

Risky Business: Assessing and Addressing Executive Compensation Risk

A Community Bank Perspective

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As financial institutions close on Treasury purchases through the TARP Capital Purchase Program (CPP), management and compensation committees now turn to the task of implementing the related executive compensation restrictions. While so far the restrictions apply only to TARP participants, these provisions, or variations thereof, are likely to cascade to non-participating banks and across industries within a relatively short time frame.

The four major TARP/CPP requirements related to executive pay are:

1. Prohibition of incentives tied to “unnecessary and excessive risk.”
2. “Clawbacks” to recover bonuses and incentive compensation in which payment was based on materially inaccurate financial statements or other performance criteria.
3. Prohibition of “golden parachute” payments for virtually all termination events except for certain qualified retirement payments.
4. A \$500,000 limit on the deductibility of compensation.

Perhaps the more nuanced – and therefore difficult – requirement facing compensation committees is creating and overseeing a process that ensures incentive plans do not encourage “unnecessary and excessive risk-taking.” From a practical standpoint, assessing risk and participating in regulatory reviews is something banks do as a matter of normal business. However, the standards are heightened for banks that receive TARP funds.

The Treasury has not provided specific guidance in this area and due to the short window for compliance, there is no precedent to follow. For some smaller institutions, even determining who will serve in the role of SRO for the purposes of compliance is a challenge.

This issue paper suggests an effective framework for identifying and analyzing compensation-related risk. While the process steps are specific to TARP participants, the assessment process should be considered best practice for all companies.

A Step-by-Step Process - TARP/PPP Compliance

Within 90 days of Purchase:

- » The compensation committee should identify the SRO (or persons who serve in that capacity) and other constituencies who should be involved in the risk assessment process (e.g. CEO, Human Resources, legal counsel, outside advisors).
- » The SRO should be briefed by the compensation committee, CEO, Human Resources, and/or the committee's independent advisor(s) on the company's executive compensation philosophy, total compensation program, incentive plan approach (including any performance measures used) and the committee's process for assessing performance and making awards under the plans. The committee should work with the SRO to define a process for conducting the risk assessment.
- » The SRO should identify any compensation programs or practices that could promote excessive risk taking, such as performance measures with significant focus/weight in the total compensation program or policies that encourage (or fail to mitigate) significant risk-taking (short or long-term).
- » The compensation committee and SRO should meet to review the assessment and determine if program changes are needed. In addition to overall plan metrics and payouts, the committee should consider policies to reduce the potential for excessive risk taking (e.g. incentive holdbacks and/or equity holding requirements). The committee should consult with internal and external advisors as appropriate to determine any changes needed in light of the assessment review and best/emerging practice.
- » The compensation committee should report its findings and recommendations to the CEO and, ultimately, the full Board.
- » For public companies, the compensation committee should work with management and/or outside advisors as appropriate on the required disclosure of risk assessment in the proxy's Compensation Discussion and Analysis (CD&A).
- » The compensation committee must certify in the Compensation Committee Report (CCR) or to appropriate regulators (if not public) that it has conducted this process. (Note; this step may not take place within the 90 days depending on timing of proxy.)

Within 120 days of Purchase:

- » The CEO must certify to the Treasury's TARP Chief Compliance Officer that the review has taken place.

Annually:

- » Within 135 days of the completion of each fiscal year of TARP participation, the CEO must certify to the Treasury's TARP Chief Compliance Officer that the compensation committee has met at least once during the prior fiscal year with the SRO to discuss the relationship between risk management policies and executive incentive compensation arrangements.

Ongoing:

- » The bank must maintain records of these certifications for six years

A Risk Assessment Check List

All companies, whether TARP participants or not, are advised to consider the following questions as part of a risk assessment of incentive compensation practices:

- ✓ ***What risks could threaten the institution's value?*** This is the starting point for every assessment. The compensation committee should review and understand the business strategy, risk profile, potential business risks and how they are being addressed by management. The SRO should be able to explain how key risk areas might directly and indirectly affect performance and payouts under the institution's executive compensation programs.
- ✓ ***Do incentive plan metrics reflect the institution's business strategy?*** Performance and awards under the compensation program should be aligned with the institution's overall business strategy and support the desired risk profile. The existence of a potentially "risky" performance measure in the incentive plan, in itself, would not automatically drive executives to "unnecessary and excessive risk taking." For example, the inherent riskiness of loan growth can be mitigated by internal credit and quality controls, as well by limiting the amount of incentive paid out under this particular performance measure.
- ✓ ***Is the leverage and ratio of incentive compensation appropriate?*** The compensation committee should understand both the amount of the incentive opportunity and the proportion of total compensation that is based on performance. Unlike the large investment banks, where incentives may amount to more than 50x base salary, community banks do not have highly leveraged compensation programs. Additionally, a program that focuses 90% of an executive's total compensation on incenting specific performance goals is more likely to drive potentially risky behaviors than a program that is 50% incentive-focused. While not necessarily a concern for most community banks, the committee should understand its total compensation mix and incentive leverage to ensure it drives appropriate and desired results.
- ✓ ***Do we understand the full range of total upside/downside payouts under our incentive plans?*** Compensation committees need to understand potential payouts under multiple performance scenarios, including threshold, target and maximum performance. Where equity/long term incentives are granted, awards should be estimated under best, realistic and worst case stock price/payout scenarios, although this can be challenging in the current economy. For institutions with multiple performance-based programs, a more sophisticated "dynamic pay modeling" analysis can be conducted to determine the range of possible performance and payouts. At minimum, committees should understand and be comfortable that the maximum payout opportunity under the best performance scenario is both reasonable and not likely to motivate excessive risk taking.
- ✓ ***Do plans have protection/controls to avoid excessive risk taking?*** Do incentive plans allow for unlimited upside opportunity, or are maximum awards defined? Does a single performance measure drive a majority or even all the incentive rewards, or is there a balanced "portfolio" of performance measures? Best practice is for plans to be based on multiple performance perspectives. The committee should examine any performance measures that are significant drivers of total compensation, particularly if the same measures are used in both short- and long-term plans and might over-emphasize those aspects of performance.

- ✓ ***Do plans focus executives on long-term performance that aligns with shareholder interests?*** Retaining a long-term view of performance is a powerful way to reduce the likelihood that executives will take risks and protect the bank and its shareholders. Among the kinds of policies companies today are considering to promote a long-term focus:
 - Stock ownership and retention requirements such as “hold to retirement” and “hold past retirement.”
 - Limited or zero severance for poor performance, which may require changing employment agreements already in place and eliminating equity acceleration for certain types of terminations.
 - Holding back a portion of annual incentive awards pending sustained performance results.
 - Paying incentive awards above a certain level (e.g. target) in restricted stock or unvested deferred compensation.
- ✓ ***How does performance compare to industry/peers?*** In addition to reviewing performance against the bank’s business plan, performance should be considered on a relative basis. Particular attention should be paid to performance dramatically above or below industry/peer group levels – both of which are potential red flags of inappropriate risk-taking that warrant a closer look.
- ✓ ***Do the plans allow the committee to exercise discretion when appropriate?*** No compensation program can predict all possible situations and sometimes, common sense needs to prevail over formula-driven award payouts.

The Broader Picture

It is important that institutions not lose sight of the fact that executives should be encouraged to take the kinds of reasonable risks that make possible real innovation, business improvements or outstanding shareholder returns. Compensation-related risk is a double-edged sword that ideally balances the need to motivate appropriate risk taking, without encouraging or rewarding excessive risk.

After completing their analysis, most community bank compensation committees are likely to conclude that their own executive compensation programs do not rise to the definition of promoting “unnecessary and excessive risk.” But no institution can afford to be cavalier about the risk assessment process. It is critical in the current economic and governance environment that compensation committees understand the level of risk inherent in their business, develop appropriate balance in executive incentive plans and regularly monitor and assess their plans’ effectiveness. Practices such as short-term incentive hold backs, equity holding policies and a greater focus on long-term performance will become more common in executive compensation programs going forward.

In conclusion, committees today will be called upon to do more due diligence of their executive compensation programs. Regardless of TARP/PPP requirements, understanding risk and the relationship between pay and performance are best practices that will be critical to the long-term success of all institutions.

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