

# Executive Incentive Practices Post-TARP

By Susan O'Donnell

*New mandates signal the start of a new era in executive compensation.*

Executive compensation programs have experienced unprecedented change over the past six years, from Sarbanes-Oxley and new accounting and disclosure rules to heightened governance standards and, most recently, unprecedented government involvement. Confronted with escalating global financial and economic crises, the U.S. Treasury introduced the Troubled Assets Relief Program (TARP) last fall with the goal of infusing the financial system with additional capital. The program included strict limits on executive compensation programs at participating companies.

While the financial services industry is in the eye of the current regulatory storm, these new mandates signal the start of a new era in executive compensation. Like the egregious actions at Enron and WorldCom that drove enactment of Sarbanes-Oxley in 2002, the questionable practices of a few financial firms are likely to drive major changes for all companies. As this article is being written, the administration, Congress, the Treasury Department and bank regulators alike are introducing further pay-related policies, many of which could eventually be extended to all companies.

The current financial crisis is widely blamed on the distinctive and highly leveraged pay practices of Wall Street, which encouraged some executives to take significant financial risks with the lure of significant rewards. The American Recovery and Reinvestment Act signed on February 17 introduced new requirements for TARP participants that subject companies in the program to significant restrictions including the following:

- Generally prohibiting “paying or accruing any bonus, retention award, or incentive compensation”
- Requiring a review and elimination of any incentive practices that might encourage executives “to take unnecessary and excessive risks that threaten the value of the [company]”
- Requiring recovery of “any bonus, retention award, or incentive compensation paid ... based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate”

There are legitimate criticisms and real challenges, but well-designed incentives should remain an effective and core element of total compensation. Financial institutions have an opportunity and obligation to learn from these events. While the ultimate extent of government intervention is unknown, it is certain that many past compensation practices, particularly those related to incentive compensation, will change. Programs at investment banks and other companies that historically have had very highly leveraged compensation programs may require major changes. The more conservative practices of traditional community banks and many other industries are likely to require fewer major revisions. However, *all* companies will need to be mindful of best practices as they emerge.

This article examines the most significant incentive trends developing, including what went

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Exhibit 1. Today's Influencers of Executive Compensation

| Influencer                 | Driver   | Resulting Programs/Practices   |
|----------------------------|--|--|
| Shareholders/<br>investors | Increased influence on compensation practices  | <ul style="list-style-type: none"> <li>■ Shareholder proposals to vote on executive compensation practices (say on pay)</li> <li>■ Withhold vote on directors</li> </ul> |
| SEC                        | Clear, transparent communication of compensation programs  | <ul style="list-style-type: none"> <li>■ Increased disclosure requirements related to executive compensation practices, philosophies, performance goals</li> </ul>       |
| Media/public               | Fueling the anger  | <ul style="list-style-type: none"> <li>■ Optics and perception is a factor in compensation</li> </ul>  |
| Treasury/<br>government    | Responding to constituencies, stepping in to take action on and drive executive compensation practices going forward | <ul style="list-style-type: none"> <li>■ Government guidelines on pay</li> <li>■ Say on pay</li> <li>■ Compensation committee independence</li> </ul>                    |

wrong, how incentive compensation practices will change post-TARP and likely best practices going forward (Exhibit 1).

### Incentives: What Went Wrong?

Incentive compensation grew out of companies' desire to reduce fixed compensation costs and focus on pay for performance. They were considered "pay at risk" because, unlike *guaranteed* compensation such as salary and benefits, incentive payouts depended on the achievement of tangible, predefined performance goals. Such risk-based pay was generally considered a positive means of aligning pay and performance, encouraging executives to make the right decisions, and driving the right results.

This pay-for-performance model broke down at some large investment banks when risk taking became a motivator in itself. With performance focused on short-term results, rewards paid in one year were often misaligned with longer-term outcomes. As executives took on increasing levels of unmanaged risk, the promise of large rewards masked the inherently high downside risks of new and highly complex investment strategies. Organizations underestimated the financial impact when such risks didn't go according to plan. While these practices were generally limited to this segment of the financial services industry, the market collapse exposed the potential for huge disconnects in the pay-performance relationship and prompted today's regulatory and legislative activism.

The shortcomings in current incentive compensation practices can be addressed by better risk management and by more closely aligning pay with meaningful, long-term performance. However, companies will continue to face some real challenges:

- **Disclosure and analysis.** Despite expanded proxy requirements, executive compensation disclosure remains neither straightforward nor clear. It does not communicate the real value of pay or, more important, the degree of pay-to-performance alignment. The result has been contradictory media reports of executive compensation levels, with data often provided without context or explanation. For example, the Summary Compensation Table, which purportedly reports total compensation value, in reality reflects the accounting expense to the company. The stock and option awards columns report the *expense* of prior equity awards, not their grant or actual award value. The value of award grants is reported in the Grants of Plan-Based Awards Table but still does not always represent the *actual* realized value to the executives (which may be zero if the stock options are underwater or much greater if the stock price soars). The Securities and Exchange Commission (SEC) has proposed additional changes to its disclosure requirements.
- **Time warp.** Aligning the time frame for performance and compensation value can also be tricky. Short- and long-term incentive awards that are granted in one year are typically reported in subsequent years, by which time the performance outlook may be quite different. Stock options can change radically in value when

they are exercised five to seven years out from the grant date. The value of a stock award may seem high in the year granted, particularly for performance shares, but may never vest. Similarly, large deferred compensation balances may reflect accrual of compensation, often the executive's own earnings, over a long career.

- **Control factor.** Stock performance, a key driver of executive compensation, is intended to align executives with shareholders' interests. However, share prices are influenced by many external factors. The question that is often at debate is to what extent executives should benefit—or lose out—as a result of events that were outside their control.
- **Piecemeal views.** Too often, the individual elements of compensation are evaluated out of context, which can be highly misleading. Accurately assessing the pay-to-performance relationship requires consideration of all moving parts: the different performance goals, timelines and payout schedules. For example, one company might provide a relatively large equity award that is offset by a below-market salary, while another company makes the opposite trade-off in value.

## What Are Best Practices for Incentives Going Forward?

Four key concepts will drive future government mandates and best-practice compensation design for all companies.

- Mitigating “risk taking” in incentive plan design
- Focusing on a long-term performance horizon
- Understanding the shareholder perspective
- Ensuring proper risk controls and protections

The remainder of this article discusses each of these areas in detail.

### Mitigating “Risk Taking” in Incentive Plan Design

One of the original areas of Treasury concern was overly risky compensation incentives. To that end, TARP companies are prohibited from providing incentives to senior executive officers that promote

“unnecessary and excessive risks” and must follow specific compliance steps. SEC staff have also stressed that *all* public companies should be reassessing and mitigating the level of risk embedded in their compensation programs. Whether or not the TARP standard becomes a universal mandate, this issue clearly has regulators' attention and should be addressed by every public company.

It is important to remember, however, that risk is what enables businesses to innovate, compete and prosper and is key to the idea of pay for performance. What's needed is a *balance* between motivating high performance and ensuring that results stem from reasonable risk taking. Effective ways to mitigate pay-related risk *and* ensure a proper relationship between pay and performance include the following:

- Understand the link between business risk and incentive awards.
- Ensure a balance in the incentive plan.
- Understand the program's total upside/downside potential.
- Understand industry/market practices.

***Understand the link between business risk and incentive awards.*** A key objective of incentive programs is to motivate and reward the achievement of business performance in support of the organization's business strategy. Where many financial companies failed was in not recognizing the extreme levels of risk inherent in some business strategies, which they continued to reward.

Companies should scrutinize their business strategy, risk profile, potential business risks and how they are addressed in any incentive plans. They should understand the performance measures linked to these risk factors and the specific payouts for achieving various goals. However, the mere existence of a potentially risky performance measure does not constitute unnecessary and excessive risk taking. For example, the potential risk inherent in pursuing loan growth can be effectively mitigated by including program controls over *process* (such as credit approval requirements) or *design* (such as adding credit quality, loan retention, loan profitability or other performance metrics). Risk can also be mitigated by limiting, or capping, the maximum payout for a particular performance measure.

***Ensure a balance in the incentive plan.*** Balance is reflected in many forms, all of which should work together in your total compensation program. One

element is the *mix* of pay vehicles—the proportion of fixed compensation (for example, base salary and benefits) versus variable, or at-risk, compensation (for example, performance-based incentives). The greater the proportion of variable pay, the more you are communicating that the executive should focus on the performance goals related to those rewards and the greater the potential to engage in risky behaviors. For example, at large investment banks, it was not unusual for incentives to constitute 95

percent of traders' total compensation, as opposed to a more traditional commercial or savings bank where incentives typically constitute 40 percent to 50 percent of total pay.

Another key issue is the need for variety in the *number, type and weight of performance measures*. No single performance measure should drive all or even a majority of incentive rewards, especially if it is used in both short- and long-term plans. An incentive program that focuses significantly on revenue may successfully drive top-line growth—but at the downside risk of quality earnings or profitability. Conversely, an incentive program that incorporates too many goals may end up diluting executives' performance focus.

Balanced incentive plans also incorporate *multiple levels of performance*, such as company, division/unit and individual performance. A plan focused solely on individual performance may encourage decisions that are personally of benefit to the executive or to the detriment of the company or team, while plans focused solely on company goals may not drive appropriate accountability.

**Understand the program's total upside/downside potential.** Leverage reflects the incremental rewards that would be provided for varying levels of performance under different scenarios, including threshold, target and maximum performance. At investment banks, incentive programs tended to be very highly leveraged, allowing significant and uncapped payouts for increasingly risky behavior. More typically, incentive plan payouts are defined and capped.

Assessing the leverage in short-term incentive plans is relatively straightforward, but it is more

difficult to calculate cumulative values for multi-part incentive programs that incorporate short- and long-term performance, multiple performance measures and stock price growth over time. Most companies do not fully understand the aggregate

potential of payouts in their compensation program. One useful tool for performing such a review is "dynamic pay modeling," which analyzes all the programs' moving parts and payout possibilities. By projecting award values under best-

realistic- and worst-case performance scenarios, such a model reveals the company's actual total exposure at the extremes of performance.

Finance professionals are familiar with performing what-if analyses and can help ensure that the full range of performance scenarios are calculated, understood, reasonable and unlikely to motivate excessive risk taking.

**Understand industry/market practices.** In addition to reviewing performance against the company's business plan, performance and the resulting payouts should be assessed relative to your industry or peers. Particular attention should be paid to performance or compensation that is dramatically above or below the industry/peer group, both red flags of potentially inappropriate risk taking that warrant a closer look.

### Focusing on a Long-Term Performance Horizon

One of the biggest criticisms of Wall Street pay programs following the market collapse was that investment traders were richly rewarded for high-risk investments and loans that ended up in the red. As a result, politicians and regulators have put the issue of sustained performance high on their agenda for compensation reform.

The key is aligning compensation payouts with the appropriate time frame for the performance being measured. Unlike the leverage challenge—which requires analyzing complex payout arrangements—refocusing programs on long-term performance is

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relatively easy. The following techniques are now considered best practice:

- Focus the majority of incentive opportunities on long-term performance.
- Hold back a portion of annual incentive awards pending evidence of sustained performance.
- Pay incentive awards above a certain level in restricted stock.
- Institute stock ownership and retention requirements.

***Focus the majority of incentive opportunities on long-term performance.*** Short-term goals are a critical component of performance-based pay programs, but companies should ensure they don't represent the lion's share of value to the employee. Overemphasizing annual performance drives more short-term thinking, as was seen in some financial executives' very high-risk investment decisions. Similarly, sales incentives that are based primarily on short-term revenue generation may motivate behavior that hurts future performance. Companies should consider rebalancing the proportion of total compensation based on annual performance relative to longer-term performance. For example, a loan executive's total compensation opportunity of \$300,000, consisting of a \$200,000 base salary, 35 percent target (as a percentage of base salary) for annual cash incentive and 15 percent based on stock could be reallocated to 20 percent for short-term and 30 percent for longer-term performance. Long-term performance might be defined to also reflect the quality of the loan portfolio over a three-year basis and company performance.

***Hold back a portion of annual incentive awards pending evidence of sustained performance.*** Because annual cash incentives tend to foster a more short-term mentality, it is important to protect the company and shareholders from rewarding temporary or potentially fraudulent gains that stemmed from overly risky behavior. In "bonus banking," part of an annual incentive award is withheld until a stated future time when the performance has proved to be sustained. This approach is easier to administer than a traditional clawback program, which requires that the company recoup funds already paid to the employee.

As a simplified example, consider a lender who receives a base salary of \$200,000 and an annual incentive potentially worth 35 percent (\$70,000).

For target performance, \$40,000 could be paid out at the end of the year and the remaining \$30,000 deposited in a "bonus bank" account with payout based on achieving a defined level of quality performance on the loans three years later. That would focus the lender on loan quality from the start of the loan process. This approach also promotes a more balanced performance focus at companies without long-term incentive or equity plans, since a portion of total incentive can be based on annual results and the rest on long-term results.

***Pay incentive awards above a certain level in restricted stock.*** By paying out part of an annual incentive payout (for example, target performance) in the form of restricted stock, the value of the reward is linked to longer-term stock performance. This approach promotes retention, gives the employee a long-term ownership stake and is potentially more cost-effective, since the cost of the award portion paid in stock can be expensed over multiple years.

***Institute stock ownership and retention requirements.*** Sustained stock ownership better aligns executives' interests with the long-term success of the organization. Ownership guidelines typically require that the executive acquire a multiple of compensation or a specific number of shares within a defined period of time, typically five years. Or, a company may require that an executive hold (that is, not sell) a defined percentage of vested stock awards for a period of time. An emerging trend is to require that executives retain stock for several years past retirement. However, all things in moderation: Too much stock ownership could overly focus an executive on share price performance, contrary to the goal of long-term value creation.

## Understanding the Shareholder Perspective

Shareholders are clearly gaining power and influence over executive compensation practices. Expanded proxy disclosure rules now provide more detailed pay information that is used by investor activists and proxy ratings agencies to influence board decision making. A nonbinding shareholder vote (say on pay) is already mandated for TARP

participants and is high on the agenda of the White House and some legislators.

At the heart of say on pay lies the ultimate goal of most publicly traded companies: to align executive pay with long-term stock price performance. Measuring that alignment, however, is not simple. As mentioned above, stock price is a factor of much more than just company or executive performance. Over the long term, however, there should be a clear relationship between the level of executive compensation and shareholder returns. If not, shareholders have a right to voice their concerns—and, in today's more activist environment, they are very likely to do so.

Since the say-on-pay vote is based on the public information provided to shareholders in the proxy compensation tables and the Compensation Discussion and Analysis (CD&A) section, those disclosures should be a focus of attention. Companies must ensure they effectively communicate the compensation philosophy, decision-making process, performance metrics, compensation decisions and the resulting pay-for-performance relationship.

### Ensuring Proper Risk Controls and Protections

Clawbacks are a means by which companies (or the government) can retroactively recover incentive payouts if the related performance is subsequently found to be materially inaccurate. They are a specific requirement for TARP participants. There are better protections available, however, to *proactively* ensure that compensation programs will protect the company's and shareholders' interests. In addition to the "bonus bank" arrangements suggested above, these include the following:

- Capping potential upside payouts
- Delaying incentive payouts pending the final audit of performance results
- Reviewing both absolute performance (tied to specific strategic and business goals) and relative performance (results compared to an industry or peers). Generally, absolute measures work well for annual plans, while relative performance measures are more effective for long-term plans. At a minimum, companies should understand how they per-

form compared to both absolute and relative performance metrics, even if both aren't made formal in the plans.

- Incorporating appropriate board discretion in pay decisions. No one formula can capture all performance contingencies. The compensation committee and management should look beyond incentive plan calculations to ensure the overall pay-for-performance relationship is appropriate. For example, a plan might call for stretch award payouts if the bank ranks in the top quartile for total shareholder return (TSR). But in today's economic environment, where most banks are posting negative TSR, companies may decide that an adjustment to the formula is warranted (that is, no award is appropriate).

### Looking Ahead

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Expectations about executive pay are high, the issues are complex, and change is certain. The Obama administration has publicly embraced executive compensation as a key initiative that will likely expand beyond TARP participants into the broader financial services sector and, ultimately, to general industry. While specific mandates and best practices will emerge gradually, we do know this much:

- Incentive plans and total compensation programs must be reviewed, adjusted and monitored to ensure they do not motivate or reward inappropriate risk taking.
- Rewards should focus on driving sustained, long-term performance.
- Total compensation must be clearly aligned with both company performance and the interests of shareholders.
- More attention should be paid to proxy tables and CD&A disclosure, which remain the primary means for explaining your company's pay programs and decisions.
- Shareholders will have a greater voice in executive compensation decision making.

In addition, the design and oversight of the company's incentive plans have become more complex and require new perspectives on pay for performance. TARP companies already must appoint a senior risk officer to evaluate and review incentive plans with

the compensation committee, and some governance activists advocate that all boards create a committee specifically for risk management.

Financial professionals must take an active role as well. As the steward of the financial resources (that is, compensation dollars) and reporter of financial results, you have the information and analytical tools to help conduct some of the analyses (such as dynamic pay models) and ensure the proper level of

disclosure (for example, CD&A, proxy tables) discussed here. At minimum, you can engage with the board, human resources and senior management to herald these best practices and protect the interests of the company and its shareholders.

What better way to ensure that compensation programs appropriately attract and retain the talent needed to drive the long-term sustained success of your bank?

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