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Prepare for a clampdown on executive compensation

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Historically, executive compensation plans have been designed to attract, retain and motivate key management. Today, executive compensation has become synonymous with corporate excess and managerial recklessness. U.S. Treasury Secretary Timothy Geithner has pointed to executive compensation practices as contributing to the downturn. In a July 2009 report, *A review of corporate governance in UK banks and other financial industry entities*, Sir David Walker (who led an independent review of corporate governance in the UK banking industry) states, "It is clear that governance failures have contributed materially to excessive risk-taking in the lead up to the financial crisis." Whether they've received government funds or not, financial institutions must rethink how they reward executives going forward. Regulatory compliance and stakeholder confidence may depend on it.

Regulators demanding change

The traditional approach to linking executive pay to performance is being shattered with the revelation that excessive risk-taking was a major contributing factor to the recent financial crisis. In the Troubled Asset Relief Program (TARP) regulations, the Treasury Department acknowledged the need for compensation committees to review and discuss corporate risk in the context of executive compensation planning. In fact, financial institutions' compensation committees are required to certify this assessment if they received TARP funds. The TARP regulations include:

- prohibition of "golden parachute" compensation for senior executive officers (SEOs);
- limiting the tax deduction on executive compensation to $500,000;
- recovery of bonuses that were paid based on "materially inaccurate" performance metric information;
- certification requirement by the compensation committee in either the compensation committee report of the institution's proxy statement or to the institution's primary regulator that incentive compensation arrangements do not encourage SEOs to take unnecessary and excessive risks; and
- compliance reporting regime for the CEO (or principal executive officer) to certify.

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The TARP rules apply to the five most highly compensated employees: the CEO, the CFO and the next three highest-paid officers of the financial institution, whether public or private. The rule defines the most highly compensated employees by calculating their total annual compensation using SEC Regulation S-K. Private institutions are directed to use proxy rules to determine their SEOs.

The Federal Reserve has also proposed rules that would govern how financial institutions structure their executive compensation plans. On Oct. 27, 2009, the Federal Reserve Board (FRB) published proposed guidance on incentive compensation plans in the Federal Register. These proposed rules will likely cause all banks to review and rethink their incentive compensation.

For large, complex banking organizations (LCBOs),[1] this new guidance and subsequent regulatory review will create substantial work. However, all institutions need to be prepared to respond to the guidance and should be aware of the scope and substance of the new rules. Specifically, the FRB announced two supervisory initiatives: one for LCBOs and another for all other banking organizations. The LCBO initiative would involve in-depth "horizontal" reviews of incentive compensation. For all other banks, the FRB would incorporate an incentive compensation review as part of their normal "risk-focused" examination process.

The proposed guidance articulates three principles designed to ensure that incentive compensation plans do not encourage excessive risk-taking by banks and that they are consistent with safety and soundness principles. The principles address three key areas:

- adopting incentives that do not encourage excessive risk-taking;
- compatibility with effective controls and risk management; and
- strong corporate governance, including active oversight by boards of directors.

The proposed guidance would apply to senior executives and any other employees or group of employees who could expose a bank to "material amounts" of risk, e.g., loan officers.

Within the context of balancing risk-taking and compensation, the FRB has identified four methods that should be used to design incentive compensation plans:

- **Risk adjustment of rewards** – The size of incentive payments is adjusted based on the risk of the activities being rewarded. The adjustment can be based on qualitative or quantitative measures.

- **Deferral of payment** – Payouts are delayed until any risks would have been realized. This could also include "clawback" provisions. The delay is needed to obtain reliable financial or operational results.

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1 According to the Federal Reserve, "LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their regulatory structures, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one key financial market." The Federal Reserve has identified 28 banks as LCBOs.

- **Longer performance periods** – Incentives are awarded over a longer time to make it more likely that risks would be realized before incentive rewards are determined. This design feature relates to performance measures that are multiple years in length.

- **Reduced sensitivity to short-term performance** – Reduces how quickly rewards increase as an employee achieves higher levels of performance. For example, a bonus might increase 50 percent for each 10 percent increase in performance. This feature would cause the payment structure to reduce the increased bonus from a 50-percent increase to only a 25-percent or 10-percent increase.

This guidance may have profound implications for all institutions, especially LCBOs. The FRB notes that an ad hoc approach is not likely to work, so institutions would be expected to have systems in place to balance risk and rewards in compensation.

In addition, Congress and the SEC have reached beyond the American Recovery and Reinvestment Act of 2009 and interim final rule guidance for TARP participants. On the congressional front, emerging legislation, such as the *Corporate and Financial Institution Compensation Fairness Act of 2009* (HR 3269), would impose additional rules and reporting on certain financial institutions regarding incentive compensation structures and enterprise risk.

Below is a summary of several bills and their key provisions.

Legislation	Key provisions
Corporate and Financial Institution Compensation Fairness Act of 2009 (HR 3269)	• Non-binding "say-on-pay" shareholder vote • New compensation committee independence standards
Shareholder Bill of Rights Act of 2009 (S 1074)	• Non-binding shareholder votes on severance packages • Clawback provisions for compensation arrangements • No severance payments for poor performance terminations
Shareholder Empowerment Act of 2009 (HR 2861)	• Non-binding shareholder votes on severance packages • Clawback provisions for compensation arrangements • No severance payments for poor performance terminations
Excessive Pay Capped Deduction Act of 2009 (S 1007)	• Bar on employer deduction for compensation paid to any employee totaling more than 100 times average employee compensation
Ending Excessive Corporate Deductions for Stock Options Act (S 1491)	• Limit employer stock option compensation deduction to cost recognized on financial statements • Exclude stock options from the performance-based exception to the $1 million limit on compensation deduction

Broadening the reach beyond the financial services industry, the SEC has also approved a new rule, *Proxy Disclosure Enhancements*. The proposed rules would have required discussion and analysis of compensation policies if risks arising from those compensation policies "may have a material effect on the company." The final rules require a company to address its compensation policies and practices for all employees, including non-executive officers, if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. The "reasonably likely" disclosure threshold would parallel the MD&A requirement, which requires risk-oriented disclosure of known trends and uncertainties that are material to the business.

U.S. legislators and regulators are not alone in their push for an overhaul of executive compensation. The Financial Services Authority, an independent body that regulates the financial services industry in the UK, released its own best practices for executive compensation at financial institutions.

Back to the drawing board

In today's environment, executive compensation is not just a reward, it's also a risk for financial institutions. Simply slashing executive pay will not be enough to satisfy regulators or fix the root of the problem — the issue is not so much how much institutions reward, but why. The movement for principles-based reporting has gained momentum, not only from the SEC, but also from industry groups.

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In effect, these agents of corporate governance are advocating new design criteria and imposing limitations on how executive pay should be delivered. The Center on Executive Compensation, an organization dedicated to developing and promoting principles-based pay and governance practices, released *Putting the Center's Principles Into Practice*. This guide outlines principles that can be included in a sound executive compensation plan, including linking pay to positive results.

Although many corporate governance groups have suggested a new structure for executive compensation, they can sometimes overlook an organization's business strategy, corporate culture and competitive environment. Often, an emphasis on rules comes at the expense of practical application. As financial institutions begin to redesign their executive compensation in light of pending regulations and possible changes in laws, there are several principles that they should keep in mind:

- Initiate the corporate risk oversight process.
- Evaluate and merge risk into the compensation philosophy.
- Evaluate plan design against enterprise risk.
- Revisit key performance metrics.
- Incorporate the results from the above steps into corporate governance processes.

Compensation committees face the unenviable tasks of trying to define unnecessary and excessive risks and trying to balance effective incentive compensation with concerns about those risks. The compensation committee and senior risk officers should review the institution's incentive plans to ensure they do not encourage excessive risk-taking. They should also examine short- and long-term risks facing an institution and ways to mitigate risks that affect compensation.

In evaluating and adjusting compensation plans, committees should scrutinize business functions and various positions to determine the degree to which they can increase the company's risks and whether those risks can be mitigated. They also should define who is able to authorize risks for the institution and can then evaluate the balance between risk and pay in those positions.

In setting up compensation plans, companies should match incentive objectives and payouts to the duration of risks. For example, activities that carry long-term risks should be paired with long-term payouts. Institutions should be careful of uncapped payouts, formulaic awards and steep incentive curves. In addition, features such as clawbacks, deferrals and shareholding requirements can help minimize risk.

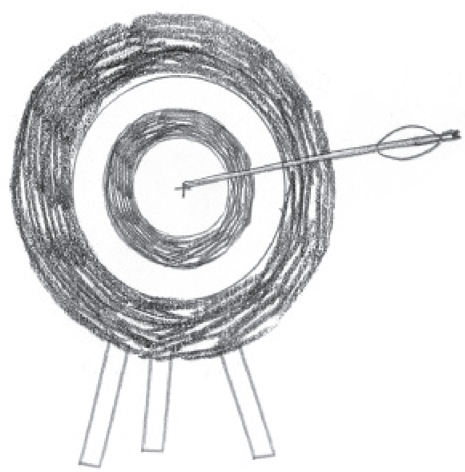
Finally, financial institutions should establish clear oversight and governance processes regarding pay plans to make sure the plans are consistent with corporate goals and risk tolerances, operate under realistic assumptions and address both corporate standards and business unit autonomy.

The future of compensation

In today's environment, financial institutions will need to rethink how they pay executives, as well as practice greater discipline in compensation plan design and selection of performance metrics. Additionally, using incentive compensation to drive executive behavior will bring greater regulatory oversight and reporting requirements. Boards and/or compensation committees will share the burden of due diligence and risk management to ensure that compensation arrangements mitigate corporate risk and preserve long-term shareholder value. In short, executives and directors will be in the risk management spotlight.

It is clear that changing laws and regulations will require many institutions to restructure their plans. How institutions will respond to these emerging rules and pressures is uncertain. Shareholders will likely play an important role in the future of executive compensation. If the reaction is similar to that of TARP participants, we may see more "fixed" compensation, such as increased reliance on base salaries and restricted stock, less variable pay (cash bonuses) and fewer stock options.

Does this mean that cash-based incentives are on the way out? Probably not. However, compensation committees will be more circumspect in their use of cash-based incentives and will most likely impose additional plan design features, including longer vesting periods, mandatory deferral features and award clawbacks, especially if performance metrics are revised. Beyond compliance and avoiding public outrage, well-designed compensation plans can help financial institutions better manage operational risks, a reward in itself. •



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