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FEDERAL RESERVE PROPOSES INCENTIVE COMPENSATION GUIDANCE FOR BANKS

On October 22, 2009, the Federal Reserve issued proposed guidance (the Proposed Guidance) addressing incentive compensation practices at banks regulated by the Federal Reserve. The Proposed Guidance does not impose a cap on pay or ban any particular practices. Rather, it sets forth general principles, along with specific suggestions, regarding how a bank should structure and administer its incentive compensation arrangements to avoid encouraging excessive risk-taking by senior executives and other employees.

As part of the Proposed Guidance, the Federal Reserve announced two supervisory initiatives, one targeting 28 large, complex banks (the LCBOs), and the other targeting all other banks regulated by the Federal Reserve. According to the Federal Reserve, these initiatives are intended to encourage banks to take action to implement "safe and sound" incentive compensation practices and to assist the Federal Reserve in identifying "emerging best practices" in the banking industry. The supervisory initiative for the 28 LCBOs will require the LCBOs to provide the Federal Reserve with extensive information about their incentive compensation practices. The Federal Reserve will use this data to conduct a "horizontal review" of incentive compensation practices at the LCBOs. For non-LCBO banks, the Federal Reserve will review incentive compensation arrangements as part of its regular, risk-focused supervision program. The Federal Reserve's findings from the supervisory initiatives will be incorporated, as determined appropriate by the Federal Reserve, into each bank's supervisory ratings.

Although the Proposed Guidance is in proposed form subject to a 30-day comment period, the Federal Reserve nonetheless expects banks to "immediately review their incentive compensation arrangements to ensure that they do not encourage excessive risk-taking and to implement corrective programs where needed." Further, the Federal Reserve intends to implement the supervisory initiatives right away.

BANKS SUBJECT TO THE PROPOSED GUIDANCE

The Proposed Guidance applies to all banking organizations supervised by the Federal Reserve, including US bank holding companies, state banks that are members of the Federal Reserve, Edge and agreement corporations, as well as the US operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the US.

INCENTIVE COMPENSATION PROGRAMS COVERED

The Proposed Guidance states that incentive compensation programs for both executive and non-executive personnel may, if not properly structured, expose a bank

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to material risk and threaten the bank's safety and soundness. Consistent with that assessment, the incentive compensation plans covering the following employees are specifically identified as being subject to the Proposed Guidance:

- "Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines";
- "Individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk (e.g., traders with large position limits relative to the firm's overall risk tolerance)"; and
- "Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the firm to material amounts of risk, even if no individual employee is likely to expose the firm to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk)."

THE FEDERAL RESERVE'S PRINCIPLES FOR INCENTIVE COMPENSATION

The Proposed Guidance establishes the following three general principles for structuring and administering incentive compensation arrangements at banks:

- *Principle 1: Balanced Risk-Taking Incentives.* "Incentive compensation arrangements should balance risk and financial results in a manner that does not provide employees incentives to take excessive risks on behalf of the banking organization."
- *Principle 2: Compatibility with Effective Controls and Risk Management.* "A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements."
- *Principle 3: Strong Corporate Governance.* "Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices."

Highlights of the Federal Reserve's principles follow.

Principle 1—Balanced Risk-Taking Incentives

According to the Federal Reserve, a "balanced" incentive compensation arrangement is an arrangement where "the amounts paid to an employee appropriately take into account the risks, as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness." The Proposed Guidance notes as an example that, under a balanced arrangement, if two employees generate the same amount of short term profit, but one employee's actions expose the bank to materially greater risk, the employee who engaged in the higher risk activity should receive less incentive compensation than the other employee.

The Proposed Guidance states that the nature of the performance metrics used in an incentive compensation arrangement, as well as the percentage of an employee's total compensation that is incentive compensation, should be considered in assessing the overall balance of an arrangement. It also provides that if the metrics used are ones that closely track an employee's activities (e.g., profit or revenue generated by the individual employee), those metrics are more likely to encourage excessive risk-taking than metrics that are more distantly linked to the employee's activities (e.g., firm-wide profit).

How to Assess Balance

In determining whether an incentive compensation program is balanced with respect to an employee, the Proposed Guidance provides that a bank should:

- Consider all the types of risk that the employee may pose for the organization, including "credit, market, liquidity, operational, legal, compliance, and reputational risk";
- Evaluate risk over both short and long-term time horizons; and
- Pay "special attention" to risks that have a very low probability of materializing, but would have highly negative effects if realized (referred to as "bad tail risks").

In assessing balance, the Proposed Guidance further provides that, to the extent available, banks should utilize reliable quantitative measures of risk and risk outcomes or, if not available, utilize informed estimates of those risks and risk outcomes. The Proposed Guidance recommends that banks, particularly LCBOs, use forward-looking scenario analysis to evaluate the balance of its incentive compensation arrangements over time based on a spectrum of performance levels, risk outcomes, and risks taken.

Features that Add Balance

The Proposed Guidance provides that banks should modify incentive compensation arrangements that may encourage excessive risk-taking and identifies four features that "are often used to make compensation more sensitive to risk":

- *Risk Adjustment of Awards.* Adjust (either by application of a quantitative measure or through the exercise of judgment) the amount of the award to reflect the risk to the bank of the employee's activities;
- *Deferral of Payment.* Defer payment of an award until well beyond the end of the applicable performance period and adjust the amount to be paid to reflect losses or other aspects of performance that come to light during the deferral period;
- *Longer Performance Periods.* Impose longer performance periods to allow more risks to become known or realized before payment; and
- *Reduced Sensitivity to Short-Term Performance.* Provide that the rate of increase in the amount to be paid under an award decreases as higher levels of performance are attained.

The Proposed Guidance notes, however, that each of these methods has advantages and disadvantages and that multiple methods may need to be utilized in combination to appropriately balance an arrangement. It also notes that it is likely that methods and practices for making incentive compensation risk sensitive will evolve rapidly and that banks should keep abreast of these developments.

One Size Does Not Fit All

The Proposed Guidance states that differences between levels and functions of employees (e.g., senior executives versus credit officers versus traders) and differences between banks (e.g., size) should be taken into account in structuring balanced incentive compensation arrangements for different employees and banks. In this respect, the Proposed Guidance questions the effectiveness of using equity-based compensation as a method to reduce the risk-taking activity of lower-level employees since those employees may believe that their activities will not have a material impact on the bank's stock price. On the other hand, the Proposed Guidance states that incentive compensation arrangements for senior executives at LCBOs "are likely to be better balanced" if they involve (i) deferral over a multiyear period, with downward adjustment for poor performance and/or multiyear performance periods; or (ii) "equity based-instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the firm during the deferral period."

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The Proposed Guidance notes that contracts or arrangements under which an executive receives accelerated payout of deferred amounts and/or other large payments upon a change in control or termination of employment without regard to risk or risk outcomes can provide incentive for employees to engage in undue risk-taking.

Communication to Employees of the Impact of Risk on the Amount Paid

In order to influence the risk-taking behavior of employees, the Proposed Guidance notes that employees must understand how the amount of their incentive compensation will vary depending on the risks that they take.

Principle 2—Effective Internal Controls and Risk Management

Under the Proposed Guidance, strong internal controls and risk management are identified as being essential to designing and maintaining a balanced incentive compensation program. In this regard, the Federal Reserve notes as follows:

- The ability of employees to influence risk measures or other aspects of the arrangement can undermine the effectiveness of efforts to discourage excessive risk-taking.

- Banks should have specific policies and procedures that identify, among other things, (i) the roles of the persons, business units, and control units permitted to be involved in the design and administration of incentive compensation arrangements; (ii) the sources of the risk-related inputs; and (iii) the person(s) whose approval is required to adopt or amend an incentive compensation arrangement.
- Banks should engage in regular internal reviews of their incentive compensation practices, and separate reviews should be conducted by their internal audit departments, to ensure that the banks' policies promoting balanced incentive compensation are both followed and effective.
- Banks' risk managers should be involved with developing and monitoring incentive compensation arrangements.
- Banks should monitor incentive compensation awards to determine whether amounts paid under the awards appropriately reflect adverse risk outcomes.

Principle 3—Strong Corporate Governance

The Proposed Guidance states that banks "should have strong and effective corporate governance to help ensure sound compensation practices." To this end, it notes that, among other things, a bank's board of directors (or the appropriate committee thereof) should:

- Actively oversee the bank's incentive compensation arrangements;
- "Review and approve the overall goals and purposes of the [bank's] incentive compensation system";
- Regularly review the design and performance of the bank's incentive compensation system;
- Receive and review reports on incentive compensation payments relative to risk outcomes on a backward-looking basis to determine whether excessive risk-taking is being promoted;
- Directly approve the incentive compensation arrangements for senior executives;
- Closely monitor the risk sensitivity of the incentive compensation arrangements for senior executives utilizing, among other tools, both forward- and backward-looking scenario analysis done separately from other employees; and
- With respect to senior executives, obtain sufficient information to determine whether any "clawback" rights have been triggered.

The Proposed Guidance specifically provides that LCBOs should employ a systematic approach, with "formalized policies, procedures, and systems," to make sure that their incentive compensation arrangements are balanced. It goes on to state that such an approach should provide for the bank to, among other things:

- Identify the employees eligible to receive incentive compensation who are subject to the Proposed Guidance (i.e., those whose activities may expose the bank to material risk);
- Identify the risks (and the time horizon of each) that the activities of such employees pose to the bank;
- Determine the potential for the performance metrics included in the incentive compensation arrangements to encourage the employees to take excessive risks and include measures designed to ensure that the arrangements will be balanced (e.g., longer performance periods, deferred payments, etc.);
- Communicate to employees how risk will affect their potential payouts; and
- Monitor outstanding incentive compensation awards made so that modifications can be made to the incentive compensation program if payments made thereunder are determined to be not appropriately sensitive to risk.

With respect to banks other than LCBOs (such as regional banks and community banks), the Federal Reserve states that these banks should have incentive compensation policies, procedures, and systems that are tailored appropriately for the size of the bank and the scope of the bank's incentive compensation practices.

NEXT STEPS

Banks will need to quickly identify an appropriate team of human resources, risk management, finance, and other bank personnel to respond to the principles set forth in the Proposed Guidance. Key aspects of this process will include (i) identifying the incentive compensation plans and bank employees subject to the Proposed Guidance; (ii) evaluating the risk-taking balance of each covered incentive compensation arrangement; (iii) reviewing the bank's processes for designing, implementing, and monitoring incentive compensation programs; and (iv) assessing the bank's corporate governance structure and processes as they relate to incentive compensation.

Each of the LCBOs should immediately prepare to provide the Federal Reserve with the information and documentation that the Federal Reserve will be requiring in connection with its horizontal review of incentive compensation programs at LCBOs. The Federal Reserve will be specifically requesting information and documentation describing: (i) the structure of the bank's incentive compensation programs; (ii) the bank's current processes for overseeing its incentive compensation arrangements and ensuring that those arrangements do not encourage excessive risk-taking; and (iii) the bank's plan and timetable "for improving the risk-sensitivity of incentive compensation arrangements and related risk management, controls, and corporate governance practices."

We hope that you find this brief summary helpful. If you would like more information or assistance in addressing the issues raised in this advisory, please feel free to contact:

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