2015 Compensation Update

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The Bankers' Statement – Spring 2015

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As 2015 gets under way, bank compensation committees are tasked with setting the bank's executive compensation strategy for the year and effectively communicating that compensation structure to shareholders. Compensation committees need to strike a balance between a compensation program that attracts and retains employees and encourages those employees to take appropriate business risks while advancing the bank's growth strategies and discouraging inappropriate risks. In order to achieve that balance, the compensation committees must be aware of current banking compensation trends, develop a strategy to address these trends, and communicate their compensation strategy to regulators, their employees and shareholders.

Current Executive Compensation Environment and Trends

After several years of turbulence in compensation practices, a result of shifting regulatory mandates and a rocky economy, a few trends are emerging. Notably, compensation is moving towards a more performance-based model. According to a 2015 survey,[1] compensation committees believe their greatest challenge in designing executive pay is aligning executive incentives with business strategy and objectives. Compensation committees are addressing this challenge via a number of strategic changes:

- Compensation committees are moving away from stock options and time-based vesting of stock grants and instead granting performance-based grants (where the number of restricted shares or restricted stock units granted is based on satisfaction of performance standards) and performance-based vesting (where the vesting is based on satisfaction of performance standards). One example of this is an award that grants a number of restricted stock units if a performance goal is satisfied in fiscal year 1 and that vests the shares at the end of 3 years if the performance goal is also met

over the 3-year period. In this way, the company protects against risky decisions that might increase the number of restricted stock units granted with long-term adverse consequences, since the shares would not ultimately vest.

- Performance goals themselves are also evolving. Many companies are using absolute performance goals rather than relative performance goals.
- There has been an increased use of forfeiture provisions, clawback provisions and shareholding requirements in agreements to address concerns that the compensation programs could otherwise encourage an executive to take inappropriate risks.

Compensation committees are also preparing for new reporting requirements that will apply to publicly traded companies that compare executive pay to that of the bank's "median" employee to ensure that the committee is prepared for any backlash that may follow the disclosure of that pay ratio.

Many compensation committees are particularly focused on executive bonuses. There has been increased emphasis on aligning bonuses with progress toward business goals, both short-term and long-term. There has also been increased attention given to the potential adverse consequences that could arise due to the incentives created by bonuses. Compensation committees are designing combined programs to mitigate risks. For example, instead of rewarding loan origination based solely on volume (which could encourage extending risky loans to obtain a bigger bonus), they are including offsetting adjustments that reduce the bonus based on loan default rates. This shifts the incentive to balance the risks.

With regard to retirement benefits, banks continue to supplement their qualified deferred compensation plans (such as 401(k), employee stock ownership plans, and pension plans) with non-qualified arrangements (like "salary continuation agreements") and employment agreements. Many banks are surprised at the incentives in their salary continuation agreements that may not facilitate the bank's business goals. For example, many agreements provide that no amount is payable until the employee has a "separation from service," which makes phased retirement (working a reduced schedule for reduced pay, supplemented by the commencement of the plan benefit) difficult. This leads to the executive retiring more quickly than might be desired by both the bank and the executive. Other agreements hard wire payment at a fixed date, which triggers double payment to people who continue to work after that date. The Internal Revenue Code limits the ability to change these arrangements, but you have the best options if you plan ahead.

Finally, given the current level of M&A activity in the banking industry, many compensation committees are evaluating the benefits their executives would receive if a change in control occurs. Often the employment agreements and salary continuation agreements promise compensation well in excess of the limits under Internal Revenue Code Section 280G, with a cut back to the maximum amount that could be paid under that section.

In general, Section 280G limits the amount that can be paid to an executive in connection with a change in control to three times the five-year average of that executive's W-2 wages as reported in box 1 for the five years prior to the date of the change in control. Compensation committees (and executives) should monitor how these limits would be expected to apply to avoid unnecessary surprises (and resulting ill-will) when the cut-backs are calculated. Committees should also note that significant use of pre-tax benefits (like 401(k) plan contributions and contributory non-qualified deferred compensation plans) reduce W-2

wages for 280G calculations, which means the executive will face bigger cut-backs. Compensation committees need to consider the executive's overall pay structure before promising large pay-outs in salary continuation agreements and employment agreements.

Increased Emphasis on Proxy Disclosures and Shareholder Communication

Not only is the mix of executive compensation shifting, but both shareholders and regulators (like the SEC) want enhanced communication regarding the compensation structure. Companies can no longer merely provide a generic description of compensation in its public disclosures. Instead, companies need to explain how their compensation structure supports and encourages the bank's strategic goals and business plan. They also want to see that the compensation structure adequately balances risks and reward by encouraging appropriate risk-taking and discouraging inappropriate risks.

To address this, some companies are including an executive summary in the Compensation Discussion and Analysis section of the proxy statement. This executive summary explains how the bank's mix of compensation supports its business goals, fits with the banks philosophy and adequately balances risk and reward.

Best Practices

Bank compensation committees have to be aware of the current executive compensation environment and trends. Additionally, they should establish and adhere to a number of practices to satisfy shareholder, employee and regulatory expectations:

- Document the compensation committee charter.
- Prepare compliance calendars to ensure they are meeting all necessary state and federal reporting requirements.
- In addition to annual performance reviews of the executives, review the performance of the committee members and its advisors annually.
- Review "tally sheets" that reflect each senior executive's total compensation package and range of potential results, which assists in evaluating the package and also in assessing compensation risk versus reward.

Closing Thoughts

Due to the changes in the market and regulatory requirements, executive compensation in the banking industry is changing. Compensation committees need to fully understand the total compensation package for the bank's executives and to be able to articulate how that compensation structure (e.g., the mix between cash/benefits, short/long term, etc.) is aligned with the bank's business goals.

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[1] Pearl Meyer & Partners 2015 Executive Pay Practices Study