

ABABANK DIRECTORS BRIEFING

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THE DIRECTOR'S JOB

COMPENSATION COMMITTEE STEPS INTO THE SPOTLIGHT AS EXECUTIVE PAY ISSUES DRAW MORE ATTENTION

The federal government's TARP Capital Purchase Program puts a bright light on banks' executive compensation practices. TARP capital paperwork includes explicit rules and limits on top officers' compensation. The open-ended nature of the government's side of the aid holds out the potential of even more compensation rules.

"When you have the government as your investment banker, there are always going to be strings attached," said Michele Sullivan, executive in charge in the Financial Institutions Risk Consulting Practice at Crowe Horwath LLP. She spoke during the Dec. 10 ABA America's Community Bankers Director Telephone Briefing, "Effective Board Committees: The Audit Committee and Beyond."

The biggest headlines have concerned the very largest banks' pay practices. And this controversy comes, said Sullivan, at a time when corporate directors themselves have grown somewhat skeptical. She quoted a recent study by *The New Economy* magazine, in which twice as many directors as members of management—33% compared to 16.6%—felt their companies' performance was well off target. And one out of five reported they were strongly considering freezing top executives' salaries in 2009.

COMP COMMITTEE DUTIES

Private banks' boards aren't required to have a separate Compensation Committee, although many corporate governance experts believe that it is a "best practice" to maintain one. Publicly traded companies are required to maintain formal Compensation Committees, as we'll review

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DEAR DIRECTOR:

Banks Watch New D.C. Players For Signs Of How They'll Treat Industry As They Address Crisis

In the 1950 film "All About Eve," Bette Davis, as film star Margo Channing, uttered the immortal line: "Fasten your seatbelts, it's going to be a bumpy night."

A similar warning applies to the new, 111th Congress.

"I truly believe that this next year is going to be as important as what happened in the 1930s, for the future of the industry," ABA President and CEO Edward L. Yingling said late last year.

One of the advantages that the banking industry has, going into the new year and the new Congress, is that the supervisory scheme

already applied to banking has frequently been the government's method of choice in addressing financial services issues.

"Through all this recent turmoil, the insured depository model is the model that has been ratified all the way along," said Floyd Stoner, ABA Executive Vice-President for Congressional Relations, in an interview in the January *ABA Banking Journal*.

Foreclosures cloud outlook

Every advantage will help. Much of what the 110th Congress and the Bush Administration struggled with in the closing days of 2008 will carry over to the new year. By one count, banks face 30 major issues.

A key one: the challenge of massive foreclosures. This continues to perplex experts. Even bank regulators argue over the efficacy of efforts taken thus far to modify endangered mortgage borrowers' loans, to keep

them out of foreclosure.

The federal TARP program has been eyed as the source of the next potential solution to that problem. Negotiations were still going on among Washington leaders as the winter holidays commenced, concerning how to tap what has become a ready reservoir for many efforts to help the economy.

Already, the TARP program, originally conceived to purchase bad assets and establish a pricing mechanism

2009 "is going to be as important as what happened in the 1930s"

in their markets, has been turned inside out. A small amount, thus far, wound up being used for something like the original

purpose. That was as part of the plan to help Citigroup. However, the major portion of its first half of allocated funds have gone to the TARP Capital Purchase Program.

This hurt relations between the Bush Administration—most directly the Treasury Department—and Congress. Many in Congress who supported the Emergency Economic Stabilization Act of 2008, which created and funded TARP, felt bamboozled.

"Members of Congress don't feel that what they voted for has been implemented," Stoner told the magazine. "That causes problems. It's a fundamental issue: 'You told us you were going to do this, then you didn't'."

Concerns over the foreclosure issue continue to color the debate. For its part, ABA stands ready to work with Congress on the foreclosure challenge, said Robert Davis, ABA Executive Vice-President,

BY THE EDITORS OF ABA BANKING JOURNAL

mortgage finance, risk management, and public policy, in the same article. Stoner doesn't see the second half of TARP money being released without provision for foreclosures.

Widening web

Other complications have taken the already complex TARP program and

related efforts and interlinked them with added issues.

For instance, after efforts to pass a congressionally sanctioned bailout of the Detroit automakers failed, the Bush Administration tapped \$13.4 billion out of the \$350 billion of the first half of authorized TARP funds to help finance automakers'

recovery efforts. Plans were for \$4 billion more to come out of the \$350 billion authorized, but not yet released, by Congress.

(Under federal law, after a formal request for release of the second batch of TARP funds, Congress has a limited time to pass a joint resolution disapproving release. If Congress misses its deadline, the funds then become available to the Treasury Department.)

In related news, in late December the Federal Reserve approved the request of GMAC LLC to become a bank holding company. The company is the General Motors "captive" finance company that makes loans for many GM vehicles. Today it is jointly owned by GM and a private equity fund, although the ownership mix will change significantly.

Besides financing cars, the company also makes mortgages and business loans and engages in the insurance business. There is some speculation GMAC may use some TARP funds.

But in a time of tapping TARP for the auto industry, others have found encouragement in their own hopes for a federal rescue.

The Federal Reserve's new program to help get certain loan-backed securities markets going again, backed up by a slice of TARP money, attracted the attention of commercial real estate developers. In December, some of the nation's largest were among the interests calling for federal help. They worry about the ability of banks and other large lenders to refinance a wave of commercial mortgages coming due. One source puts the amount of such loans at \$160 billion for 2009 alone.

Congress and financial regulation

While solving the problems of the present continues to press on the Federal Reserve and the outgoing and incoming Administrations, a longer-term matter that Congress already planned to take up in the

BOARDROOM BRIEFS

FDIC Hikes Premiums For First Quarter

Deposit insurance assessments will rise by seven cents for every \$100 of deposits in the first quarter of this year, in the wake of a mid-December vote by FDIC's board. Most banks were paying from 5 to 7 cents per \$100 for coverage; the range will rise for them: 12 to 14 cents.

FDIC is attempting to restore its required reserve ratio—the ratio of Deposit Insurance Fund balances to insured deposits—to at least 1.15% by the end of 2013. Federal law requires DIF to maintain a ratio of between 1.15%-1.5%, and FDIC must implement a restoration plan when the actual ratio drops below the lower number. The ratio stood at 1.01% in June, and has fallen further since, as bank failures and other costs to FDIC have risen.

Still pending is a more-detailed approach to assessments that is the second part of FDIC's restoration plan. Comments were accepted through mid-December on that portion of the plan, which was reviewed in detail in the October 2008 newsletter. If adopted as proposed, subsequent assessments would fall still harder on riskier banks. For the majority of banks, those that had been paying 5 to 7 cents, the rate, as proposed, would double to a range of 10 to 14.

These measures do not reflect any potential expanded burdens on the insurance fund, such as the temporary increase of general insurance limits to \$250,000. Many think the latter will wind up becoming permanent.

Fed Shifts Approach To Overdraft Programs

A two-prong approach to popular overdraft checking services was taken by the Federal Reserve in late December.

First, the agency made changes, effective in 2010, to deposit account disclosure requirements under Regulation DD, which implements the Truth In Savings Act. All institutions will be required to disclose overdraft fees on their periodic customer statements. Before the revisions, only institutions that promoted overdraft service had to make such disclosures. Also, the new rule will require banks providing balances to customers through automated means, such as cash machines, websites, and phone banking, to exclude from those balances any amount that comes from an overdraft program or transfer from the customer's other accounts. A *supplemental* balance including such services can be provided, so long as it is made clear that those are being counted in.

Second, the agency *proposed* changes to Regulation E, which governs electronic banking. The Fed draft would require institutions with overdraft plans to take one of two alternative approaches to use of overdraft plans with cash machines and debit cards. One would permit customers to choose *not to participate* in the plans for electronic banking. The other would require customers to specifically choose to *participate*.

Notably, the Fed appears to have dropped the idea of applying "unfair and deceptive practices" enforcement, a concern, earlier on, among bankers.

111th is the future of financial services regulation.

One factor that will be examined is the future role of the Federal Reserve. While FDIC and Treasury have played major roles in addressing parts of the ongoing financial crisis, the Federal Reserve has, in stepping into the breach many times, watched both its turf and its balance sheet expand enormously.

Many aren't comfortable with this. "I don't think the *Fed* is comfortable with where it is right now," said ABA's Wayne Abernathy, Executive Vice-President, Financial Institutions Policy and Regulatory Affairs, in *ABA Banking Journal's* interview.

Both the House and Senate financial services committees will be looking closely at financial services regulation and oversight. The ABA lobbyists say there is no congressional consensus yet on what direction to take. At this point, they estimate legislation will begin moving out of the House by mid-summer. The time frame isn't quite as clear in the Senate.

"There is one thing we do know," said Stoner, "and that's important. In the House, Financial Services Committee Chairman Barney Frank (D.-Mass.) has indicated that he wants the focus to be on issues that brought us the problems. Specifically, that means looking at the gaps in the regulatory structure, as opposed to a total remake of the banking regulations."

To date, the incoming Obama Administration has not given a definitive indication of what it wants to pursue. "We would expect the Administration to put something on the table, first," said Stoner, before much moves in Congress.

Obama touches on issues

Subsequent to the *ABA BJ* interview, President-Elect Obama held a Dec. 18 press conference where he announced several key financial-services-related nominations. He took that opportuni-

in the next section.

First, some basics, from Sullivan. The typical Compensation Committee is composed of three to five directors, and meets three to five times a year, frequently quarterly.

"There's no requirement that they be compensation experts," said Sullivan, "but having a good basic understanding of key elements of compensation—and the risks and ramifications of compensation decisions—are imperative."

Among the annual tasks of the committee, said Sullivan, are these:

- *Yardsticks.* Establishment and monitoring measurements of performance.
- *Making comparisons.* Oversight of compensation equity analysis, comparing compensation both internally—such as among the top five bank officers in regard to each other—and also externally—comparing the officers' compensation to peers' leaders.
- *Hiring on, firing off.* Review of both employment agreements and severance agreements, and adoption of any necessary updates.
- *Give back and take back.* Oversight of any necessary special steps related to compensation, including "claw-backs," the effort to recover excess payments, and retention payments, made in better economic times.
- *Ownership boundaries.* Establishment of ownership guidance for executives.

BEST PRACTICES FOR ALL

Sullivan outlined practices that will help all board- and board-committee level compensation deliberations. The first group of practices are **strategic**.

This includes continuous training, so directors are up on state-of-the-art compensation practices and issues.

"Compensation schemes and tactics have become more and more complex," said Sullivan. "The changes in the tax law, both in the past several years, as well as what's going to be coming out of Washington, continue to add to the complexities."

Another key practice is documentation of the bank's compensation strategy, including both the design of the bank's approach to compensation for executives as well as a record of the evaluation process it uses for making compensation decisions.

Sullivan also endorsed the use of

more "executive sessions" of the Compensation Committee. Executive sessions are meetings held without any members of management present, either as committee members or observers, the intent being to encourage and facilitate frank discussion.

The second group of best practices put forward by Sullivan are best characterized as **tactical**.

These measures include development of a group of peer companies for compensation comparisons; establishment of CEO performance goals and measurement methods; determination of pay levels for target results versus actual results; and development of an in-depth annual CEO performance evaluation.

One more best practice that Sullivan recommended is a self-evaluation of the Compensation Committee.

EXCHANGE RULES CAN HELP

Sullivan turned to brief explanations of the stock exchanges' requirements for compensation committees.

"We can get into a bit of overload in saying that all of the public company practices would be 'best practices' for private companies," said Sullivan. "However, there are some nuggets of wisdom in both the New York Stock Exchange rule and the NASDAQ rule that would be helpful to private company compensation committees."

New York Stock Exchange Rule 303A.05 has three main requirements:

- *Independence.* Establishment of a committee composed entirely of directors meeting independence requirements. "This is very similar to what's required for an Audit Committee or a Governance Committee," said Sullivan.
- *Committee duties.* Creation of a written committee charter establishing at least the minimum responsibilities of: setting goals and objectives relating to CEO compensation and performance; making recommendations to the board regarding compensation of the top four officers besides the CEO; production of a committee report to be published in the company's 10-K; and creation and posting on the internet of the Compensation Committee's charter.
- *Completion of an annual perform-*

THE DIRECTOR'S JOB (CONT'D.)

ance evaluation of the Compensation Committee.

NASDAQ's Rule 4350(c)3 doesn't actually require a listed firm's board to have a Compensation Committee. However, said Sullivan, the board must address executive officer compensation in one of two ways. These are the determination of compensation, or recommendation to the board of a determination, by either a majority of the board's independent directors or a formal Compensation Committee composed entirely of independent directors. An exception; a Compensation Committee of at least three may include a nonindependent director, who can serve for up to two years.

Sullivan also pointed out that NASDAQ rules bar a CEO from being present when a vote on his or her own compensation is taking place. The CEO can be present when other officers' compensation is under consideration.

HOT ISSUES FOR 2009

Sullivan reviewed three areas that boards and their compensation committees will want to consider in the days ahead:

- *Executive pay issues.* Among the tasks, especially in public

companies, will be aligning company performance and top executives' pay, balancing the need for incentives with the need to justify compensation levels by results. Third-party surveys and other such tools will play a part. Sullivan said boards will have to consider such issues as appearance, as in the ratio of CEO pay to the pay of the lowest-ranking staff.

- *Executive severance agreements.* "One of the tasks here is making sure that the variation by an executive's level and their tenure is appropriate," said Sullivan. There are issues in tax and benefits rules to consider, as well.

- *Use of compensation consultants.* Sullivan advised committee members and other directors to "clearly identify who the consultant works for—the consultant should work for the board." Understand any conflicts of interest the consultant may have, and also understand the resources and expertise the consultant brings to the assignment.

CDs of the entire briefing can be obtained by going to www.aba.com/teleweb/tb121008.htm To be added to the e-mailing list for the 2009 series, e-mail tleiva@aba.com

DEAR DIRECTOR (CONT'D.)

ty to sketch, in very broad strokes, what he has in mind.

While stimulus and job creation are critical, he said, "what will be just as important to our long-term stability is a 21st century regulatory framework to ensure that a crisis like this can never happen again." Financial regulatory reform—to "reform our outdated financial regulations"—will be a top priority.

Much of what he added to this was rhetoric, with some clues:

"These individuals [his nominees] will help put in place new, common-sense rules of the road that will protect investors, consumers, and our entire economy from fraud and manipulation by an irresponsible few. These rules will reward the industriousness and entrepreneurial spirit that's always been the engine of our prosperity, and crack down on the culture of greed and scheming that has led us to this day of reckoning. Instead of allowing interests to put their thumbs on the economic scales and CEOs run off

with excessive golden parachutes, we'll ensure openness, accountability, and transparency in our markets so that people can trust the value of the financial product they're buying. And instead of appointing people with disdain for regulation, I will ensure that our regulatory agencies are led by individuals who are ready and willing to enforce the law."

Over the years Washington has seen many proposals to consolidate and streamline regulatory agencies and regulatory functions, for instance, but rarely in such times.

Many issues will factor into such a debate, should it go so far as redrawing the regulatory map. While much of today's structure goes back to the 1930s, some of it has been of even longer standing.

The concept of national banks, and a national bank regulator—the Office of the Comptroller of the Currency—in the modern sense, goes back to the Civil War. National banks were formed in part to help finance the Union cause.

And the right of states to regulate commerce within their own borders, which goes back to the country's earliest years, is tied up in the state system of chartering and regulatory agencies.

And that's not all, folks...

Other issues will be coming up, as well, as Congress debates the future of the financial regulatory system. Accounting rules will be looked at closely, for example. And consumerist-type regulatory burdens can also be expected to come up in any financial legislative package. ABA's Bob Davis warned that "we aren't going to get out unscathed."

There is some hope.

ABA's Floyd Stoner explains it best: "In any time of great change, there are opportunities as well as concerns, and we want to maximize those opportunities."

Sincerely,

Steve Cocheo

for *ABA Banking Journal*

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