BankDirector

Breakout 3: Compensation, Regulatory Oversight & Liquidity – What Have We Learned?

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Compensation, Regulatory Oversight & Liquidity – What Have We Learned?

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What is on the horizon?

- *Incentive compensation is in the spotlight*
- *Expect more regulation. Expect it will go beyond guidance.*
- *Evaluate/update your governance structure*
- *Consider building in a structured opportunity to adjust incentives based on risk*
- *Have a plan, have a process, be proactive. Properly implemented, these processes lower risk.*

Latest from Washington

The recent failure of Silicon Valley Bank / Signature has produced a renewed sense of urgency.

Federal Reserve – Vice Chair for Supervision, Michael S. Barr

- *"SVB's board of* ***directors and management failed to manage the bank's risks****."*
- *The [Fed] exam team noted* ***weaknesses regarding the SVB's board [compensation committee] oversight*** *of the incentive compensation program.*
- *"Its senior leadership* ***focused on short-term profits****..."*
- *"In addition, our oversight of incentive compensation for bank managers should also be improved. SVB's senior* ***management responded to the poor incentives approved by its board of directors; they were not compensated to manage the bank's risk****, and they did not do so effectively."*
- *"****Stronger or more specific supervisory guidance or rules on incentive compensation*** *for firms of SVBFG's size, complexity, and risk profile—or more rigorous enforcement of existing guidance and rules—may have mitigated these risks."*

Aon *– SVB's incentive practices were effectively "pre-Great Recession" in that they were incented solely on profit, had no formal risk review process and the compensation committee did not exercise its oversight responsibilities.*

Latest from Washington

The recent failure of Silicon Valley Bank / Signature has produced a renewed sense of urgency.

Elsewhere in Washington

- **White House:** The President is **calling on Congress to expand the FDIC's authority to claw back compensation** – including gains from stock sales – from executives at failed banks like Silicon Valley Bank and Signature Bank.
- **Senator Gary Peters:** Given how incentive-based compensation can continue to lead to certain financial institutions and professionals taking excessive and reckless risks, **implementation of this long-delayed rule [Section 956]** is an important reform to ensure reckless financial risks and financial mismanagement do not put our banking system at risk.
- **Proposed bill – Failed Bank Executives Clawback Act:** Would require the FDIC to claw back from executives all or part of the compensation received over the **5-year period preceding a bank's insolvency** as is necessary to prevent unjust enrichment.

***Aon** – There is bipartisan support for going forward to changes for compensation at banks. This isn't a matter of "if", it is a matter of "when". Most likely rules promulgation would be 2024.*

Where Are We Now?

In effect now	Sound Incentive Compensation Policies	How does your bank implement existing regulatory guidance to oversee all incentive compensation arrangements? This is an expectation today.
Coming soon!	Clawback(s)	If you are public, new clawback rules will most likely be in effect by August of this year. Many firms are contemplating two clawback policies – one under the law and one for the rest of the bank.
	Sec. 956 Incentive Compensation Arrangements	This is the last compensation provision under Dodd-Frank to be implemented. Everyone is calling for this to be enacted given SVB/Signature/First Republic bank failures. This is going to happen.
	Liquidity Monitoring	How have your risk monitoring functions expanded to think not only about credit, but about liquidity and capital levels when assessing how your incentive compensation plans payout?

Regulatory Update

Compensation Related Items

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Dodd-Frank Wall Street Reform and Consumer Protection Act

Section	Provision	Shorthand	Applicability	Status
Implemented				
951(a)	Shareholder Vote on Executive Compensation	Management Say-on-Pay (“MSOP”)	All public companies	Effective 2011
951(b)	Shareholder Vote on Golden Parachute Compensation	Say-on-Golden-Parachutes	All public companies	Effective 2011
953(b)	Pay Ratio Disclosure	CEO Pay Ratio	All public companies	Effective 2018
953(a)	Pay Versus Performance Disclosure	Pay Versus Performance	All public companies	Effective 2023
Not Implemented				
954	Recovery of Erroneous Awarded Compensation	Clawbacks	All public companies	SEC adopted final rules October 2022 Listing exchanges have proposed standards. **If the SEC approves the Nasdaq/NYSE proposals, Companies must adopt a revised clawback policy by December 1, 2023**
956	Enhanced Compensation Structure Reporting	Incentive-based Compensation Arrangements	Financial Institutions (Banks > $1 B)	Proposed March 2011, Re-proposed April 2016 **This is the only Dodd-Frank compensation provision not implemented! Regulators have stated this has found new focus in D.C.**

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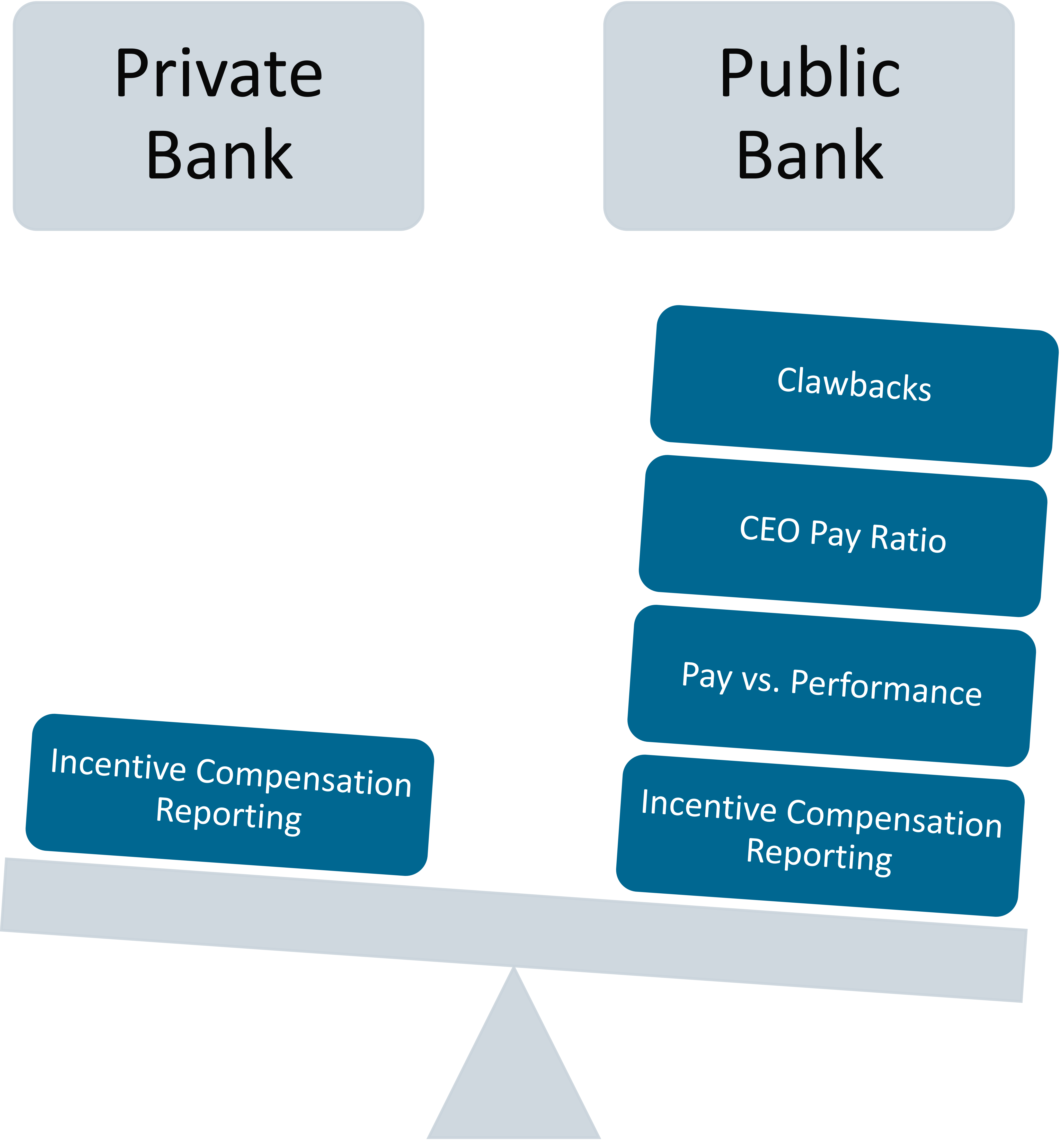
How Does Dodd-Frank Apply to You?



Clawbacks have been shaped primarily by three pieces of legislation

SEC Clawback Rule (Section 954) – Key Features

COMPANIES COVERED

- **Any company listed on a national securities exchange**
- Includes emerging growth companies, smaller reporting companies, foreign private issuers, and controlled companies.

WHAT • Companies are required to recover **"excess" incentive compensation[1] paid based on a misstated financial reporting measure**	**TRIGGERS** • **"Big R" restatements**: corrections of material errors made by restating prior period financial statements • **"Little r" restatements**: restatements: corrections of non-material errors to previously issued financial statements that would result in a material misstatement if left uncorrected or that are corrected in a current period financial report • Covered person **fault or misconduct doesn't matter**
WHO • Current and former **Executive officers** • Those who perform a policy-making function (modeled after the Section 16 definition)	**LOOK-BACK PERIOD** • Incentive compensation paid relating to the **3 completed fiscal years immediately preceding the date of the required accounting restatement**
NO BOARD DISCRETION • Board is **required to take action** if a restatement triggers a clawback	**MISCONDUCT OUTSIDE OF RESTATEMENT** • Not covered by new SEC rule / exchange listing standards • Some companies have separate discretionary provisions or policies to address misconduct and other code of conduct violations

DISCLOSURE

- All companies **must file their clawback policy** as an exhibit to their Form 10-K
- If a company has a restatement, it must: (i) disclose by checkmark on cover of Form 10-K and (ii) describe actions taken in the proxy statement

COMPLIANCE DATE: **If the SEC approves the proposals by June 11, 2023, Companies must adopt a revised clawback policy by August 8, 2023**

(1) Incentive-based compensation is defined as "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure"; time-based equity is excluded, but equity tied to the achievement of TSR or stock price hurdles is included.

Incentive Compensation Arrangements (Section 956)

This is the subsequent regulation to Sound Incentive Compensation Policies (SICP, June 2010). Unlike SICP, proposed Section 956 goes beyond simply guidance. The focus is on:

1. Prohibiting any type of incentive that the regulators determine encourages inappropriate risks that could lead to material financial loss
2. Requiring disclosure to regulators the structure of all incentive compensation arrangements

Background

- Applies to both public and private financial institutions with assets $1 billion or more
- Joint regulation by the OCC, Federal Reserve Board, FDIC, FHFA, NCUA, and SEC ("Agencies")
- Original proposal was April 2011 and totaled 71 pages. Re-proposed in April 2016 with a range of 279 pages to 700 pages based upon regulatory body publishing. Aligned with rulemaking by foreign regulators. Latest comment period ended July 2016.
- Congress could codify any or all of the measures in the 2011 or 2016 proposals. Congress also could amend Section 956 so that its general prohibition of the relevant types of incentive-based pay goes into effect and is enforceable by a certain date, regardless of whether the banking regulators have finalized associated regulations.
- **Large portions of Section 956 need to be rethought given (a) changes to SIFI rules, (b) risks beyond credit and (c) how Europe has evolved on similar items, i.e., they are on version 5 of these rules**

Three levels of financial institution	Covers banks, credit unions and U.S. based subsidiaries of foreign parents • Level 1: Firms with assets >= $250 B • Level 2: Firms with assets >= $50 B and less than $250 B • Level 3: Firms with assets >= $1 B and less than $50 B Note: Regulators may classify any firm with assets >= $10 B up to $50 B as a Level 1 or 2

Incentive Compensation Arrangements (Section 956)

Level 1 & 2 firms: Downward adjustments, forfeitures, and clawbacks

Applies to senior executive officers (SEO) and significant risk takers.

Downward Adjustment	During a period where incentive compensation is being earned, it must be eligible for a downward adjustment, taking into account non-financial measures.
Forfeiture & Clawback	Once incentive compensation has been earned, but is deferred, it must be eligible for forfeiture. Circumstances when forfeiture or downward adjustment reviews are expected include, but are not limited to: ▪ Poor financial performance attributable to significant variation from firm's risk parameters ▪ Inappropriate risk-taking regardless of financial impact ▪ Material risk management or control failures ▪ Non-compliance with regulatory requirement ▪ Legal action by regulatory body ▪ Financial restatement ▪ Other conduct/performance issues defined by the firm ▪ **Clawback:** Once an award has vested, it must be subject to a 7-year clawback Example: Level 1 SEO example with 12 years of impact ▪ 3-year performance-based LTI ▪ 2-year mandatory deferral ▪ 7-year clawback period

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Sound Incentive Compensations Policies (SICP)

Sound Incentive Compensations Policies, **"The Guidance"** (finalized June, 2010) requires incentive compensation plan arrangements to balance risk and financial results in a manner that does not encourage employees to expose their organization to imprudent risk. The Guidance applies to individuals or groups of employees that can expose an organization to material amounts of risk.

- Anchored by three principles:

*As banks of all sizes have already spent time ensuring balanced risk and reward in their incentive plan designs, **these two highlighted principles are often a remaining focus area for banks below the $50b "Large Bank" threshold***

- The Guidance sets forth four, nonexclusive, methods for balancing incentive compensation and risk:
  1. Risk adjusting awards
  2. Deferring payment
  3. Using longer performance periods
  4. Reducing the sensitivity of awards to measures of short-term performance

- Subsequent guidance has also been provided by the OCC through its "Heightened Standards" (2014) and its 2016 horizontal review of "Sales Practices and Incentive Compensation"

- The CFPB has also released guidance and expectations around Detecting and Preventing Consumer Harm from Production Incentives

Regulatory Focus Areas for Incentive Compensation

Over time, regulators have demonstrated focused attention in the following six primary areas:

Principl e 1	Risk Review of its Incentive Plan Design	Firms need to develop an approach by which they **review incentive plans to ensure that each plan accounts for the risks** that are inherent in the roles covered by the plan. This assessment must align to the overall governance structure outlined by the firm and occur on a regular basis.
Principle s 2 & 3	Governance Structure for Managing Incentives	Regulators expect significant involvement in the design, decision making and ongoing monitoring of compensation programs **by the board and internal control functions**.
	Process for the Identification of Covered Employees	Banks should implement a systematic, documentable methodology for the identification of those individuals who are subject to the oversight of regulators. This process must **identify individuals and jobs which individually and/or collectively expose the bank to material amounts of risk**.
	Monitoring and Validation Exercises	Regulators expect banks to monitor the effectiveness of the balancing mechanisms within the compensation framework to discourage excessive risk taking. **Monitoring should occur both throughout the process of making compensation decisions, but also after the fact**.
	Approach to Training and Documentation	A heightened expectation of the regulators is that **compensation decisions are well documented to make for auditing of the process and outcomes possible**. Additionally, they expect that compensation decision makers are well versed in accounting for risk in their compensation decisions.
	Sales Practices Controls	A heightened expectation exists around **account opening, sales goals, and balance between revenue targets and risk management / customer satisfaction**. Additionally, banks should have sales practices governance frameworks whereby information channels are not siloed but, instead, reviewed holistically.

Incentive Compensation Design and Governance

Incentive Compensation – Evolving Risk Management Practices

- Regulators acknowledge risks are obvious in the rearview mirror but are less easily identified beforehand.
- Fed Vice Chair for Supervision Michael S. Barr before the House Financial Services Committee
  - *"We should be humble about our ability—and that of bank managers—to predict how losses might be incurred, how future financial stress might unfold, and what the effect of financial stress might be on the financial system and our broader economy."*
- In effect, it has become even more clear that risks cannot be expected to be managed solely through the right mix of goals and the selection of the proper incentive payout trigger.
- **Based on this, we are seeing an evolution in:**
  - **Incentive compensation governance structures**
  - **Incentive plan design practices**

Evolving Governance Structure – Regional & Community Bank Practice

Backward looking to last fiscal year

What material activities occurred?

- *exceptions for individual payment?*
- *modifications to incentive plans?*

Compensation Committee

Incentive Comp Steering Committee (**ICSC**)

LOB LOB LOB LOB

Line of business (LOB) plan sponsors. Validate all calculations. Coordinate w/ ICSC.

Forward looking to next fiscal year

How have incentive plans been designed/ modified to be compatible with SICP?

ICSC reviews/approves plans, payouts, material changes, and certain exceptions.

May work directly with LOBs to ask questions, review/modify plans, prepare communication materials and evaluate modifications/ exceptions.

--or--

ICSC may delegate this work to a separate working group or other individuals and instead focus only on reviewing and approving plans before being presented to the Comp Committee.

Prior Year Future Year

Audit Committee

Internal Audit

Backward looking to last fiscal year

Audits some calculations, data flows, and processes for overall accuracy

Governance Structure – Regional & Community Bank Practice

Compensation Committee

Governing body that has overall responsibility under SICP.

Committee should adopt an Incentive Compensation & Risk Management Policy which:

- Defines the governing framework.
- Defines what the Committee will approve (e.g., new plans, mid-year modifications, material exceptions, clawbacks)
- Establishes the type of sub-committees and/or working groups to be used and sets expected frequency of communication

Incentive Comp Steering Committee (ICSC)

Formal committee allows for a documented trail for review by regulators that describes both process and outcomes.

- Formalized via a charter. Typically, co-owned by Risk and HR.
- Comprised of executives, such as the CHRO, CFO, Chief Risk, General Counsel, Chief Credit.
- ICSC reviews plans and approves plans, payouts, material changes, and certain exceptions.

Other responsibilities: May be handled directly by the ICSC **or** may be delegated to other senior personnel from HR, legal, compliance, audit, credit, finance or other control functions.

- Participate in the plan design alongside business lines. Serves as an integrated control, providing insight on market practice and risk considerations at the earliest stages of plan design.
- Conduct initial risk assessments on plans in collaboration with business lines.

Risk Management – Incentive Modifier Approach

Balanced Scorecard

Financial Results
Expense Management
Operational/Strategic Results

Payout Triggers:
Credit Quality, Liquidity, Capital Ratios

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Enterprise Risk Management Modifier (0 – 100%)
(Quantitative to start, but board has full discretion)

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Final Risk Adjusted Incentive Award $$$

Rating established based on adherence to risk appetite, direction of risk (increasing, stable, decreasing), environmental factors, and each executive's area of accountability.

Business Area	Risk Assessment Area							
	Credit	Liquidity	Compliance	Legal	Operational	Reputational	Interest Rate	Strategic
Commercial Banking	High	--	Low	Low	Medium	Low	Medium	Medium
Commercial RE	Medium	--	Low	Low	Medium	Low	Medium	Medium
Mortgage		--	Medium	Medium	Medium	Medium	Medium	High
Retail Banking	Medium	--	Medium	Medium	Medium	Medium	Medium	Medium
Wealth Management	--	--	Low	Low	Medium	Low	Medium	Low
Treasury & Finance	--	Low	Low	--	Low	Low	Medium	--
Operations	--	--	Medium	Low	Medium	Low	--	Medium
Technology	--	--	Medium	Medium	Medium	Medium	--	Medium

EXAMPLE

Evolving Practices – Incentive Governance

At the Board / Committee level:

- Ensure Committee books are available to all Board members
- Ensure cross-pollination of Compensation and Risk Committee members
- Ensure the Chief Risk Officer has appropriate and regular interaction with the Compensation Committee
- Ensure Compensation Committee charters include, as part of the Committee's duties, oversight of all incentive compensation at the Bank. The charter should also allow for delegation of authority
- Review potential delegation of duties from compensation committee to management led Incentive Compensation Steering Committee for overall incentive management with reporting / accountability back to the compensation committee

Thank you!

- *Where is your bank on existing regulatory expectations?*
- *How have you changed your risk monitoring processes given 2023?*
- *Get ready for more regulation, not less.*

- *Questions?*