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New Strategies and Rules for Incentive Compensation for Banks

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Compensation Risk as a Central Theme to Recent Regulations

- **Congress and the Department of the Treasury (Treasury)**
  - TARP/CPP compensation limitations and requirements change methods of compensating employees and mandate semi-annual risk analysis
- **Securities & Exchange Commission (SEC)**
  - Disclosure of material risks relating to compensation will help shareholders make more informed voting and investment decisions
- **Federal Reserve Board (Fed)**
  - Focus on incentive compensation arrangements which encourage employees to take risks beyond the risk tolerance of shareholders
- **Federal Deposit Insurance Corporation (FDIC)**
  - Focus on incentive compensation arrangements which reward for short-term results not aligned with interests of the bank’s other stakeholders including the FDIC

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Emergency Economic Stabilization Act of 2008 (EESA)

- **TARP/CPP**
  - Troubled Asset Relief Program (TARP) and Capital Purchase Program (CPP) under TARP established the initial limitations and governance requirements relating to compensation plans for TARP recipients
  - Amended by the American Recovery and Reinvestment Act of 2009 (ARRA), the TARP rules impose both:
    - Compensation limitations and prohibitions (bonuses, severances, claw-backs)
    - Corporate governance changes (certifications, disclosures, risk assessments)

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Emergency Economic Stabilization Act of 2008 (EESA)

- **TARP/CPP – Compensation Committee – Required Actions**
  - Conduct semi-annual risk assessment senior risk officer
  - Provide annual narrative of risk assessment process and actions taken
  - Provide annual certifications that the committee has properly reviewed compensation plans and programs and taken necessary actions.

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Securities and Exchange Commission (SEC)

- **Enhanced Proxy Disclosure Rules – Approved December 16, 2009**
  - Enhanced disclosure in proxy statements related to risk oversight, corporate governance, and executive compensation
  - Proxy statement must include a discussion of any compensation plans or programs for employees generally, not limited to those applicable to named executive officers, in circumstances where the risks arising from the policies are “reasonably likely” to have a “material adverse effect” on the company

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Federal Reserve Board (Fed)

- **Proposed Federal Reserve Guidance on Sound Incentive Compensation**
  - Fed believes that incentive compensation practices were one of the contributing factors in the financial crisis
  - Though subject to public comment and possible further revision, the Fed is requiring immediate compliance with proposed guidance
  - Applies to nearly 6,900 banking organizations
  - Banks that are subject to TARP/CPP requirements have good start

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Proposed Federal Reserve Guidance on Sound Incentive Compensation

- Guidance applies to incentive compensation arrangements for multiple levels of employees
  - Senior executives and others who are responsible for oversight
  - Individual employees whose activities may expose the firm to material amounts of risk
  - Groups of employees who, in the aggregate, may expose the firm to material amounts of risk

Proposed Federal Reserve Guidance on Sound Incentive Compensation

- Three principles of a sound incentive compensation system

  #1 - Balanced risk taking incentives

  #2 - Compatibility with effective controls and risk management

  #3 - Strong corporate governance

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Proposed Federal Reserve Guidance

Two Supervisory Initiatives

- **Large, Complex Banking Organizations ("LCBOs")**
  - LCBOs warrant the most intensive supervisory attention in the short run
  - The Fed will conduct a formal horizontal review of incentive compensation arrangements at these organizations

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Proposed Federal Reserve Guidance

Two Supervisory Initiatives

- **Community and Regional Banking Organizations with Incentive Compensation Arrangements**
  - Review non-LCBOs as part of its regular review process
  - In connection with the review of risk management, internal controls and corporate governance
  - Tailored to reflect the scope and complexity of the bank's activities and scope of its incentive compensation arrangements
  - The findings will be incorporated into the supervisory ratings

Federal Deposit Insurance Corporation (FDIC)

Advance notice of proposed rulemaking (ANPR)

- ANPR is seeking comment on ways that the FDIC's risk-based insurance assessment system could be changed to account for the risks posed by compensation programs
- The FDIC does not intend to establish compensation ceilings
- The FDIC, through a series of 15 questions, is seeking comments on how it should adequately reflect compensation-related risk in its assessment regime
- The FDIC currently appears to support incentive programs utilizing restricted, non-discounted company stock that becomes available to employees at intervals over a period of years (similar to Pay Czar approach)
- Comments on the ANPR are due by February 18, 2010

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Compensation Committee Requirements

- Maintain a separate **compensation committee** that is composed of Independent Directors
- Articulate the bank's **compensation strategy** and rationale for the design
- **Document the organization's pro**cesses for establishing, modifying and monitoring compensation arrangement
- Identify and describe **roles** of the personnel involved in the design, implementation and monitoring of the incentive compensation arrangements

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Compensation Committee Requirements

- Actively **oversee** incentive compensation arrangements
- **Review incentive compensation programs** to make certain they do not jeopardize the safety and soundness of the organization
- Approve and document any **material exceptions or adjustments** to the incentive compensation arrangements
- Use outside counsel, consultants, or other **experts with expertise** in compensation and risk management

First Level Criteria for Compensation Assessment

- Compensation plans:
  - Consistent with the best interests of the company's shareholders and other stakeholders
  - Fully compliant with applicable laws and regulations
  - Do not encourage excessive risk taking
  - Do not pose a threat to the safety and soundness of the organization
  - Transparent, fair, and reasonable

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Apply Features of Risk Balanced Design

- The design of incentive plans have considered and documented:
  - The use of short-term versus long-term performance measures
  - The alignment between the size of incentive awards and the amount of risk assumed
  - The use of absolute versus relative performance measures
  - The relationship between the amount of incentive compensation opportunity compared to the individual's overall total compensation mix
  - The timing of incentive compensation payouts and the length of performance periods
  - The cohort that will participate in the plan
  - Use of Claw-backs and Slip-backs

Risk-Balanced Design:

1. Stakeholders Want Maximum Leveraging of Performance and Pay

- **Incentive Compensation Performance Measures**
  - Reduced emphasis on immediate, single and/or short-term measures of desired bank, business unit and individual performance
  - May need to be expanded to capture broad institutional enterprise value, safety and soundness, and the risk outcomes attributed to desired performance

Risk-Balanced Design:

2. Risk Categories to Test Performance and Pay Alignment

- **Incentive Compensation and Risk Mitigation**
  - Assess the organizational risk using the following categories created by employee activities linked to various levels of incentive awards
    - Strategic
    - Credit Quality
    - Market
    - Liquidity
    - Operational
    - Legal
    - Compliance
    - Reputational

Risk-Balanced Design:

3. Incentive Compensation Performance Measures

- Absolute
  - Assesses actual performance and risk outcomes against pre-established criteria based on the institution's own
    - Strategic plan
    - Business plan
    - Risk parameters
- Relative
  - Assesses actual performance and risk outcomes against pre-established criteria based on the aggregated performance levels and risk parameters of:
    - A designated peer group or index comprised of other institutions
    - A specific peer institution

Risk-Balanced Design

4. Each Cohort Has a Different Impact on Risks

- Business units of the organization
- Senior executives overseeing organization-wide business lines or activities
- Individuals whose activities may expose the organization to material amounts of risk
- Groups of individuals whose activities, in the aggregate, may expose the organization to material amounts of risk

Risk-Balanced Design

5. Time to Outcome

- Arrangements likely to encourage excessive risk-taking:
  - Incentive payments are based on:
    - Future revenues booked as current income
    - Short-term financial measures which do not reflect the varying levels of risk associated with various streams of revenue
    - Low probability of a risk being realized but highly adverse impact if were to be realized

Risk-Balanced Design

Programs Unbalanced for Risk

- Provide incentives for employees of an institution to engage in excessive risk-taking
  - Beyond the organization’s ability to effectively identify and manage the risk
  - Which can ultimately increase the institution’s risk of failure
  - That is reasonably likely to have an adverse material impact on the organization

Risk-Balanced Design

Scenario Analysis

- Banks should rely on informed judgments to estimate risk and risk outcomes
- Use scenario analysis by evaluating projected incentive payments and associated costs based on a range of performance levels

Performance	Incentive Pay Levels	Risk Assessment
X	Y	Low
X+1	Y+2	Low
X+2	Y+4	Moderate
X+3	Y+8	High

Other Factors (examples):
- Cohort
- Time to pay
- Type of risk
- Percentage of total pay
- Bank versus individual

Risk-Balanced Design

Disclosure to Primary Regulator

- General design philosophy of the bank’s compensation policies and practices
- The bank’s risk assessment and incentive considerations in structuring its compensation policies and practices
- How the bank’s compensation policies and practices address the realization of risks over the short- and long-term
- The bank’s policies regarding adjustments, and adjustment it has made, to its compensation policies and practices based on changes in its risk profile
- The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met in terms of its incentive compensation arrangements

Supervisory Initiatives

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- Horizontal review at 28 large complex banking organizations (LCBO)
- Review of compensation practices of other banking organizations not classified as LCBO
  - Applies to organizations within regulatory purview of the Federal Reserve
  - Fed will also be able to directly affect compensation practices of the holding company and non-bank subsidiaries
  - Review as part of the regular, risk focused exam

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Compensation Program Examples:

Retail Deposit Function

- **Position Responsibilities –** Acquire new customers, maintain existing customer relationships, deposit gathering, cross sell retail banking products, and generate referrals to other business lines such as lending and trust. Does not engage in retail lending activities.
- **Risk Assessment – Low**
- **Variable Compensation Implications**
- **Plan Design Considerations**

Compensation Program Examples:

Commercial Lending Function

- **Position Responsibilities –** Acquire and close new commercial loans, maintain existing customer relationships, and cross sell other banking products.
- **Risk Assessment – Medium**
- **Variable Compensation Implications**
- **Plan Design Considerations**

Compensation Program Examples:

Chief Executive Officer

- **Position Responsibilities –** Overall management of all aspects of the bank's activities commensurate with the best interests of customers, shareholders, employees, and the public.
- **Risk Assessment – High**
- **Variable Compensation Implications**
- **Plan Design Considerations**

Review Consequences

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- Banks need to act now to review their plans
- Fed's review will be part of the regular exam
- Findings will be factored into supervisory rating
- Results are confidential supervisory matters
- Fed can require corrective action plan to remedy compensation deficiencies
- Fed can take formal or informal enforcement action
  - Lack of corrective action could result in a MOU or C&D order
- Fed plans to release a report by the end of 2010 that will document trends and developments in compensation practices

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