensure proper monitoring.

### Summary

Compensation committee members today need to have more detailed knowledge around incentive compensation arrangements. Fiduciary duties now require greater emphasis on monitoring to ensure compliance with emerging regulations. Developing a systematic and rigorous assessment process for assessing and monitoring compensation programs for potential risk is the first step to ensuring compliance. While the new regulations may seem onerous and bureaucratic, banks should consider this an opportunity to review and improve compensation practices. Many of the design features associated with reducing risk promote a more balanced approach and greater linkages of rewards to actual performance over time. Since regulations and their enforcement will continue to evolve during the next few years, it will be important for bank boards and committees to continue to monitor emerging regulations and best practices.

**Questions to Ask about Risk and Compensation:**

The following list of questions is provided to help board members in their oversight role.

- Do our incentive plan measures align with and support the bank’s business strategy?
- Is our total compensation “mix” appropriately balanced between fixed compensation (salary/benefits) and incentive compensation? (e.g. More than 75 percent of compensation in incentive pay may drive “riskier” behaviors.)
- Is there an appropriate balance/consideration of:
  - short and long-term performance?
  - absolute and relative performance?
  - bank and individual performance?
  - financial and operational/strategic performance?
  - formula and discretion?
- Is the leverage (i.e. upside and downside reward) appropriate?
- Are there appropriate considerations of “caps” on awards?
- Do the rewards paid align with the time horizon of the risk taken to achieve those results?
- Is there appropriate focus on long-term performance? Example features include multi-year performance periods and deferral mechanisms.
- Are there protections/controls in place to avoid excessive risk taking?
- Is there accountability at the board and management level to assess risk and monitor compensation?
- Are incentive plan designs approved by an objective function/party responsible?
- Are incentive payouts audited and approved by an objective party? Are payouts audited?
- Do the payouts align with 1) performance, 2) risk timeframe, 3) market/industry practice, 4) shareholder interests?
- Do we have a defensible peer group/market reference?
- Do executives hold an appropriate amount of pay in stock (i.e. aligned with long-term shareholder interests)? Stock ownership guidelines and holding periods are policies that can help mitigate risk.
- Are incentive plans subject to claw backs?