

**SUMMARY OF
FEDERAL RESERVE'S PROPOSED GUIDANCE
ON
SOUND INCENTIVE COMPENSATION PRACTICES¹**

October 23, 2009

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¹ Board of Governors of the Federal Reserve System, "Proposed Guidance in Sound Incentive Compensation Policies" (October 22, 2009).

I. Highlights

- All Federal Reserve member organizations must evaluate their incentive compensation arrangements and related risk management, control, and corporate governance processes and immediately address deficiencies in such arrangements or processes that are inconsistent with safety and soundness.
- Because incentive compensation arrangements for executive and non-executive employees may pose safety and soundness risks if not properly structured, the proposed guidance applies to senior executives as well as other employees who, either individually or as part of a group, may expose the organization to material risks.
- Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above the target. Employees may be particularly motivated to take excessive risk in order to reach performance targets that are aggressive, but potentially achievable.
- The required review of policies, procedures, and systems implemented by a small banking organization (assets < \$175mm) using incentive compensation arrangements on a limited basis will be substantially less extensive, formalized, and detailed than the review required for a large, complex banking organization that uses incentive compensation arrangements extensively.
- Supervisory findings on incentive compensation practices will be included in an organization's annual report/examination or inspection, and reflected in its supervisory ratings.
 - Enforcement action is possible if an organization's incentive compensation arrangements or related risk management, control, or governance processes pose a risk to the safety and soundness of the organization and such deficiencies are not cured promptly.
- The Federal Reserve will work with the Securities and Exchange Commission ("SEC") to improve the disclosures provided by public banking organizations in ways that promote the safety and soundness of these organizations.

II. Summary

The Federal Reserve's proposed guidance is based on three key principles, discussed in greater detail below, that are designed to ensure that incentive compensation arrangements at banking organizations do not encourage employees to take excessive risks and are consistent with the safety. These principles provide that incentive compensation arrangements at a banking organization should –

- Provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk;
- Be compatible with effective controls and risk management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

In addition to proposing incentive compensation guidance, the Federal Reserve announced two supervisory initiatives that are intended to move the banking industry towards safe and sound incentive compensation arrangements.

1. LCBO Review. A special horizontal review of incentive compensation practices at large complex banking organizations (LCBOs). Each LCBO will be expected to provide information and documentation that clearly describes the organization's current incentive compensation practices and its plans for improving its incentive compensation practices.

2. Non-LCBO Review. A review of incentive compensation practices at other banking organizations as part of the risk-focused examination process for these organizations. Non-LCBO banking organizations will undergo risk management reviews during the regular, risk-focused Federal Reserve examination process. Such reviews will be tailored to reflect the scope and complexity of the organization's activities, as well as the prevalence and scope of the organization's incentive compensation arrangements.

A. The Three Principles of a Sound Incentive Compensation System

Incentive compensation arrangements for executive and non-executive employees who have the ability to expose an organization to a material amount of risk may, if not properly structured, pose a threat to the organization's safety and soundness. Thus, the proposed guidance applies to incentive compensation arrangements for:

- 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 risk (e.g., traders taking large positions); 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 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).

1. Balanced Risk-Taking Incentives

An incentive compensation arrangement is balanced when amounts paid to employees appropriately take into account (i) the risks and the benefits from the activity and (ii) the impact of the activity on the organization's safety and soundness. The activities of employees may create a wide range of risks for a banking organization, including credit, market, liquidity, operational, legal, compliance, and reputational risks.

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes.

- An employee whose activities create materially greater risk for the organization should receive less than an employee who generates the same financial benefit for the organization with less risk.

If an incentive compensation arrangement may encourage employees to take excessive risks, the banking organization should modify the arrangement as needed to ensure that it is consistent with safety and soundness.

- Modification methods include: (i) Risk Adjustment of Awards, (ii) Deferral of Payment, (iii) Longer Performance Periods, and (iv) Reduced Sensitivity to Short-Term Performance.

For most organizations, the use of a single, formulaic approach to incentive compensation is likely to provide at least some employees with incentives to take excessive risks. An organization's compensation approach needs to give effect to differences between senior executives and employees, job function and different banking businesses. Banking organizations also should carefully review change of control arrangements ("golden parachutes") and the potential impact of such arrangements on safety and soundness.

2. Compatibility with Effective Controls and Risk Management

Risk-management and internal controls should reinforce and support balanced incentive compensation arrangements. An organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements.

- Regular internal reviews will ensure that an organization's processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed.

Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An organization's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements.

Organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining excessive risk-taking.

- Compensation arrangements for employees in risk management and control functions thus should be sufficient to attract and retain qualified personnel with appropriate experience and expertise in these fields.

3. Strong Corporate Governance

The board of directors is responsible for ensuring that incentive compensation arrangements are appropriately balanced and do not jeopardize the safety and soundness of the organization. Accordingly, the board of directors should actively oversee the development and operation of a banking organization's incentive compensation systems and related control processes.

- Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors should directly approve the incentive compensation arrangements for senior executives.

The board of directors should regularly review the design and monitor the performance of the organization's incentive compensation systems.

If a separate compensation committee is not already in place (and not otherwise required), the board of directors should consider establishing such a committee.

- The scope and level of the compensation information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.

The SEC, for example, has proposed to adopt certain disclosure requirements relating to incentive compensation practices for public companies. The Federal Reserve will work with the SEC to improve the disclosures provided by public banking organizations in ways that promote the safety and soundness of these organizations.

IV. Open Issues

The Federal Reserve identified several to be addressed areas/open issues and is soliciting comments prior to finalizing the proposed guidance –

- Formulaic limits for compensation?

For example, should at least 60 percent of all incentive compensation received by senior executives of all large, complex banking organizations be deferred? Should at least 50 percent of incentive compensation be paid in the form of stock, options, or other equity-linked instruments? Would such formulaic limits on determining and paying incentive compensation likely promote the long-term safety and soundness of banking organizations generally?

- Exempting Certain Incentive Plans?

Are there types of incentive compensation plans, such as firm-wide profit sharing plans that provide for distributions in a manner that is not materially linked to the performance of specific employees or groups of employees, that should be exempted from the guidance because they are unlikely to affect the risk-taking incentives of all, or a significant number of, employees?