

Hot Topics for Bank Directors: Executive and Director Compensation



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Bank executive and director compensation topics



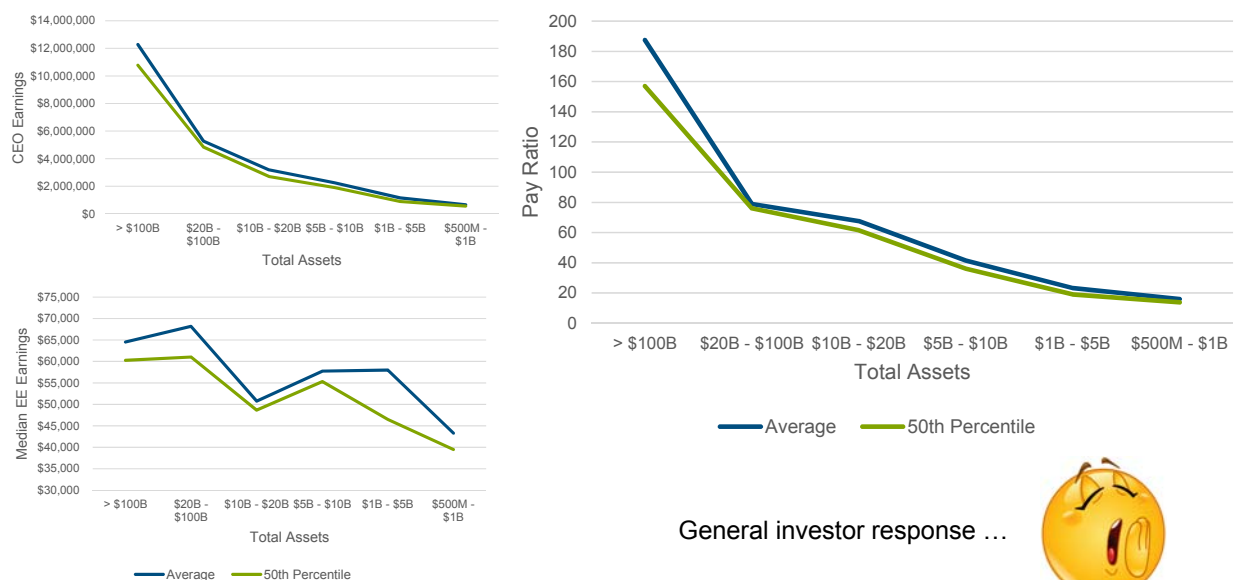
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CEO pay ratio: results for banks by size



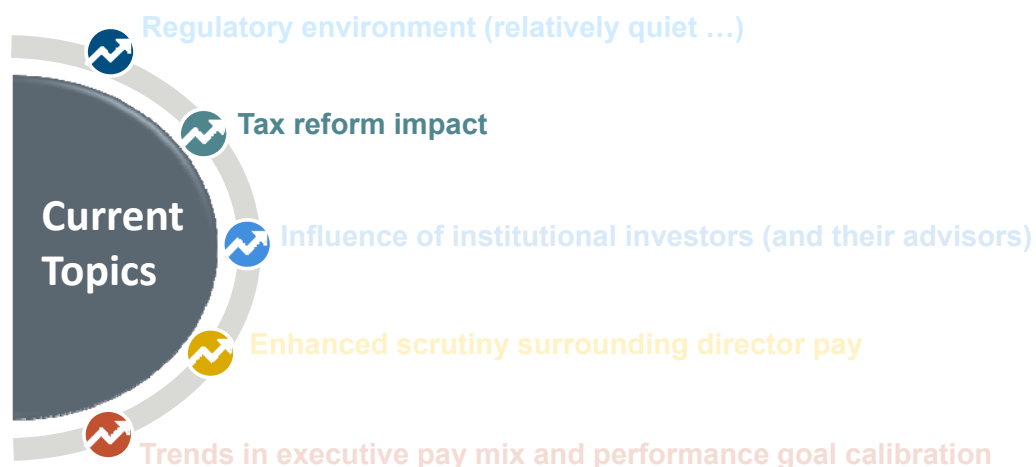
General investor response ...



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Data source: Main Data Group

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Tax reform: impact of tax rate changes

Significant Tax Rate Changes
<ul style="list-style-type: none"> • Lower corporate tax rate (from 35% to 21%) • Generally lower individual tax rates, with top bracket reduced from 39.6% to 37% (sunsets 2025) • Alternative minimum tax thresholds increased
Potential Impact on Executive Compensation
<ul style="list-style-type: none"> • Executives may be less likely to defer compensation (409A rules did not change) • Among companies granting stock options, prevalence of ISOs may increase due to lower corporate tax rate and higher AMT thresholds • Potential one-time or ongoing pay enhancements • Adjustments to goals or outcomes for certain outstanding performance awards
Company Responses to Lower Corporate Tax Rate
<ul style="list-style-type: none"> • Dividends and share buybacks • Capital investments and hiring • Sharing the wealth with employees

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Section 162(m): overview

- Section 162(m) initially established in 1994; limits public company tax deduction for compensation paid to a “covered employee” to \$1 million per year
 - “Covered Employees” are CEO and next three highest paid Named Executive Officers (NEOs) serving as executive officers as of fiscal year end
 - Exception for qualifying “performance-based” compensation
 - Many believe rule contributed to increase in NEO compensation by encouraging emphasis on variable pay (with upside), “umbrella” plans, and salaries of up to \$1M

Significant Changes

- Elimination of “performance-based compensation” exception
- Covered employee includes CEO, CFO, and next three highest paid NEOs; for taxable years after 12/31/16, also includes former NEOs who previously were covered employees
- Corporations with publicly-traded debt and certain foreign private issuers are now also subject to 162(m)
- Limited grandfathering rules for compensation provided pursuant to a written binding contract in effect on 11/2/2017

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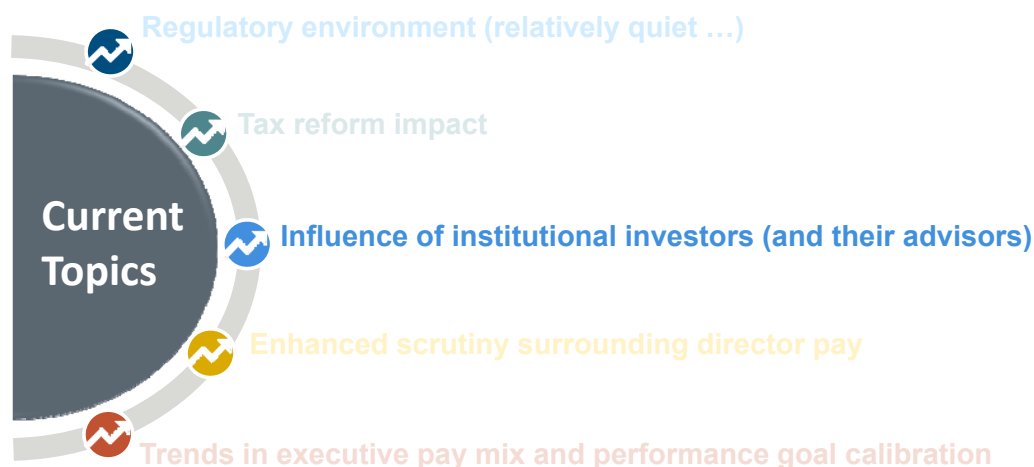
Section 162(m): unintended consequences

Potential Outcome	Observations
Increase in Base Salaries and Other “Non Performance-Based” Pay (e.g., Restricted Stock)	<ul style="list-style-type: none"> • No tax-related reason to cap salaries at \$1M or qualify restricted stock as “performance-based”; example: Netflix increased salaries and eliminated STI • Stock options will no longer be fully deductible; usage may decrease if not viewed as tied to strategy • May have compounding impact on incentives and benefits tied to base salary (if salary multiples are not recalibrated)
Goal-Setting Practices May Change	<ul style="list-style-type: none"> • Timing of goal setting can be more flexible • Goals not limited to shareholder approved list • Adjustments won’t be limited to pre-determined items specified in plan
Discretion and Individual Goals May Play a Larger Role	<ul style="list-style-type: none"> • Increased prevalence of non-financial, strategic, and individual goals, some of which will involve subjective assessments • Greater use of discretion (positive and negative) to consider all relevant facts and circumstances beyond formulaic results
Vesting or Deferral Periods May be Longer	<ul style="list-style-type: none"> • Companies may want to spread vesting or payouts over more years to fit within the \$1 million annual threshold • May also apply for former NEOs who will remain “covered employees”

Companies should ensure the additional flexibility under the revised rules does not adversely impact the alignment of pay with performance and the motivational impact of incentive plans.

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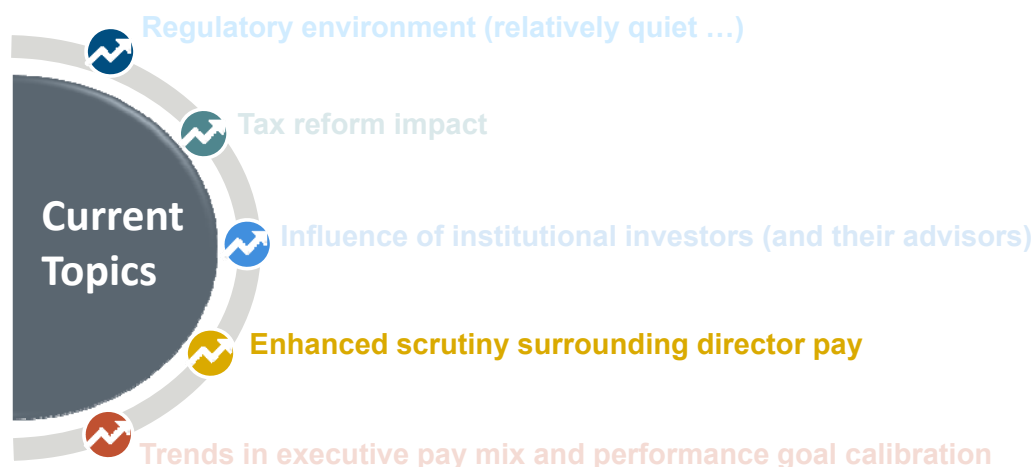
Investor advisory firms

- Institutional Shareholder Services (ISS) and Glass Lewis
 - Governance watchdogs engaged by institutional investors
 - Advise on how to vote shares on proxy proposals (e.g. director nominations, say-on-pay, new or amended equity plans, etc.)
- Substantial energy focused on the governance of executive and director pay
 - Independence
 - Policies
 - Process
 - Peer group benchmarking
 - Transparency regarding pay philosophy and pay design decisions
 - Overall reasonableness of compensation
 - Evaluation of pay-performance alignment (particularly for CEO)
- Depending on the level of institutional ownership, ISS and Glass Lewis can materially influence annual meeting vote outcomes (many believe too much!)
 - Over-the-counter companies are not beyond their reach; sometimes this is a surprise to the Board/management



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Director compensation definitely on the radar

- Reasonableness of director pay will be an area of focus for investor advisory firms going forward
 - Focused on extreme outliers relative to companies in the same index and industry
- The business judgement rule (BJR) which provides a higher level of litigation protection to directors, has slowly been chipped away over the past six years, culminating in a 2017 judgment that is close to eviscerating the BJR on discretionary director pay

- [Seinfeld v. Slager](#) (2012): Challenge to large director RSU grant even where plan had an individual overall cap (deeming cap not sufficiently defined and too high to provide BJR protection to directors)
 - [Calma v. Templeton](#) (2015): Plan without separate limits for director grants not sufficient to provide BJR protection
 - [In re Investors Bancorp](#) (2017): Even with shareholder approval of separate director limits, no BJR permitted where the plan allows discretion for directors to determine their own awards; seems to indicate formulaic and self-executing equity grants may be the only ones that will receive BJR protection
- Given this environment, director compensation studies and reports must be carefully benchmarked and assessed; disclosure and rationale for director pay (including benchmarking) will become an increasingly important element in future proxies

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Mix of total pay opportunity by bank asset size: CEO & CFO

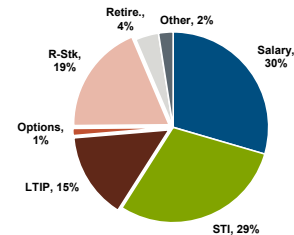
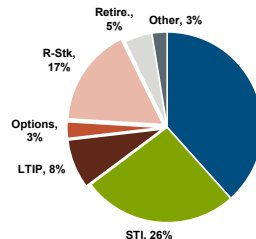
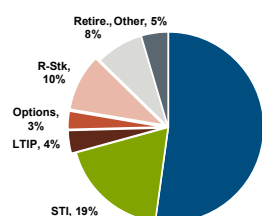
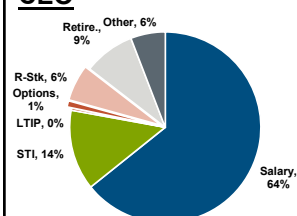
Assets: \$500m - \$1b

\$1b - \$5b

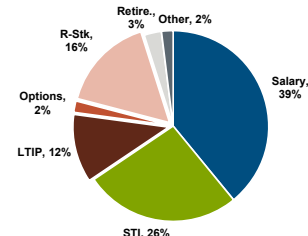
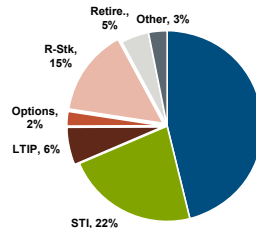
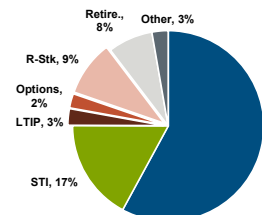
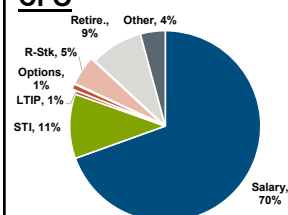
\$5b - \$10b

\$10b - \$20b

CEO



CFO



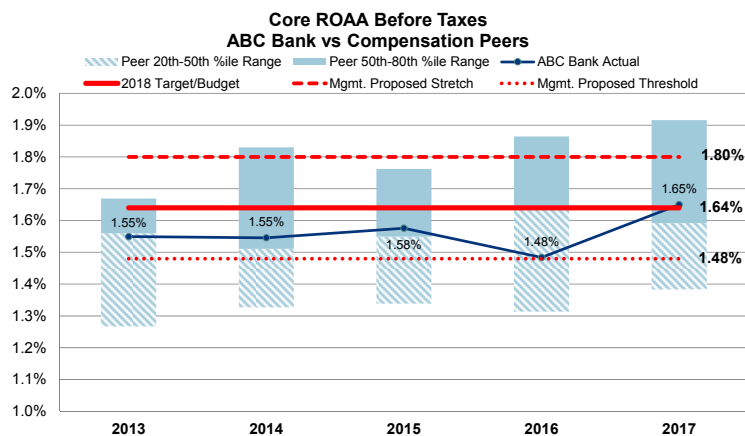
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STI = short-term incentives; LTIP = long-term incentive plan (e.g. performance shares); R-Stk = restricted stock

Data source: Main Data Group

Testing the implied rigor of target (budget), threshold & stretch

- A simple mapping of your proposed goal structure on historical performance of your bank and your peers can provide helpful context for the implied rigor of your goals



Side note: Given the material changes in tax law and consistent M&A activity, historical comparisons of this nature are most relevant on a pretax, core basis, even if the actual metric in the plan is a "vanilla" after-tax operating measure (like ROAA)

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Q & A



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