



## **The Changing Role of the Compensation Committee of the Board of Directors in Community Banks**

*Submitted by Jon Doukas, April 12, 2016*

**Introduction.** Traditionally, most executive compensation decisions have been handled at the December meeting of the board of directors, and these decisions were based on limited information and the board's subjective judgment. However, executive compensation has become more complex. The passage of the FDIC Improvement Act of 1991 (FDICIA), Dobb-Frank Wall Street Reform Consumer Protection Act, and Securities and Exchange Commission Regulations, regarding executive pay communications to stockholders, have made compensation procedures and decisions more challenging. Media coverage and stockholder interest have also increased in recent years. The result has been the need to develop a more formalized approach to the institution's total compensation programs.

**Current Environment.** In addition to regulatory requirements, other changes in compensation activities must be considered in determining an effective approach to the development of an overall compensation plan. The low level of inflation during the past few years and the increased availability of bankers (due to both consolidation and downsizing) have kept annual increases in a range of 2% to 4%. Due to fewer promotional opportunities from restructuring and continuing consolidation, more financial institution employees now remain in their current positions for longer periods of time.

This has resulted in more uniform salaries and has impacted an institution's ability to provide rewards for performance within base salary programs. In turn, more interest has been created in bonus and incentive programs to provide a mechanism to improve profitability and to reward responsible individuals while, at the same time, controlling personnel expenses. A need has been created for developing and administering internal programs that maintain consistency and objectivity regarding compensation decisions. Accordingly, a need has also developed for stronger board oversight.

**Director Compensation.** There has been a considerable evolution in remuneration to financial institution boards of directors in recent years. At one time, director compensation was limited to fees for meetings attended. Director compensation has changed along with changes in time commitments and duties. Various forms of compensation, including board fees and retainers, are presently being utilized to provide directors with increased compensation for their time, knowledge, and expertise.

The following charts present information on director fees including retainers, board fees, and committee payments. It is estimated that more than 40% of all financial institutions now provide annual retainers, as well as board and committee fees, to compensate directors for their responsibilities and time required for bank and bank-related community activities.

### **MEDIAN DIRECTOR COMPENSATION SURVEY RESULTS**

(For financial institutions in the \$100 million to \$300 million asset size range rounded)

	<u>Monthly Fees</u>			<u>Annualized Fees</u>		
	<u>Low</u>	<u>Median</u>	<u>High</u>	<u>Low</u>	<u>Median</u>	<u>High</u>
Monthly Director Retainer Fees	\$200	\$350	\$500	\$2,400	\$ 4,200	\$ 6,000
Board Meetings Fees *	200	350	500	2,400	4,200	6,000
Committee Meeting Fees **	100	175	250	1,200	2,100	3,000
<b>TOTAL BOARD COMPENSATION</b>				<b>*\$6,000</b>	<b>*\$10,500</b>	<b>*\$15,000</b>

\* Based upon 12 board meetings per year.

\*\* Based upon 12 committee meetings per year.

## MEDIAN DIRECTOR COMPENSATION SURVEY RESULTS

(For financial institutions in the \$300 million to \$500 million asset size range rounded)

	<u>Monthly Fees</u>			<u>Annualized Fees</u>		
	<u>Low</u>	<u>Median</u>	<u>High</u>	<u>Low</u>	<u>Median</u>	<u>High</u>
Monthly Director Retainer Fees	\$400	\$600	\$800	\$4,800	\$ 7,200	\$ 9,600
Board Meetings Fees *	400	600	800	4,800	7,200	9,600
Committee Meeting Fees **	200	300	400	2,400	3,600	4,800
<b>TOTAL BOARD COMPENSATION</b>				<b>*12,000</b>	<b>*\$18,000</b>	<b>*\$24,000</b>

\* Based upon 12 board meetings per year.

\*\* Based upon 12 committee meetings per year.

## MEDIAN DIRECTOR COMPENSATION SURVEY RESULTS

(For financial institutions in the \$500 million to \$1billion asset size range rounded)

	<u>Monthly Fees</u>			<u>Annualized Fees</u>		
	<u>Low</u>	<u>Median</u>	<u>High</u>	<u>Low</u>	<u>Median</u>	<u>High</u>
Monthly Director Retainer Fees	\$600	\$800	\$1000	\$ 7,200	\$9,600	\$12,000
Board Meetings Fees *	600	800	1000	7,200	9,600	12,000
Committee Meeting Fees **	300	400	500	3,600	4,800	6,000
<b>TOTAL BOARD COMPENSATION</b>				<b>*\$12,000</b>	<b>*\$18,000</b>	<b>*\$24,000</b>

\* Based upon 12 board meetings per year.

\*\* Based upon 12 committee meetings per year.

Director compensation should be reviewed annually and should be consistent with current industry standards. Recruiting and retaining qualified and committed directors is contingent upon competitive director compensation practices.

**The Compensation Committee.** A director's Compensation Committee should be established. Its specific duties and responsibilities should include the following.

1. Overseeing overall staffing levels and personnel costs for board information and budget considerations.
2. Functioning as the institution's retirement committee for all defined contribution and payment plans, such as pension and profit-sharing plans.
3. Reviewing and recommending the compensation structure for the President and Chief Executive Officer, including base salary adjustments, executive benefits, and incentive/bonus arrangements.
4. Reviewing the institution's compensation plan for effectiveness and conformance with the need to:
  - a. support management philosophy, strategy, and style;
  - b. attract, motivate, and retain qualified employees;
  - c. benefit the organization by maximizing productivity, controlling personnel costs, and complying with laws and regulations; and
  - d. work effectively by requiring management involvement, understanding, and support.
5. Recommending performance objectives to be utilized in the evaluation of the President and Chief Executive Officer's performance.
6. Annually reviewing director, board, and committee fee structure with recommendations for change consistent with current needs and industry standards.
7. Maintaining awareness of trends and changes in compensation and benefit programs.
8. Monitoring programs for effectiveness and compliance with regulatory and internal policies.

The compensation committee should consist of outside directors with the experience, objectivity, and independence to ensure affective analysis, oversight, and administration of the various compensation programs.

The compensation committee is a mechanism by which the full board is provided with information and insight as to the current status of compensation programs. It also provides recommendations for any required change.

**Executive Compensation.** Through its compensation committee, the board of directors has the responsibility to review the compensation structure for the President and Chief Executive Officer position. Salaries are influenced by external conditions, individual qualifications, and performance results. Each of these factors should be considered in determining the annual base salary for the President and Chief Executive Officer.

Location, experience, years in position, institution performance, and other factors impact the determination of the most appropriate base salary.

To maintain competitive salary structures and to establish the appropriate salary for executive management, an annual review of internal and external compensation information is required. Commercially available and state association salary surveys can be used for the review of and adjustments to salary programs. Executive management performance criteria and evaluation procedures need to be developed and utilized in the determination of compensation adjustments.

**Benefits.** The board of directors and the compensation committee should review all institution benefits on an annual basis. In addition, the availability and participation in executive benefit programs should be determined by the compensation committee. These benefits can include executive medical coverage, executive insurance, supplemental retirement benefits, stock options, use of automobile and/or travel allowance, and club memberships. Again, internal structure, competitive factors, and corporate approach impact the design and availability of such programs.

**Bonus and Incentive Programs.** The role of incentive/bonus programs has continued to increase as a mechanism for using organization results to determine performance payments to employees, officers, and senior executive personnel. Program design elements including timeframes, types of payments, participation, methods of measurement, and funding levels need to be consistent with corporate philosophy and other compensation elements of base salary and benefits. Performance criteria and effective evaluation systems are critical to the effective administration and objectivity of these programs. Due to expanded review of compensation by regulatory agencies and additional reporting and communication requirements, the board and its compensation committee must be an integral part of the design and evaluation process. More than 65% of all financial institutions now provide some form of incentive/bonus opportunities to employees and/or officers. Expansion of such programs is expected to continue.

**Regulatory Considerations.** All financial institutions will have their executive compensation activities reviewed by their appropriate agency. This review should utilize

current standards to determine if the organization's current structure is in line with industry actions. The agencies are mandated by law to consider the following:

1. the combined value of all cash and non-cash benefits provided to the individual;
2. the compensation history of the individual and other individuals with comparable expertise at the institution;
3. the financial condition of the institution;
4. comparable compensation practices at comparable institutions;
5. the projected total cost and benefits to the institution for post-employment benefits; and
6. any other factors the agency determines to be relevant.

Because of these pending standards, all financial institutions should review their current executive compensation plans and develop procedures for future review and changes, which, in most cases, would be assigned to the directors' compensation committee.

In addition, publicly-traded companies will now come under executive compensation disclosure standards for 10K reports and proxy materials sent to stockholders. This information covers all compensation to key executive officers. The regulations require a three-year summary compensation table, including salary, bonus payments, and other forms of compensation, as well as information on long-term compensation arrangements. Additional tables are required for stock options, stock appreciate rights, long-term incentive plans, and defined benefit (pension plan) participation and values.

Regulations also require disclosure of director compensation, including retainer, board and committee fees, bonus/incentive participation and awards, and other forms of compensation.

To determine the relationship of company performance and executive compensation, a performance graph should be developed and included in the disclosure of compensation information. The new regulations also require disclosure of the factors and criteria utilized to determine the structure and amount of executive compensation.

**Conclusion.** Changes in the compensation environment clearly mandate an objective review by each financial institution of its compensation philosophy and practices.

Many of the client programs reviewed by the writer reveal that more attention and analysis is needed to assure consistency, value, and effectiveness in the compensation

programs. Objective review and analysis should also raise the comfort level of all parties involved as proper attention is given to this vital area.

The compensation committee is the appropriate forum for providing the highest level of oversight to this function; it is also a virtual requirement in the present industry environment.

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