



Bank Director Assembly

Executive Compensation: A New Day in Director Oversight

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A Year Ago We Asked.... How Will TARP Affect Bank Compensation?

- **Trickle down very likely, particularly in areas of:**
 - Process and requirements to assess “risk” in compensation programs
 - Clawbacks on incentives
 - Severance and parachute payments (280g)
 - “Say on pay”
- **What this could mean:**
 - Strong likelihood of greater regulation of executive compensation going forward
 - Changing executive compensation practices
 - Pressure to balance pay for performance with less “risky” incentives
 - Overall more investor influence (including government as investor)
 - Compensation committee workload increase as result of new compliance and changing landscape
- **Exact nature of changes will be shaped in part by Obama administration**



Well, it happened. In spades...

Recent Influences On Executive Pay & Governance

<p>Economic and Financial Crisis Continues Fall 08 – current</p>	<ul style="list-style-type: none"> ■ Financial industry in headlines ■ Compensation practices to blame ■ Increased number of bank failures ■ Public perception and media scrutiny
<p>Treasury/CPP/TARP Fall 08 – current</p>	<ul style="list-style-type: none"> ■ Executive compensation restrictions and compliance ■ Governance/Compensation Committee requirements (independence, risk review)
<p>Obama Administration June 09</p>	<ul style="list-style-type: none"> ■ Broad principles (risk, pay for performance, SERPS/golden parachutes) ■ Say on Pay (non binding shareholder vote) ■ Compensation Committee independence/consultant independence
<p>SEC New Disclosure Rules New leadership (Mary Shapiro) 2009</p>	<ul style="list-style-type: none"> ■ Disclosure Rules (including: risk discussion, director/nominee experience and qualifications, CEO/Chair role, shareholder voting results, proxy solicitation process, proxy tables, compensation consultant relationship)
<p>Congress About a dozen bills – One passed by the House</p>	<ul style="list-style-type: none"> ■ Shareholder vote ■ Committee independence standards ■ Risk assessment for financial institutions
<p>Bank Regulators - FRB and FDIC October 09 and January 10</p>	<ul style="list-style-type: none"> ■ Proposed guidelines for linking risk assessment and compensation ■ Role of Board/Compensation Committee
<p>Shareholder Activism Ongoing</p>	<ul style="list-style-type: none"> ■ Increased proposals related to executive compensation and board governance ■ Advisory votes on pay ■ Withhold votes on directors ■ Independent board chairs
<p>Shareholder Advisory Firms (e.g. RMG, Glass Lewis) Ongoing</p>	<ul style="list-style-type: none"> ■ Increased influence and power to drive shareholder votes (stock plans, say on pay) ■ RMG new 2010 guidelines

■ Common Provisions in Proposed Legislation

- **Say on pay**
 - Non-binding
 - Has been shown to change behavior in Canada
 - Will require public companies to have more dialogue with their shareholders regarding pay
- **Disclosure and shareholder approval of golden parachutes**
 - Separate non-binding vote
- **Separation of CEO and Chairman roles**
- **Clawbacks**
 - Triggered by financial restatement, current or former executive officers would be required to pay back all incentive-based compensation (including gains from stock options) for the period preceding restatement in excess what would have been paid
- **Independent compensation committee**
- **Risk assessments**
- **Disclosure regarding hedging**

■ In Summary – Core Governance Principles

Governance “Best” Practices Will Embrace Increased:

- **Board Accountability**
 - Increased disclosure
 - Shareholder influence and demands
 - Board oversight responsibilities (e.g. compensation risk assessment - all employees)
 - Board leadership structure (e.g. Chair role)
- **Independence Standards – More than just a Definition; It’s a “Mindset”**
 - Compensation committee
 - Compensation consultant
 - Risk staff
- **Knowledge, Skills, Experience**
 - Increased focus on Board member experience/skills
 - Education on emerging and best practices
- **Communication**
 - Management – Board – Shareholders
- **Processes and Oversight**
 - Board/committee meetings
 - Oversight/review processes
 - Compliance

■ In Summary – Core Compensation Principles

Compensation “Best” Practices Should Embrace:

- **Risk Assessment**
 - Ensure compensation programs do not motivate unnecessary or excessive risk taking (all employees, not just executives)
 - Implement governance protocols, process controls and design features to mitigate risk taking
- **Long-Term Horizon of Performance and Rewards**
 - Rewards based on the long-term value and soundness of the institution
 - Review mix, leverage and design features to ensure a long-term view of performance
- **Pay for Performance**
 - Ultimately ensure pay and performance are aligned
 - Use appropriate balance of performance measures
 - Reward short and long-term performance in appropriate balance
- **Limited Focus on Perquisites and Benefits**

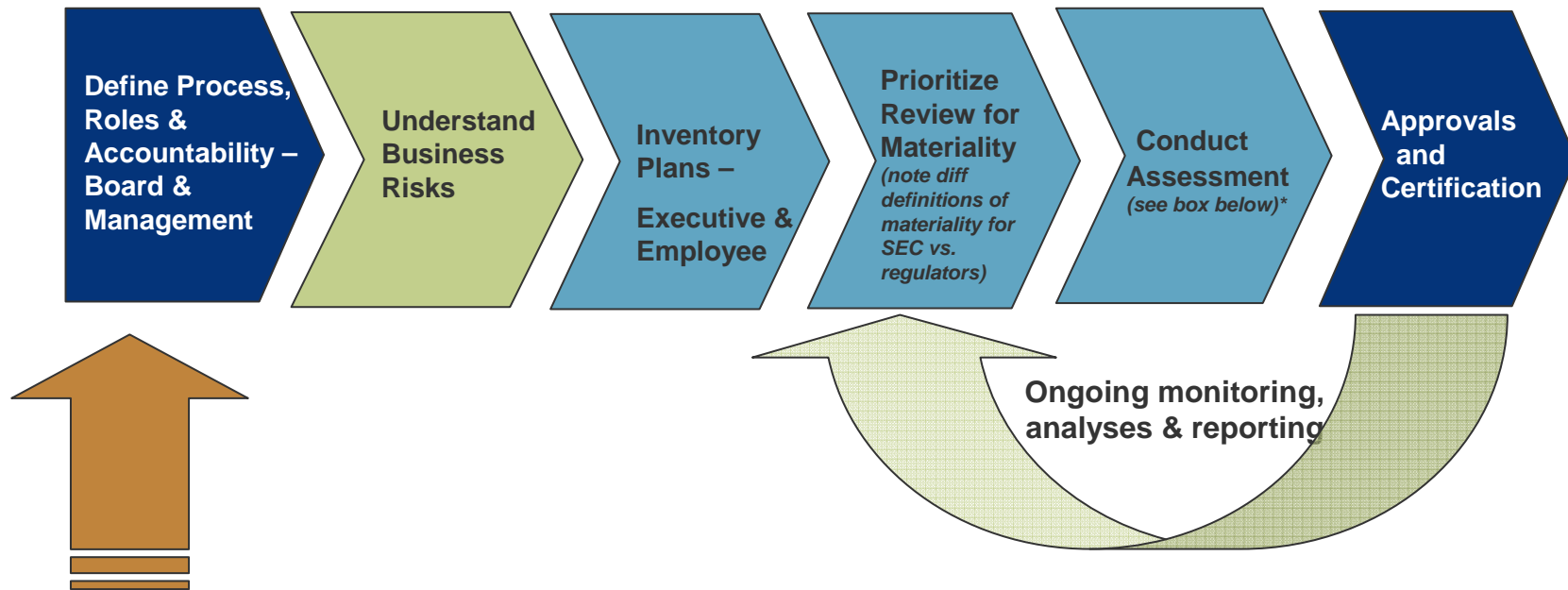


Unnecessary and excessive risk can be hard to define like Justice Potter Stewart's explanation of obscenity "I know it when I see it..."

■ The Process – Charting New Ground

Who Should Conduct an Assessment?	Team Structure
<ul style="list-style-type: none"> ■ Objective parties ■ Small group of experts ■ Individuals with a company-wide view ■ Advisors with an external market view 	<ul style="list-style-type: none"> ■ Senior Risk Officer (SRO) ■ Support from HR, Internal Audit, Legal, Advisors ■ Report to Compensation Committee ■ Coordinate with Audit/Risk/Investment Committees
Who Should Not Be Involved?	Considerations
<ul style="list-style-type: none"> ■ Interested parties ■ Large management team ■ Individuals with a narrow focus 	<ul style="list-style-type: none"> ■ CEO & CFO may lead compliance, but should not review their own compensation and performance ■ Specialist may provide insights on key risks, but may not have the depth to recognize risk interactions
Frequency/Timeframe	Scope
<ul style="list-style-type: none"> ■ First time process ■ Annual reviews thereafter ■ Semiannual reviews for TARP participants ■ Follow-up on specific items during the year 	<ul style="list-style-type: none"> ■ Review of business risk ■ Review of incentive/compensation risk ■ Stress test based on positive and negative outliers ■ Identify areas for change and follow-up

Assessing Compensation Risk – An Example Process



START
NOW

* Conducting the Assessment:

- ✓ Review risks resulting from employee function/role
- ✓ Understand the time horizon over which risks may be realized
- ✓ Assess controls, processes, policies, governance practices and plan design features that may lead to increased risk taking or mitigate risk taking
- ✓ Identify changes to policies, controls, incentive plans as appropriate

■ Compensation Risk Scorecard (partial example)

Risk Factor	Specific Parameters	Effectiveness Rating				
		1	2	3	4	5
Performance Metrics	Incentive plan metrics are selected in the context of the Company's business strategy, goals and key risks					
	There is a balanced "portfolio" of performance measures across short- and long-term incentive plans					
	No one performance measure receives too much weight/impact toward incentive payout					
	...					
Quality of Goal Setting	Target performance levels represent reasonable variation relative to historical performance and investment analyst forecasts					
	The probability of payout at threshold, target and stretch is understood and reasonable					
	Over time, historical payouts track with stock price					
	...					
Pay Mix and Balance	The overall pay mix reflects desired philosophy and objectives					
	There is appropriate balance between short- and long-term performance					
	There is appropriate balance between cash and equity compensation					
					

■ Compensation Risk Scorecard (partial example)

Risk Factor	Specific Parameters	Effectiveness Rating				
		1	2	3	4	5
Leverage	The full range of total compensation opportunity for low and high performance is known and appropriate (Dynamic Pay Modeling)					
	Incentive plans do not provide for uncapped upside (or controls are in place to manage extraordinary windfalls)					
	Changes in performance result in appropriate changes in payout (i.e. curve)					
	...					
External Reference	The compensation peer group is based on companies similar in size and other key parameters					
	Compensation practices are in line with industry/peer practice					
	Company performance explains any pay variation from market practice					
	...					
Checks and Balances	The company has an audit process for determining incentive plan payouts					
	The company has a defined clawback policy					
	The company has stock ownership/retention guidelines					
					
Other	The Company has formal governance practices related to CEO performance					
					

Assessing Incentive Design Features - EXAMPLES

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:

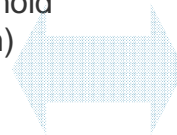
- Financial, operational, quality
- Short and long-term
- Bank and Individual
- Absolute and relative
- Formula and discretion



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
 Clawback
 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 clawback
 No ownership/holding requirements

■ Acceptable Risk-Reward Relationships

Typically Acceptable:

- Defined range of incentive awards (e.g. 50% - 150% of target)
- Majority of incentive compensation weighted toward long-term performance (e.g. multi-year performance periods)
- Deferral of incentive award to align with time horizon of risk (e.g. loan production incentive with hold back for loan quality)
- Long-term incentive/equity vesting schedules that are three years or more
- Meaningful stock ownership and retention guidelines (hold til/past retirement)

May Be Questionable:

- Short-term incentive based solely on Net Income (or ROA, ROE....)
- Both short and long-term incentive plan based on Net Income (or ROA, ROE....)
- Uncapped or upside awards >200%
- Guaranteed minimum payouts
- Quarterly bonus payments without “true-up” if full year results fall short
- Immediate (or quick) vesting of equity-based incentives
- Mega grants

■ Assessing Incentive Design Features - EXAMPLES

- **An incentive plan where EPS is the sole measure and no payout will occur if the target is not hit.**

Implication

- All-or-nothing approach on a measure that already has enormous pressure, especially if the Street watches the stock

Potential Fixes

- Implementation of payouts below the target – e.g., some payout for 90% of EPS performance
- Additional measures that would counterbalance the EPS goal such as asset quality

Other Short-term Incentive Techniques

- Holdbacks/deferrals – portion of annual award contingent on sustained future performance
- Payment in stock – pay part (or above target) payouts in stock
- Shifting mix to long-term (can be cash for mutuals/private banks)

■ Assessing Incentive Design Features - EXAMPLES

- **Stock option awards where the executive team already has a significant number of options underwater**

Implication

- Executives need to hit a home run in order to see any reward from their long-term incentives

Potential Fixes

- Use restricted stock or units and vest them based on operational measures or time vest.

Other Long-term Incentive Techniques

- Extended vesting of awards (i.e. vesting of restricted stock)
- Stock ownership and retention guidelines
- Hold until or past retirement requirements

Assessing Incentive Design Features - EXAMPLES

Desired objectives will drive the LTI approach(es) you choose



- Some instruments are better at meeting certain objectives than others.
- One equity instrument alone is not likely to achieve all four objectives.
- Phantom/cash versions are possible
- BALANCE is key.

■ Assessing Incentive Design Features - EXAMPLES

- **Producers are compensated based on the number of transactions without a qualitative requirement**

Implication

- No measurement of whether the transactions created profit for the institution

Potential Fixes

- Add quality measures or if approval is separated from the producer, only pay for approved transactions
- Holdback a portion of the incentive until quality can be known
- Consider risk horizon and timeframe of results/rewards
 - » If results not known for several years – timing for reward should not be based on one year
- Place more focus on longer term, sustainable performance
 - » Adjust the “mix” of total compensation to focus more on long-term performance; enhance long-term incentive timeframes/vesting
- Ensure reward periods match the timeframe required to determine whether a decision/action was successful
 - » If not, change design features to allow for better alignment

■ Incentive Compensation Risk – Key Questions

- Do incentive plan metrics reflect the company's business strategy?
- Is there an appropriate balance and mix of performance metrics?
- Is the leverage (upside and downside) appropriate?
- How much focus is placed on short-term performance? Is it appropriately reflecting the time horizon of the risk taken?
- Is there appropriate focus on long-term performance? How is long-term defined?
- 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?
- Do the payouts align with shareholder interests?
- Do executives hold an appropriate amount of pay in stock (i.e. aligned with shareholders)?
- Do the payouts align with market practice?

■ Risk Assessment

“Risk comes from not knowing what you're doing.”

-- Warren Buffett

■ Ensure Pay for Performance

- **Ensuring PFP is a complex balancing act:**
 - Economic environment
 - Influences out of control of management (e.g. stock price, rates)
 - Optics and perceptions - media/public/shareholders
 - Disclosure limitations
 - Regulatory mandates
 - Piecemeal view
 - Contradicts risk mitigation (i.e. no risk pay is the opposite of pay for performance!)
- **BALANCE is the key to effective pay for performance**
 - Short-term and long-term
 - Absolute and relative
 - Financial, operational, strategic
 - Bank, team and individual
 - Formula and discretionary
 - You want ALL of these in aggregate – not in each plan
- **Review performance in aggregate and over a longer period of time – stress test and understand potential range of outcomes for performance and pay**

■ Best Practice Solutions

■ Clarify Objectives

- Different goals drive different approaches
- Align with total compensation philosophy
- Ensure “total”/holistic view of compensation
 - » Coordinate with short-term incentives
- Test: What is the “message” of your LTI and total compensation programs?

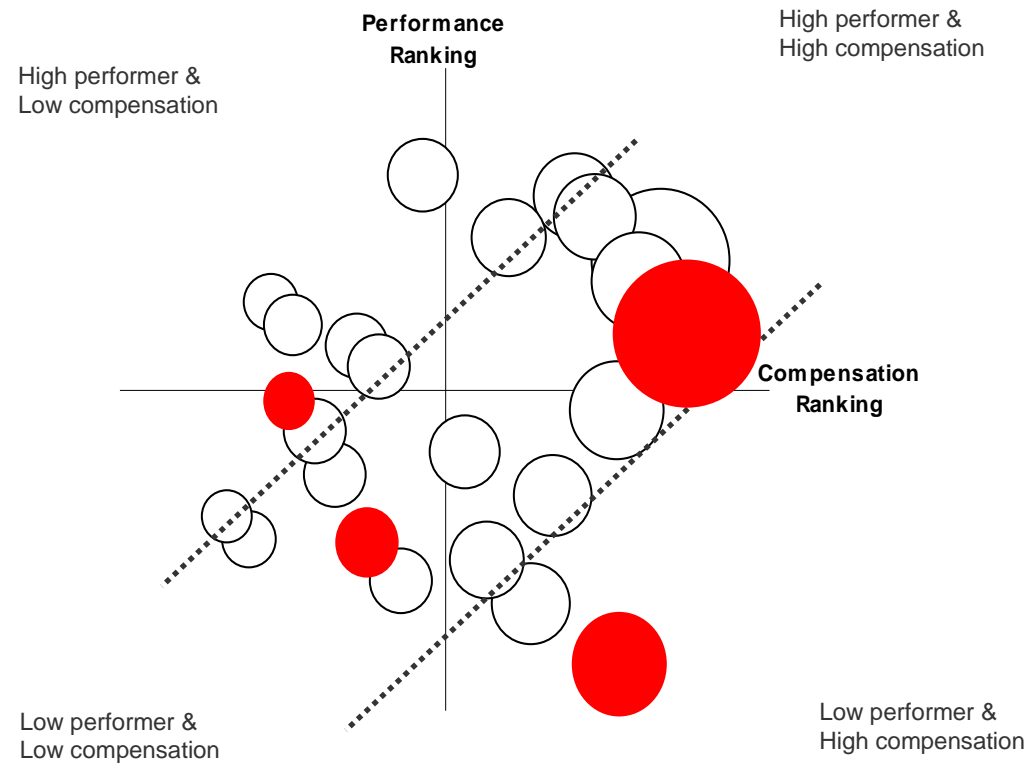
■ Ensure “Balance”

Balance Elements	Short Term Incentive Plan	Long-Term Incentive Plan
Short vs. Long-Term Perspective	Short Term Perspective	Long-Term Perspective
Bank/Team vs. Individual Performance	Bank/Team and Individual Performance	Bank Performance
Absolute vs. Relative Performance	Absolute Performance (i.e. budget/strategic plan)	Relative Performance (industry/peers)
Objective/Formulaic vs. Discretionary	Combination	Objective/Formulaic
“Look Back” vs. “Look Forward”	“Look Back”	Traditionally “Look Back” Emerging focus on “Look Forward” (i.e. performance vesting)

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■ An Example Alignment Test – Where is Your Bank?

CEO Total Direct Compensation Relative to 3-Year TSR
An Illustration – Can be any measure; any peer group



■ Say On Pay

“A public-opinion poll is no substitute for thought.”

–Warren Buffett

■ What Banks Should Do Now

✓ Stay Informed

- The best starting point is education and information; understand what may be coming, implications and what changes may be appropriate going forward

✓ Develop Processes, Define Roles

- Establish process for assessing incentive plan risk and ongoing reviews/compliance
- Review governance practices in light of pending legislation (independence, process, disclosure)
- Clarify roles of management, Compensation Committee, Board

✓ Review Compensation Program and Incentive Plans

- Review total compensation programs and incentive plans in particular to ensure they do not motivate and reward inappropriate risk taking
- Ensure compensation focuses on driving sustained, long-term performance that supports your unique business goals and strategies
- Ensure performance is measured using a balanced portfolio of performance measures
- Ensure total compensation program is clearly aligned with both company business strategy and interests of shareholders

✓ Prepare for Future – Disclosure and Regulatory Reviews

- Evaluate proxy statement and CD&A to assess areas where additional/better/different disclosure may be required
- Prepare for enhanced risk assessment as part of banking regulatory review process