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Life after TARP

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For many banks there is—or shortly will be—life after TARP.

In 2010, we saw a number of firms repay their TARP funds through capital raises or retained earnings. In addition, for banks under $10 billion in assets the Small Business Lending Fund now provides an opportunity for the best performing TARP banks to swap their TARP capital and be unencumbered by the TARP compensation restrictions. As we look to 2011, we expect both these trends to continue and the pool of TARP banks to shrink.

No matter how emancipation from TARP's pay restrictions occurs, banks will be presented with a unique, timely opportunity to question how they should design their executive compensation programs. Some will rush right back to what they were doing before TARP as they believe their programs were thoughtful and successful. Others will use the opportunity to completely rethink executive pay in the context of a transformed economic, regulatory and shareholder advocacy environment. Still others will do something in between. The question for any post-TARP bank is what is the right course of action for their institution?

Regardless of the decision, it is clear that satisfying the interests of executives, regulators and shareholders – not to mention the press – will be nearly impossible. Banks are faced with navigating these disparate interests and finding the "best" choice on a wide range of decision points. With that in mind, the purpose of this article is to outline some of the complicated issues, highlight choices that must be made and consider some of the implications of the more likely alternatives.

LOOKING AHEAD

To provide context to the design decisions that post-TARP banks are facing, let's first consider the environment. The analysis should begin with a review of the business model of banking itself. Most notably, in the current environment and in light of government and regulatory interventions, it is simply harder for banks to make money. Banks face the prospect of a rising rate environment, decreased net interest margins, reduced lending and trading activities, scrutiny of consumer fees, caps on allowable interest rates and higher capitalization requirements. With lower revenues and less leverage, earnings will be squeezed. In the short term, reduced or reversed loan loss provisions will work to partially offset the squeeze on earnings. However, as credit quality stabilizes, these positive offsets will be temporary and likely not extend much beyond 2011. With a history of paying total compensation at a consistent percentage of revenue, banks will simply have less money to spend on compensation.

Once a bank is no longer constrained by TARP compensation restrictions on bonuses, equity and severance pay, they are free to make one of three broad choices within the environment described above.

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1. **Back to Normal**
   There is indeed a great temptation to simply move beyond the TARP mandated compensation restrictions and return to what existed in the past including historical "target" pay levels. Management is familiar with these programs and board of directors are comfortable with them. In fact, many of the banks who repaid TARP did exactly that. Of course, this choice ignores the fact that the world has actually changed quite a bit during the last two years. For example, all banks are now required to comply with regulations covering Sound Incentive Compensation Policies. In addition, for public banks, there are new requirements from both the SEC and the Dodd-Frank Act that look quite similar to the restrictions that are mandated through TARP. Nevertheless, back to normal remains a comfortable and attractive choice.

2. **Rebalancing**
   A second alternative is to recognize that the world has changed. In this new reality there is in fact merit to adjusting targets, a different weighting of pay components, adding new performance metrics and a longer term focus of compensation through deferral (and clawback) features. In other words, the previous program would be "gently" modified to reflect the new reality. Given that the old program would serve as the foundation, both the Board and management find comfort in the familiar while embracing the new enhancements. Modification, rather than redesign, is viewed by many as the best of both worlds. Not surprisingly, rebalancing compensation has been the response for many banks who were in the second wave to repay TARP.

3. **Starting from Scratch**
   Some banks have taken (and others are considering) a fresh holistic look at their executive compensation programs and, as a result, rebuilt them from the ground up. This approach is used by firms who believe that the environment has fundamentally changed and the old way of doing things is simply inadequate. Starting from scratch includes a thorough review of the total reward strategy and a willingness to introduce wholesale change and is favored by both regulators and shareholder advocates. This level of change is likely to be embraced by leadership who wants to signal a break with the past.

OUR CHOICES

Any firm that chooses "Rebalancing" or "Starting from Scratch Approach" will be faced with a number of challenges relating to the "new normal." With this context in mind—management and compensation committees are faced with the following choices when crafting their new post-TARP compensation plans.

1. How much is enough? In the "new normal", where earnings are challenged, should target payout levels and performance benchmarks be lowered?

2. What vehicles should we use to deliver total compensation? Which ones will most effectively drive behavior, encourage retention, maximize long-term value and be viewed favorably by the regulators?

3. Should salary stock and/or increased salaries be part of the equation? If so, does this mean total pay goes down to reflect the decline in risk?

4. Should we care about Section 162(m) if it restricts the execution of our compensation strategy?

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5. What metrics should be used to determine performance? Running a bank and measuring its performance has never been one-dimensional, so why should incentive plans be any less nuanced?

6. Should performance be measured on an absolute or relative basis?

7. What portion of incentive compensation should be delivered currently and what portion should be delivered on a long-term basis? Should individuals responsible for highly speculative investments, trades or loans with long tail risks, have more incentives deferred over an extended time horizon?

8. Should equity have a performance vesting component?

THE DETAILS

As firms work to implement one of these broad strategies they face the challenge of working through each of the questions listed above. If we look across the questions, five consistent themes emerge:

1. Pay Levels: How much should we pay?

One obvious way to answer this question is to consult market data. However, TARP restrictions will lead to benchmarking results with low pay levels and unconventional pay mixes. Recommending changes with only traditional "market justification" will be challenging.

As banks look to the future, we recommend a benchmark comprised of target pay levels (at all peers) and actual data from non-TARP peers. Non-TARP peers are clearly a better indicator of the long term outlook for executive pay because banks still in TARP are saddled with no incentives and/or increased fixed pay with reduced upside. In addition, target pay levels allow you to calibrate pay *opportunity* and let pay-for-performance mechanisms settle actual pay at an appropriate level.

2. Exchange Rates: How should the components be valued when changing from one form of pay to another?

There is the question about how to establish exchange rates between fixed and variable pay. Banks will be forced to confront the question of relative worth illustrated by the following examples:

- Salary paid in cash versus salary paid in stock
- Annual cash bonuses versus deferred cash bonuses versus long term-performance plans
- Time-vested versus performance-vested restricted stock and how this contrasts with stock options

There is a fair amount of academic research on how to make such exchanges; however, the reality is that many banks have been quite comfortable communicating that a dollar of incentive is equal to a dollar of cash salary. This ignores the fact that fixed compensation, salary, has a higher value than variable compensation, incentives. When designing compensation programs in the context of the new reality of compensation, firms must consider the different values of the various pay components.

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3. Pay Mix: What is the optimal combination?

TARP fundamentally changed the way compensation was delivered: salary stock was introduced, cash incentives were eliminated and equity was restricted and capped. This has left many banks with a pay mix that is skewed toward fixed pay and equity. As each bank exits TARP, it must determine the appropriate mix of pay given that each firm has a unique strategy and management style. That being said, every plan should have the following three components:

- Fixed salary (in cash, stock or both)
- Annual incentives (paid currently or deferred)
- Long-term incentives (equity or performance plans)

The weighting of various components should vary by institution and position within the institution.

4. Performance Measurement: How should performance be measured?

A bank's goals & objectives are a powerful tool for communicating what is important to an organization. We have surely learned that an over dependency on one or two measures (historically EPS growth and ROCE) will not tell the full story. It is clear that consideration must be given to profitability, capital, risk management, operational effectiveness and shareholder value.

Once we have a sense of what the measures actually look like, the next step is to determine whether to use absolute or relative performance. Absolute standards are budgets, forecasts, plans and historical norms indicating the level of return that can be expected for a given amount of risk. Relative standards are comparisons to a relevant group of peer institutions. On the one hand, absolute performance measurement relies to a great extent on management forecasts, creating an incentive to downplay expectations as well as an inability to account for unexpected events that lift, or sink, all banks. On the other hand, relative performance ensures that external macro level factors are taken into consideration yet can pay generously for poor absolute performance (e.g., high pay for losing the least amount of money).

In the end, no single measure or straightforward approach will be sufficient. It is clear that a portfolio of measures, some of which work at cross purposes, needs to be considered. Similarly, both absolute and relative metrics are relevant and must be balanced. Most importantly, compensation committees will need to look at a number of facts, weigh them against each other and holistically make a judgment as to how well the institution performed. Abdicating that decision to a formula may be simpler—but it is not as effective as real judgment.

5. New Regulatory Reality – Risk Reviews are Here to Stay

A number of banks who have repaid TARP are faced with a "new normal" that includes many of the regulatory requirements that were created under TARP now applying to the banks in particular, and public companies in general.

As now required for all banks, all "incentive compensation" must be reviewed within the requirements of Sound Incentive Compensation Policies. These regulations require that all incentives balance risk and reward, incorporate effective risk controls, and have oversight by the Board. Additionally, the definition of incentive compensation includes cash, equity, as well as executive agreements and deferred compensation arrangements. The regulations call for an ongoing process for the design, review and monitoring of incentive arrangements. This came directly from the bi-annual risk review required under TARP.

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It is now, or soon to be, required that all public companies follow these regulations. The SEC now requires a review of incentive plans for purposes of proxy disclosure. Also, through Dodd-Frank we have "say-on-pay" and will soon have mandatory clawbacks. All of these requirements have their foundation in TARP compensation restrictions.

The point is clear: when designing bank compensation plans, all parties involved need to be mindful of the new regulatory landscape that has evolved since TARP was put in place.

CONCLUSION

As banks work through the many questions they face, it is apparent that no answer will stand on its own. Any changes made should be part of a comprehensive reward strategy that fits within the context of a firm's unique business strategy and management style. Having said that, to ignore that the world has changed is at best naive, and perhaps, at worst, detrimental to the future stability of the bank. Change is inevitable—embracing it and making the most of the situation is what makes institutions great. For our clients striving to emerge from TARP with a better, more effective executive compensation program, we are recommending:

- A shift in pay mix with a greater emphasis on fixed and long term pay and less annual cash incentive
- Delivery of a portion of incentive compensation in performance vesting equity
- Selected use of stock options
- Explicit deferral of incentive compensation with the ability to "clawback" in case of future losses
- A modest reduction in total compensation opportunity (at target) versus pre-TARP levels
- Adoption of a "balanced scorecard" of financial, risk, capital, operational and shareholder measures
- A combination of relative performance and threshold absolute standards

In the end, this will be an inflection point upon which we will look back and see who made the most of the situation. While some of these changes sound innovative and even cutting edge, no change comes without risks."

What we have learned is that having compensation focused primarily upon profit in the short term can have negative consequences. At the same time, compensation still exists to motivate superior performance; however, in a balanced and sound manner.

All this goes to say that when banks work to review their compensation plans in a post-TARP world, they have to be aware of the amount of change occurring at the present time. Many executives accepted that they were "doing time" under TARP and felt underpaid and unappreciated for all they did to stabilize and save the bank. Now that business is back to "normal", telling executives that there is a "new normal" can at best be unsettling and at worst be seen as the "last straw". Having the management team motivated and retained for a post-TARP bank is more important than ever. ■

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