

# Client Alert

June 30, 2010

## **Federal Reserve Joins Forces with FDIC, OCC and OTS to Issue Final Guidance on Incentive Compensation Oversight**

### **More Institutions Covered, but Some Relief Given to Smaller Banks**

#### **Background**

The Federal Reserve Board (FRB) was joined by the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS), (collectively the Agencies) on June 21 in issuing final guidance<sup>1</sup> governing incentive compensation for banking organizations. The Agencies' stated purpose is to "ensure that incentive compensation arrangements at financial organizations take into account risk and are consistent with safe and sound practices" and to "assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes." The final guidance became effective upon publication in the Federal Register on June 25.

The final guidance is generally consistent with the FRB's proposal in October of 2009<sup>2</sup>, leaving the following principles intact:

- Incentive compensation arrangements (ICAs) should appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk
- ICAs should be compatible with effective controls and risk management
- ICAs should be supported by strong corporate governance, including active and effective oversight by the organization's Board of Directors

The Agencies expect all banking organizations to regularly review ICAs for all executive and non-executive employees and "immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness." Larger banking organizations must adhere to more systematic and formalized policies, procedures and processes, while reviews for smaller banking organizations are expected to be less extensive, formalized and

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<sup>1</sup> See full text at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20100621a1.pdf>

<sup>2</sup> For a detailed summary of the originally proposed guidance, see our November 4, 2009 Client Alert at <http://pearlmeier.com/knowledgecenter/alerts/PMP%20CA%20-%20Fed%27sNewPayOversight%2011.4.09.pdf>

detailed. The Agencies' review will be tailored to reflect the scope and complexity of each organization's activities, as well as the prevalence and scope of its ICAs.

### **Highlights of Changes and Clarifications from Proposed Guidance**

Among the important refinements and clarifications included in the final guidance:

- **Expansion of applicability:** The final guidance covers banking organizations supervised by *all* of the Agencies, not just those supervised by the FRB.
- **Some relief given to smaller banking organizations:** The final guidance clarifies that smaller banking organizations and those that are not significant users of ICAs are exempt from certain guidelines.
- **Additional procedures specified for large banking organizations:** The final guidance provides specific procedural steps to ensure a systematic approach to risk review.
- **Emphasis on tailored deferrals and equity vesting for senior executives:** The final guidance strongly suggests that a substantial portion of compensation should be deferred over a multi-year period and based on company-wide financial performance, with the actual number of equity-based instruments ultimately received based on the organization's or executive's performance.
- **No blanket exemption for any type of employee, or amount or form of compensation:** Analysis of whether or not an ICA encourages excessive risk, and which employees must be included in the risk assessment, will continue to be evaluated on a facts and circumstances basis.
- **Confirmation that the guidelines are principles-based, not formula-driven:** Given the wide range of banking organizations covered, rigid formulas are not prescribed and no incentive vehicle is specifically prohibited or required.
- **Risk controls insufficient on a stand-alone basis:** Risk management procedures and controls that ordinarily limit risk-taking by banking organizations do not obviate the need to have properly balanced ICAs.
- **No exemption for recruitment and retention needs:** Deviance from the guidelines is not permitted for ICAs for purposes of recruitment and retention.
- **Golden parachutes and handshakes not prohibited:** However, the guidance does strongly suggest that organizations offering such benefits consider other risk-balancing features.
- **Board expertise:** A Committee of the Board should be responsible for oversight and monitoring of ICA-related risk. The governance bar is set higher for Director expertise levels at larger banking organizations, while smaller banks and those that don't use ICAs to a significant degree may obtain such expertise on a collective basis and/or from outside advisors.
- **Deference to foreign supervisors:** The Agencies will defer to the supervisors of the home countries of foreign banking organizations regarding governance of ICAs, but their U.S. operations must conform to the final guidance principles.

## Details of the Final Guidance

### *Applicability*

As approved, the final guidance applies to “incentive compensation” of “covered individuals” of “banking organizations.” Some rules affect “large banking organizations” differently from “smaller banking organizations.” Each of these terms as used in the final guidance is defined below.

Incentive Compensation: Current or potential compensation tied to achievement of one or more specific metrics (e.g., sales, revenue, or income). Payments awarded solely for, and contingent on, continued employment (e.g., salary) are exempted. The Agencies also clarified that incentive compensation does not include compensation arrangements that are based solely on the employee’s level of compensation and that does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the organization contributes a set percentage of an employee’s salary).

Covered Individuals: Unlike the small group of senior most executives at the focal point of the SEC and TARP regulations, the Agencies’ ICA guidelines cover a wide range of individuals including:

- Senior executives (at a minimum, “executive officers” as defined by the FRB and OTS, and “named executive officers” as defined by the SEC of public companies) and others responsible for overseeing the organization’s firm-wide activities or material business lines.
- Individual employees, including non-executive employees, whose activities might expose the firm to material risk (e.g., traders with large position limits relative to the firm’s overall risk tolerance).
- Groups of employees with the same or similar ICAs who, *in the aggregate*, may expose the firm to material amounts of risk, even if no individual employee is likely to do so (e.g., loan officers who, as a group, originate loans that account for a material part of the organization’s credit risk).

***PM&P Observation:*** Carried to its extreme, it is arguable that the collective actions of any large group of employees at any level could expose a firm to material risk. While the final guidance does not provide specific exceptions, it indicates that personnel such as tellers, bookkeepers, couriers and data processors are likely to be excluded.

For purposes of determining covered individuals, the final guidance clarifies that risk may be considered material, even if it does not in itself threaten the organization’s solvency.

Banking Organizations: All banking organizations supervised by the Agencies, including national banks, state member banks, state non-member banks, saving associations, U.S. bank holding companies, savings and loan holding companies, the U.S. operations of foreign banks with a branch, agency or commercial lending company in the U.S., and Edge and agreement corporations.

Large Banking Organizations (LBOs): For banking organizations supervised by (i) the FRB, large, complex banking organizations as identified by the FRB for supervisor purposes; (ii) the

OCC, the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (iii) the FDIC, large, complex insured depository institutions (IDIs); and (iv) the OTS, the largest and most complex savings associations and savings and loan holding companies. The guidance indicates that there are approximately 5,000 LBOs.

Smaller Banking Organizations (SBOs): All banking organizations that are not considered to be LBOs under any relevant Agency's standards. The guidance indicates that there are over 8,000 SBOs.

### ***Principles of a Sound Incentive Compensation System***

The final guidance sets forth three principles for designing and implementing ICAs for banking organizations:

#### **Principle #1: Balanced Risk-Taking Incentives**

ICAs should not encourage employees to expose the firm to imprudent risks. For example, the guidance suggests that arrangements that motivate employees to increase short-term revenue or profit, without regard to risk, may expose the organization to greater risk. The guidance suggests the following considerations:

- **Full Range of Risk:** All risks associated with an employee's activities should be considered, including but not limited to credit, market, liquidity, operational, legal, compliance and reputational risks. Even low probability risks should be considered if they would have highly adverse effects.
- **Time Horizon of Risk:** Banking organizations should consider the time horizon over which those risks may be realized in assessing whether ICAs are balanced. The guidance suggests that short-term financial criteria are inherently flawed.
- **Fixing Unbalanced Arrangements:** The guidance provides tips for balancing incentive arrangements, to be used individually or in combination as appropriate to the situation:
  - Adjusting awards based on the level of risk to the organization
  - Deferring payouts that will be adjusted for subsequent losses during deferral period or subject to clawback
  - Providing longer performance periods (similar to the deferral concept in that payouts are made only after all risk outcomes are realized or better understood)
  - Reducing sensitivity to short-term performance (aligning payouts with performance)

**PM&P Observation:** The Agencies emphasize that these suggestions are not intended to be an exhaustive list, nor should they be deemed appropriate for all banks or simply adopted as boilerplate. Rather, organizations should determine which, if any, of these or other risk-mitigators, are most appropriate to their own situation, compensation philosophy, and goals.

**Special Guidance for LBOs:** *The final guidance instructs LBOs to actively monitor developments in the field of compensation and risk sensitivity and to incorporate into ICAs any new or emerging practices that are likely to improve a firm's long-term financial well-being, safety and soundness.*

- **Controls on Use of Discretion:** Where judgment plays a significant role in the design or operation of incentive arrangements, firms must have strong policies and procedures in place regarding how managers exercise their judgment to balance risk considerations. Managers should have appropriate information about the employee's risk-taking activities to make informed judgments.
- **Quantitative Measures:** If available, quantitative measures of risk and risk outcomes to assess the balance of ICAs are preferred. The use of scenario analysis (i.e., evaluation of payments on a forward-looking basis based on a range of performance levels, risk outcomes, and levels of risks taken) is encouraged for determining if certain ICA features are likely to achieve balance over time.

**Special Guidance for LBOs:** *The final guidance provides that LBOs should determine before implementation whether ICAs are likely to balance risk-taking. It recommends the use of simulation analysis or a similar technique to assess whether the ICA would be appropriately reduced as the firm's risks from the employee's activities increases.*

- **Risk Motivating Factors:** Eliminate ICA design features that could potentially encourage undue risk-taking behavior, including:
    - Where incentive compensation comprises a large portion of total compensation
    - Where substantially all of a covered individual's potential incentive compensation is paid even when risk, or risk outcomes, are materially worse than expected
    - Where a covered employee's incentive compensation payments are closely tied to business generated by the employee (versus basing payments on measures such as firm-wide profit that are only distantly linked). The final guidance takes this one step further than the proposed guidance by stating that incentives based entirely on organization-wide performance "are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives."
- PM&P Observation:** Ironically, some of the same factors cited by the Agencies as encouraging adverse risk-taking are often cited as practices promoting a pay-for-performance philosophy (e.g., line-of-sight compensation).
- **Tailored Programs:** Balancing risk is not a one-size-fits-all process. ICAs should be tailored to specific employees, reflecting the substantial differences between senior executives and other employees, and to the needs of the particular organization.

**Special Guidance for LBOs:** *The final guidance strongly suggests that ICAs for senior executives be balanced either by deferring a substantial amount of awards over a multi-year period to reduce payouts in the event of poor performance, by making substantial use of multi-year performance periods, or both. It also recommends paying out a significant portion of incentive awards in equity that vests over multiple years, with the final award based on the organization's performance over the deferral period. The appropriateness of deferrals and the use of equity for lower-level employees are considered to be more dependent on the level, nature and duration of the risks that the employee's own activities pose to the firm.*

- **Golden Parachute Arrangements:** Windfall payouts upon termination of employment or change-in-control may encourage undue risk-taking by providing a safety net against risky outcomes. While not prohibited, such arrangements should be carefully reviewed to keep overall risk-taking in balance.

**Special Guidance for LBOs:** *LBOs are also cautioned against providing "golden handshakes" (compensating new employees for deferred compensation they had to forfeit from their former employers) because they can undermine the balance of risk in the previous bank employer's deferral arrangements. LBOs are instructed to monitor whether golden handshake arrangements are materially weakening the firm's efforts to constrain the risk-taking incentives of the employees.*

- **Communication:** Banking organizations should clearly communicate to employees how ICAs and payments will be reduced as risks increase, tailoring the sophistication of the communication to each audience.

## Principle #2: Compatibility with Effective Controls and Risk Management

- **Strong Controls:** The final guidance emphasizes that organizations should have strong controls governing the process for designing, implementing and monitoring ICAs. These processes should reinforce and support balanced programs (i.e., not be considered a substitute for balanced programs). Banks should create and maintain documentation to permit an audit of the effectiveness of its processes. LBOs must have formal processes in place, while SBOs are expected to incorporate reviews of these processes into their compliance monitoring processes.

**Special Guidance for LBOs:** *LBOs must have policies and procedures that: (i) identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of ICAs; (ii) identify the source of significant risk-related factors into these processes and establish appropriate controls over their development and approval; and (iii) identify the individual(s) and department(s) whose approval is necessary for the establishment of new ICAs or modification of existing arrangements. Audit, compliance, or other personnel responsible for compliance monitoring also must conduct regular internal reviews to ensure compliance. In addition, an LBO's internal audit department should separately conduct regular audits that are reported to appropriate levels of management and, where appropriate, to the full Board.*

- **Monitoring, Reporting and Adjustments:** ICAs should be monitored, reported, and if needed, modified to ensure that they appropriately reflect risk. The final guidance provides that the extent to which the ICAs are monitored should be based on the size and complexity of the firm, as well as the extent to which ICAs are used. SBOs that make only limited use of ICAs can monitor those arrangements through normal management processes.

- **Substance of Review:** A risk assessment process of ICAs should include, but not be limited to:
  - Reviewing the types of risks associated with the activities of employees covered by an ICA.
  - Approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements.
  - Analyzing risk-taking and risk outcomes relative to incentive compensation payments.
- **Adequate and Independent Resources:** The guidelines provide that adequate resources are needed to implement these principles. Banking organizations should identify the functions/roles that should have input into the design and assessment of ICAs (e.g. risk management, audit, finance, human resources). The level of compensation provided to the risk management and control functions should be sufficient to attract and retain qualified employees and avoid a conflict of interest.

### Principle #3: Strong Corporate Governance

Effective oversight by the Board of Directors is required to ensure sound compensation practices.

- **Board Involvement:** The Board, Compensation Committee or other Committee with primary responsibility over compensation should directly approve ICAs for senior executives; ensure incentives are designed and operated in a manner that will achieve balance; and document any material exceptions or adjustments to the ICAs. The Board is also responsible for ensuring that all ICAs for all covered employees are balanced. The final guidance clarifies that the Board's (or Committee's) oversight should be scaled to the scope and prevalence of the ICAs.

*Special Guidance for LBOs and Significant Users of ICAs: Boards/Committees of these organizations must: (i) actively oversee the ICAs and related control processes; (ii) review and approve the overall goals and purposes of the ICA system; and (iii) provide clear direction to management to ensure that the goals and policies are carried out in a balanced manner.*

**PM&P Observation:** Note that the heightened Board oversight function in this case applies both to LBOs as well as to SBOs with significant ICAs.

- **Board Monitoring:** Boards or Committees should monitor ICAs by continuing to:
  - Review data/analysis by management (or other sources) of how the design and operation of the ICAs is promoting appropriate risk-taking, with the assessment scaled to the size and complexity of the firm, as well as the prevalence and scope of its ICAs.
  - Closely monitor ICAs to senior executives and the sensitivity of ICAs to risk outcomes.

- Monitor whether clawbacks for senior executives have been triggered and/or executed as planned.
- Keep abreast of significant marketplace changes in compensation plan mechanisms and incentives, recognizing that ICAs at one organization may not be suitable for use at another firm because of differences in the risks, controls, structure, and management among firms.

**Special Guidance for LBOs and Significant Users of ICAs:** *These organizations must review: (i) on at least an annual basis, assessments by management (which includes appropriate input from risk-management personnel) of the effectiveness of the design and operation of the ICAs in promoting appropriate risk-taking; and (ii) periodic reports that assess ICAs and payments relative to risk on a forward- and backward-looking basis.*

**PM&P Observation:** Again, this heightened review process applies both to LBOs as well as to SBOs with significant ICA programs in place.

- **Board Composition and Resources:** The Board should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope and complexity of the firm's activities. This expertise may be collective and/or can be obtained from outside consultants who are independent and do not exert undue levels of influence on the Board. Less complex firms may not need such internal or external expertise.

**Special Guidance for LBOs and Significant Users of ICAs:** *There should be a separate Compensation Committee consisting solely or predominately of independent Directors. The Committee should work closely with any Board-level Risk and Audit Committees where the substance of their actions overlaps.*

- **Disclosure:** Shareholders should receive appropriate information concerning ICAs and related risk management, control and governance processes so that they may take actions to restrain the potential for such ICAs to encourage employees to take imprudent risks.

**Special Guidance for LBOs:** *Certain procedural steps for LBOs should be taken that are already familiar to those undergoing the FRB's horizontal review, as follows: (i) identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks (including the three categories of "covered employees"); (ii) Identify the types and time horizons of risks to the organization from the activities of these employees; (iii) assess the potential for the performance measures included in the ICAs for these employees to encourage the employees to take imprudent risks; (iv) include balancing elements, such as risk adjustments or deferral periods, within the ICAs for these employees that are reasonably designed to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities; (v) communicate to employees how their ICAs or payments will be adjusted to reflect the risks of their activities to the organization; and (iv) monitor ICAs, payments, risks taken, and risk outcomes for these employees and modify the relevant ICAs if payments made are not appropriately sensitive to risk and risk outcomes.*

### **Ongoing Supervisory Initiatives**

The proposed guidance had directed the FRB to conduct two supervisory initiatives, including a formal “horizontal review” of ICAs at the 28 largest LBOs under FRB supervision, as well as regular supervisory reviews of the other banking organizations under its supervision. According to the Agencies’ joint press release, the FRB has now completed its first round of horizontal review and delivered assessments to the 28 affected firms that include analysis of their current ICAs and areas that need prompt attention. Those banks are submitting plans to the FRB outlining steps and timelines for addressing outstanding issues to ensure their ICAs do not encourage excessive risk-taking.

From its review of the 28 largest banks under its supervision, the FRB has noted at least four areas of deficiencies, including:

- Many firms need to better identify which employees individually or as a group may expose banking organizations to material risk;
- While many firms are using or are considering various methods to make ICAs more risk sensitive, many are not fully capturing the risks involved or applying these methods to enough employees;
- Many firms using deferral arrangements to adjust for risk are taking a “one-size-fits-all” approach, rather than tailoring deferral arrangements to the type or duration of risk; and
- Many firms lack adequate mechanisms to evaluate whether established practices are successful in balancing risk.

The press release also indicates that the Agencies are incorporating oversight of ICAs into their regular examinations of other banking organizations, tailoring reviews to the size, complexity, and other characteristics of each organization. Finally, the press release indicates that the FRB will prepare a report in conjunction with other Agencies after the conclusion of 2010 on trends and developments in compensation practices at banking organizations.

### **Conclusion**

Banking organizations should immediately begin addressing any deficiencies in their ICAs in accordance with the final guidance, if they have not already done so, and LBOs should be aware of their heightened responsibilities. While SBOs have been given some relief under the rules, they still need to ensure their ICAs and risk management controls are aligned with the final guidance.

Importantly, banking organizations may not circumvent or satisfy the implications of the final guidance simply by replacing ICAs with non-incentive-based compensation. While the final guidance provides a structure to consider ICAs, it does not obviate the Agencies’ pre-existing safety and soundness standards prohibiting excessive compensation delivered in any format. Public banking organizations continue to be subject to SEC and relevant exchange requirements, and those still subject to TARP have specific rules governing other elements of compensation. Moreover, the Dodd-Frank Wall Street Reform and Consumer Protection Act, expected to be signed by the President shortly, would require the FRB, in consultation with the OCC and FDIC, to establish further standards applicable to compensation. We will issue a Client Alert on the Dodd-Frank Act when it is finalized.

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