Federal Banking Agencies Issue Final Guidance on Incentive Compensation

On June 25, 2010, the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) published in the Federal Register, 75 Fed. Reg. 36395, final guidance (Final Guidance) addressing incentive compensation practices at the financial institutions they supervise. The Final Guidance is effective immediately.

The Final Guidance is substantially similar to the proposed guidance (Proposed Guidance) issued by the Federal Reserve in October 2009, and establishes three general principles for incentive compensation arrangements. Under the principles, incentive compensation arrangements should (i) provide employees with incentives that appropriately balance risk and reward; (ii) be compatible with effective controls and risk-management; and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. Consistent with the Proposed Guidance, the Final Guidance sets forth only general principles and does not impose a cap on pay or specifically ban any particular practices.

Key modifications and clarifications made by the Final Guidance include:

- The Final Guidance expands application of the principles to all financial institutions supervised by the Agencies, not just those subject to regulation by the Federal Reserve.
- The Final Guidance clarifies that application of the principles embodied in the Final Guidance varies depending on the size and complexity of the subject banking organization and its level of usage of incentive compensation arrangements.
- The Final Guidance clarifies which aspects of the Final Guidance apply only to large banking organizations (LBOs)—and, in some instances, also to other organizations that use incentive compensation to a significant degree—but that are not applicable to other banking organizations.

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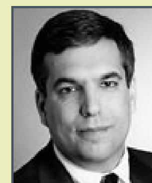

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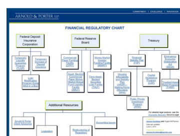

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- In response to comments expressing concern that the Proposed Guidance might be viewed as establishing substantive qualification requirements for membership on bank's board of directors, the Final Guidance clarifies that risk-management and compensation expertise at the board level (i) may be present collectively among the members of the board; (ii) may come from formal training or from experience; or (iii) may come from the advice of outside experts. Furthermore, the Final Guidance recognizes that smaller organizations with less complex and extensive incentive compensation arrangements may not need "specially tailored board expertise" or need to retain outside experts in this area.
- The Final Guidance, like the Proposed Guidance, expresses concern about "golden handshakes" (i.e., arrangements where a new employer makes up for compensation forfeited by an employee when he or she terminated employment with a prior employer), on the grounds that golden handshakes, in the view of the Agencies, could undermine various strategies used to balance incentive compensation at the prior employer by providing payment without regard to risk or risk outcomes. The Final Guidance appears to limit this concern to the LBO context.
- The Final Guidance emphasizes that banking organizations not only should provide rewards when performance standards are met or exceeded, but also should reduce compensation when standards are not met. In other words, incentive compensation arrangements should not create a "heads I win, tails the firm loses" expectation.

Banking Organizations Subject to the Final Guidance

The Final Guidance applies to all banking organizations supervised by the Agencies, including national banks, state member banks, state nonmember banks, savings associations, US bank holding companies, savings and loan holding companies, the US operations of foreign banks with a branch, agency, or commercial lending company in the United States, and Edge and agreement corporations.

Incentive Compensation Programs Covered

The Final Guidance states the Agencies' view that incentive compensation arrangements for both executives and non-executives may, if not properly structured, expose a banking organization to material risk and threaten its safety and soundness. Accordingly, the Final Guidance specifically applies to incentive compensation arrangements for the following employees, collectively referred to in the Final Guidance as "covered employees":

- "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 organization to material amounts of risk (e.g., traders with large positions 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 organization to material amounts of risk, even if no individual employee is likely to expose the organization 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)."

Principles for Incentive Compensation

Consistent with the Proposed Guidance, the Final Guidance establishes the following three general principles for structuring and administering incentive compensation arrangements at banking organizations:

- *Principle 1: Balanced Risk-Taking Incentives*. "Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks."
- *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, including active and effective oversight by the board of directors."

Highlights of the Agencies' principles follow.

Principle 1—Balanced Risk-Taking Incentives

According to the Agencies, a "balanced incentive compensation" arrangement is an arrangement where "the amounts paid to an employee appropriately take into account the risks (including compliance 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 Final Guidance notes as an example that, under a balanced arrangement, if two employees generate the same amount of short-term revenue or profit, but one employee's actions expose the banking organization to materially larger risks, the employee who engaged in the higher risk activity should receive less incentive compensation than the other employee.

The Final Guidance states that the nature of the performance metrics used in an incentive compensation arrangement 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 imprudent risk-taking than metrics that are more distantly linked to the employee's activities (e.g., firm-wide profit). The Final Guidance states that, for this reason, incentive compensation arrangements that are based solely on overall organization-wide performance are unlikely to provide employees (other than senior executives and others who can affect an organization's overall risk profile) with unbalanced risk taking incentives.

How to Assess Balance

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

- Consider all the types of risk that the employee may pose for the organization, including "credit, market, liquidity, operational, legal, compliance, and reputational risks";
- Evaluate risk over both short- and long-term time horizons; and
- Pay attention to risks (or combinations of risky strategies and positions) 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 Final Guidance further provides that, to the extent available, banking organizations should utilize reliable quantitative measures of risk and risk outcomes, or if not available, utilize informed estimates, supported by available data, of those risks and risk outcomes. The Final Guidance states that LBOs should use forward-looking simulation analysis to evaluate the balance of their incentive compensation arrangements over time based upon a spectrum of performance levels, risk outcomes, and risks taken.

Features that Add Balance

The Final Guidance provides that banking organizations should modify their incentive compensation arrangements that may encourage imprudent 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 banking organization 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 Final Guidance notes, however, that this is not an exclusive list, 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.

The Final Guidance also notes that, in cases where the design or operation of an incentive compensation arrangement involves significant judgment, strong policies and procedures, internal controls, and ex post monitoring of payments are important to ensuring that the arrangement is balanced.

The Final Guidance specifically advises LBOs to keep abreast of the evolution of methods and practices for making incentive compensation risk sensitive as rapid development is anticipated.

One Size Does Not Fit All

The Final Guidance, like the Proposed Guidance, states that differences between levels and functions of employees (e.g., senior executives versus credit officers versus traders) and differences in complexity of activities or business strategies between banking organizations should be taken into account in structuring balanced incentive compensation arrangements for different employees and banking organizations. In this respect, the Final 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 banking organization's stock price. On the other hand, the Final Guidance states that incentive compensation arrangements for senior executives at LBOs "are likely to be better balanced" if they involve (i) deferral over a multi-year period, with downward adjustment for poor performance and/or multi-year 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 organization during the deferral period."

Golden Parachutes and Golden Handshakes

The Final Guidance takes the position that golden parachute arrangements that, upon a change in control or termination of employment, provide large additional payments or that accelerate payment of deferred amounts without regard to risk or risk outcomes may neutralize the effect of any balancing features included in an incentive compensation arrangement. Banking organizations are instructed to review any existing or proposed golden parachutes and to consider including balancing features—such as risk adjustments or deferral requirements that extend past termination of employment.

In the case of LBOs, the Final Guidance states that provisions that require a departing employee to forfeit deferred incentive compensation payments may weaken the effectiveness of a deferral arrangement utilized to add balance if the departing employee is able to negotiate an arrangement with his or her new employer to make up for the compensation forfeited upon leaving his or her prior employer (commonly known as a golden handshake). The Agencies, while acknowledging the difficulty of regulating golden handshakes where the new employer is not subject to the Final Guidance, state that they intend to continue to work with banking organizations and others to develop methods for addressing golden handshake concerns.

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

In order to influence the risk-taking behavior of employees, the Final 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 Final 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 Agencies note as follows:

- The ability of employees to influence risk measures or other aspects of the arrangement can undermine the effectiveness of efforts to discourage imprudent risk-taking.
- Banking organizations should have appropriate controls in place to make sure that the processes for achieving balanced incentive compensation arrangements are followed.
- LBOs 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.

- LBOs 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 banking organizations' policies promoting balanced incentive compensation are both followed and effective.
- Banking organizations' risk managers should be involved with developing and monitoring incentive compensation arrangements.
- Banking organizations should monitor incentive compensation awards to determine whether amounts paid under the awards appropriately reflect adverse risk outcomes.
- Banking organizations should develop methods and processes to monitor incentive compensation arrangements that are commensurate with the size and complexity of the organization, as well as its use of incentive compensation.

Principle 3—Strong Corporate Governance

The Final Guidance states that banking organizations "should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors." To this end, it notes that, among other things, a banking organization's board of directors (or the appropriate committee thereof) should:

- Directly approve the incentive compensation arrangements for senior executives;
- In the case of LBOs and organizations that are significant users of incentive compensation, actively oversee the banking organization's incentive compensation policies, systems, and related control processes, as well as "[r]eview and approve the overall goals and purposes of the organization's incentive compensation system";
- In the case of LBOs and organizations that are significant users of incentive compensation, receive and review assessments by management of the effectiveness of the design and operation of the banking organization's incentive compensation system in providing appropriate risk-taking incentives as well as review incentive compensation payments on backward-looking basis to determine whether imprudent risk taking is being promoted;
- Monitor the performance, and regularly review the design and function, of the incentive compensation arrangements; and
- Closely monitor incentive compensation payments to senior executives and the sensitivity of those payments to risk outcomes, and obtain sufficient information to determine whether any "clawback" rights have been "triggered and executed."

Additionally, the Final Guidance specifically provides that LBOs 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 LBO to, among other things:

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

Agency Monitoring and Enforcement

Since the announcement of the Proposed Guidance, the Federal Reserve has been actively engaged in a horizontal review of the incentive compensation practices at the LBOs.

The Agencies state in the Final Guidance that they intend to continue to review such practices at the LBOs and to address, through the supervisory process, any deficiencies. Reviews of incentive compensation practices at banking organizations that are not LBOs will be conducted, according to the Final Guidance, through regularly scheduled examinations and the usual supervisory process. The Final Guidance states that the Agencies will take supervisory or enforcement action, as necessary, "to ensure that material deficiencies that pose a threat to the safety and soundness of [a banking] organization are promptly addressed."

Next Steps

Banking organizations should already have begun the process of responding to the principles set forth in the Proposed Guidance and the Final Guidance. An appropriate team of board members, senior management, human resources, risk management, finance, and other banking organization personnel should be engaged in applying the principles to the banking organization's incentive compensation arrangements. Key aspects of this process will include:

- Identifying the incentive compensation plans and banking organization employees subject to the Final Guidance;
- Evaluating the risk-taking balance of each covered incentive compensation arrangement;
- Reviewing the banking organization's processes for designing, implementing, and monitoring incentive compensation programs; and
- Assessing the banking organization's corporate governance structure and processes as they relate to incentive compensation.

Banking organizations should also continue to monitor developments in this area, including a report that the Federal Reserve intends to issue after the end of the year addressing trends and developments in compensation practices at banking organizations.

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 your Arnold & Porter attorney or:

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