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Banking Regulatory Agencies Issue Final Guidance on
<u>Sound Incentive Compensation Policies</u>

On June 21, 2010, the Office of the Comptroller of the Currency, the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation joined the Federal Reserve (collectively, "the Agencies") and adopted final guidance designed to help ensure that incentive compensation policies at financial organizations do not encourage excessive risk-taking or undermine the safety and soundness of the organization. The final guidance retains the same key principles found in the proposed guidance issued in October 2009,[1] but includes certain adjustments and clarifications based on commenter feedback. In general, the changes reduce the compliance burden on smaller or other organizations that are not significant users of incentive compensation, and clarify the scope, intent, and terminology found in the guidance. This letter summarizes the Agencies' final guidance, which is largely unchanged from the proposed guidance in 2009. The final guidance will become effective upon publication in the Federal Register.

The Agencies' Final Guidance

The Agencies' final guidance covers all banking organizations under their supervision (approximately 8,000 in total) and is to be applied to incentive compensation arrangements for three categories of "covered employees:"

- Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;[2]
- Individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk (e.g., traders with large position limits relative to the organization'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).

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[1] See our alert letter "Federal Reserve Issues Proposed Guidance on Sound Incentive Compensation Policies" dated October 30, 2009 for a summary of the Federal Reserve's original proposed guidance.

[2] Senior officers include, at a minimum, "executive officers" as defined under the Federal Reserve's Regulation O and, for publicly traded companies, "named executive officers" as defined by the SEC for proxy reporting purposes. Savings associations should also refer to OTS's rule on loans to savings association executive officers, directors, and principal shareholders.

The guidance is based on three key principles, which are consistent with the Financial Stability Board's Principles for Sound Compensation Practices and related Implementation Standards issued in April and September 2009, respectively.

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. Arrangements should not only be balanced in design, but also implemented so that actual payments vary based on risk-adjusted performance or ultimate risk outcomes.

- Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.
  - Forms of risk include credit, market, liquidity, operational, legal, compliance, and reputational.
- An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.
  - Examples include factoring risk into the determinations of the size and payout of an incentive award, deferring incentive payouts with deferrals subject to ongoing performance, applying longer performance periods, and reducing sensitivity to short-term performance, such as by flattening the incentive payout curve for higher levels of performance.
- The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees – including the substantial differences between senior executives and other employees – as well as between banking organizations.
  - For example, deferring a substantial fraction of a covered employee's earned compensation for a multi-year period, with ultimate payment dependent on the firm's (or business unit/individual's) subsequent financial performance and risk outcomes is one way to balance risk and reward in financial incentives.
  - Also, deferral arrangements and vesting periods may not be the same for all covered employees, but should reflect the risk types and their time periods.
- Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.
  - The payment of severance or accelerated payment of deferred compensation at termination without regard to risk or risk outcomes may cause inappropriate risk-taking by employees because they are insulated from risk outcomes.
- Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.

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.

- Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk management and other functions.
  - Large banking organizations ("LBOs")[3] should maintain policies and procedures that (i) identify and describe the role(s) of those involved in the design, implementation, and monitoring of incentive compensation arrangements, (ii) identify the sources of risk and establish appropriate controls to govern these risks, and (iii) identify those required to approve new arrangements or modify existing ones.
- Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk-taking.
  - This could include (i) reviewing the types of risks associated with the activities of employees covered by an incentive arrangement, (ii) approving the risk measures used in risk adjustments and performance measures, and (iii) analyzing risk-taking and risk outcomes related to incentive payments.
- Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.
  - To help preserve independence, incentive compensation arrangements for risk management and control personnel should not be tied predominantly to the financial performance of the business unit(s) that they review.
- Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.

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.[4]

- The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.

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[3] The Federal Reserve's proposed guidance used the term large, complex banking organizations ("LCBOs"). The term was changed to large banking organizations ("LBOs") in the final guidance for consistency with the terminology used by the other banking regulatory agencies. Each banking agency has its own definition of LBO, which is applied to the banking organizations under its supervision.

[4] The term "board of directors" as used in the guidance refers to the members of the Board who have primary responsibility for overseeing the incentive compensation system. Therefore, this term may refer to a compensation committee or similar committee designated by the full board to oversee incentive compensation arrangements.

  - The review should include look-back and forward-looking simulation analyses.
  - The review should include sufficient information to determine if any existing clawback provision in senior executive compensation arrangements has been triggered and executed as intended.
- The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.
  - This includes access to outside counsel, consultants, or others with expertise in incentive compensation or risk management.
- A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.
- LBOs should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.
  - Such an approach should allow the organization to effectively (i) identify employees eligible for incentive compensation and those who may expose the organization to material risk, (ii) identify the types and time horizons of risks from the activities of these employees, (iii) assess the potential for the performance measures used to encourage excessive risk-taking, (iv) include incentive design elements that balance inherent risks of the employees activities as needed, (v) communicate to employees the ways incentive awards and payouts are adjusted for risk, and (vi) monitor and modify incentive compensation programs for these employees as needed to appropriately align the pay-to-risk profile.
  - The boards or compensation committees of LBOs should review a report by management, with input from risk-management and control personnel, or other sources of the effectiveness of the firm's incentive arrangements in motivating balanced risk taking and performance.

Conclusion

Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in the guidance, do not encourage imprudent risk-taking, and do not pose a threat to the safety and soundness of the organization. Following the release of the proposed guidance in 2009, the Agencies completed the first round of a "horizontal review" of incentive compensation practices across multiple LBOs. In May 2010, the Federal Reserve delivered to each banking organization included in the review an assessment of the organization's incentive compensation practices and deficient areas that require immediate attention. The following areas were found to be deficient at many firms:

- Identifying which employees can expose the banking organization to material risk;
- Designing risk sensitive incentive compensation that fully captured the risks involved and applying such design to enough employees;
- Tailoring deferral arrangements according to type or duration of risk, rather than applying a "one-size-fits-all" approach;

- Evaluating whether established practices are successful in balancing risk.

The Agencies expect banking organizations to take prompt action to address any deficiencies in their incentive arrangements or related risk-management, control, and governance processes. The final guidance also clarifies that LBOs should actively monitor industry, academic, and regulatory developments in incentive practices and theory and be prepared to incorporate new or emerging methods that are likely to improve the organization's financial safety and soundness.

Though the final guidance is not rules-based, it does provide banking organizations with direction on how to comply through suggestions and examples. Like the proposed guidance, it continues to serve as a framework from which all public companies can review and assess their incentive compensation programs for material risks stemming from these programs.

The Agencies will update the guidance as appropriate to reflect best practices as they develop over time. In addition, the Agencies have acknowledged that coordination of international oversight of sound compensation practices is important to promote competitive balance and ensure that international banking organizations are subject to consistent requirements. Finally, the Federal Reserve, in collaboration with the other banking regulatory agencies, will prepare a report on trends and developments in compensation practices at banking organizations after the conclusion of 2010.

The Agencies' press release with a link to the full text of the final guidance can be found at http://www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm.

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