



American
Bankers
Association

Strategic Solution Session

New Approaches to Senior Executive
Compensation

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“The most terrifying words in the English language are: I’m from the government and I’m here to help.” -- Ronald Reagan

Government Intervention in Executive Compensation

- 2008 Compensation Czar –Special Master Kenneth Feinberg takes on TARP compliance
- 2009 President Obama pronounces Broad Principles which launch major regulatory reform
- Congress bills evolve over several years
- 2010 Dodd-Frank Wall Street Reform Act signed



Where are the compensation experts?

Regulator Compliance Expands




- 2008
 - CPP/TARP
- 2009
 - Obama Administration releases Executive Compensation Principles and Proposals
 - SEC enhances executive compensation disclosures (including risk, board leadership)
- 2010
 - Federal Reserve joins forces with FDIC, OCC and OTS to issue final guidance on incentive compensation oversight and risk
 - Dodd-Frank Financial Services Reform Act signed into law
- 2011
 - SEC finalizes Say on Pay rules
 - Proposed rules to implement Dodd-Frank limits on incentive pay risk
 - Implementation of some Dodd-Frank provisions delayed until 2012



Final Agency Guidance - Sound Incentive Compensation Practices

- Effective June 25, 2010
- Covers all community banks
- Purpose:
 - Ensure incentive compensation arrangements (ICAs) at all financial institutions do not encourage imprudent risk-taking and are consistent with the safety and soundness of the organization
- Principles Based Guidance:
 - Applies to all institutions but guidance acknowledges application will vary based on size and complexity of the company and ICAs
- Three Core Principles:
 - ICAs should balance risk and financial results in a manner that does not encourage employees to take imprudent risk
 - ICAs should be compatible with effective controls and risk management
 - ICAs should be supported by strong corporate governance




These principles
were reinforced
under Dodd Frank



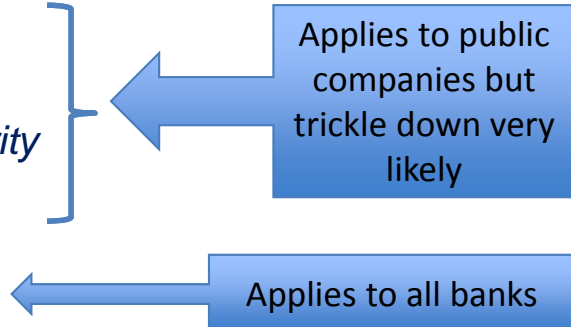
Final Agency Guidance

- Covered Individuals – a wide net cast
 - **Senior executives** (e.g., “executive officers” and “named executive officers”, or others) responsible for overseeing the organization's firm-wide activities or business lines
 - **Individual employees** (including non executives) whose activities might expose the company to material risk
 - **Groups of employees** who in the aggregate may expose the firm to material amounts of risk, even if no individual employee is likely to do so (e.g., loan officers)
- The Effect:
 - Increases Board’s oversight responsibilities of incentive compensation practices for the entire company (i.e. not just executives)
 - Increases focus regulators have on compensation programs and policies.
- *The Dodd-Frank Act adds more ‘teeth’ to the current guidance for banks \$1 billion in assets or more.*




Dodd-Frank Regulation of Incentive Pay at Financial Institutions (Section 956)

- Signed by President Obama on July 21, 2010
 - Almost all of the executive compensation and corporate governance provisions in the Act applies to all U.S. public companies; only one targeted at financial institutions (incentive risk and excessive compensation)
 - Defers to the SEC to develop specific requirements. Implementation varies with most expected to be implemented by 2012 (See Appendix)
- Primary Components:
 - Say on Pay, Say on Frequency, Say on Golden Parachutes
 - Enhanced Disclosure (pay for performance, role of Chair of Board, internal equity, hedging)
 - *Clawback Policies*
 - *Compensation Committee Independence & Authority*
 - *Compensation Committee Advisors*
 - *Special Rules for Covered Financial Institutions*
 - Proxy Access
 - Broker Vote



Applies to public companies but trickle down very likely

Applies to all banks



Dodd-Frank Regulation of Incentive Pay at Financial Institutions (Section 956)

- Overview

- Directs banking regulators to prescribe regulations and restrictions on incentive-based compensation arrangements that includes three mandates*:
 - Disclosure: Covered financial institutions (CFI) must disclose annually to their Regulator(s) all incentive-based compensation arrangements (ICA) for “covered persons”
 - Covered persons include: executive officers, employees, directors, or principal shareholder
 - Prohibitions: CFIs cannot maintain ICAs for “covered persons” that encourage inappropriate risks by providing excessive compensation or compensation that could lead to a material financial loss.
 - Policies and Procedures: CFIs must maintain policies and procedures appropriate to their size, complexity and use of ICAs to help ensure compliance.
- Applies to financial institutions with assets at least \$1 billion
- Special rules for institutions with assets greater than \$50 billion
 - Mandatory deferral of a substantial portion of ICAs to executive officers
 - Enhanced internal review and approval of ICAs for other individuals who have the ability to expose the CFI to significant loss.
- Oversight by the following regulators (FRB, OCC, FDIC, OTS, NCUA, FHFA, SEC)

*Final rules adopted by each Regulator may differ slightly based on the agencies' unique standards.



Dodd-Frank Regulation of Incentive Pay at Financial Institutions (definitions)

- Scope and definitions
 - CFIs include: depository institutions, registered broker dealers, credit unions, investment advisors, FNMA, FHLMC and any other financial institutions that the regulators determine should be covered.
 - Incentive-Based Compensation (ICAs): Broadly defined as variable compensation paid in any form that serves as incentive for performance
 - Compensation: includes all payments, fees or benefits (whether in cash or other) to covered persons, including payments or benefits under an employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, post employment benefit.
 - Covered Person: Executive officer, employee, director, or principal shareholder of a CFI.
 - Excessive Compensation: When amounts paid are unreasonable or disproportionate to the amount, nature, quality and scope of services performed. Consideration will be given to value delivered, compensation history, financial condition of the CFI, comparable compensation practices at comparable firms based on asset size, geography and complexity of the firm's operations and assets, any other factors the Regulator deems relevant. Applies to all covered persons.
 - Material Financial Loss: Unfortunately, not defined. Applies to subset of covered persons and refers back to June guidance. As recap:
 - Covered persons includes: executive officers, non executive employees whose activities could expose the CFI to material financial loss and/or groups of employees who in aggregate could expose the CFI to financial loss
 - Guidance refers to balanced plan design, appropriate controls and risk management procedures and strong corporate governance.

Regulatory Update – Implementation Schedule

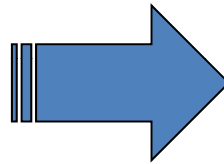
Regulation	Regulator(s)	Rule/Guidance	Who it Impacts	Effective Date
Agency Guidance	FRB, FDIC, OCC, OTS	Incentive Compensation Arrangements	All institutions	EFFECTIVE 2011
Dodd-Frank	FRB, FDIC, OCC, OTS, NCUE, SEC, FHFA	Incentive Compensation Excessive Compensation	All institutions > \$1b assets Special rules for banks > \$50b	Final rules by 6/12
	SEC	Say on Pay Say on Frequency of Pay Say on Golden Parachutes	All public companies (However “trickle down” to non public companies likely regarding Compensation Committee independence and Clawbacks.)	EFFECTIVE 2011
	SEC Stock Exchanges	Compensation Committee & Advisor Independence; Committee Oversight		Final rules by 12/11 Effective 2012
	SEC	Disclosure of Compensation Consultant Conflict of Interest		Final rules by 12/11 Effective 2012
	SEC	Clawback Policy		Final rules by 6/12 Effective 2012 - 2013
	SEC	Proxy disclosures: Pay-performance; internal equity ration, COB/CEO roles, hedging		Final rules by 6/12 Effective 2012 - 2013



Regulations Driving New Best Practices in Compensation

Need to Review/Update:


- Compensation Philosophy
- Total Compensation Components and Mix
- Incentive Plan Designs
- Pay Policies and Controls
- Governance Processes
- Pay-Performance Alignment – Short and Long-Term
- Internal Pay Relationships



New Programs Should:

- Support bank's business strategy
- Be looked at in a holistic/total manner
- Support sound risk management
- Promote long-term "view"
- Be balanced
- Have appropriate Board/Committee oversight
- Be shareholder aligned

*Requires new reporting and disclosure requirements –
to regulators and shareholders*



Compensation Best Practice #1: Define your Compensation Philosophy:

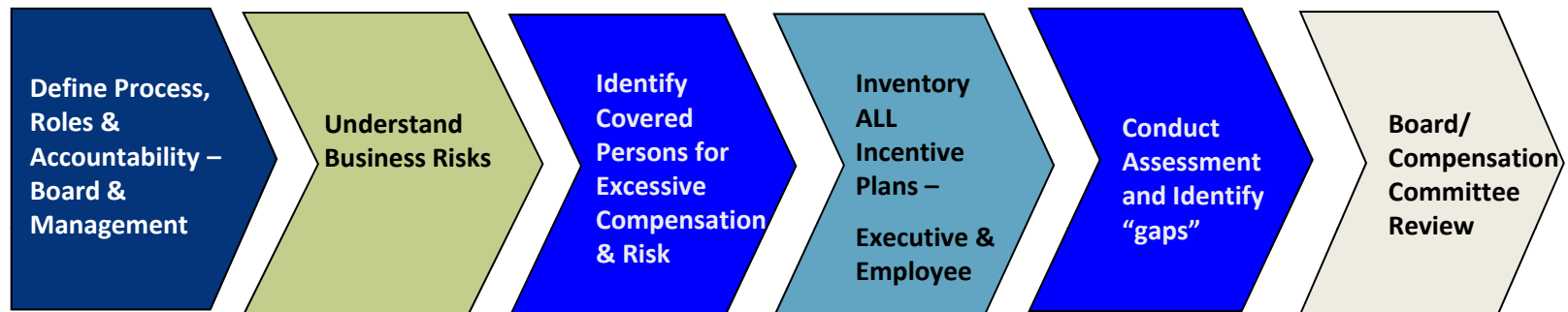
Why is it so important?

- Critical foundation for all programs and decisions
- Overall message to employees, potential employees, regulators, shareholders
- Should be clear and easy to understand and disclose (to regulators and shareholders)
- “Meat” of proxy Compensation Discussion and Analysis (CD&A) and basis for shareholder non binding approval of compensation (i.e. “say on pay” vote)
- Basis for measuring effectiveness of programs

What's in a Compensation Philosophy?

- ✓ Objectives of total program
- ✓ Components
- ✓ Competitive reference/positioning
- ✓ Mix of total compensation
- ✓ Pay for performance approach

Compensation Best Practice #2: Assess Incentive Plans for Risk: Process



Update
Charters and
Governance
Oversight

Coordinate
Committee/
Board
Activities

For Excessive
Compensation:
•Executives
•Employee
•Directors
•Principal Shareholders

For Incentive Risk:
•Executives
•Employees who could
expose CFI to risk
•Groups of employees
who in aggregate could
expose CFI to risk

Ongoing monitoring,
analyses & reporting



Compensation Best Practice #2: Assess Incentive Plans for Risk: Principles



Governance

- Does the bank have the proper board and management resources, skills, experience needed to oversee risk assessment?
- Is there clear understanding of the expanded role of the Compensation Committee and the need to coordinate (e.g. Board, Audit, Risk)?
- What members of management will participate in the risk assessment process (e.g. Audit, Compliance, Risk, Human Resources)?



Policies/Procedures/Controls

- Does the bank have the proper policies, procedures and controls in place to mitigate risk taking?
- Does the bank have the appropriate review procedures, reporting, documentation and approval process?



Incentive Plan Design Features

- Are compensation programs appropriately designed to mitigate inappropriate risk taking?
- Do incentives appropriately consider risks and time horizon over which risks may be realized?

Compensation Best Practice #2: Assess Incentive Plans for Risk

LOWER RISK

HIGHER RISK

MIX

At least half of compensation in base salary

Most of compensation paid based long-term, sustained performance

Majority of compensation in incentive pay

Most of compensation paid based on annual, short-term results

MEASURES

Balance of performance measures:

- Financial, operational, quality
- Short and long-term
- Bank and Individual
- Absolute and relative
- Formula and discretion

1 (or few) performance measures

1 (or few) performance perspectives (e.g. all top line metrics without accounting for quality)

Same performance measures used for short and long-term incentives

DESIGN FEATURES

Cap/maximum payout

Appropriate performance-payout curve

Multi-year performance period (or hold back/deferral if focus on short-term)

Discretion allowed

Claw back

Ownership/holding requirements

No cap/unlimited upside

Threshold/target set too high

Quarterly or single year performance without some focus on longer-term

Formulaic calculation

No claw back

No ownership/holding requirements

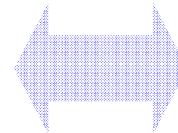
Compensation Best Practice #2: Assess Incentive Plans for Risk

LOWER RISK

HIGHER RISK

GOAL SETTING

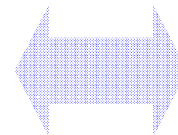
Centralized review process for approving goals
Realistic goals considering historical and projected performance
Performance goals adjusted for risk



Decentralized process for approving goals
Unrealistic goals and/or goals that are not aligned with historical and/or projected performance
Performance goals are not adjusted for risk

CONTROLS AND GOVERNANCE PROTOCOLS

Robust process to review and approve plan designs AND payouts
Compensation Committee/Executive management reviews and approves the range of potential payouts (i.e. scenario test)
Guidelines and approvals are in place for adjusting results as appropriate




No centralized process in place to review and approve plan designs OR payouts
Compensation Committee and/or Executive management do not understand the full range of potential payouts



Compensation Best Practice #2: Assess Incentive Plans for Risk: Questions

- 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% 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, 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?




Compensation Best Practice #3: Long Term Perspective

Why it's important

- Rewards long-term performance and success of institution
- Mitigates risk taking by aligning payouts more closely with time horizon of risk
- Aligns with regulators' interests for holdback/deferral of compensation (i.e. payments made in future)
- Rewards long-term performance and value to shareholders
- Provides means for implementing claw back (if necessary)

Potential Techniques

- ✓ Add long-term component if none exists
- ✓ Ensure a meaningful portion of compensation rewards multi-year performance
- ✓ Holdbacks/deferrals - portion of award is contingent on sustained future performance
- ✓ Risk adjusted performance measures
- ✓ Payment in stock (e.g. pay part (or above target) payouts in stock)
- ✓ Shift overall pay mix toward more long-term
- ✓ Encourage accumulation of and long term stock ownership
- ✓ Retention policies
- ✓ Stock ownership policies
- ✓ Hold to or through retirement
- ✓ Longer vesting periods
- ✓ Clawbacks



Compensation Best Practice #4: Pay-Performance Alignment

- ? How do we define high performance in this environment
- ? What performance measures are most appropriate
- ? How do we reward investments/growth that impact short-term bottom line but are in best interests long term
- ? How do we retain our top performers during challenging times
- ? How do we ensure shareholder and regulator support?

Ten Techniques

1. Ensure measures support strategic goals
2. Incorporate balance of performance measures (profit, operational, risk)
3. Balance short and long-term performance horizon
4. Consider both absolute and relative performance
5. Balance formula and discretion
6. Incorporate Company, Team and Individual performance
7. Provide appropriate leverage (i.e. pay-performance relationship)
8. Model and understand payout opportunities (upside and downside)
9. Ensure reward and retention of high performers (even when Bank-wide plans are not funded)
10. Regularly assess /test pay-performance relationship (annual and over multiple years)



Compensation Best Practice #5: Total/Holistic Approach

Rationale:

- Provides a comprehensive view of possible outcomes and effectiveness of compensation programs
- Component/piecemeal approach can lead you down wrong path
- Helps support decision making and influence programs to ensure they achieve desired outcomes

Best Practice Techniques

- ✓ Tally Sheets – total compensation and benefits paid in given year (annual/static view)
- ✓ Pay Mix - understand mix of pay relative to philosophy and market (e.g. fixed vs. performance; short vs. long-term; cash vs. equity)
- ✓ Pay Opportunity Ranges – model total compensation variation under different performance scenarios and outcomes to assess appropriate payout relationship
- ✓ Realizable pay – understand total compensation actually earned vs. awarded (e.g. stock, performance based pay)
- ✓ Retention – understand what kind of “hook” your programs have for retaining key talent? What do they “give up” if they leave? Is it meaningful?
- ✓ Ownership – do executives have a meaningful level of ownership in the bank?
- ✓ Termination scenarios – what is paid under voluntary/involuntary, change in control, retirement, death, disability?
- ✓ Internal comparisons – are differences between executives appropriate and explainable



Balance is Key

Total compensation program (in aggregate) should embrace/ acknowledge all of these various perspectives





The New World

- Executive pay is under the microscope
 - Regulators, shareholders, media
 - Clearly defined and aligned compensation programs are your best defense
- Increased level of transparency
 - Look through a new set of lenses
 - More sets of eyes on your decisions
- Past is not an indicator of the future
 - Market practice \neq best/emerging practice
 - What was acceptable in the past may not be acceptable in the future
- Change is constant