

Compensating Bank Employees: New Responsibilities for Bank Directors

Washington Bankers Association

December 1, 2011

**Presented By
Henry M. Fields
Morrison & Foerster LLP**

Lessons Learned : Academia

Squam Lake Group: February 2010: non-partisan Group of 15 academics provides recommendations on executive compensation, as part of broader set of recommendations to reform the financial system

Squam Lake Group Analysis

- Y Structure of executive compensation can affect the risk of systemically important financial institutions (“SIFI’s”)
- Y When SIFI’s are threatened, governments intervene to protect them and this in turn **privatizes gains, while losses are socialized**
- Y If things go well, bank employees claim the profits, but if not, society subsidizes the losses
- Y Incentive for owners and employees to take more risk
- Y Society has a stake in assuring the executive compensation doesn’t reward excessive risk

Squam Lake Group makes other recommendations (not involving executive compensation) to address the socialization of losses.

Squam Lake Recommendations

Don't regulate the level of executive compensation

- ÿ No convincing evidence that high levels of executive compensation are inherently risky for the companies themselves or for the economy
- ÿ Restrictions on pay could have unintended consequences, pushing the best talent out of the banking system
- ÿ Let the market decide compensation levels
(Not opposed to corporate governance improvements, e.g., tighter independence standards for compensation committees)

Squam Lake Recommendations

Change the structure of executive compensation by withholding a significant share of each executive's annual cash compensation for several years

- Executives become creditors (in addition to any equity stake they have in stock options or restricted stock)
- Creditor status should reduce incentive to pursue risky strategies
- Executives forfeit their holdbacks if the firm fails or requires extraordinary government assistance
- Stock awards align executives with stockholders but do little to reduce the conflict between firms and society

Lessons Learned: Int'l Regulators

- Y Flawed compensation practices were one of many factors contributing to the financial crisis
- Y Banks too often rewarded employees without adequate recognition of risk
- Y Recommendations for SIFI's

FSF Recommendations (April 2009)*

Y Compensation must be subject to effective governance

- Y Board must actively oversee design and operation of compensation system
- Y Compensation committee must have independence and necessary expertise in risk management and compensation
- Y Those exercising financial and risk controls over business lines must not receive compensation reflecting financial success of the business lines

Y Compensation must be aligned with prudent risk-taking (and sensitive to the time horizon of risks)

Y Banks must demonstrate to regulators that they have sound compensation systems

- Y Compensation needs to be subject to vigorous and sustained supervisory review
- Y Compensation needs to be clearly disclosed to all stakeholders (Basel Pillar 3 Disclosure)

*(Financial Stability Forum, FSF Principles for Sound Compensation Practices (2 April 2009))

FSB Recommendations (Sept. 2009)*

Governance: Board compensation committee an integral part of governance structure. Compensation Committee:

- ÿ Must have competence and independence
- ÿ Should evaluate practices by which compensation is paid for potential future revenues that are uncertain to be realized
- ÿ Should work closely with risk committee in evaluating incentives created by compensation system
- ÿ Should ensure an annual compensation review, independent of management, to be submitted to supervisors or disclosed publicly
- ÿ Employees in risk and compliance function should be compensated independent of other business areas

*(Financial Stability Board, FSB Principles for Sound Compensation Practices: Implementation Standards (25 September 2009))

FSB Recommendations (Sept. 2009)

Compensation and Capital: total variable compensation should not limit ability of bank to strengthen its capital base

Y Supervisors should limit variable compensation as a percentage of total net revenues when inconsistent with the maintenance of sound capital

FSB Recommendations (Sept. 2009)

Pay Structure and Risk Alignment: variable compensation needs to take full range of risk into account, including effect on capital, liquidity and revenues

- Y Reduced financial performance should lead to reduction in variable compensation
- Y For senior executives (and others who have material impact), a substantial amount of compensation should be variable and measured by performance, and 40% to 60% should be deferred over a period of at least 3 years (more senior the management, higher the percentage of deferral). At least 50% should be paid in equity (linked to long-term value creation)
- Y Unvested compensation should be subject to clawback
- Y Guaranteed bonuses not consistent with sound risk management
- Y Severance obligations should be re-examined, and maintained only if aligned with long-term value creation and prudent risk-taking

FSB Recommendations (Sept. 2009)

Disclosure: Banks should make annual public disclosure of compensation, including:

- ÿ How firm wide compensation was determined
- ÿ Design of compensation system, including criteria for performance measurement and risk adjustment (linkage between pay and performance, deferral policy, vesting criteria, and allocations between cash and equity)
- ÿ Aggregate quantitative data on compensation

FSB Recommendations (Sept. 2009)

Supervisory Oversight

- Y Banks need to demonstrate to supervisors that variable compensation takes into account appropriate consideration of risk, capital, liquidity and the likelihood and timeliness of earnings
- Y Failure by a firm to implement sound compensation practices should result in prompt remedial action, including, if necessary, appropriate corrective measures to offset undue risk from non-compliance
- Y Supervisors need to coordinate internationally to ensure these standards are implemented consistently across jurisdictions

U.S Bank Regulators

Perspective of U.S. bank regulatory agencies:

- ÿ As in the United States, bank failures of all sizes occurred, US bank regulators have focused on the need to change compensation practices at all U.S. banks, not merely SIFI's
- ÿ Aligning interests of shareholders and employees is not always sufficient to protect safety and soundness
- ÿ Moral hazard: because banks benefit from the Federal safety net (including FDIC insurance and the Fed discount window), shareholders may be willing to tolerate a degree of risk that is inconsistent with safety and soundness

U.S Bank Regulators

Conclusions:

- Y Not sufficient for Board to assess compensation arrangements and related corporate governance practices from standpoint of shareholders
- Y Board required to assure safety and soundness of *institution*— e.g., the interests of the FDIC as the insurer of deposits
- Y These conclusions not limited to SIFI's but apply in principle to every FDIC-insured bank

What is duty of the Board? State law requires the Board to exercise its fiduciary responsibility on behalf of shareholders

Bank regulatory agencies: bank directors responsible to assure safety and soundness of bank as well

Sources of Bank Compensation Restrictions

Treasury rolls out its executive compensation wish list

- ÿ Limits on compensation to avoid incentives for CEO's to take excessive risk that threatens safety and soundness
- ÿ Clawbacks based on materially inaccurate financial statements
- ÿ Prohibition on golden parachute payments
- ÿ Prohibition on bonuses, retention awards or incentive compensation for CEO's (except for restricted stock)
- ÿ Prohibition on compensation plans that encourage earnings manipulation to enhance employee's compensation

TARP

- ÿ Compensation committee of independent directors to meet semi-annually to review compensation and risks, if any, posed
- ÿ Adoption of luxury expenditures policy
- ÿ Disclosure of perks offered to CEO's
- ÿ Disclosures related to engagement of compensation consultants
- ÿ Prohibition on tax gross-ups
- ÿ Say on pay compliance

Query: What will remain behind when you repay TARP?

Restrictions on Troubled Banks

Pre-Financial Crisis

- FDIA § 18(k) and FDIC Regulations, Part 359: golden parachutes/severance limitations for troubled institutions
- FDIA § 38, ability of bank agencies to restrict compensation for senior executive officers of undercapitalized institutions

Safety and Soundness under FDIA

ÿ FDIA, § 39(c): Standards for Safety and Soundness (pre-crisis)

ÿ Banking Agencies required to prescribe:

ÿ Standards, by regulation or guidelines, that prohibit compensation arrangements that would result in excessive compensation or could lead to material loss;

ÿ Standards for determining when compensation is excessive, taking into account:

ÿ All cash and noncash benefits provided to the employee

ÿ Compensation history of those with comparable expertise

ÿ The financial condition of the institution

ÿ Comparable compensation at comparable institutions

ÿ For post-employment benefits, the projected total cost to the institution

ÿ Any involvement of the individual in fraud, breach of fiduciary duty or insider abuse

ÿ Other factors the Agencies deem relevant

ÿ Such other standards relating to compensation as the Agencies deem appropriate

Guidance on Incentive Compensation

- ÿ Initially proposed in October of 2009; adopted June 25, 2010
- ÿ Phase-in over three years
- ÿ Principles-based
- ÿ Purpose: to assist banking organizations in designing and implementing incentive compensation arrangements that effectively consider potential risks and risk outcomes
- ÿ Covers bank holding companies as well as banks
- ÿ Consistent with FSF and FSB approach to variable compensation

Guidance on Incentive Compensation

“Incentive Compensation” covered by the Guidance:

- ÿ That portion of compensation tied to achievement of one or more specific metrics (e.g., revenues, income)
- ÿ Does not include base salary
- ÿ Does not include other compensation which is not performance based—for example, contributions to a 401(k) plan

Covered employees:

- ÿ Senior executives and others responsible for material business lines
- ÿ Employees whose activities can expose the banking organization to material risk (e.g., traders)
- ÿ Groups of employees subject to the same or similar incentives who, in the aggregate, can expose the firm to material risk (e.g., group of loan officers who, as a group, originate loans accounting for a material amount of credit risk).

Guidance on Incentive Compensation

Banking organizations expected to maintain incentive compensation practices that are consistent with safety and soundness **“even when these practices go beyond those needed to align shareholder and employee interests.”** To meet these standards, the practices should:

- ÿ Provide employees incentives that appropriately balance risk and reward
- ÿ Be compatible with effective controls and risk-management; and
- ÿ Be supported by strong corporate governance, including active and effective oversight by the organization’s Board

Guidance on Incentive Compensation

- ÿ Banking organizations need to regularly review incentive compensation practices and correct identified deficiencies
- ÿ No one size fits all: systems need to be tailored to size and complexity of the firm, its business strategy and risk tolerance
- ÿ Large, complex banking organizations (“LBO’s”) expected to have systematic and formalized policies, procedures and process
- ÿ Smaller banking organizations using incentive compensation expected to have less extensive, formalized and detailed systems

Guidance on Incentive Compensation

Supervision and examination

- Y Incentive compensation practices to be evaluated in connection with evaluation of firm's risk management internal controls and corporate governance during regular, risk-focused exams
- Y If banking organization does not use incentive compensation to a significant extent, this area will require little, if any, examination work. Banking organization won't be deemed to be a significant user if it has a firm-wide profit-sharing or bonus plan based on the firm's profitability, even if it covers most employees
- Y Findings will be communicated to the banking organization in the ROE and taken into account in ratings—related to risk management, internal controls and corporate governance
- Y Agency may take enforcement action if incentive compensation arrangements pose a risk to safety and soundness

Guidance on Incentive Compensation

Principle #1: Balanced Risk Taking

- Y Incentive compensation should take into account not only the financial benefits of the incentivized behavior but also the risks (including the compliance risks).
- Y Organization-wide incentives linked to firm performance are less likely to encourage imprudent risks on behalf of individual employees
- Y Incentive compensation should be designed to make sure that pay-outs vary based on risk outcomes: e.g., substantial incentive pay-outs shouldn't be available if risk outcomes are negative
- Y Banking organizations should be particularly alert to “bad tail risks” (owners and management may have less incentive to guard against them because of the federal safety net)

Guidance on Incentive Compensation

How to make compensation more sensitive to risk:

- Y Risk adjustment of awards (based on quantitative measures or judgment)
- Y Deferral of Payment beyond performance period (may be more appropriate when possible risk outcomes hard to quantify)
- Y Longer performance periods
- Y Reduced sensitivity to short-term performance: reduce the rate at which awards increase as employee achieves higher levels of performance, thereby reducing the magnitude of incentives)

To the extent judgment (rather than quantitative data) used in design of incentive compensation, monitoring of outcomes particularly important

Guidance on Incentive Compensation

Principle #2: Compatibility with Effective Controls and Risk-Management

- Y Strong controls needed to assure viable process for designing, implementing, and monitoring incentive compensation arrangements
- Y The controls should be reflected in sufficient documentation to permit effective auditing and examination
- Y Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified personnel and avoid conflicts of interest. Compensation should not be based on performance of the business units they review—but rather on the achievement of their functions: adherence to internal controls
- Y Recognition that system may be constantly under challenge by those seeking to increase their incentive compensation

Guidance on Incentive Compensation

Principle #3: Strong Corporate Governance

Compensation committee should:

- ÿ Approve incentive compensation for senior executives and carefully monitor the arrangements
- ÿ Be ultimately responsible for assuring that incentive compensation is appropriately balanced
 - ÿ Monitoring function
 - ÿ Oversight of internal controls
- ÿ Should have sufficient expertise and expertise (or access to such expertise and experience) in risk management and compensation practices: smaller banking organizations may not have the expertise themselves but can retain outside experts, although the board cannot delegate the ultimate responsibility for design of appropriate incentive compensation

Guidance on Incentive Compensation

Disclosure

- Y Disclosure practices should support safe and sound incentive compensation practices
- Y Disclosure should be sufficient to permit shareholders to monitor incentive compensation practices and related risk management, control and governance procedures
- Y Such disclosure is consistent with July 2011 Basel Committee's proposed "Pillar 3" disclosure requirements of remuneration "to allow market participants to assess the quality of the compensation practices and the quality of support for a firm's strategy and risk Posture."

Dodd Frank § 956

Banking agencies required to prescribe regulations or guidelines with respect to incentive compensation for banking organizations (banks and bank holding companies) with \$1 billion or more that:

- Prohibit incentive-based compensation that encourages excessive risk-taking
- Require disclosure to regulators of the nature of incentive-based compensation to “covered persons” (executive officers, other employees, directors or principal shareholders) to permit regulators to determine whether compensation is excessive or may lead to a material loss
- Require banking organizations to adopt corporate governance guidelines for developing, monitoring and evaluating incentive compensation arrangements

Dodd Frank § 956: \$1 billion +

Proposed rules on incentive compensation practices **at banks and bank holding companies with \$1 billion or more** issued on April 14, 2011

Will be effective six months after publication of final rule

Proposed rules based largely on the Guidance on Incentive Compensation discussed above

The Guidance and these rules likely to become “best practices” for all banks and bank holding companies

Dodd Frank § 956: \$1 billion +

Required annual report to regulators on structure of incentive-based compensation sufficient to allow assessment of whether the structure (or features) likely to provide excessive compensation or benefits that could lead to a material loss.

Dodd Frank § 956: \$1 billion +

Prohibitions on excessive incentive-based compensation

- Y Incentive-based compensation must not encourage inappropriate risk by providing excessive compensation: *i.e.*, compensation that is unreasonable or disproportionate to services . FDIA § 39(c)
- Y Incentive-based compensation must not encourage inappropriate risk that could lead to a material loss. To meet this standard:
 1. Must balance risk and reward, *e.g.*, by using deferral of payments, risk adjustment of awards, reduced sensitivity to short-term performance, or longer performance periods
 2. Must be compatible with effective controls and risk management
 3. Must be supported by strong governance, including effective board oversight

Dodd Frank § 956: \$1 billion +

Policies and Procedures

- Y Incentive-based compensation will be prohibited unless adopted pursuant to policies and procedures approved by the Board, which are reasonably designed to ensure and monitor compliance with the substantive aspects of the rules
- Y The policies and procedures may be commensurate with the size and complexity of the institution, as well as scope and nature of the use of incentive-based compensation

Dodd Frank § 956: \$1 billion +

Policies and Procedures must, at a minimum:

1. Be consistent with reporting requirements and prohibitions of rule
2. Ensure that risk management, risk oversight and internal control personnel have an appropriate role in design of compensation structure and assessing its effectiveness in restraining inappropriate risk taking
3. Provide for monitoring to determine whether incentive compensation is reduced to reflect adverse risk outcomes or high levels of risk taken
4. Provide for board to receive sufficient data to assess whether compensation structure is consistent with Dodd Frank § 564
5. Ensure that institution has adequate documentation of processes for establishing, implementing, modifying and monitoring incentive-based compensation to determine compliance

Dodd Frank § 956: \$1 billion +

6. Where deferral is used, take into account amounts and time periods appropriate to the duties and responsibilities of those receiving incentive-based compensation and the size and complexity of the institution; and provide for adjustments to reflect actual losses or other measures of performance realized (or better known) during the deferral period
7. Subject incentive-based compensation to approval and oversight by the Board

Dodd Frank § 956: \$50 billion +

In addition, institutions with \$50 billion in assets subject to additional prohibitions:

- Senior officers and heads of material business lines must defer at least 50% of incentive awards for at least 3 years
- During deferral period, award must be adjusted to reflect actual losses or other measures of performance that become better known during the deferral period
- Board must identify those covered persons other than executives who can expose the institution to substantial losses (e.g., traders) and approve compensation for them, balancing risk and financial rewards

SEC-Dodd Frank Developments

- ÿ Say-on-Pay advisory vote
- ÿ Say-on-Frequency advisory vote (how often to vote on say-on-pay)
- ÿ Say-on-Golden Parachutes triggered by business combinations
- ÿ SEC to adopt rules directing the securities exchanges to adopt listing standards with respect to the independence of compensation committee members—and the use of advisors/consultants to the compensation committee
- ÿ SEC to require expanded disclosure on executive compensation, including the relation of pay to performance and the ratio of median employee compensation to CEO compensation
- ÿ SEC to direct securities exchanges to adopt listing standards with respect to clawbacks in event of accounting restatements

Some Consequences for Board

- Y Board responsible for oversight of design, implementation, monitoring and evaluation of incentive-based compensation system that balances risk and rewards
- Y Board will need to review and approve the overall goals and purposes of incentive compensation and ensure consistency with the firm's risk tolerance
- Y Compensation system will need to be incorporated into written policies and procedures approved by the Board
- Y Board cannot simply rely on its duty to its shareholders but must balance shareholder rewards with risk: dual constituency based on federal safety net
- Y Compensation committee will need to be independent of management and have sufficient expertise (or engage expertise) to fulfill its duties
- Y Banking organizations will be examined and rated on effectiveness of Board governance over compensation system

About Morrison & Foerster

Banking and Financial Services Practice

Y Morrison & Foerster has one of the premier financial services practices in the United States. We serve our clients efficiently and effectively by offering comprehensive expertise in virtually all matters affecting financial institutions.



"one of the finest Financial Services Regulatory Practices... decades of banking experience... exceptional breadth and depth of expertise."

-Chambers USA



"The firm's geographical diversity is matched by the variety of work it handles within the financial services sector."

-Legal 500 US



"Regarded as one of the US' innovative finance teams, Morrison & Foerster has a comprehensive banking and finance practice."

-PLC Which lawyer? Global 50 Portrait

MoFo Resources

Helping you to stay ahead

Y Our **Regulatory Reform – News and Resources** site includes client alerts, articles, related resources and presentations dedicated to keeping you ahead of regulatory reform.

<http://www.mofo.com/resources/regulatory-reform/>

Y **FrankNDodd** is our online resource that tracks rulemaking pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, including rule proposals, rulemaking, and publication of study results and public comments, as well as key dates for comment deadlines, enactment deadlines, and effective dates.

To obtain a password for our FrankNDodd site, please email subscribe@frankndodd.com indicating you are a contact of Henry Fields.

Questions

Henry M. Fields
Morrison & Foerster LLP
555 West Fifth Street
Los Angeles, CA 90013

(213) 892-5275
hfields@mof.com