Bank Director

Breakout 4: Incentive Compensation Post-SVB

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#BBTF23

Incentive Compensation in a Post-SVB World

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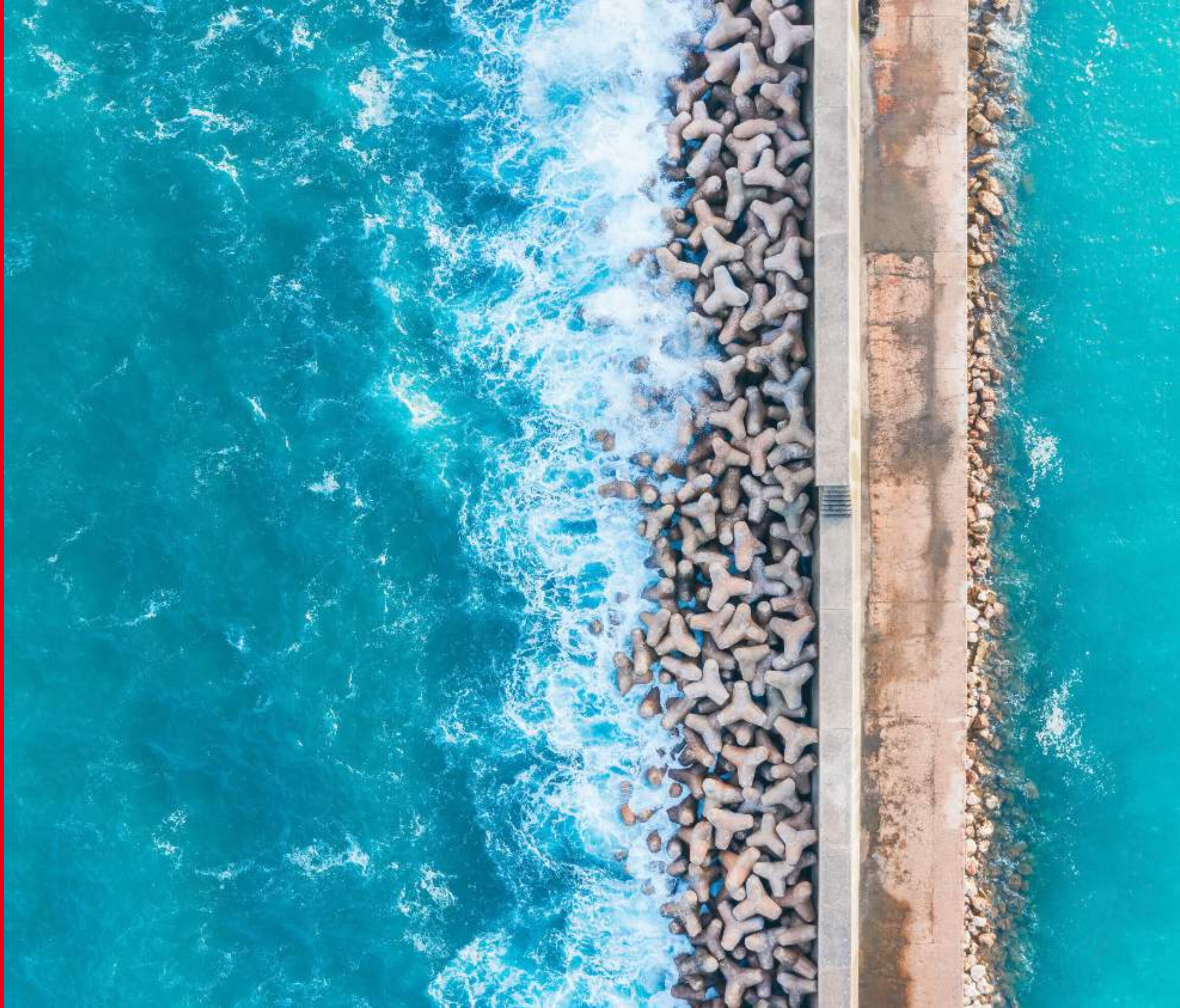

What is on the horizon?

- *What should banks be aware of?*
  - *Incentive compensation is in the spotlight*
  - *Expect more regulation. It will go beyond guidance.*
  - *Consideration of incentive risk must broaden – we can't just focus on credit risk*
  - *Evaluate/update your governance structure*

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 – Recovering Executive Compensation from Unaccountable Practices ACT (RECOUP Act):** Would allow the FDIC to claw back from senior executive (senior leadership & certain directors) all or part of the compensation received over the **2-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. The RECOUP Act passed 21-2 out of committee.*

Regarding Section 956, we have two agencies stating that proposed rules will come at the end of 2023 (FDIC) or early 2024 (SEC). This isn't a matter of "if", it is a matter of "when".

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!	Public Company Clawback(s)	If you are public, new clawback rules (D-F Section 954) will be effective October 2, 2023 requiring issuers to adopt a policy <u>by December 1st of this year</u>. 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. New proposed rules may be proposed in late 2023 or early 2024.
	Liquidity Monitoring	How have your risk monitoring functions expanded to think not only about credit, but also liquidity, capital levels and other risk factors when assessing how your incentive compensation plans payout?

Incentive Risk Regulatory Overview

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

Incentive Compensation Arrangements (Section 956, as proposed in 2016)

Level 1 & 2 firms: Prescriptive, not guidance, regarding 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

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 expect an evolution in:**
  - **Incentive plan design practices**
  - **Incentive compensation governance structures**

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%)
(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.

EXAMPLE

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

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

Individual Modification:
Adjustment which may affect one or more individual plan participants

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

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Evolving 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.

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

Key Questions / Comments:

- *Where is your bank on existing regulatory expectations?*
- *Are you preparing for the December 1, 2023 implementation of D-F clawbacks?*
- *How have you reviewed your risk-monitoring and governance processes given 2023 challenges?*
- *Get ready for more regulation, not less.*