

Compensation and Governance Best Practices of Financial Institutions Post-Dodd-Frank

By Susan O'Donnell

A combination of regulatory, legislative and investor activism, accelerated by the prolonged economic downturn, has had unprecedented influence on pay programs and governance at financial institutions. Many practices considered typical or "normal" a few years ago are more likely to be perceived as potentially risky or not sufficiently shareholder friendly in today's environment. What historically had been internal Board and management deliberations about the details of executive pay programs are now subject to additional disclosure and scrutiny by regulators, investors, media and public. Compensation practices today must be reviewed through a new set of lenses and under an entirely different set of perceptions and rules. Moreover, with the banking industry having been most in the spotlight during the financial crisis, expectations are particularly high.

Recent Events and Influences

To understand current expectations around compensation, it is helpful to recognize the events and key players that have driven these monumental changes. Following is a high-level chronology of recent events that have defined the new rules under which financial institutions must play.

AUGUST 2006

The SEC releases a sweeping update of disclosure requirements for executive and Director compensation for public company proxy statements and other securities filings – the Commission's first significant update in decades. Among other changes, the new rules significantly expand the reporting of practices and policies related to stock option grants – a reaction to controversy at the time over the timing and pricing of some large executive grants. The new rules also affect related party transactions, Board independence, and stock ownership by Directors and officers.

OCTOBER 2007

The SEC communicates its dissatisfaction with the level of compliance following an evaluation of the first proxy season conducted under the new rules, citing instances where companies failed to adequately explain the "why" of compensation outcomes. Among the problematical areas cited:

- Excessive discussion of pay program mechanics and Board voting procedures
- Overuse of boilerplate and technical language, rather than specific analyses of how pay and performance were determined.
- Inadequate explanations of significant differences in pay levels or programs among named executive officers (NEOs).
- A lack of clarity around how quantitative and/or qualitative performance metrics were linked to actual payouts.

DECEMBER 2007	The IRS unveils its own major changes to reporting standards for non-profit organizations, paralleling the SEC's public company goal of increasing transparency around executive pay.
MARCH 2008	The IRS announces that executive awards accelerated following an involuntary termination will no longer be considered tax-deductible compensation under Section 162(m).
OCTOBER 2008	The Emergency Economic Stabilization Act of 2008 (EESA) creates three new Treasury programs to address problems with the financial and credit markets, each with slightly different restrictions on executive pay at participating organizations.
FEBRUARY 2009	Outrage over Wall Street bonuses prompts Treasury to impose further limits on executive pay through the new Generally Available Capital Access Program (GACAP) for healthy companies and the Exceptional Financial Recovery Assistance Program (EFRAP) for institutions needing "exceptional assistance." Treasury suggests Congress is likely to legislate some similar pay limits for all public companies.
JUNE 2009	The Obama Administration outlines broad-based compensation best practices, laying the groundwork for mandatory Say on Pay advisory votes and new standards for Compensation Committee independence.
NOVEMBER 2009	The Federal Reserve proposes regulations to increase its oversight of incentive compensation practice and prompts a "horizontal review" of the 28 largest banking organizations.
DECEMBER 2009	The SEC makes several meaningful and practical tweaks to its new disclosure rules, expanding requirements in several key areas including compensation-related risk oversight, the use of compensation consultants, and Board leadership.
JUNE 2010	Banking regulators (FRB, FDIC, OCC, OTS) come together to issue Agency Guidance requiring all financial institutions to assess and adjust incentive compensation arrangements to ensure they do not motivate inappropriate risk taking.
JULY 2010	Congress passes the Dodd-Frank Wall Street Reform and Consumer Protection Act, culminating years of Congressional and Senate bills related to executive compensation and corporate governance practices. Coming in at more than 2,000 pages, the Act institutes a broad array of new regulations on executive pay at financial institutions, although most provisions apply only to public companies and only one provision applies to all banks. The SEC is directed to issue detailed rules.
FEBRUARY 2011	FDIC approves proposed rules to more closely regulate the use of incentive compensation arrangements (ICAs) for executives and other covered employees of financial institutions. The new regulations create a framework for implementing and enforcing Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Below is a brief summary of the compensation and governance provisions in the Dodd-Frank Act and their likely impact:

Dodd-Frank Requirement	What It Means for Banks
Shareholder Advisory Votes (i.e. Say on Pay, Say on Frequency of Pay, Say on Golden Parachutes)	Shareholders at public companies are given a non-binding vote on executive compensation practices, on the frequency of the Say on Pay votes (annual, biannual, triennially or abstain), and on golden parachute payments following a merger or acquisition.
Proxy Access	Significant shareholders can use company proxy solicitation materials to nominate their own director candidates.
No Broker Vote	Brokers may not vote without customer instruction on certain compensation-related proxy issues, including Say on Pay.
Clawback Policies	Requires companies to maintain and disclose their policies for recouping executive payments in the event of a financial restatement.
Independence Standards for Compensation Committees and Advisors	Requires Compensation Committee members and their advisors to meet defined standards for independence. Companies in violation will risk delisting from the Exchanges.
Additional Disclosures Required	<ul style="list-style-type: none"> • Rationale of the structure and role of the Chairman of the Board • Relationship between pay and performance • Internal equity relationships (i.e. CEO compensation compared to the median employee) • Policies on hedging of company securities
Special Rules for Financial Institutions	Expands regulation of compensation arrangements that may encourage inappropriate risk-taking.

Emerging Best Practices

The remainder of this paper discusses emerging best practices in five critical areas. Banks that focus on improving processes in these areas should be well positioned to meet regulatory requirements and ensure sound pay and governance practices:

- Incentive Plan Design and Mitigating Risk
- Long-Term Performance Perspective
- Pay-for-Performance Alignment
- Shareholder Influences
- Increased Disclosure Requirements

Best Practice Area #1: Incentive Plan Design – Mitigating Risk

Banks have always been in the business of assessing and managing risk, as has the development of compensation programs that effectively drive and reward performance. What's new is the requirement that organizations assess and ensure that those compensation programs do not unintentionally encourage employees to take inappropriate risks.

While the majority of U.S. banks were not part of the financial crisis and don't utilize the complex and highly leveraged pay programs that were to blame for the financial crisis, nevertheless, all banks must now formally assess, monitor and disclose how they ensure their incentive programs do not reward inappropriate risk-taking. They also must be prepared to respond to more detailed questions asked by their regulator(s) about internal processes, controls, governance practices and incentive plan designs. While the regulations take the size and complexity of the institution into account in determining the amount of rigor and assessment required, all institutions must be prepared to rationalize their practices. That said, a large institution with 75 incentive plans will undergo more comprehensive and sophisticated analyses than a smaller community bank with only two incentive programs.

The risk review needs to be conducted relative to three guiding principles set forth by the regulators that require banks to assess the following:

- 1. Plan Design Features that Mitigate Risk** – Incentives must consider the full range of potential risks, the time horizon of risk, and the design features that are used to mitigate risk.
- 2. Controls and Risk Management Practices** – Strong controls, documentation, review and approval procedures must be in place.
- 3. Corporate Governance Practices** – Boards of Directors must have appropriate access to internal and external resources and be actively involved in the review and monitoring of incentive arrangements.

So what exactly constitutes "risky" practices or the potential for motivating risk-taking? Following is an abbreviated summary of a check list of potentially problematical practices and design features. Where appropriate, banks may be expected to adopt additional or alternative design features, or introduce more rigorous processes/controls/governance to better control the level of risk.

Feature	Features with Potentially Higher Risk
Total Compensation Mix	<ul style="list-style-type: none"> ✓ A significant portion of total compensation is based on incentive pay (e.g. greater than 75%) ✓ A significant portion of compensation rewards based on annual or quarterly performance ✓ Incentive plan award targets are significantly larger than market practice
Performance Metrics	<ul style="list-style-type: none"> ✓ Single (or too few) performance measures ✓ Excessive or sole focus on top-line metrics ✓ Lack of risk balanced performance measures ✓ The use of the same metrics for both short- and long-term incentives
Payout Curve; Leverage	<ul style="list-style-type: none"> ✓ An abnormally large payout range (e.g. more than 300% of maximum payout) ✓ High upside reward with little downside risk ✓ No award cap ✓ Small changes in performance that result in significantly larger payout (e.g. tiered payout curve) ✓ “All or nothing” payouts for a single metric or the entire plan
Pay-Performance Alignment Pay-Risk Alignment	<ul style="list-style-type: none"> ✓ A performance period that is shorter than the risk horizon for the risk taken ✓ All rewards based on one-year performance ✓ The use of only absolute goals, without any consideration of relative performance (e.g. to industry) or vice versa ✓ Misalignment between the time period of the reward and when actual performance is known ✓ Lack of long-term or deferral features needed to ensure time horizon of risk and reward ✓ No projection of the full range of possible payouts under different performance and risk scenarios
Goal Setting and Award Payouts	<ul style="list-style-type: none"> ✓ No process or centralized review body for approving goals ✓ Goals that are unrealistic or not aligned with historical and/or projected performance ✓ Performance goals that fail to account or adjust for risk ✓ No oversight or review of incentive payouts by independent parties
Controls and Governance	<ul style="list-style-type: none"> ✓ Inadequate internal resources for independent risk oversight ✓ Compensation Committee and/or Board lack independent internal and/or external resources needed to support oversight ✓ Payment for risk control functions that do not avoid potential conflict of interest ✓ Absent or inadequate process to monitor and modify plans as appropriate ✓ Incentive plans developed without oversight and review by independent parties ✓ No oversight or approval of incentives and control processes by the Compensation Committee or Board ✓ Lack of monitoring or understanding of potential and actual payouts by the Board/Management ✓ No clawback provisions or process to monitor clawbacks ✓ Inadequate disclosure to shareholders and regulators receive of incentive compensation arrangements

Best Practice Area #2: Long-Term Perspective

With the increased focus on the time horizon of risk and reward, it comes as no surprise that there is much greater emphasis today on long-term rewards, a bank with only an annual incentive plan or one that puts too much focus on short-term results may be perceived as more risky. Alternatively, including long-term incentives (or long-term features) as part of the total compensation package promotes several objectives:

- Focuses employees on multi-year, sustained performance
- Mitigates the potential for excessive risk-taking by reducing emphasis on short-term results
- Provides a more balanced view of performance

There are several emerging techniques being used by banks to incorporate a long-term perspective in their compensation programs. However, the use of any particular program always should be assessed in light of the company's own compensation philosophy and strategic objectives.

Potential Techniques for Supporting a Long-Term Performance Perspective
✓ Add a long-term incentive if none exists (equity for public companies; phantom/long-term cash if not public)
✓ Ensure a meaningful portion of compensation rewards multi-year performance
✓ Holdback/deferrals – Defer a portion of an award or hold a portion of payouts contingent on sustained future performance
✓ Payment in stock – Provide part of annual incentive payouts (e.g. the above-target value portion) in equity
✓ Shift the overall pay mix toward long-term results by putting more incentive opportunity in long-term vs. short term incentives
✓ Encourage long-term stock ownership through: <ul style="list-style-type: none">• Stock ownership policies for executives and Board members – Such programs are becoming mainstream and are expected by regulators and shareholders. Ownership typically is defined as a multiple of base salary (or the annual retainer for Directors) that must be accumulated within a certain period (typically about 5 years).• Retention policies – Require executives to retain all or a portion of awards granted or exercised for a stated period of time (e.g. until/past retirement).• Holding requirement – Prohibit executives/Directors from selling shares for a period after vesting or option exercise. This approach is increasingly popular as a way to comply with clawback requirements.
✓ Extend vesting – Required a longer vesting period, or shorter vesting with subsequent retention of shares

Best Practice Area #3: Pay-for-Performance Alignment

This has always been a hot area for the media, regulators and shareholders and will be even more so in the wake of Dodd-Frank. Increased shareholder influence on compensation practices means banks must be attentive to demonstrating a meaningful alignment between pay and performance and this will require more in-depth analyses for many organizations going forward. Additionally, companies must more clearly and effectively discuss the rationale and the results of their pay decisions in their disclosures to shareholders and regulators.

Analyzing the pay-performance relationships is more challenging than it seems, given external influences, disclosure limitations and perspectives. For example:

- **The economy** – During periods of economic downturn, even strong companies are hurt by a depressed market and pay-for-performance comes under greater scrutiny. Balancing the need to reward talented executives and employees, while ensuring alignment with shareholder perceptions, becomes more challenging.
- **Optics and perceptions** – The media and public tend to selectively report on certain aspects of compensation packages. Such a piecemeal view, without the benefit of providing the context of the entire program, can create a misleading or distorted view of pay.
- **Disclosure limitations** – The numbers presented in proxy tables do not necessarily reflect the real value to the executive that is ultimately based on performance. For example, stock option grants have no value unless and until the underlying stock price increases. So while a company may disclose an option grant of \$100,000, the value the executive will receive can range from zero to something much larger than the grant value, depending on stock price. The same is true of performance share awards that grant stock based on the achievement of specific performance goals. Unless certain performance goals are achieved, the awards are forfeited.
- **Regulatory mandates** – If regulators begin to prescribe certain types of designs, we run the risk of limiting the creativity and flexibility many banks should have for developing programs that best align with their philosophy and resulting performance.
- **Government mandated restrictions** – TARP participants, for example, were not permitted to have performance-based pay programs while they were receiving government funds.

What can banks do to ensure a meaningful pay-performance alignment?

One key to performance-based pay is ensuring the overall compensation program embraces balance. Not only does a balanced program enhance a sound pay-performance relationship, it also promotes appropriate risk management.

A well-balanced total compensation program should embrace all of the features below in some manner:

- Reflect both short- and long-term performance
- Consider both absolute (targeted) and relative (compared to peers/industry) performance
- Include a balanced portfolio of performance measures (e.g. financial, operational, strategic, risk)
- Consider company, team/division/function and individual performance
- Balance formulaic and qualitative performance metrics

A second key requirement to ensuring an effective pay-performance relationship is to actually model and monitor the relationship. This is an area where many banks fall short.

By conducting certain scenario analyses companies can be proactive in both the design of programs and showing the rationale for rewards that result from these programs. While not common practice, we suggest all organizations ask themselves the following questions:

- Do we understand the complete range of compensation that would result from our programs in aggregate under various performance scenarios?
 - What are the potential upside/downside values if both short- and long-term incentive plans pay out at threshold and max performance?
 - What might be the total realized value of compensation received under different stock price assumptions over the next several years?
- Do we know how compensation could vary under different risk scenarios (e.g., considering the impact of changes interest rates, asset quality, stock market, customer retention)?
- Can we persuasively demonstrate a meaningful link between pay and performance relative to our decisions each year?
- Can we relate the long-term award values received by executives to company performance relative to peers/industry over multiple years?
- Do we monitor the level of equity/ownership by our executives, employees and board members? Are levels of ownership sufficient to ensure their alignment with shareholders? Do our executives and board members hold and retain stock over the long-term?

Analyzing and modeling these questions is not as complicated as it might sound. But the answers can significantly increase the likelihood of ensuring a proper relationship between pay-performance, addressing regulator/shareholder issues, and ultimately creating programs that help the company attract and retain the talent needed to ensure the company's long-term success.

Best Practice Area #4: Preparing for Increased Shareholder Influence

It is not surprising that the implementation of many of the Dodd-Frank Act provisions may have the impact of increasing shareholder activism. Today's environment is generating a growing number of investor proposals on executive pay and governance, more "withhold" votes on directors, and a stronger push for governance reform such as annual election of directors and separation of the CEO/ Board Chair roles. While shareholders have always filed suits over executive compensation practices, the newly expanded disclosure and the increased influence of investors through advisory votes on pay practices will provide new ammunition. This may have the effect of increasing shareholder activism and potential lawsuits alleging excessive compensation, breach of duties (good faith, due care, disclosure) and corporate waste.

More than ever, it is critical that companies understand their shareholders' perspectives on compensation and governance and listen to their views.

For companies with a large institutional ownership base, another important area of focus is to better understand the standards and influence of shareholder advisory firms such as ISS, Glass Lewis and others, related to compensation and governance practices. While these advisory firms have no formal authority, they have gained significant power by defining standards and best practices. For some, failure to adhere to their practice recommendations can result in a

withhold vote which can impact companies' compensation and governance proposals (e.g. say on pay, equity plan, director elections). Companies that have significant institutional ownership need to understand the principles that guide their shareholders' vote recommendations. Companies that do not may find themselves without the support they would like to have regarding directors re-elections, new stock plans and/or say on pay votes.

Below is a sample list of practices that many shareholders and advisory firms have deemed to be inappropriate and which may lead to a withhold vote recommendation: on compensation programs. This is far from an all-inclusive list. Shareholders and their advisory firms are regularly updating their views. But the following are considered particularly problematic practices for many shareholders and advisory firms:

- Repricing or replacing of underwater stock options/SARS without prior shareholder approval
- Excessive perquisites or tax gross-ups
- Change-in-Control payments exceeding three times base salary and average/target/most recent bonus; single-trigger; and/or tax gross-ups
- Excessive perquisites, or perquisites with gross ups
- Guaranteed multiyear incentive awards
- Increases to CEO pay when 1-and 3-year TSR is below the industry median

Best Practice Area #5: Improving Disclosure

As a result of the increased SEC disclosure requirements and the growing influence of shareholders and their advisory firms, public companies must focus on improving their proxy disclosures. In particular, the Compensation Discussion and Analysis (CD&A) and related tables are key to gaining shareholder understanding and support for programs. Shareholder advisory firms in particular rely on the information provided in the CD&A to make their vote recommendations and if the language is deemed unclear, vague, or unpersuasive, they may withhold their support on compensation and governance-related matters.

Rather than broadly describing compensation programs and decisions, public companies today must discuss the rationale and support for their decisions and validate that they resulted in a proper pay-performance relationship.

A well-structured CD&A includes:

- An executive summary that highlights and explains the company's business situation and pay-performance results (i.e. sets the tone for the reader as they reviewing the details that follow).
- A well structured "story" that articulates the company's philosophy and how its pay decisions support the philosophy, rather than just providing an overview of the pay philosophy and program components.
- Clear disclosure of the performance and incentive metrics used to support the pay-for-performance philosophy and resulting pay decisions. Even if plans are discretionary, the factors and rationale for the awards must be clear to the reader.

- Summary of factors considered in making pay decisions, including the use of tally sheets, pay-for-performance analyses and risk scenarios and how they influenced decisions.
- Actual pay decisions and rationale. It may be appropriate to show additional tables, graphs, charts that show a “story.”
- An explanation of how the resulting programs support sound risk management practices.

While the SEC will continue to issue comment letters on the effectiveness of proxies and CD&As in meeting their requirements, they have indicated there will be no further “grace periods” for companies. Instead of allowing a promise to “fix” the deficiency in next year’s proxy, the SEC may require more proactive action (e.g. amended proxy filing or 8-k) if it finds compliance issues. However, the greater impact for many companies is more likely to be the results of the new Say on Pay proxy advisory votes on their compensation practices.

Conclusion

The sea of change companies, especially banks, has faced the last several years is clearly unprecedented. New regulations, disclosure requirements and expectations are driving new best practices in compensation and governance. We can no longer look back at what worked in the past, but instead must make a critical evaluation of current practices to ensure they support new expectations. For many banks, this may result in only modest tweaks to programs, disclosure and approach. For others, the change may be more significant.

In summary, remember:

- The impact of regulation and emerging best practices will continue to evolve.
- Look at your programs/practices through a new set of lenses; ask if you can do things better; consider possible perceptions of your programs and decisions; wear the shareholder hat when assessing whether decisions make sense.
- Leading companies will stay informed, be proactive and help define success in the new environment; regulations define the guidelines and boundaries but not the limits of your creativity and innovation.
- Do what is right – not what was done; many accepted historical practices are no longer considered best practice. Benchmarking is less critical than thinking proactively.
- A well balanced total compensation program is key to success; helps mitigate risk and ensure appropriate pay-for-performance.

For some, the new environment brings with it much controversy and a feeling of restrictions. But if considered more positively, banks today can use this as an opportunity to take a fresh look at current programs and practices and make improvements that will make good banks great and great banks even greater.

About the Author

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About Pearl Meyer & Partners

For more than 20 years, PM&P has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges through the development of programs that align rewards with business goals to create long-term value for all stakeholders: shareholders, executives and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles and San Jose.

About our Banking Expertise

Our banking practice is headed in our Boston office where we provide consulting services and administer compensation surveys for bank executives, employees and board of directors. We have a team of consultants exclusively dedicated to serving the banking industry. To learn more about PM&P's Bank compensation services and to review additional content go to www.pearlmeyer.com/banking or email us at banking@pearlmeyer.com.



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