



NYBA

2011 FINANCIAL SERVICES FORUM
Breakfast Workshop:
Executive Compensation Post Dodd Frank

November 10, 2011

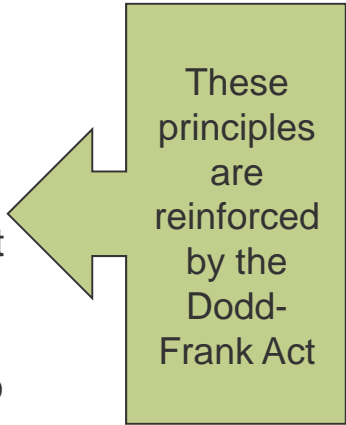
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Regulatory Update – Agency Guidance

- **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**
- **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
- **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)



These principles are reinforced by the Dodd-Frank Act

Regulatory Update - Dodd-Frank Act

- **Signed by President Obama on July 21, 2010**
 - Mostly applicable to public companies; only one requirement targeted at financial institutions (incentive compensation)
- **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 banks > \$1b assets; adds more "teeth" to Agency Guidance

■ Dodd Frank – Implementation Schedule

Regulation	Regulator(s)	Rule/Guidance	Who it Impacts	Effective Date
Agency Guidance	FRB, FDIC, OCC, OTS	Incentive Compensation Arrangements	All institutions	EFFECTIVE
Dodd-Frank	FRB, FDIC, OCC, OTS, NCUE, SEC, FHFA	Incentive Compensation Arrangements	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
	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

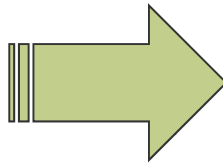
■ Federal Reserve Horizontal Review Findings

- **Progress occurring; evolutionary but not there yet**
- **Desired areas of focus:**
 - Risk Adjustment of Incentive Awards
 - » Quantitative or qualitative
 - Robust policies/procedures to guide consistent use of judgment
 - Documented decisions
 - » Risk adjust bonus pools or awards
 - » Defer portion of payout to align with time horizon of risk
 - » Longer performance periods
 - Identify Key Employees
 - Improve Risk Management Processes and Controls
 - » Involvement of risk management personnel
 - » Improved written policies and procedures
 - Improve Corporate Governance
 - » Board Involvement

Regulations Driving New Best Practices

Need to Review/Update:

- ✓ Compensation Philosophy
- ✓ Incentive Plan Designs
- ✓ Pay-Performance Alignment – Short and Long-Term
- ✓ Governance Practices



Compensation Programs Should:

- ✓ Support bank's business strategy
- ✓ Be looked at in a holistic/total manner
- ✓ Support sound risk management
- ✓ Promote long-term "view"
- ✓ Be balanced
- ✓ Have appropriate Board/Committee oversight
- ✓ Be shareholder aligned

*Requires new reporting and disclosure requirements –
to regulators and shareholders*

■ Compensation Philosophy

Why is it so important?

- Critical foundation for all programs and decisions
- Overall message to employees, potential employees, regulators, shareholders
- Should be clear and easy to understand and disclose (to regulators and shareholders)
- “Meat” of proxy Compensation Discussion and Analysis (CD&A) and basis for shareholder non binding approval of compensation (i.e. “say on pay” vote)
- Basis for measuring effectiveness of programs

What's in a Compensation Philosophy?

- ✓ Objectives of total program
- ✓ Components
- ✓ Competitive reference/positioning
- ✓ Mix of total compensation
- ✓ Pay for performance approach

Five Incentive Plan Best Practices

1. Alignment

- Business strategy
- Shareholders
- Regulators

2. Balance/Mix

- Performance measures – earnings, growth, strategic, risk
- Time horizon – short vs. long-term
- Perspective – absolute vs. relative
- Approach – quantitative vs. qualitative
- Form of payout – cash vs. equity

■ Five Incentive Plan Best Practices

3. Risk Mitigation Design Techniques

- Risk Adjust
 - Quantitative/Qualitative
 - Bonus pool
- Deferrals/Holdbacks
- Long-term/Multi-Year Performance
 - Performance shares
 - Portfolio approach
- Payout Leverage
- Caps
- Discretion

■ Five Incentive Plan Best Practices

4. Goal Setting and Payouts

- Goal Setting
 - Guiding principles
 - Centralized
- Payouts
 - Audit/review
 - Approvals
 - Monitor

5. Policies

- Clawback Policy
- Ownership/Holding Requirements

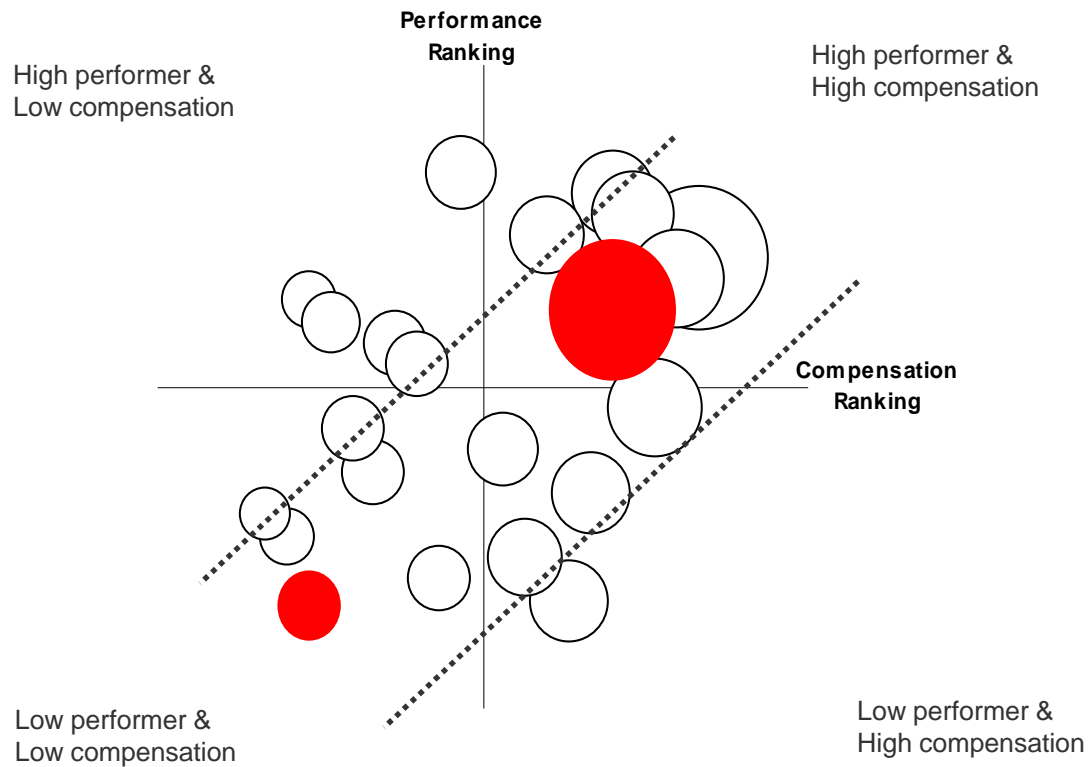
■ Pay-Performance Alignment

- Important to regulators and shareholders
- Ensure alignment:
 - “Right” performance measures
 - Proper program design/leverage
 - Test/model



PFP Alignment Test – Example

Total Compensation Relative to Performance



▪ Total/Holistic Approach

Best Practice Techniques

- ✓ Tally Sheets – Total compensation and benefits paid in given year (annual/static view)
- ✓ Pay Mix - Understand mix of pay relative to philosophy and market (e.g. fixed vs. performance; short vs. long-term; cash vs. equity)
- ✓ Pay Opportunity Ranges – Show total compensation potential under different performance outcomes to assess appropriate payout relationship
- ✓ Realizable pay – Shows total compensation actually earned vs. awarded (e.g. stock, performance based pay)
- ✓ Retention – Understand whether executives have a “hook” enabling them to retain top talent. What do they “give up” if they leave? Is it meaningful?
- ✓ Ownership – Do executives have a meaningful level of ownership in the bank?
- ✓ Termination scenarios – What is paid under voluntary/involuntary, change in control, retirement, death, disability?
- ✓ Internal comparisons – Are differences between executives appropriate and explainable

▪ Say on Pay (SOP) Implications

- **All in all minimum impact**
 - Of ~ 3000 companies that filed SOP votes all but 38 received support
 - » 1 community bank - Umpqua
 - Average rate of approval for companies passing SOP was over 90%
- **Primary reasons for failures:**
 - PFP disconnect
 - Poor pay practices
- **Impact of ISS/Proxy Advisory Firms**
 - If ISS supported, 100% shareholder support
 - ~250 companies received “Against” from ISS typically resulting in lower support
 - » 28 community banks received “Against” (average support of 75%)

■ Say on Pay Implications

■ Impact

- Non binding but....
- Negative media attention
- Pressure on directors
- Shareholder law suits (7 so far) against executives and directors (sometimes consultants)
- Expect more failures in 2012

■ Avoiding “Failure”

- Better disclosure
 - » Executive summary, graphs/charts, more rationale of decisions/resulting PFP alignment
 - Understand potential shareholder criticisms
 - » Request ISS/GL reports
 - » Review GRID score (Yahoo Finance)
- Review and adjust pay practices/programs as appropriate
- Improve shareholder communications

On Yahoo Finance: Company Profile Corporate Governance

BANK ABC's Governance Risk Indicator (GRI®) as of Nov 1, 2011 is: Audit (Low Concern), Board (Low Concern), Compensation (High Concern), Shareholder Rights (High Concern). Brought to you by [Institutional Shareholder Services \(ISS\) View Financials](#)

■ “Poor Pay Practices” – ISS “Hot Buttons”

- **Excessive severance and/or change in control provisions**
 - *CIC payments exceeding 3x base and average/target/most recent bonus*
 - *CIC severance payments with single/modified single triggers*
 - *CIC payments with excise tax gross ups (including modified gross ups)*
 - *Liberal definition of CIC (i.e. payments result without actual CIC occurring)*
- **Tax gross ups/reimbursement**
 - *On executive perquisites or other payments (e.g. life insurance, bonus, restricted stock)*
- **Option Repricing**
- **Egregious employment contracts**
 - Multi year guarantees for salary increase, non performance -based bonuses and equity compensation
- **Excessive pension/SERP payouts**
 - Inclusion of additional years of service not worked in pension calculation
 - Inclusion of performance-based equity or long-term awards in pension calculation
- **New CEO with overly generous new- hire package**
 - Excessive “make whole” provisions without sufficient rationale
- **Abnormally large bonus payouts without justifiable performance linkage or proper disclosure**
- **Hedging – executives using company stock in hedging activities such as “cashless collars, forward sales, equity swamps or similar arrangements**
- **Internal pay disparity – between CEO and other executives**

■ 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