



STUART MOORE  
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Final Guidance on  
Sound Incentive Compensation Policies  
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# Webinar Agenda



- ★ Review the Final Guidance on Sound Incentive Compensation Policies
- ★ Format
  - 50 minutes covering the content of the incentive compensation policies
  - 10 minutes Q&A

# Executive Summary



# Final Guidance on Sound Incentive Compensation Policies

- ★ Final guidance issued on June 21, 2010
  - Issued jointly by Federal Reserve Board, FDIC, OCC, OTS and Treasury
  
- ★ Effective 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>
  
- ★ Amalfi Consulting Client Alert
  - [http://www.amalficonsulting.com/clientalerts/clal\\_guidance\\_100701.pdf](http://www.amalficonsulting.com/clientalerts/clal_guidance_100701.pdf)
  
- ★ Applies to all banking institutions utilizing incentive compensation
  
- ★ Still based on three principles

# The Bottom Line

- ★ Must have a process for incentive plan design and management
- ★ Board/ Compensation Committee needs to own this process
- ★ Incentive compensation structures need to:
  - Take into account risk as well as performance
  - Pay over time
  - Recover/offset pay if things “go boom” in the future
  - Be well documented
- ★ Regulators are expecting change to occur

# 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\* 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."*

\*emphasis added

# Changes From Proposed 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
- ★ Requirement for a “compensation expert” on compensation committee or board has been eliminated
- ★ 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
  - No “one size fits all” to address safety & soundness concerns
  - Strong risk management practices will not save a faulty design

# Profile of An Affected 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
- ★ Annual cash incentive plan
  - Based on annual performance metrics
  - Paid annually in cash
- ★ Equity use has short-term focus
  - Annual results (formula or discretionary award)
  - Vesting based on time (no long-term holding requirement)
  - Significant use of stock options
- ★ Golden parachute payments

# Related Regs and Legislation

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

- Bill passed, signed into law by President on July 21, 2010
- Mandates bank regulators to collect data and issue rules on excessive compensation and risky compensation practices
- Applicable to all banking and financial organizations > \$1B assets
- Requires:
  - Say-on-pay
  - Mandatory clawbacks
  - CEO pay test
  - Compensation committee independence
  - Other governance rules for all public companies

# Detailed Review



# Topics

- ★ Safety & soundness foundation
- ★ Definition of employee groups
- ★ Definition of incentive compensation
- ★ Principle #1: Balanced risk-taking incentives
- ★ Principle #2: Effective controls and risk management
- ★ Principle #3: Strong corporate governance
- ★ Final Thoughts

# Safety & Soundness Foundation

## ★ Overview

- Aligning interests of shareholders and employees
  - Not always sufficient to address safety and soundness concerns
  - Shareholders may be willing to tolerate risk that exposes the Federal safety net
- Attracting and retaining staff
- These goals do not override the requirement for balanced incentive compensation systems
- Do not encourage imprudent risk-taking
- Take account of the full range of risks that employees' activities may pose
  - Credit, market, liquidity, operational, legal, compliance, and reputational risks
- Balancing adjustments to incentive compensation

## ★ Observations

- Traditional alignment of employees with shareholders introduces too much risk in a “bail out” world
- Need to recruit or retain key personnel does not justify an otherwise risky incentive program

# Definition of Employee Groups

## ★ Overview

- 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 are most likely to be outside the scope

## ★ Observations

- TARP banks found that creating an inventory of incentive compensation arrangements is not a trivial task

# Definition of Incentive Compensation

## ★ Overview

- Current or potential compensation that is tied to achievement of one or more specific metrics
- Does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment
- 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 subject to the guidance, since the value is tied to stock price performance



# Principle #1 – Balanced Risk Taking Incentives

# How Do You Create A Balanced Incentive Plan?

## ★ Overview

- By adding or modifying features that cause the amounts ultimately received to reflect risk and risk outcomes
- Four methods
  1. 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.
  2. Deferral of Payment: Payment is delayed significantly beyond the end of the performance period and the eventual payout is adjusted to reflect actual results. Adjustments may be formulaic or judgmental, although judgmental adjustments are not predictable and may not influence behavior.
  3. Longer Performance Periods: Factors in risk and adjusts the eventual payout to risk outcomes.
  4. Reduced Sensitivity to Short-Term Performance: The rate at which pay increases is reduced as higher levels of performance are achieved. Reduces the magnitude of the incentives and the related risk-taking. Guards against employees taking imprudent risks to reach performance targets that are aggressive.

# How Do You Create A Balanced Incentive Plan? (cont.)

## ★ Observations

- There may be the need to use more than one of these approaches to obtain the desired balance
- Care is needed to ensure deferrals are compliant with 409A

# Important Factors in Plan Design

## ★ Overview

- Balanced incentive compensation arrangements should be tailored
  - Account for differences among employees
  - Substantial differences between senior executives and other employees
  - Between banking organizations
- Performance measures have an important effect on the balance of the incentive
  - Incentives closely tied to short-term revenue or profit of business generated by an employee may encourage excessive risk-taking
  - Payout distantly linked to an employee's activities (e.g., firm-wide profit), may reduce excessive risk
- Payouts should vary based on risk and risk outcomes
  - Paying incentives even when risk or risk outcomes are materially worse than expected can lead to excessively risky behavior.
- Size of payments relative to the total pay package may encourage excessive risk-taking

# Important Factors in Plan Design (cont.)

## ★ Observations

- “One size fits all” will not work for all incentive plans
- Continued skepticism over short-term plans and the call for “balanced” approaches may cause a review of fixed versus variable pay
- Need to use balanced approach may require a review of business unit or individual performance measures

# Golden Parachutes and Deferral of Payments

## ★ Overview

- Consider the potential for “golden parachutes” and the vesting arrangements for payment deferrals to affect the risk-taking behavior
- Arrangements providing a guaranteed payout upon a change in control or departure may neutralize the effect of any balancing features
- For LBOs, provisions that require forfeiture of deferred incentive payments upon departure may weaken the effectiveness of the deferral where the executive can negotiate a “golden handshake” arrangement

## ★ Observations

- Consider 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

# Principle #2 – Effective Controls & Risk Management



# Change in Risk Management

## ★ Overview

- Final Guidance includes a change to risk management
  - Incentives should balance risk and financial results in a manner that does not encourage taking imprudent risks
- Banking organizations should have appropriate controls
- Ensure that processes for achieving balanced incentive compensation arrangements are followed
- Maintain the integrity of risk management and other functions

# Processes for Strong Risk Management

## ★ Overview

- Guidance calls for strong processes and controls. 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
- Produce documentation sufficient to permit an audit of the process and the level of compliance with the policies and procedures

# Processes for Strong Risk Management

## ★ Observations

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

# Proactive Risk Management

## ★ Overview

- Risk-management personnel should have input into the organization's processes for designing incentive compensation arrangements and effectiveness in restraining excessive risk taking
- Guidance creates an expectation that risk personnel be involved up front in the design of incentive compensation (unlike TARP rules)
- Risk managers can:
  - Review the risks associated with the activities of employees covered by incentive plans
  - Approve risk measures used in risk adjustments and performance measures
  - Approve measures of risk outcomes in deferral of incentive payments
  - Analyze risk-taking and risk outcomes relative to incentive payouts
- Other functions, such as HR and finance, also play an important role

# Proactive Risk Management (continued)

## ★ Observations

- Risk analysis is expected to be made up front before potential payouts, performance measures and other aspects of incentive plans or awards are finalized
- For LBOs and significant users of incentive compensation, this up front exercise should also include scenario analyses that assesses levels of payout at various levels of risk
- Risk-management processes and internal controls should reinforce and support development of balanced incentive compensation arrangements

# Compensation of Risk Personnel

## ★ Overview

- Competitive and sufficient to attract and retain qualified personnel
- Should avoid conflicts of interest
- Not based predominately on the financial performance of the business units that the risk or control personnel review
- Based primarily on achievement of objectives for their functions (e.g., risk adjusted performance or adherence to internal controls)

## ★ Observations

- Concern continues about conflicts of interest
- Expecting use of “soft goals” (such as achievement of objectives of their functions) as the primary performance measure for risk-management and internal audit personnel

# Learning from TARP Banks

## ★ Overview

- TARP banks are required, by law, to conduct risk reviews of their incentive plans twice a year while a TARP participant
- 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
- TARP banks potentially had to modify their incentive plans in response to the risk review findings

## ★ Observations

- Many banks discovered plans they did not know existed
- TARP banks are ahead of the curve
- Most other banks will have to compile all incentive plans and then review for risk
- Wall Street Reform & Consumer Protection Act also has a provision for regulators to require submission of these materials on an ongoing basis

# Principle #3 – Strong Corporate Governance



# Role of the Board or Comp Committee

## ★ Overview

- With regard to Executive Compensation, the Board is expected to:
  - Approve incentive plans for senior executives
  - Approve and document material exceptions or adjustments: 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: Be involved in the plan designs to ensure they are consistent with safety & soundness principles
  - Receive data and monitor incentive plan performance: Receive data and analyses from management, including internal audit, to ensure that overall incentive compensation plans are consistent with safety & soundness principles
  - Monitor payments: Review incentive payments, including the ability to determine if a clawback provision or a reduction in pay provision has been triggered

# Role of the Board or Comp Committee (cont)

## ★ Observations

- Board is ultimately responsible for ensuring that incentive compensation arrangements for all covered employees are balanced and do not jeopardize safety and soundness
- Board activity should be geared to reflect the size and complexity of the organization and its incentive programs
- Not all market practices are suitable for all organizations
- Boards and committees cannot justify a program simply by being in line with market

# Board Expertise and External Resources

## ★ Overview

- Board and committee should have or have access to:
  - A level of expertise and experience in risk-management and compensation practices in the industry
  - Appropriate for the nature, scope and complexity of the organization's activities
    - Expertise may be present collectively among the board and committee members
    - May come from training or experience
    - May be obtained from advice of outside counsel, consultants and other experts
- Have resources and authority to hire counsel, consultants and other experts
- Give due attention to potential conflicts of interest arising from other dealings

# Board Expertise and External Resources (continued)

## ★ Observations

- Guidance drops the notion of requiring a “compensation expert”
- Confirms that the board and comp committee (not outside advisors) retain ultimate responsibility for safety and soundness

# Disclosures to Shareholders

## ★ Overview

- Adequate disclosure to shareholders:
  - Concerning incentive compensation arrangements
  - Related risk management, control, and governance processes
  - To allow shareholders to monitor, and where appropriate, take action to restrain the potential for excessive risk-taking
- Scope and nature of disclosure should be tailored to the nature and complexity of the organization
- FRB plans to work with the SEC regarding to its proposed risk-related and other disclosure requirements for public companies

## ★ Observations

- 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
- New forms have the potential to be more invasive as guidance applies to covered employees and not just senior executives
- Financial Reform legislation includes shareholder “say-on-pay”

# Significant Users of Incentive Compensation & LBOs

## ★ Overview

- 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 eligible for incentive compensation who may pose risk to the organization
    - Identify the types and time horizons of risks to the organization
    - 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 will be measured

# Supervisory Review & Enforcement Actions

## ★ Overview

- Supervisory Reviews - Findings will be part of rating components regarding:
  - Risk-management
  - Internal controls
  - Corporate governance
  - Overall supervisory rating
- Enforcement Actions - Formal enforcement action may be taken:
  - If incentive compensation arrangements or related risk-management, control or governance processes pose a risk to the safety and soundness
  - 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

# Questions & Answers



# Contact Information



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