



VEDDER PRICE®

Final Guidance on  
Sound Incentive Compensation Policies  
July 15, 2010

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# Webinar Agenda



- ★ The goal of today's webinar is to review the final guidance in the June 21, 2010 Joint Release on sound incentive compensation policies
  - Executive summary of guidance
  - Detailed review of guidance
  
- ★ Webinar format
  - 50 minutes covering the content of the incentive compensation policies
  - 10 minutes reviewing questions from the audience



Final Incentive Compensation Guidance  
Executive Summary

# Final Guidance - Sound Incentive Compensation Policies

- ★ Final guidance issued on June 21, 2010
  - Guidance was initially proposed by Fed in October 2009
  - *Applies to all banking institutions*
  
- ★ Published in Federal Register on June 25, 2010
  - Press release: <http://www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm>
  - Full text: <http://edocket.access.gpo.gov/2010/pdf/2010-15435.pdf>

# The Regulators Expect Action

- ★ *"Many large banking organizations have already implemented some changes in their incentive compensation policies, but more work clearly needs to be done," Federal Reserve Governor Daniel K. Tarullo said.*
  
- ★ *"The Federal Reserve expects firms to make material progress this year [emphasis added] on the matters identified as we work toward the ultimate goal of ensuring that incentive compensation programs are risk appropriate and are supported by strong corporate governance."*

# Where Does this Guidance Fall?

## ★ **Guidance on Sound Incentive Compensation Policies – In Force**

- Joint release by Federal Reserve, OCC, OTS, FDIC & Treasury
- Applicable to all banking organizations
- Effective June 25, 2010

## ★ **TARP Regulations – In Force**

- Interim Final Rule issued June 15, 2009
- Prohibits bonuses, incentives and golden parachutes
- Mandates risk reviews
- Applicability to existing 628 TARP banking organizations

## ★ **Dodd-Frank Wall Street Reform and Consumer Protection Act - Pending**

- May be passed any day now
- Mandates bank regulators to collect data and issue rules on excessive compensation and risky compensation practices applicable to all banking and financial organizations > \$1 B assets
- Requires say-on-pay, mandatory clawbacks, CEO pay test, compensation committee independence and other governance rules for all public companies

# What Changed From Proposed to Final Guidance?

- ★ Final guidance applies to *all* banking organizations
- ★ 3 versus 2 groups of banks
  - Small banking organizations
  - Significant users of incentive compensation: *Newly created concept*
  - Large banking organizations: Changed from large complex banking organizations
- ★ Need for a “compensation expert” on compensation committee or board has been downplayed, but need for access to expertise reinforced
- ★ More robust definition of “incentive compensation” provided
- ★ Regulators expect to see changes
  - Federal Reserve: Compliance will be a material time commitment for 1,500 banks
  - There is no “one size fits all” to address safety & soundness concerns
  - Strong risk management practices will not save a faulty design

# What Does A Bank Look Like That May Need To Change?

- ★ The Bank uses various forms of incentive compensation
  - Annual and long term incentives for Executives
  - Different incentive plans for commercial lenders, business bankers & tellers
  - Incentives for non-production level bank personnel
- ★ The annual cash incentive plan is annually focused
  - Based on annual performance metrics
  - Paid annually all in cash
- ★ The use of equity is not long-term focused
  - Annual results are the basis for either a formula or discretionary award
  - Vesting is strictly based upon time; no long-term holding requirement for equity
  - Significant use of stock options
- ★ The Bank has employment agreements and deferred compensation arrangements that provide for golden parachute payments

# What is the Bottom Line?

- ★ You need to have a process for incentive plan design and management.
  
- ★ The board/compensation committee needs to own this process.
  
- ★ Your incentive compensation structures need to:
  - Take into account risk as well as performance,
  - Pay over time,
  - Have the ability to recover/offset pay if things “go boom” in the future,
  - Are well documented
  
- ★ The regulators are expecting change to occur



# Final Incentive Compensation Guidance Detailed Review

# Topics of Conversation

- ★ Safety & soundness foundation
- ★ Definition of employee groups
- ★ Definition of incentive compensation
- ★ Principle #1: Balanced risk-taking incentives
  - How do you create a balanced incentive plan?
  - What factors are important in plan design?
  - Golden parachute payments and deferred compensation
- ★ Principle #2: Effective controls and risk management
  - Impact of Risk Management – A change
  - What are the processes for strong risk management?
  - How should risk management be proactive in design?
  - How is compensation of risk management personnel impacted?
  - What have we learned from TARP banks relative to audit?
- ★ Principle #3: Strong corporate governance
  - What is the role of the Board of Directors (or compensation committee)?
  - What about board expertise and external resources?
  - Processes for significant users of incentive compensation & LBOs
  - Supervisory review & enforcement actions
- ★ Final Thoughts

# Safety & Soundness Foundation

## ★ Overview

- Aligning the interests of shareholders and employees often promotes safety and soundness. However, aligning those interests *is not always sufficient* to address safety and soundness concerns. Shareholders may be willing to tolerate risk that is inconsistent with safety and soundness, exposing the Federal safety net.
- The final guidance continues to emphasize that while incentive compensation serves a number of important goals for banking organizations, including attracting and retaining skilled staff, *these goals do not override the requirement* for banking organizations to have incentive compensation systems that are consistent with safe and sound operations and that do not encourage imprudent risk-taking.
- To be fully effective, balancing adjustments to incentive compensation arrangements should take account of the full range of risks that employees' activities may pose for the organization, including credit, market, liquidity, operational, legal, compliance, and reputational risks.

## ★ Observations

- The final guidance continues to note that the traditional alignment of employees with shareholders introduces too much risk in the context of the Federal safety net and a “bail out” world.
- The final guidance makes particular mention that the need to recruit or retain key personnel does not justify an otherwise risky incentive program.

# Definition of Employee Groups

## ★ Overview

- The final 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 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).
- Certain employees, such as tellers, bookkeepers, or data processing personnel whose activities do not present a material risk to the organization, would most likely be outside the scope of the guidance based on facts and circumstances.

## ★ Observations

- As learned from TARP banks, organizations found that creating an inventory of incentive compensation arrangements is a non-trivial task; it is a process in itself.

# Definition of Incentive Compensation

## ★ Overview

- Incentive compensation is that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income).
- Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary).
- In addition, the term does not include compensation arrangements that are determined based solely on the employee's level of compensation and 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).

## ★ Observations

- Equity awards that are strictly time-vested are likely to be incentive compensation subject to the guidance since the value is tied to stock price performance.
- Note, if a bank does not have any incentive compensation the guidance does not apply.



Final Incentive Compensation Guidance  
Principle #1 – Balanced Risk Taking Incentives

# How Do You Create A Balanced Incentive Plan?

## ★ Overview

- 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.
- Four methods for modifying arrangements to better balance risks are discussed in the guidance.
  - Risk adjustment of awards: the amount of incentive compensation paid is adjusted based on measures that take into account the risk associated with the employee's activities.
  - Deferral of payment (clawback): Payment is delayed significantly beyond the end of the performance period and the eventual payout is adjusted (subject to clawback) to reflect actual losses. Adjustments may be formulaic or judgmental, although judgmental adjustments are not predictable and may not influence behavior.
  - Longer performance periods: Lengthening performance periods makes it easier to factor in risk and adjust the eventual payout to risk outcomes.
  - Reduced sensitivity to short-term performance: The rate at which the amount of pay increases is reduced as the higher levels of relevant performance are achieved. This approach reduces the magnitude of the incentives and the related risk-taking. Employees may be motivated to take imprudent risks to reach performance targets that are aggressive.

## ★ Observations

- The guidance notes that there may be the need to use more than one of these approaches to obtain the desired balance
- Care will need to be taken in implementing any deferral program to ensure 409A compliance

# What Factors are Important in Plan Design?

## ★ Overview

- The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences among employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.
  - For example, an unbalanced executive plan would produce the same bonus for two employees who generate the same short-term revenue or profit, but at different risks to the organizations. The higher risk warrants less pay.
- The performance measures used have an important effect on the balance of the incentive.
  - If the employee’s incentive is closely tied to short-term revenue or profit of business generated by the employee, without any adjustments for risks associated with the business, the potential to encourage excessive risk-taking may be quite strong.
  - If the payout is distantly linked to the employee’s activities (e.g., firm-wide profit), the potential to encourage excessive risk may be weak.
- Incentive compensation must also be balanced in its implementation so payouts vary based on risk and risk outcomes.
  - For example, paying incentives even when risk or risk outcomes are materially worse than expected can lead to employees having less incentive to avoid excessively risky behavior.
- The size of the incentive payments relative to the employee’s total pay package may affect the likelihood that the incentives will encourage excessive risk-taking.
  - Where incentive compensation is a small portion of the employee’s total pay package, such incentive pay is less likely to affect the employees’ risk-taking behavior than when it represents a large percentage, or even a majority, of the employee’s total pay.

## ★ Observations

- This highlights the principle that “one size fits all” will not work for entire incentive plans
- The continued skepticism over short-term plans and the call for “balanced” approaches may cause a review of fixed versus variable pay and a review of business unit or individual performance measures.

# Golden Parachute Payments and Deferred Compensation

## ★ Overview

- 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 final guidance adds language noting that arrangements that provide an employee with a guaranteed payout upon a change in control or departure regardless of performance may neutralize the effect of any balancing features included in the arrangement to help prevent imprudent risk-taking.
- For LBOs, provisions that require forfeiture of deferred incentive payments upon departure may weaken the effectiveness of the deferral by removing the employee’s financial exposure to the risk outcomes of the employee’s activities, particularly where the executive can negotiate a “golden handshake” arrangement with a new employer that makes up for the forfeited compensation

## ★ Observations

- The final guidance suggests adding risk adjustments or delayed payment features to golden parachute arrangements to mitigate the risks they create
- Golden parachute arrangements are found within employment agreements, change-in-control agreements, severance pay plans and nonqualified deferred compensation arrangements



Final Incentive Compensation Guidance  
Principle #2 – Effective Controls & Risk Management

# Impact of Risk Management – A Change

## ★ Overview

- There has been a change in the guidance relative to risk management
  - The initial guidance called for incentives that did not encourage risk-taking beyond the banking organization's ability to identify and manage risk.
  - The final guidance states incentives should balance risk and financial results in a manner that does not encourage taking imprudent risks.
- Banking organizations should have appropriate controls to ensure that their processes for achieving balanced incentive compensation arrangements are followed and to maintain the integrity of their risk management and other functions.

## ★ Observations

- The change in principle is intended to clarify that a flawed design cannot be overcome by strong risk management practices.

# What are the Processes for Strong Risk Management?

## ★ Overview

- To avoid a “fox guarding the hen house” problem that arises where those who benefit from an incentive compensation plan also design and administer the plan, the guidance calls for strong processes and controls which, for example:
  - Identify and describe roles(s) of personnel, business units, and control units authorized to be involved in the design, implementation and monitoring of incentive arrangements
  - Identify the source of significant risk-related inputs into the processes and establish controls over the development and approval of these inputs to ensure integrity
  - Identify the individual(s) and control(s) whose approval is necessary for establishment of new incentive compensation arrangements or modifications of existing arrangements
- The process should also produce documentation sufficient to permit an audit of the process and the level of compliance with the policies and procedures.

## ★ Observations

- Most banking organizations with active boards and compensation committees may already have established policies and procedures that are responsive to this concern.
- LBOs and significant users of incentives will find the need to do more than smaller banks with simpler compensation structures

# How Should Risk Management Be Proactive in Design?

## ★ Overview

- 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.
- Unlike the TARP rules which call on risk personnel to assist the board or committee in identifying risk in existing plans, the guidance creates an expectation that risk personnel be involved up front in the design of incentive compensation.
- Risk managers can:
  - Review the types of risks associated with the activities of employees covered by the incentive
  - Approve risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes in deferred-payout arrangements
  - Analyze risk-taking and risk outcomes relative to incentive payouts
- Other functions, such as HR and finance also play an important role in creating balanced arrangements

## ★ Observations

- The guidance is expecting the risk analysis to be made upfront before the performance levels of potential payout, the performance measures and other aspects of the incentive are finalized.
- For LBOs and significant users of incentive compensation, this upfront exercise should also include scenario analysis that assesses levels of payout at various levels of risk
- The guidance reiterates that risk-management processes and internal controls should reinforce and support development of balanced incentive compensation arrangements.

# How is the Compensation of Risk Personnel Impacted?

## ★ Overview

- Compensation for personnel in risk functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.
- The guidance acknowledges the need to provide competitive compensation to the risk personnel and those involved in controls.
- To avoid conflicts, the guidance suggests the pay package should not be based predominately on the financial performance of the business units that the risk or control personnel review.
  - Instead, the incentives should be based primarily on achievement of objectives for their functions (e.g., risk adjusted performance or adherence to internal controls)

## ★ Observations

- The guidance continues to reflect a concern about conflicts of interest and creates an expectation that banking organizations to use “soft goals” (such as achievement of objectives of their functions) as opposed to financial performance goals as the primary performance measure for risk-management and internal audit personnel
- Perhaps surprisingly, the guidance does not express a similar concern with respect to financial personnel.

# What Have We Learned from TARP Banks on Audit?

## ★ Overview

- TARP banks are required, by law, to conduct risk reviews of their incentive plans twice a year while they are a TARP bank.
- An important aspect of these reviews is compiling a list of each incentive plan and measuring each plan against a number of various risk elements.
- Based on the risk audits, the TARP banks had to potentially modify their incentive plans.

## ★ Observations

- One of the biggest lessons was in creating the list of incentive plans; many banks discovered plans they didn't know existed.
- TARP banks, as such, are ahead of the curve in this respect. Most other banks will have to do the first step of compilation of all their incentive plans and then audit.
- The pending Wall Street Reform & Consumer Protection Act also has a provision to have regulators require submission of these materials on an ongoing basis.



Final Incentive Compensation Guidance  
Principle #3 – Strong Corporate Governance

# What is the Role of the Board (or Comp Committee)?

## ★ Overview

- Approve incentive plans for senior executives
- Approve and document material exceptions or adjustments: In the exception process the board should carefully consider and monitor the effects of any approved exceptions on the balance of the plan, the risk-taking incentives and the safety and soundness of the organization.
- Review incentive compensation plan design: The board should be involved in the plan designs used for incentive compensation purposes for covered employees to ensure they are consistent with safety & soundness principles.
- Receive data and monitor the incentive plan performance: The board should receive data and analyses from management, including internal audit, to ensure that the overall incentive compensation plans are consistent with safety & soundness principles.
- Monitor payments: The board should review incentive payments including the ability to determine if a clawback provision or a reduction in pay provision has been triggered.

## ★ Observations

- The board is ultimately responsible for ensuring that incentive compensation arrangements for all covered employees are balanced and do not jeopardize safety and soundness
- The board activity should be scoped to reflect the size and complexity of the organization and its incentive programs
- The guidance is clear that not all market practices are suitable for all organizations and that boards and committees cannot simply justify its program by the fact that the firm's plans are in line with market.

# What About Board Expertise & External Resources

## ★ Overview

- The board and committee should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the industry that is appropriate for the nature, scope and complexity of the organization’s activities
  - The final guidance notes that this expertise may be present collectively among the board and committee members, may come from training or experience, and may be obtained from advice of outside counsel, consultants and other experts.
  - The board and committee should have resources and authority to hire counsel, consultants and other experts.
  - In selecting and using outside parties, the board and committee should give due attention to potential conflicts of interest arising from other dealings of the parties with the firm.

## ★ Observations

- The final guidance drops the notion of requiring a “compensation expert” and confirms that the board and committee, and not the outside advisors, retain ultimate responsibility for safety and soundness.

# Are Additional Disclosures Required to Shareholders?

## ★ Overview

- To help promote safety and soundness, adequate disclosure concerning incentive compensation arrangements and related risk management, control, and governance processes should be made to shareholders to allow them to monitor, and where appropriate, take action to restrain the potential for excessive risk-taking.
- The scope and nature of disclosure should be tailored to the nature and complexity of the organization.
- FRB plans to work with the SEC relating to its proposed risk-related and other disclosure requirements for public companies to ensure appropriate disclosure.

## ★ Observations

- The guidance-required disclosures are likely to be broader than those dictated by the SEC.
- While acknowledging that required disclosures can be tailored to the organization, no guidance is provided for differentiation.
- Any new guidance-reporting forms have the potential to be more invasive than current disclosure requirements because guidance applies to covered employees and not just senior executives.

## ★ Overview

- The final guidance reiterates the expectation that LBOs and significant users of incentive compensation will adopt a systematic approach to developing balanced arrangements which reflects:
  - Active Board Oversight
  - Evaluation reports from management & risk-management personnel
  - Historical & forward-looking incentive compensation reports
  - Independent compensation committee
  - Systematic approach with formalized policies, procedures & processes
    - Identify employees who incentive compensation may pose risk to the organization
    - Identify the types and time horizons of risks of these employees
    - Review performance measures in the plans for imprudent risks
    - Include balancing elements
    - Communicate the new plan designs
    - Monitor the incentive plans

## ★ Observations

- Expect that these may become the “best practices” against which most banking organizations are measured.

# Supervisory Review & Enforcement Actions

## ★ Overview

- Supervisory Reviews: Based upon supervisory reviews, the findings will be incorporated into an organizations rating components relative to risk-management, internal controls and corporate governance as well as the organization's overall supervisory rating.
- Enforcement Actions: A formal enforcement action may be taken against an organization if the incentive compensation arrangements or related risk-management, control or governance processes pose a risk to the safety and soundness of the organization, particularly if the organization is not taking prompt and effective measures to correct the deficiencies.

## ★ Observations

- Incentive compensation arrangements are now a part of the formal annual review process by regulators.

# Final Observations

- ✦ All banking organizations must be mindful of and responsive to the final guidance
- ✦ LBOs and significant users of incentive compensation will be required to have a systematic approach to ensuring balance and consistency with safety and soundness.
- ✦ Whether large or small, each organization will have to develop an appropriate approach that demonstrates awareness of the three principles
- ✦ Regional and community banks should develop and implement appropriate policies and procedures tailored to the size and complexity of the organization.
- ✦ Bank examiners will be looking for:
  - Evidence of active consideration of the three principles,
  - Appropriately detailed process plans and documentation of the steps taken in establishing, implementing and monitoring incentive compensation programs

# Final Incentive Compensation Guidance Webinar Questions & Answers



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