BankDirector

Breakout 3: Compensation, Regulation and Best Practices – Where Are We 18 Months After SVB?

Bryan Lemke
McLagan

Chris Richter
McLagan

#BDAudit24

Compensation, Regulation, and Evolving Practices

June 2024

Bryan Lemke | Associate Partner
952.886.8272 | bryan.lemke@aon.com

Chris Richter | Associate Partner
952.886.8217 | chris.richter@aon.com

What is on the horizon?

- *Expect more regulation….maybe. Significant uncertainty on timing and form.*
- *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.*

Washington Narrative

April 2023	Michael S. Barr Fed Vice Chair for Supervision

Review of the Fed's Supervision and Regulation of SVB

- *"SVB's board of **directors and management failed to manage the bank's risks**."*
- *The [Fed] exam team noted **weaknesses regarding the SVB board's [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."*

March 2024	Jerome Powell Fed Chair

Testimony Before House Financial Services Committee

- *[Referring to whether incentive compensation contributed to SVB's failure] "**I would say it's at best a tertiary factor. But it probably had something to do with it**"*
- *Do you agree that appropriate rules on incentive compensation could have reduced the likelihood of Silicon Valley Bank's failure?" **"No, I really don't think so. I don't think it's a first order question for Silicon Valley. A lot went wrong there. Incentive compensation would be way down the list."***
- *"Do you think it has something to do with the fact that Section 956 of the Dodd Frank rule hasn't by finalized by you?" **"No I don't. I don't think that incentive compensation arrangements were at the heart of the Silicon Valley Bank failure."***
- *"Do you believe in a robust rulemaking process for executive compensation?" **"I do."***
- *Will you commit to helping finalize Section 956 this year?" **"I would like to understand the problem we're solving and then I would like to see a proposal that addresses that problem.***

AON

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 ?

Sec. 956 Incentive Compensation Arrangements

This is the last compensation provision under Dodd-Frank to be implemented.
March 2023 bank failures – an inciting event to spur on finalization.

Regulatory Update

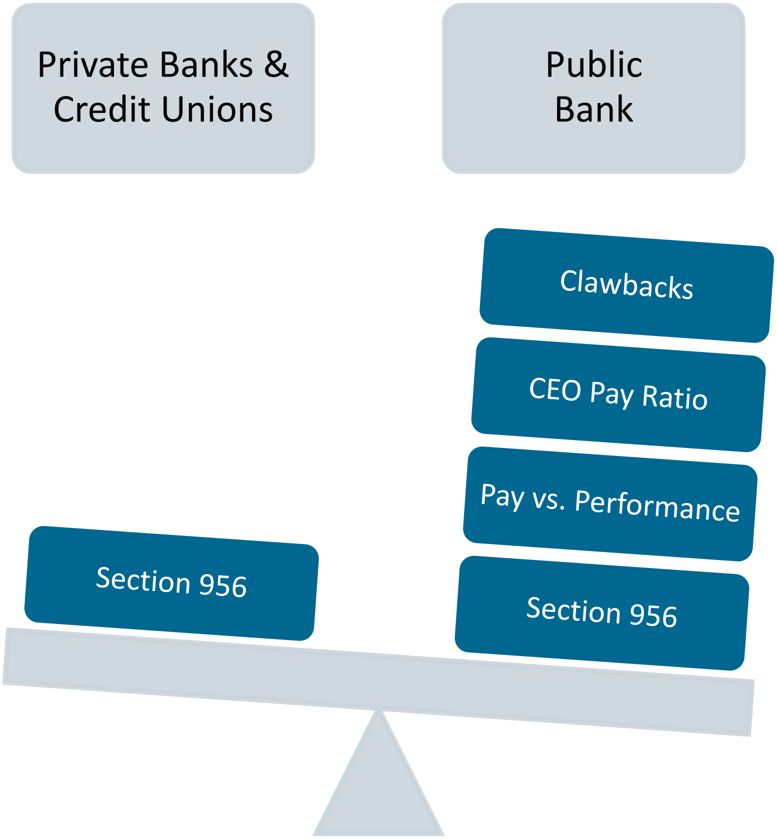
Compensation-Related Items

Dodd-Frank Wall Street Reform and Consumer Protection Act

Section	Provision	Shorthand	Applicability	Status
Not Implemented				
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!** **The 2016 proposed rules were reproposed again in May 2024, with support of only 3 of 6 agencies.**
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
954	Recovery of Erroneous Awarded Compensation	Clawbacks	All public companies	SEC adopted final rules October 2022 Companies were required to adopt clawback policies by December 1, 2023

AON

How Does Dodd-Frank Apply to You?



AON

SEC Clawback Rule (Section 954) – Key Features

COMPANIES COVERED

- **Any company listed on a national securities exchange**

WHAT

- Companies are required to recover **"excess" incentive compensation[1] paid based on a misstated financial reporting measure**

TRIGGERS

- **Restatements**
- Covered person fault or misconduct doesn't matter

WHO

- Current and former **Executive officers**

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

- 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

AON

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. Protecting against excessive incentives that may encourage inappropriate risks and lead to material financial loss
2. Prescribing specific compensation impacts for senior executive officers and significant risk takers
3. Requiring covered institutions keep records of their incentive compensation programs and their compliance with the rule for seven years

- **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. Re-proposed in April 2016. Aligned with rulemaking by foreign regulators. Latest comment period ended July 2016.

On May 6th 2024, the FDIC, OCC, and FHFA announced they are reproposing the 2016 language verbatim for additional commentary. However, the proposal cannot be official until the Federal Reserve, NCUA and the SEC also approve. Notably, whereas both the SEC and NCUA have commented about their upcoming actions on 956, the Federal Reserve has not commented to date.

Incentive Compensation Arrangements (Section 956)

Level 1 & 2 firms: Level 1: Firms with assets >= $250B Level 2: Firms with assets $50B to $250B

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

AON

Incentive Compensation Arrangements (Section 956)

Level 3 firms: Firms with assets $1B to $50B

Requirements for all firms (including Levels 1, 2, and 3)		
1.	**Prohibition on excessive compensation**	Considers individual compensation history of the individual, financial condition, market practices, cost and benefit to the institution
2.	**Arrangements leading to material financial loss**	Essentially, the same core principles defined as part of the 2010 Guidance on Sound Incentive Compensation Policies.
3.	**Performance measures**	Plans must consider financial and non-financial measures of performance, risk-taking, and potential adjustments based on negative risk outcomes.
4.	**Board of directors responsibilities**	The board must 1) conduct oversight of the firm's incentive programs, 2) approve senior executive incentive arrangements, 3) must approve material exceptions or adjustments to plans.
5.	**Annual disclosure and recordkeeping requirements**	Firms must create annual records and maintain these records for seven years. Records must list plan structure, participants, and how the program is compatible with effective risk management.

Considerations for Companies:

While not yet mandated under Section 956, many of these elements represent "good hygiene" for banks.

Incentive Compensation Arrangements (Section 956)

Summary of 2024 Proposed Alternatives

- Levels:
  - Should there be a 2-level versus a 3-level system (e.g., $1B-$50B and $50B)
  - If a 2-level system, would mandatory deferrals only apply to those firms >$50B?
- Significant Risk-Taker: Should this definition move to a principled approach versus a rules-based approach?
- Performance Goals: Should they require the establishment of performance measures and targets before the performance period?
- Options: Should they be limited to 10% from 15% of the variable compensation mix?
- Compliance Date: Should this move from 540 days to 365 days (meaning first calendar quarter 365 days after the final rule is published)?
- Clawbacks: Should they *require* clawbacks versus “consider” a clawback?
- Downward Adjustments: Should these adjustments be required versus at the discretion of the institution?
- Volume-Driven Incentive Based Compensation: Should any plans that incorporate volume-based metrics be covered and revised for risk-mitigating features versus plans solely based upon volume-based metrics?
- Hedging: Should they include prohibitions against purchasing hedging instruments to offset a covered person’s incentive compensation?

Considerations for Companies:

- Continue to monitor progress
- Engage via comment letter submissions, where applicable

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:

1. Balance risk and reward
2. Be compatible with Controls and Risk Management
3. Have strong Corporate Governance

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:

Principle	Area	Description
Principle 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.
Principles 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 (in 2023)
  - *"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**)

LO

LO

LO

LO

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 Example

Balanced Scorecard

Financial Results
Expense Management
Operational/Strategic Results

Initial Calculated Award $$$

×

Enterprise Risk Management Modifier (0 – 100%)
(board has full discretion)

=

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.

EXAMPLE

	Risk Assessment Area							
Business 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

<u>Plan Modification</u>:
Adjustment which may affect all plan participants equally, e.g., down by 10%

<u>Individual Modification</u>:
Adjustment which may affect or more individual plan participants

AON

Risk Management – Incentive Modifier Example

Balanced Scorecard

Financial Results
Expense Management
Operational/Strategic Results

=

Initial
Calculated Award
$$$

Measure	Trigger Level
Well-Capitalized Status	Falling below well-capitalized status
Liquidity Status	Total Wholesale Funding to Total Deposits and Borrowings >x%
Credit Quality	Material, unanticipated increase in non-performing assets or criticized loans
Other Factors	May include CAMELS rating, MRBAs, compliance, non-financial considerations

Impact to Initial Calculated Award
No Bonus
Board discretion, but **capped** at the initial award calculated level based on balanced scorecard

=

Final Risk Adjusted Incentive Award
$$$

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?*
- *Monitor regulatory action.*
- *Questions?*