



CLIENT ALERT

FEDERAL RESERVE ISSUES PROPOSED GUIDANCE ON SOUND INCENTIVE COMPENSATION POLICIES

October 27, 2009

On October 22, 2009, the Federal Reserve Board (FRB) released guidance designed to help ensure that incentive compensation policies at banking organizations do not encourage excessive risk-taking and are consistent with the safety and soundness of the organization. The FRB intends that the guidance promote prompt improvement of incentive compensation practices throughout the banking industry. The guidance is applicable to all banking organizations under supervision by the FRB, estimated to encompass over 6,800 organizations, including bank holding companies, state member banks and the U.S. operations of foreign banks. The proposed guidance was published in the Federal Register on October 27, 2009 and is open for public comment for a 30-day period ending on November 27, 2009.

In addition to the guidance provided in the release, the FRB also announced that it is commencing two supervisory initiatives to spur and monitor the industry's progress towards the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry. The two initiatives are:

- A special horizontal review of incentive compensation practices at large complex banking organizations (LCBOs); and
- A review of incentive compensation practices at other banking organizations as part of the risk-focused examination process for these organizations.

This Client Alert summarizes the proposed guidance and the two supervisory initiatives.

Amalfi Consulting Observation

As regulatory guidance rather than regulation or legislation, the FRB has recognized that there are significant differences among banking organizations and a variety of approaches that may be used to achieve the desired goal. Formal rules run the risk of being potentially too broad or too narrow. While the guidance sets clear expectations for banking organizations concerning their incentive compensation arrangements and related risk-management, control and governance processes, it is also noteworthy in what the guidance does not contain:

- No caps or dollar limitations on incentive compensation
- No specified deferral periods
- No formulaic approach to risk-assessment
- No minimum vesting periods
- No limitations on types of incentive compensation
- No requirement for completely independent membership on compensation committee

Proposed Guidance

The FRB states that to be consistent with safety and soundness principles, incentive compensation arrangements 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.

Unlike most of the other legislative and regulatory limitations and guidance promulgated over the past year, the FRB's proposed guidance potentially applies to nearly any employee with any form of incentive compensation arrangement, including:

- 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).

Principles of a Sound Incentive Compensation System

The FRB presents three key principles that are designed to ensure that incentive compensation arrangements do not encourage employees to take excessive risks. The guidance supports each of the principles with examples of the types of policies, procedures, and systems that the FRB believes banking organizations should have in place to help ensure compliance with the principles.

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.

- **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.**

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. Some of these risks may be realized in the short term, while others may become apparent only over the long term. In addition, some risks may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized ("bad-tail risks"). While shareholders may have less incentive to guard against bad-tail risks because of their infrequency and the existence of the federal safety net, these risks warrant special attention from a safety-and-soundness perspective given the threat they pose to the organization's solvency and the federal safety net. Organizations should consider the full range of current and potential risks associated with the activities of employees, including the cost and amount of capital and liquidity needed to support those risks, in developing balanced incentive compensation arrangements.

- **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.** If the organization determines that an incentive compensation arrangement may encourage employees to take excessive risks, the arrangement should be modified as needed to ensure that it is consistent with safety and soundness principles. The FRB mentions four methods that are often used to make compensation more sensitive to risk, as follows:

1. Risk Adjustment of Awards: The amount of an incentive award is adjusted based on measures that take into account the risk the employee's activities pose to the organization. The FRB notes that the risk measure adjustments may be determined quantitatively or set judgmentally, subject to appropriate oversight.
2. Deferral of Payment: Payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that become clear only during the deferral period. Again, the alteration of deferred payments due to risk outcomes may be determined either formulaically or judgmentally. The FRB cautions that the extensive use of judgment might render deferral arrangements unpredictable and therefore less effective at influencing employee behavior. The deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.
3. Longer Performance Periods: The performance time period during which the employee earns the award is extended.
4. Reduced Sensitivity to Short-Term Performance: The rate at which awards increase is reduced as an employee achieves higher levels of performance measure(s) to reduce the magnitude of incentives based on short-term performance measure.

- **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.**

Risks associated with activities vary significantly between banking organizations and across employees within one organization. In addition, reliable quantitative measures of risk and potential outcomes are not typically available for a banking organization as a whole, making it difficult to achieve balanced compensation arrangements for senior executives with responsibility for managing risks on a firm-wide basis through use of the risk adjustment of award method. Moreover, the payment of deferred incentive compensation in equity (such as restricted stock or stock options) may be effective in restraining the risk-taking incentives of senior executives or employees whose activities may have a material effect on the overall company. On the other hand, equity-related deferred compensation may not be as effective in restraining risky behavior of lower-level employees who may not believe that their actions will materially affect the organization's stock price. These types of differences should be taken into account when constructing balanced compensation arrangements. The use of a single, formulaic approach across the board is likely to provide at least some employees with incentives to take excessive risks.

- **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.**

Agreements that provide for significant compensation or acceleration of deferred compensation upon termination or a change in control event can provide an employee with incentives to engage in imprudent risk-taking. Organizations should carefully evaluate any such arrangements and the potential threat they might pose to the organization's safety and soundness, including whether they encourage risk-taking in light of the other features of the employee's incentive compensation arrangements. Similarly, provisions that require an employee, particularly senior executives in high demand, to forfeit deferred incentive payments upon departure from the organization may weaken the effectiveness of the deferral arrangement in achieving balance by removing the employee's financial exposure to the risk outcomes of the employee's activities at the firm.

- **Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.**

In order to achieve the desired employee behavior, it is important that the employees clearly understand that incentive compensation will vary based on risks related to their activities. The employer should inform the employee about the ways risk will be factored into the amount of incentive compensation earned and paid with as much specificity as practicable.

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.**

Employees may seek to evade processes or attempt to influence risk measures, information or judgments used to make the employee's incentive pay sensitive to risk in order to increase the employee's pay. The impact of such efforts could affect not only the employee's pay but the risk management, internal controls and other functions designed to limit risk taking throughout the organization. The organization should have strong controls over process for designing, implementing and monitoring incentive compensation plans including policies and procedures that:

- 1 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 incentive compensation arrangements;
- 2 Identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and
- 3 Identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements.

Regular internal reviews should be conducted to ensure that 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. The company's internal audit department should separately conduct regular audits of the organization's compliance with policies and controls and the results should be reported to appropriate levels of management and/or the board of directors.

- **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.**

Developing and monitoring incentive compensation plans requires an understanding of the risks and potential risk outcomes from the activities of relevant employees. Risk management personnel should have an appropriate role in the company's processes for designing and monitoring incentive compensation arrangements. Risk managers assistance might include:

1. Reviewing the types of risks associated with the activities of employees covered by an incentive compensation arrangement;
2. Approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and
3. Analyzing risk-taking and risk outcomes relative to incentive compensation 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.**

Risk management and control personnel involved in design or oversight of incentive compensation plans should have appropriate skills and experience to fulfill their roles. Compensation of such personnel must be sufficient to attract and retain qualified personnel with appropriate experience and expertise. Incentive compensation for these personnel, if any, should be based primarily on achievement of objectives of their functions and not on the financial performance of the business units 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.**

Incentive compensation awards earned and payments made as well as associated risks taken and risk outcomes should be tracked to determine whether payments are appropriately reduced to reflect adverse risk outcomes and results should be reported to appropriate levels of management and/or the board of directors.

Principle 3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices.

- **The board of directors of a banking organization should actively oversee incentive compensation arrangements.**

The board of directors is ultimately responsible for ensuring that incentive compensation arrangements are appropriately balanced and do not jeopardize the company's safety and soundness. The board should actively oversee development and operation of the company's incentive compensation systems and control processes. The board should:

1. Review and approve overall goals for the incentive compensation system.
2. Provide clear direction to management to ensure that its policies and procedures are carried out.
3. Ensure that the compensation system, including performance measures and targets, that can expose the company to large risks is designed and operated in a manner that will achieve balance.
4. Directly approve incentive compensation arrangements for senior executives.
5. Approve and document any material exceptions or adjustments to the incentive compensation arrangements for senior executives and monitor the effects of such exceptions for the balance of the arrangement.

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

The board of directors should regularly review the design and monitor the performance of the incentive compensation systems. The board should receive data and analysis from management, risk management personnel and others that are sufficient to assess whether the overall design and performance of the incentive compensation plans are consistent with the organization's safety and soundness. At companies with significant incentive compensation plans, periodic reports should review incentive compensation awards and payments relative to risk outcomes on a backward looking basis to determine whether the arrangements may be promoting excessive risk taking. Boards should also consider periodic preparation of scenario analysis on a forward-looking basis using a range of performance levels and risk outcomes. The board should also monitor any clawback provisions in arrangements with senior executives to determine if the provision has been triggered. The board should stay abreast of emerging changes in compensation plan mechanisms and incentives in the marketplace, tempered with the understanding that organizations, activities and practices in the industry are not identical. One size does not fit all. The board is responsible for ensuring that incentive compensation arrangements for its organization do not promote risk taking beyond the firm's ability to manage it effectively.

- **The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.**

If not already in place, the board of directors should consider establishing a compensation committee with primary responsibility for overseeing the company's incentive compensation system. The committee should be composed solely or predominantly of non-executive directors. The compensation committee should work closely with risk and audit committees where their activities and responsibilities overlap. The board should have the authority to select, compensate and use outside counsel, consultants and other experts with expertise in incentive compensation and risk management. The board should be aware of any conflicts of interest in working with outside parties arising from other dealings of the parties with the company. While the use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.

- **A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.**

The company should provide an appropriate amount of information concerning its incentive compensation arrangements and related risk management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take excessive risks. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.

- **Large, complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.**

At organizations with large numbers of risk taking employees engaged in diverse activities, an ad hoc approach to developing balanced arrangements is unlikely to be reliable. Thus, an LCBO should use a systematic approach--supported by robust and formalized policies, procedures, and systems--to ensure that those arrangements are appropriately balanced and consistent with safety and soundness principles. Such an approach should provide for the organization effectively to:

1. Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include (i) senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines; (ii) individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk; and (iii) 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;
2. Identify the types and time horizons of risks to the organization from the activities of these employees;
3. Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take excessive risks;
4. Include measures, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced;
5. Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and
6. Monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

Regional and community banking organizations should develop and implement appropriate policies, procedures, and systems in a manner that is tailored to the size and complexity of the organization's activities, as well as the prevalence and scope of its incentive compensation arrangements.

Supervisory Initiatives

Large, complex banking organizations. The FRB will conduct a formal horizontal review of incentive compensation arrangements at these organizations. The review is designed to achieve the following objectives:

- Enhance supervisory understanding of the details of current practices, as well as the steps taken or proposed to be taken by organizations to improve the balance of incentive compensation arrangements;
- Assess the strength of controls and whether actual payouts under incentive compensation arrangements are effectively monitored relative to actual risk outcomes;
- Understand the role played by boards of directors, compensation committees, and risk-management functions in designing, approving, and monitoring incentive compensation systems; and
- Identify emerging best practices through comparison of practices across organizations and business lines.

Each LCBO will be expected to provide the FRB information and documentation that clearly describes the following:

- The structure of the organization's current incentive compensation arrangements,
- The existing processes used by the organization to oversee these arrangements and help ensure that they do not encourage employees to take excessive risks, and
- The organization's plans, including relevant timetables, for improving the risk-sensitivity of incentive compensation arrangements and related risk management, controls, and corporate governance practices.

The FRB will work closely with each LCBO to ensure that its plans are likely to result in the establishment and maintenance of incentive compensation arrangements that are consistent with safety and soundness and do not encourage excessive risk-taking.

The FRB may take supervisory action as appropriate if the organization fails to develop, submit, or adhere to an effective plan designed to ensure that the organization's incentive compensation arrangements do not encourage excessive risk taking and are consistent with principles of safety and soundness. Such action may include the establishment of appropriate limitations on the organization's incentive compensation awards or payments to help ensure that the organization's incentive compensation arrangements do not pose a threat to the safety and soundness of the organization.

Community and regional banking organizations with incentive compensation arrangements. Supervisory staff should review incentive compensation arrangements at non-LCBO banking organizations as part of the regular, risk-focused supervisory process. These reviews should be conducted in connection with the review of the organization's risk management, internal controls and corporate governance, and should be tailored to reflect the scope and complexity of the organization's activities and prevalence and scope of its incentive compensation arrangements.

If examiners find incentive compensation practices that may be of concern, examiners should consult with the multidisciplinary group described previously. The FRB will incorporate the findings of these reviews into the organization's supervisory ratings and, where warranted, may take supervisory action against the organization to address deficiencies.

ABOUT AMALFI CONSULTING, LLC

Amalfi Consulting, LLC is an independent consultancy which has been providing compensation consulting solutions for more than a decade. Our focus is banks and other financial institutions.

Amalfi has served over 400 banks on a national basis from de novo to large publicly-traded organizations. In addition to a full array of compensation services, we also offer board governance consulting. Our principal consultants are hands-on, personally and actively involved in every step of the consulting process.

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CONTACTS

| | | |
|-----------------|----------------|--|
| Todd Leone | 1-952-893-6711 | todd.leone@amalficonsulting.com |
| Gayle Appelbaum | 1-952-893-6795 | gayle.appelbaum@amalficonsulting.com |
| Jim Bean | 1-952-883-1370 | jim.bean@amalficonsulting.com |
| Jean Riley | 1-781-934-8400 | jean.riley@amalficonsulting.com |
| Chris Richter | 1-952-883-1371 | chris.richter@amalficonsulting.com |
| Katrina Gerenz | 1-952-883-1384 | katrina.gerenz@amalficonsulting.com |