CBA Bank Counsel Seminar
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Incentive and Executive Compensation: What You Need to Know Now

Speakers:

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Background and Applicable Laws and Regulations

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Background

- Executive compensation and Silicon Valley Bank's failure

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Background

- Federal banking regulators have issued safety and soundness standards to implement Section 39 of the FDI Act and the Interagency Guidelines Establishing Standards for Safety and Soundness

- Sarbanes-Oxley Act and SEC regulations address some compensation issues for publicly traded companies, such as clawback requirements, insider trading, and executive compensation disclosure requirements

Background

- Stock exchanges may have rules impacting executive compensation
- OCC's "Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches"
  - Adopted in September 2014
  - Establishes minimum standards for the design and implementation of a risk governance framework for certain large financial institutions

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Background

- Section 951 of the Dodd-Frank Reform Act requires shareholder voting and additional disclosures regarding compensation matters for SEC-reporting companies

- Regulatory and legal limitations on golden parachutes and indemnification payments

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Best Practices for Executive Compensation

Best Practices re Executive Compensation

- Avoid excessive compensation by applying regulatory compensation standards and consulting available compensation surveys (such as Pearl Meyer's survey)

- Financial institutions should adopt the rules applicable to their specific institution, depending upon the applicability of the Sarbanes-Oxley Act, the NASDAQ rules or the NYSE rules

Best Practices re Executive Compensation

- Consider contractual clawback provisions in employment contracts, especially from the CEO and CFO in the event of a material restatement of financial statements within a 12-month period

- Prohibit insider trading during pension plan blackout periods

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Best Practices re Executive Compensation

- Approval of executive officer compensation by an independent compensation committee or by a majority of independent directors

- Adopt appropriate structures for incentive compensation which appropriately balance risks and rewards

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Trends and Surveys for Executive Compensation

$300M-+$10B Asset Banks: Targeted Executive Pay

Pay Component	Targeted Pay Positioning (% of All Respondents)			
	Below 50th Percentile	At 50th Percentile	Above 50th Percentile	No Positioning
Base Salary	14%	48%	35%	3%
Short-Term Incentives (STI)	12%	44%	29%	16%
Long-Term Incentives (LTI)	13%	33%	23%	30%
Total Direct Compensation	13%	39%	41%	7%

- Larger organizations more likely to target the 50th percentile (or median) or between the 50th and 75th percentile
- 28% increased targeted pay positioning vs. market and 10% increased the emphasis on variable pay (STI and/or LTI)

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$300M-+$10B Asset Banks: Salary Increases

- 2024 was expected to moderate vs. 2023 but remain elevated

Employee Category	Average %	50th Percentile %	75th Percentile %
CEO	4.2%	4.0%	5.0%
CEO Direct Reports	4.1%	4.0%	5.0%
Other Employees	3.7%	3.8%	4.0%

- 2025 increases slightly lower but also expected to remain elevated

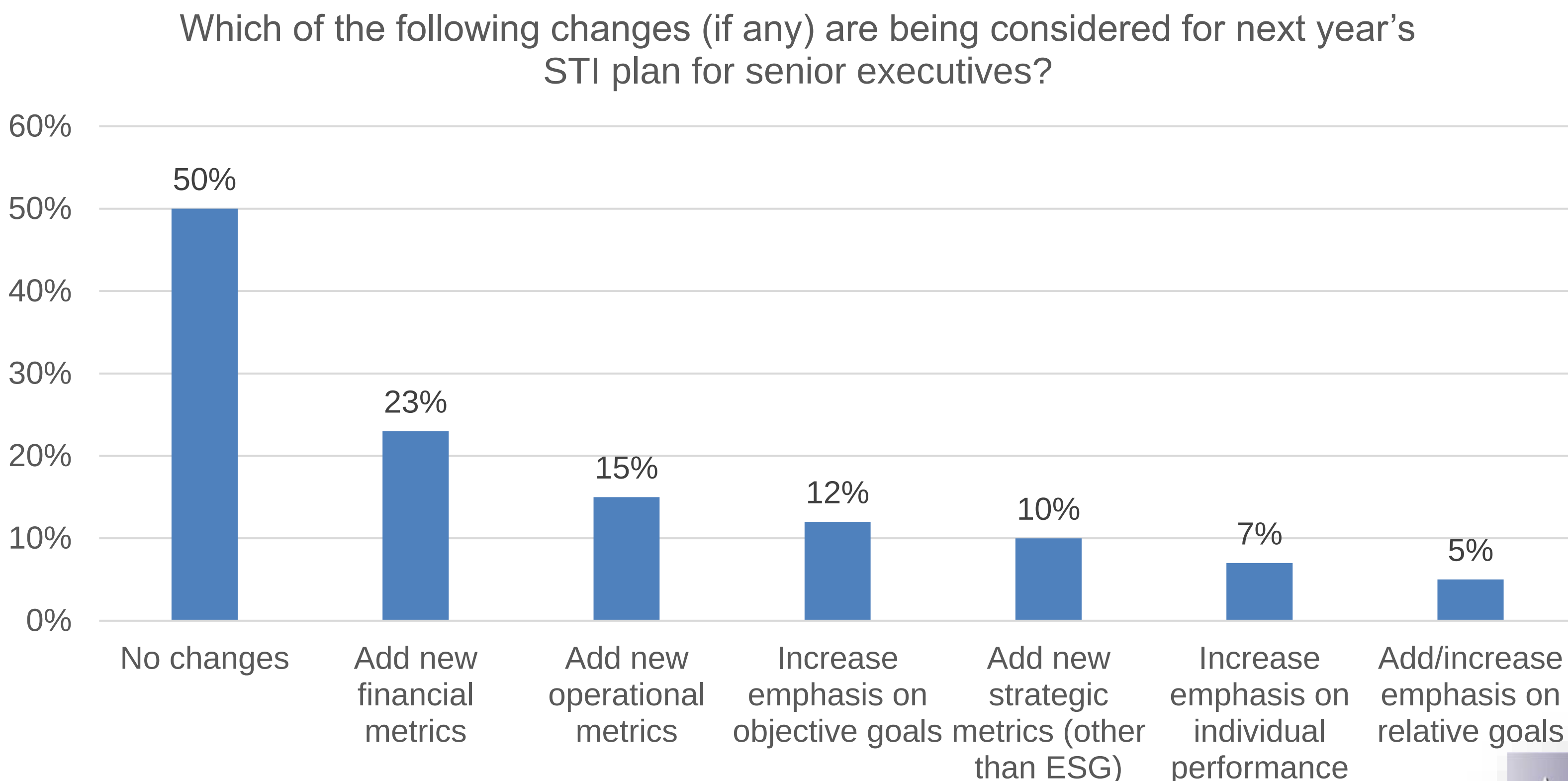
$300M-+$10B Asset Banks: STI Performance Mix Projections for 2024

- 67% have formulaic STI plan
- 70% use multiple metric categories

Performance Metric Category	2024 STI Performance Mix: CEO		2024 STI Performance Mix: Direct Reports	
	Prevalence	Median Weighting (when provided)	Prevalence	Median Weighting (when provided)
Financial	92%	80%	95%	70%
Operational	34%	25%	37%	23%
ESG	13%	10%	11%	15%
Strategic	16%	25%	21%	20%
Individual	37%	20%	42%	23%
Discretionary	24%	20%	21%	20%

$300M-+$10B Asset Banks: STI Plan Design Changes for 2024

- STI design remains primary lever to reinforce near term goals



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$300M-+$10B Asset Banks: Target LTI Value Mix Projections for 2024

- LTI coalescing around 50/50 RSU/PSU split in most cases for Execs

Public Companies	2024 LTI Mix: CEO Direct Reports		2024 LTI Mix: Non-Execs	
	Prevalence	Median Weighting (when provided)	Prevalence	Median Weighting (when provided)
RS/RSUs	94%	50%	76%	100%
Performance Shares	61%	50%	18%	50%
Stock Options	11%	23%	12%	63%
Performance Cash/Shares	0%	n/a	18%	100%

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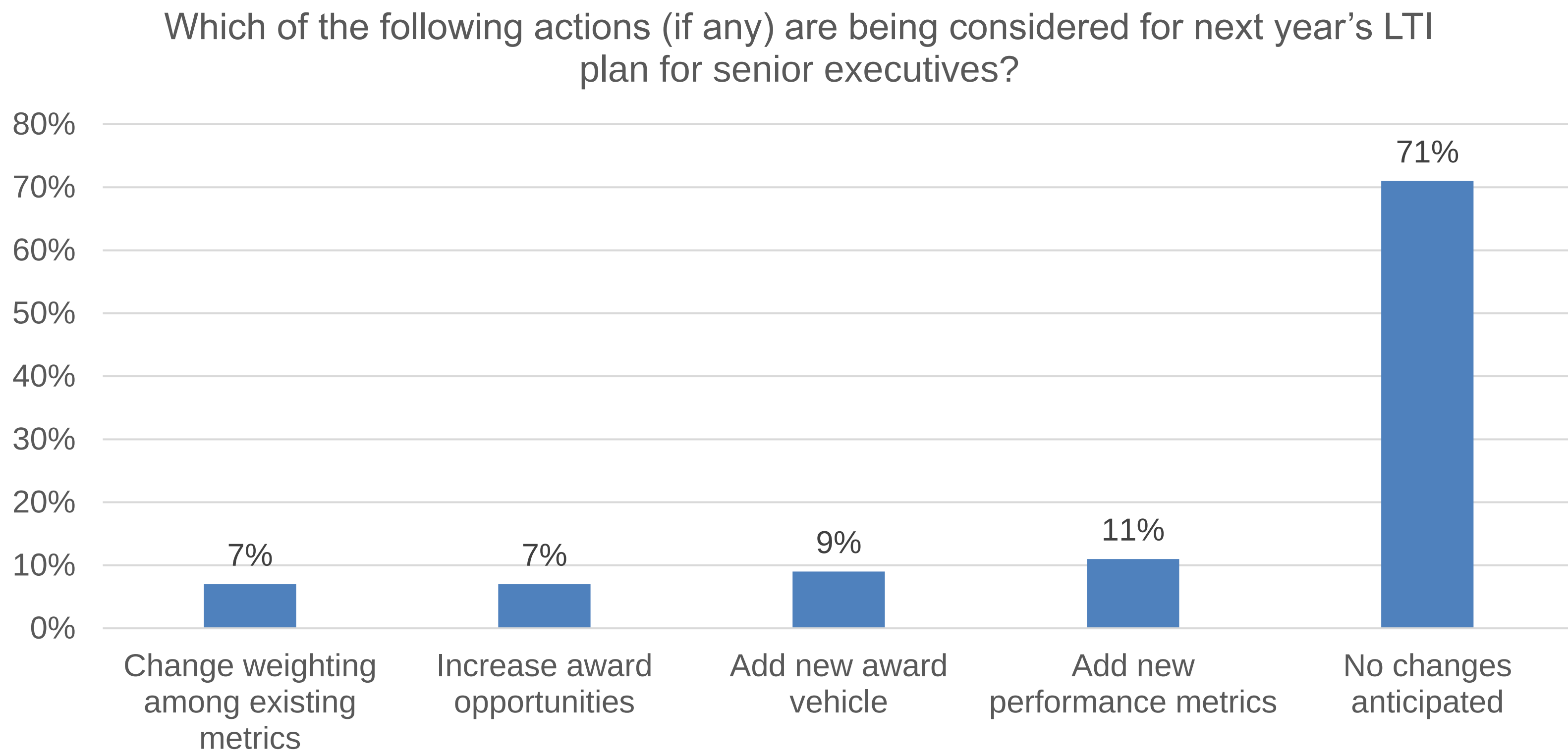
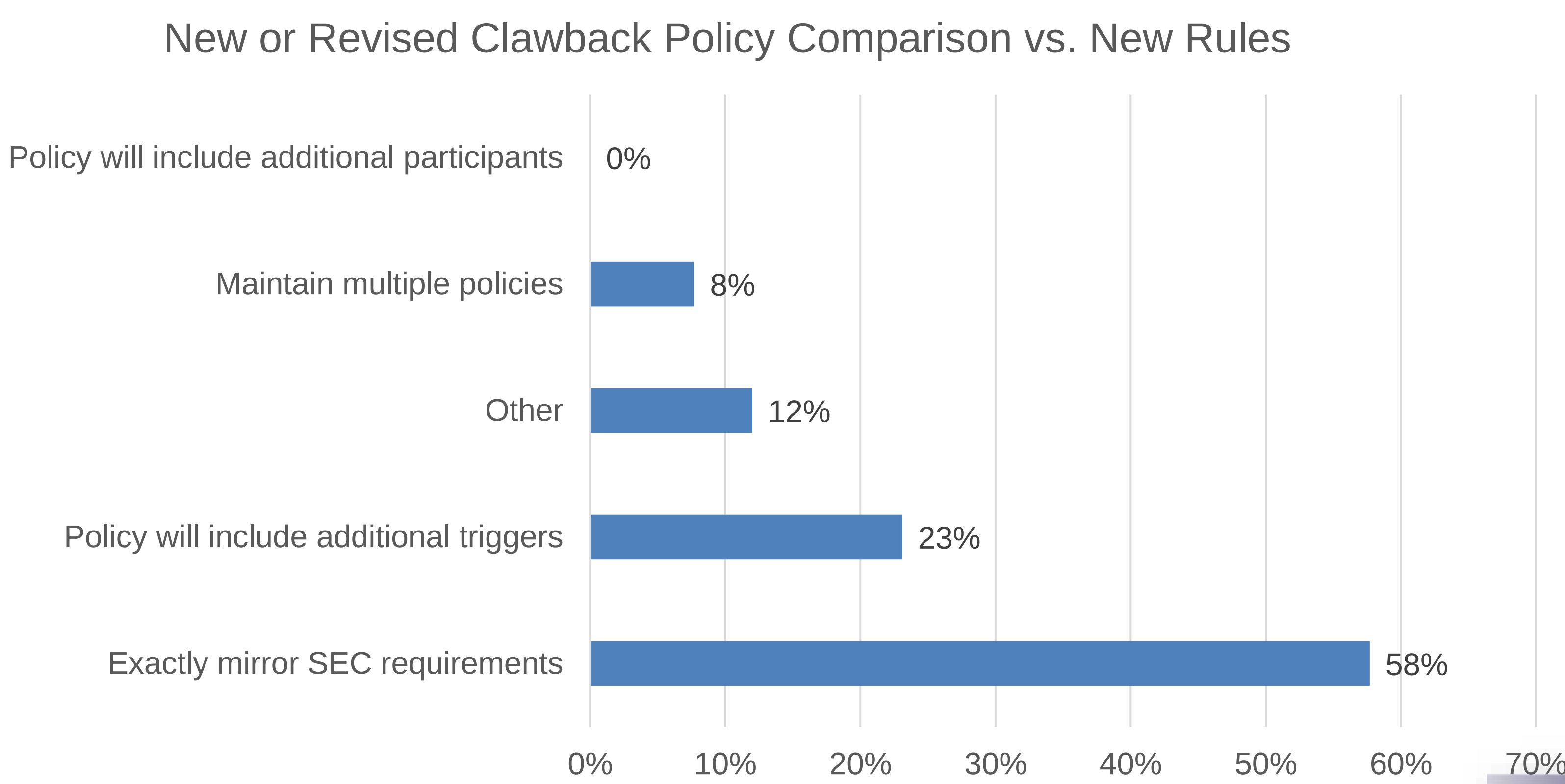
$300M-+$10B Asset Banks: LTI Plan Design Changes for 2024

- Only 30% expect to make changes



$300M-+$10B Asset Banks: New Clawback Rules

- Most public co's mirror SEC rules



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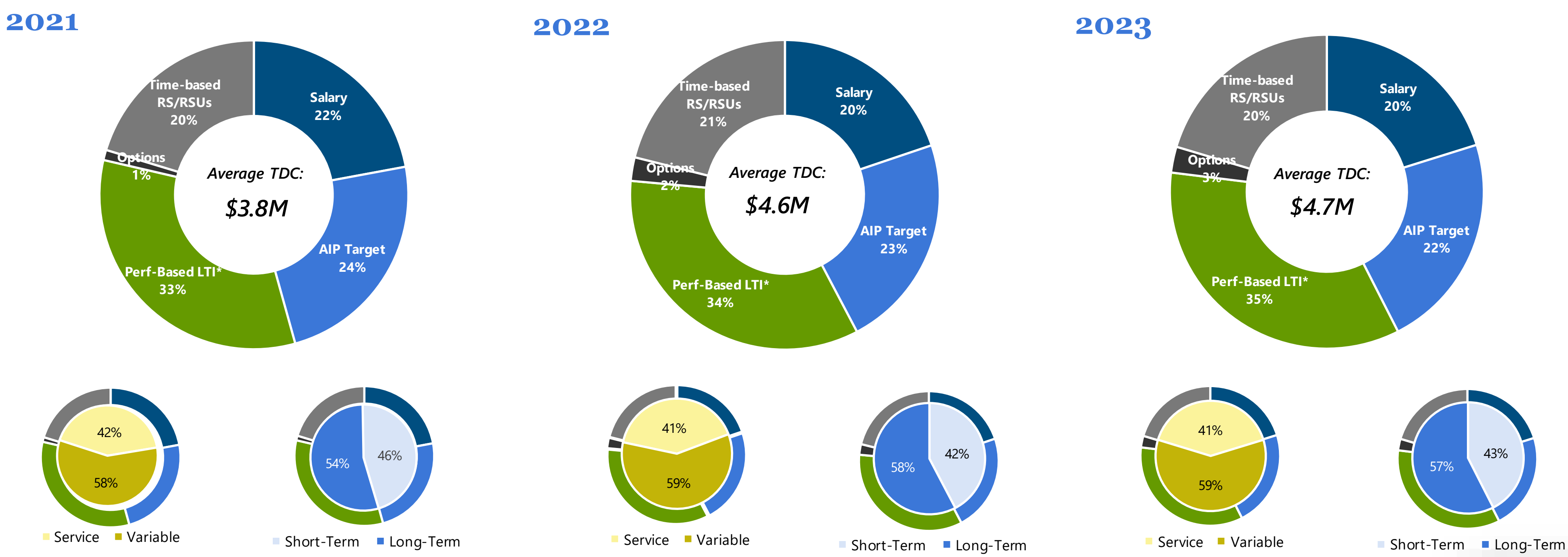
Average CEO Pay Mix Over Time – Large Banks

- CEO compensation trends from the last three fiscal years - $3B-Big 4

Total Pay Mix	Total Target Pay moderated in 2023 after significant increase in 2022	Continued increase in LTI component with PSUs still comprising the majority of LTI.	LTI Mix



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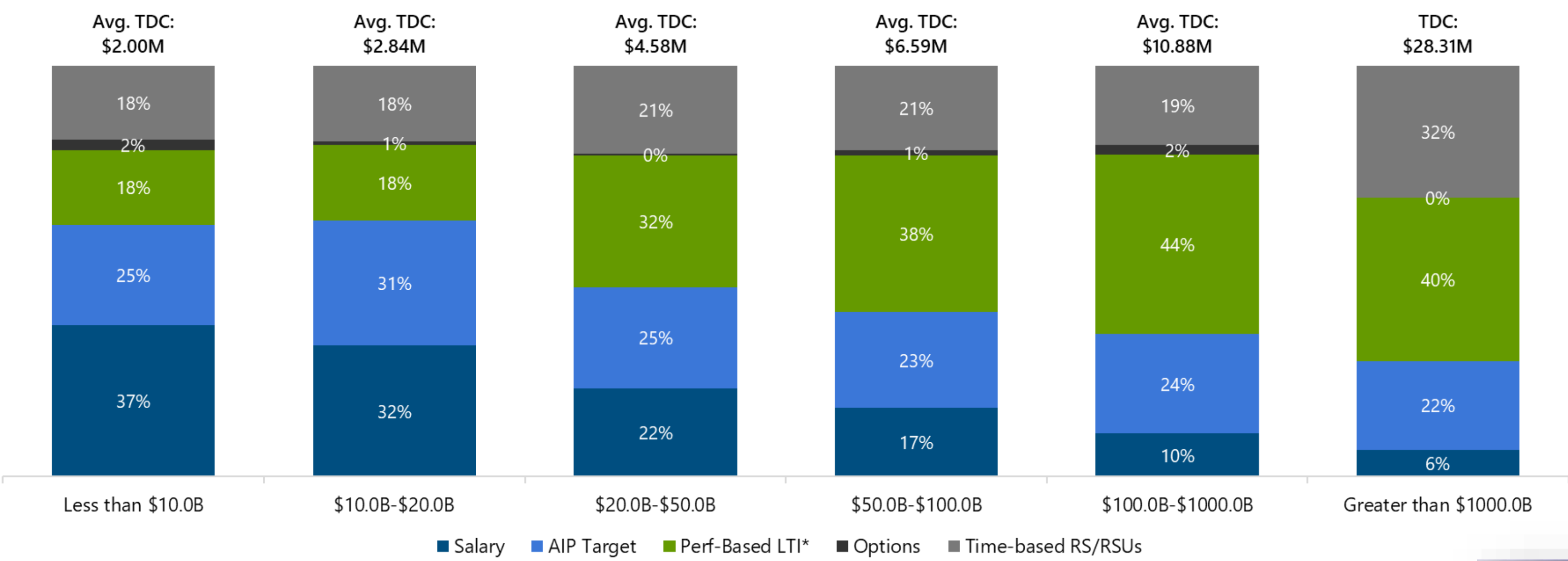
FY 2023 Large Bank CEO Pay Mix (by assets)

Total Pay Mix	Salary and bonus become increasingly smaller portion of Target Total Compensation as assets increase

Stock options largely eliminated among larger bank CEO packages. PSUs shift from a 50/50 mix to 70/30 except among the Big 4	LTI Mix



* Includes long-term performance share/unit/cash plans ("LTIP") and performance-based restricted stock ("PBRS")

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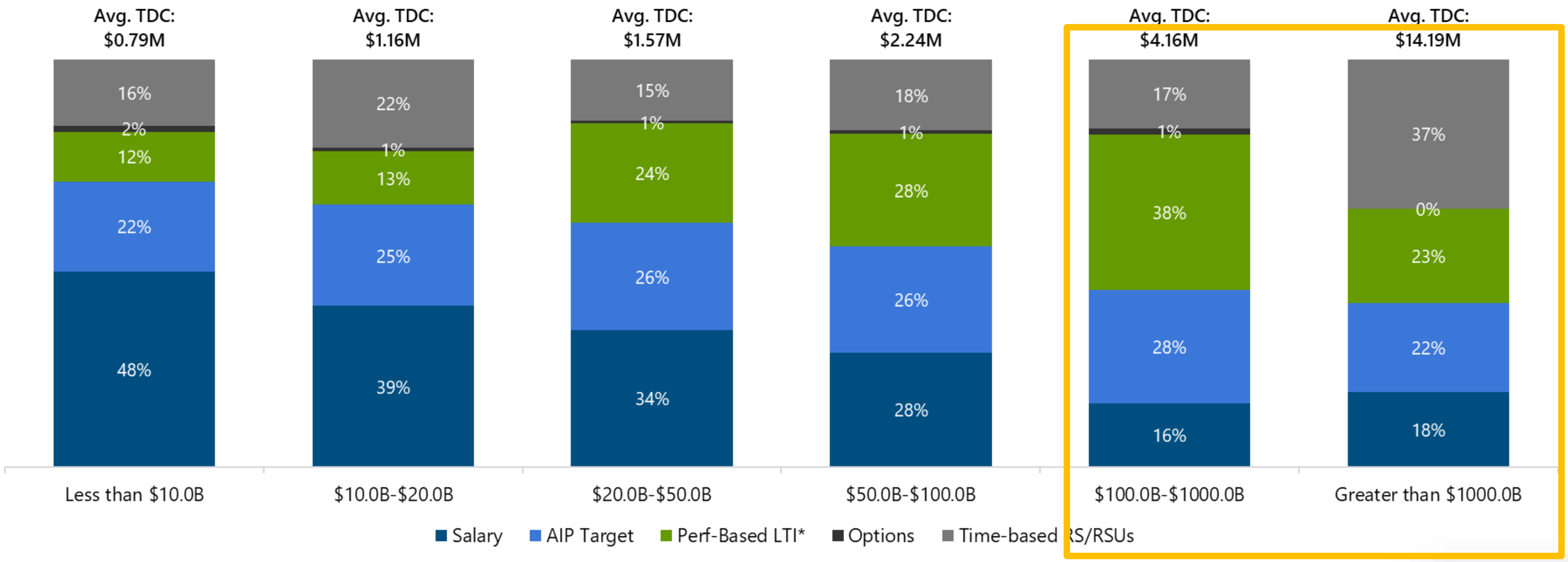
FY 2023 Large Bank NEO Pay Mix (by assets)

Total Pay Mix

While pay mix increasingly focuses on performance based pay as asset size increases, note that Big four more heavily weighted to Salary and RSUs given some NEOs subject to EU requirements



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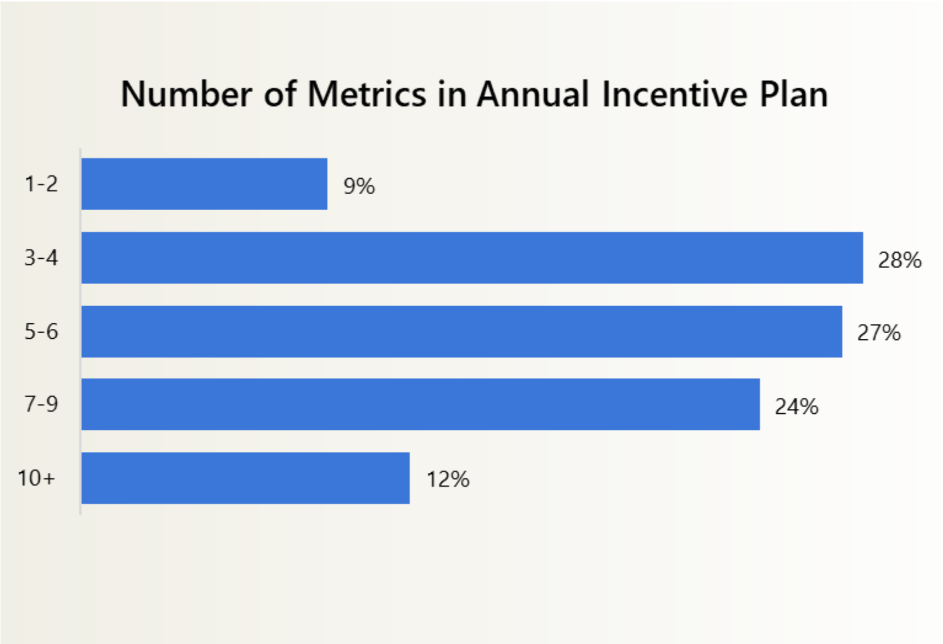
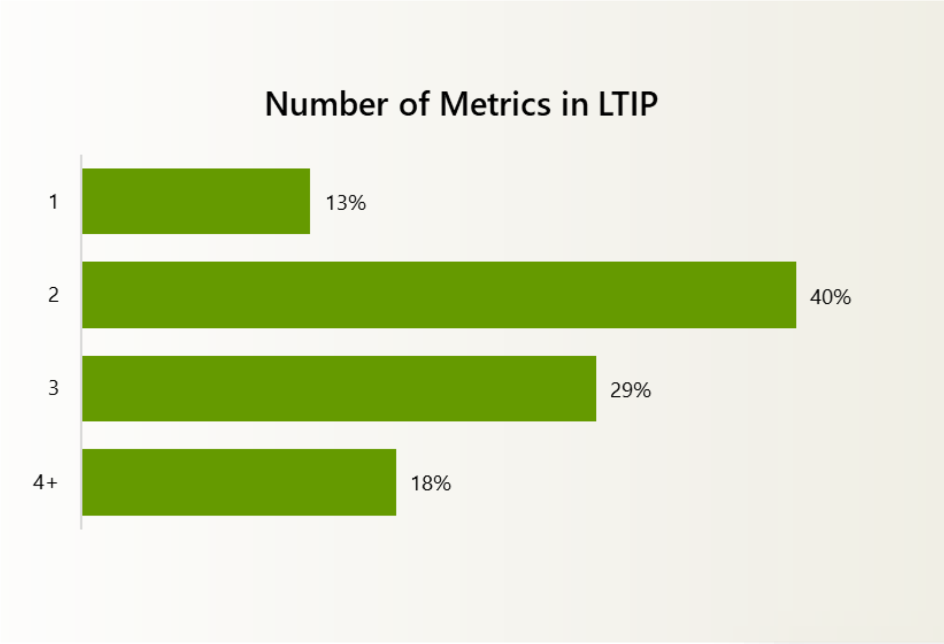
Incentive Plans: Number of Metrics For Large Banks

Incentive Plan Measures	Risk mitigation approaches encourage multiple measures in annual incentives and PSUS with majority using 5 or more measures in the annual incentive plan and 2 or more measures in the PSU program





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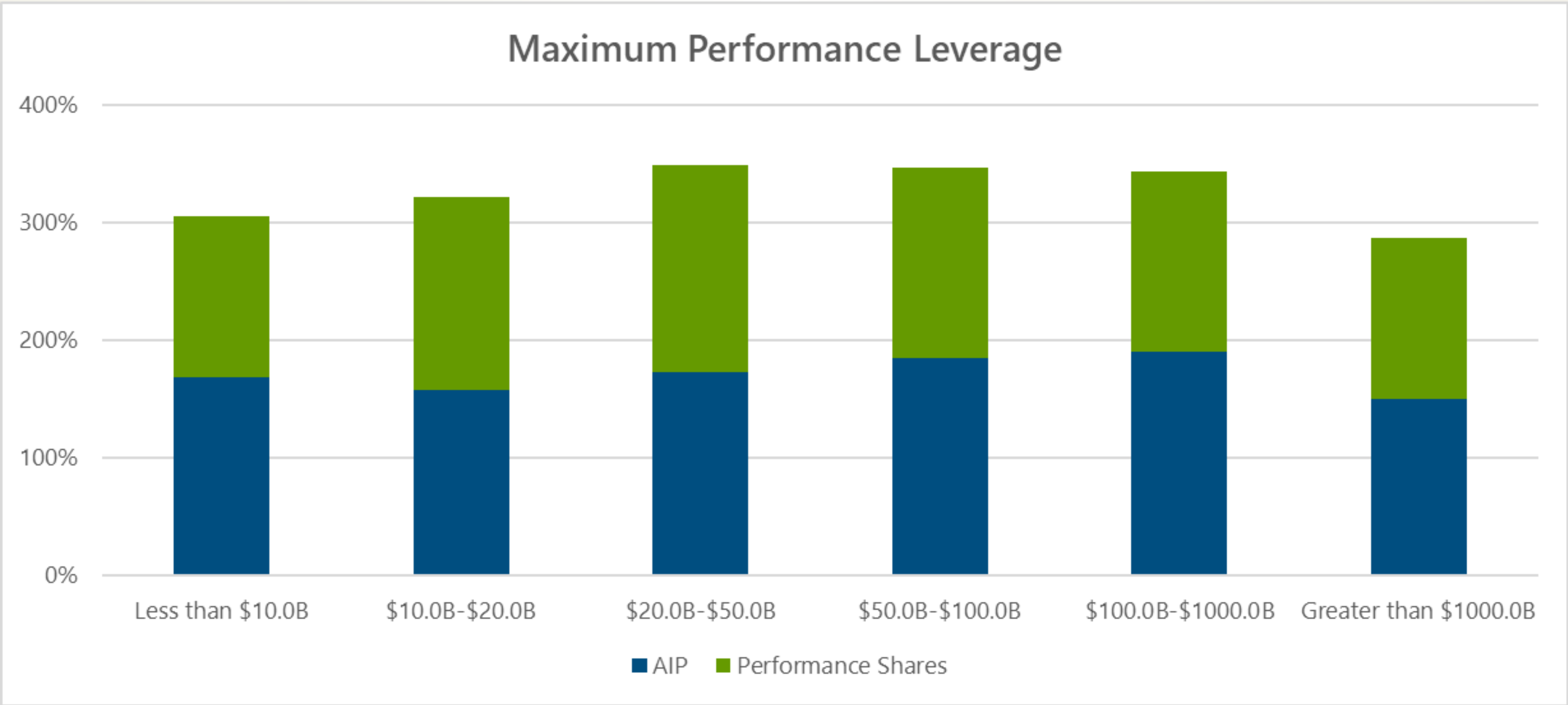
Incentive Plans: Performance Leverage For Large Banks

Incentive Plan Measures

- Performance leverage increases with asset size until banks achieve $100B assets



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Regulation of Incentive Compensation Arrangements

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Background

- Interagency Guidance on Sound Incentive Compensation Policies issued in June 2010
  - Intended to help ensure that incentive compensation arrangements take into account risk and safety and soundness principles in incentive compensation practices
  - Applies to the payment of "incentive compensation," generally meaning compensation that is tied to achievement of one or more metrics (e.g., sales, income, etc.)
  - Expect institutions to regularly review their incentive compensation arrangements
  - Emphasizes the importance of controls and corporate governance

Background

- In April 2011, the federal financial regulators published proposed rules to implement Section 956 of the Dodd-Frank Reform Act

- In April 2016, the regulators revised and re-issued the 2011 proposed rule

Background

- 2024 proposed incentive compensation rule issued in May 2024
  - Re-proposes the regulatory text of the 2016 proposed rule without change
  - But proposes certain alternatives for consideration by the public

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2024 Proposed Rule

- Problem with the 2024 proposed rule:
  - The Dodd-Frank Act required the FRB and SEC to join in on the incentive compensation rule, but they have not yet joined in on the 2024 proposal

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2024 Proposed Rule

- Applies to incentive compensation arrangements for:
  - “Senior executive officers” (including president, CEO, CFO, COO, Chief Investment Officer, Chief Credit Officer, Chief Compliance Officer, Chief Risk Officer, etc.)
  - “Significant risk-takers”
    - Received compensation for the last calendar year that ended at least 180 days before the beginning of the performance period of which at least 1/3 is incentive-based compensation and is among the highest 2 or 5 percent (depending on the size of the institution) in annual compensation (excluding senior executive officers)
    - Or who may be designated by the institution as a significant risk taker.

2024 Proposed Rule

- Covered institutions would be divided into three categories, based on average total consolidated assets over a specified period:
  - Level 1: $250 billion or more
  - Level 2: $50 billion to $250 billion
  - Level 3: $1 billion to $50 billion

2024 Proposed Rule

- For all covered institutions (+$1B Assets)
  - Must not establish or maintain any type of incentive-based compensation arrangement that encourages inappropriate risks
  - Board of directors, or a committee thereof, must:
    - Conduct oversight of the incentive-based compensation program;
    - Approve incentive-based compensation arrangements
    - Approve any material exceptions or adjustments to incentive-based compensation policies or arrangements
  - Disclosure and recordkeeping requirements

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2024 Proposed Rule

- Level 1 and Level 2 covered institutions (+$50B/+$250B assets)
  - Deferred compensation requirements
  - Vesting of amounts during deferral period
  - Not permitted to increase deferred incentive-based compensation plan amounts during the deferral period
  - Forfeiture and downward adjustments

2024 Proposed Rule

- Level 1 and Level 2 covered institutions
- (+$50B/+$250B assets) (*cont.*)

  - Clawback requirements for misconduct, fraud, misrepresentations

  - Not allowed to purchase a hedging instrument or similar instrument to hedge or offset any decrease in the value of incentive-based compensation

  - Could not award incentive-based compensation to:
    - A senior executive officer in excess of 125 percent of the target amount for that incentive-based compensation; or
    - A significant risk-taker in excess of 150 percent of the target amount for that incentive-based compensation

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2024 Proposed Rule

- Level 1 and Level 2 covered institutions (+$50B/+$250B assets) (*cont.*)
  - Prohibited from using incentive-based compensation performance measures that are based solely on industry peer performance comparisons
  - Not provide incentive-based compensation to a covered person that is based solely on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management
  - Required to have to have a risk management framework for its incentive compensation plan

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2024 Proposed Rule

- Level 1 and Level 2 covered institutions (+$50B/+$250B assets) (*cont.*)
  - Control function requirements
  - Independent monitoring requirements
  - Establish a compensation committee composed solely of directors who are not senior executive officers
  - Develop and implement policies and procedures for its incentive-based compensation program

2024 Proposed Rule

- Questions and Request for Comments
  - Whether it would be appropriate to establish a two-level structure rather than a three-level structure?
  - Whether other institutions should be included as a “covered institution”?
  - Whether the asset size thresholds for the three levels of covered institutions are appropriate?

2024 Proposed Rule

- Questions and Request for Comments (*cont.*)
  - Whether to require a Level 1 or Level 2 covered institution to claw back rather than just <u>consider</u> clawing back when triggered?
  - The appropriateness of the limitation on maximum incentive-based compensation opportunity, i.e., 125 percent and 150 percent for senior executive officers and significant risk-takers?
  - Should the proposed rule apply the limitation on maximum incentive-based compensation opportunity to Level 3 institutions?

Best Practices for Incentive Compensation

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Best Practices re Incentive Compensation

- Have policies and procedures in place that discourage employees from taking unacceptable risk to increase compensation

- Have a compensation committee comprised of independent directors that approves incentive compensation arrangements and provides oversight

Best Practices re Incentive Compensation

- Compensation agreements and plans should include:
  - Clawback provisions
  - Deferral provisions ?
  - Forfeiture and adjustment provisions ?
  - Limits on the amount of incentive compensation that can be awarded ?
- Impose risk management and controls discussed in the 2024 proposed rule

We're adjourned!

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