



American  
Bankers  
Association

# Compensation Committee Briefing and Round Table

Risk, Regulations, Rewards and Your Role

Susan O'Donnell  
Managing Director  
Pearl Meyer & Partners  
[Susan.odonnell@pearlmeyer.com](mailto:Susan.odonnell@pearlmeyer.com)  
(508) 630-1493

[aba.com](http://aba.com) | 1-800-BANKERS





# Outline

- Overview of regulations impacting community bank compensation
- Role of the Compensation Committee and emerging best practices in governance and compensation
- Assessing risk – the who, how and what
- Roundtable/peer break out discussions
- Recap/discussion/Q&A

# Compliance: Increased Oversight of Regulators



- 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




# OVERVIEW OF REGULATIONS IMPACTING COMMUNITY BANK COMPENSATION



# 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 the Board/Compensation Committee’s oversight responsibilities of incentive compensation practices for the entire company (i.e. not just executives)
- *The Dodd-Frank Act adds more ‘teeth’ to the current guidance for banks \$1 billion in assets or more.*

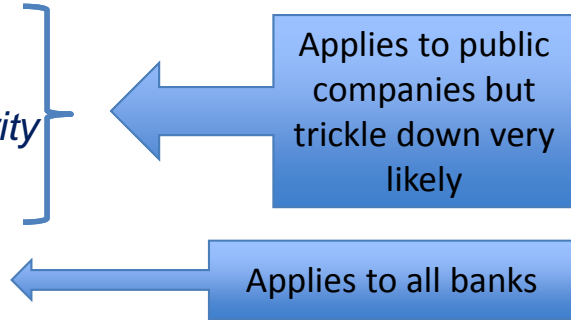
## What Compensation Committee Members Need To Do:

Understand bank’s current incentive plans and identify if any design features, controls or governance changes should be made to support new requirements




# 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

- 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.



# ROLE OF THE COMPENSATION COMMITTEE AND EMERGING BEST PRACTICES



# Implications On Compensation and Governance Practices

Regardless of specific details of various regulatory and legislative requirements, and whether your bank is public or private, several themes emerged:


## GOVERNANCE



- Board accountability, oversight and compliance
- Compensation Committee and Consultant Independence
- Board Leadership Structure (CEO/Chair role)
- Increased Disclosure and Visibility
- Increased Influence of Media/Public/Shareholders

*Increased  
scrutiny,  
disclosure  
and  
regulation*

## COMPENSATION



- Risk Management and Assessment of Pay Programs
- Focus on Long-Term Performance
- Pay for Performance Alignment
- Shifting landscape of best practices



# Governance Best Practices & Expectations

- ❑ Board Accountability
  - Increased disclosure and reporting (regulators and/or shareholders)
  - Regulator and shareholder influence and demands
- ❑ Board/Compensation Committee Oversight
  - Charter updates (new responsibilities; review vs. approve)
  - Board/Committee meetings (frequency, focus)
  - Oversight/review process
  - Executive sessions
  - Compliance
- ❑ Independence Requirements /Expectations
  - Audit Committee
  - Compensation Committee
  - Committee Advisors
  - Risk Staff

- ❑ Board leadership structure (e.g. Chair role)
  - Disclosure for public banks
  - Independent Chair of Board (or Lead Director)
- ❑ Knowledge, Skills, Experience
  - Increased disclosure on Board member experience/skills
  - Specialized skill/experience requirements for certain committee roles (e.g. compensation, finance, risk experts)
  - Education on emerging and best practices
- ❑ Communication
  - Management
  - Board
  - Regulators
  - Shareholders



# Compensation Best Practices

- ❑ Clearly Defined Compensation Philosophy
  - Communicates to regulators, shareholders, employees, candidates
  - Foundation assessing effectiveness of programs (annual “testing”)
- ❑ Risk Balanced Incentives
  - Match performance timeframe to reward timeframe
  - Incorporate risk/safety and soundness
  - Ensure balance:
    - Short and long-term focus
    - Quantitative and discretionary
    - Absolute and relative metrics
- ❑ Pay-performance alignment
  - Measures should support strategic plan
  - Understand payout opportunity range
  - Model/test alignment (1 year, 3 year, 5 year)
- ❑ Total/Holistic Approach
  - What is the “total”?
  - What is the “mix” of compensation?
  - What is the impact of pay decisions?
  - Tally Sheets: Multiple levels: (sum of parts; opportunity; realizable pay; ownership; retention; termination)
- ❑ Long-Term Focus
  - Supports safety and soundness considerations; stronger risk management design feature and enhanced alignment with shareholders
  - Potential techniques:
    - long-term incentives (cash or stock)
    - multiple year performance period
    - longer vesting
    - deferring compensation
    - greater focus on equity
    - payment of compensation in stock
- ❑ Scrutiny of executive benefits and perquisites
  - Not performance based
  - Termination/severance benefits and excessive perquisites
- ❑ Emerging best practice policies
  - Clawbacks
  - Ownership guidelines
  - Retention policies
  - Holdbacks/deferrals

# Balance is KEY

- Risk Management is better managed through balance
- Pay for Performance is better achieved through balance
- Total compensation program (in aggregate) should embrace/acknowledge all of these various perspectives (not all in one program)

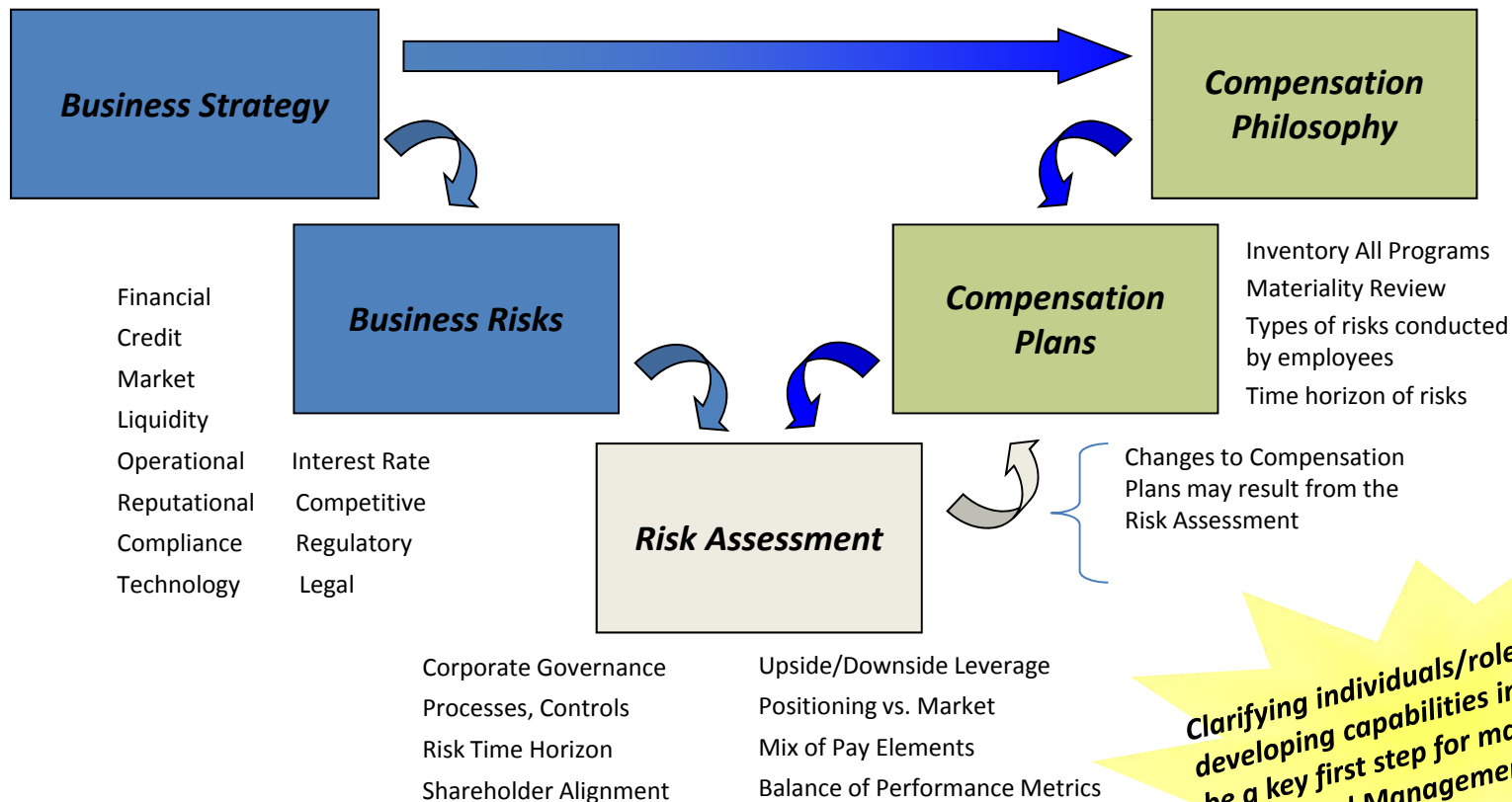




# ASSESSING RISK – THE WHO, HOW AND WHAT

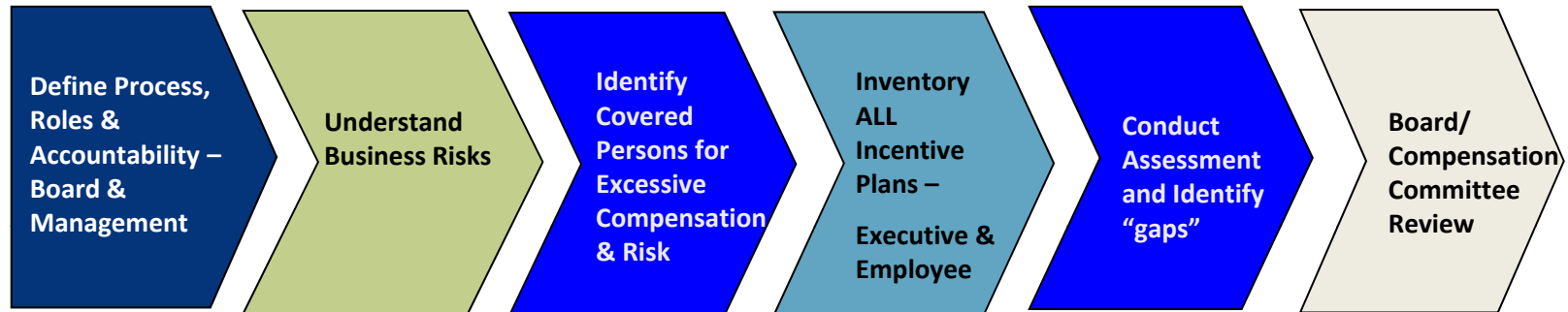
# How to Assess Compensation Risk

- Assessing business risk has always been a key responsibility of banks
- What's new is taking a further step to ensure compensation practices do not encourage risk taking
- New roles, responsibilities, accountabilities and processes are required



**Clarifying individuals/roles and developing capabilities in this area will be a key first step for many banks (Board and Management)**

# The Risk Assessment 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 Committee Role – Risk Assessment Check List

- ✓ Establish/confirm governance process around risk management
- ✓ Understand key risks that could threaten the Company
- ✓ Understand who meets the definition of “covered employees” (i.e. who has potential – individually or in aggregate – to expose the institution to material loss?)
- ✓ Receive inventory of incentive compensation arrangements impacting covered employees
- ✓ Review data and analysis provided by management summarizing the design features and controls that mitigate risk taking
- ✓ Review and approve goal setting and payment approval procedures for all covered employees
- ✓ Approve compensation arrangements for senior executives
- ✓ Interact with management (e.g. risk, audit, human resources, finance) and other board committees (e.g. risk, audit) to ensure proper information sharing to fulfill its risk monitoring role
- ✓ Monitor ongoing assessments and regulatory compliance, including reports to regulators and disclosure in the proxy statement (if applicable)
- ✓ Support/reinforce a culture of risk management through sound governance oversight

# What To Look For? Risk Mitigating Strategies and “Irritants”

## 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

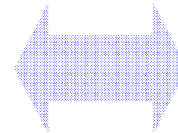
# What To Look For? Risk Mitigating Strategies and “Irritants”

## LOWER RISK

## HIGHER RISK

### GOAL SETTING

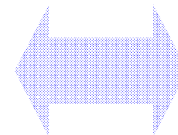
Centralized review process for approving goals  
Realistic goals considering historical and projected performance  
Performance goals adjusted for risk



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



# Questions to Ask

- 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?



# APPENDIX

## Timeline of Dodd Frank Act Implementation

# 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



# ROUND TABLE/PEER DISCUSSIONS



# Break Into Roundtable/Peer Groups

- Public banks vs. private/mutual; size (secondary)
- Each group will consider one topic area from below
- 10 – 15 minute discussion
- Report back/Q&A with group
- Topics:
  - A. Governance: How does/will your board address independence issues (chair role, committee membership, advisors – internal and external)?
  - B. Risk Management: Who is responsible for risk management at your bank? How is/will incentive risk reviews be conducted? Who will be involved from management? How will the Compensation Committee work with management and other Board Committees to ensure proper oversight?
  - C. Incentive Risk Strategies: What plan design features does your bank use to mitigate risk? What policies/controls are in place to limit the potential for risk? What areas do you see for improvement (i.e. risk mitigating strategies)?