



VEDDER PRICE®

Proposed Federal Reserve
Guidance on
Sound Incentive Compensation

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Todd Leone

President & Founder
todd.leone@amalficonsulting.com
(952) 893-6711

Tom Desmond

Managing Shareholder
tdesmond@vedderprice.com
(312) 609-7647

Webinar Agenda



- ★ The goal of today's webinar is to review the October 22, 2009 Federal Reserve Board (FRB) release on sound incentive compensation policies
 - Background of FRB release
 - Overview of FRB guidelines

- ★ Webinar format
 - 50 minutes covering the content of the FRB guidelines
 - 10 minutes reviewing questions from the audience

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FRB Incentive Compensation Guidance Background

Proposed FRB Guidance

- ★ Actual release date on October 22, 2009
 - 45 pages of guidance

- ★ Published in Federal Register on October 27, 2009
 - 30-day comment period ending November 27, 2009
 - <http://www.thefederalregister.com/d.p/2009-10-27-E9-25766>

- ★ The FRB expects immediate adherence
 - *The Board will accept comments on the guidance for 30 days. Nevertheless, the Board expects banking organizations to immediately review their incentive compensation arrangements to ensure that they do not encourage excessive risk-taking and to implement corrective programs where needed.*
 - *On November 2, 2009 the 28 largest banking organizations were called before their respective Federal Reserve Regulator and told they had until February 1, 2010 to submit their proposed plans in compliance with this guidance.*

Not Tied to TARP or the “Pay Czar”

- ★ FRB Guidance is separate and apart from the TARP regulations and TARP Pay Czar’s rules applicable to the seven entities that received exceptional assistance

- ★ The themes from the FRB and the Pay Czar are similar in many respects
 - Risk reduction by shifting pay mix to more salary and less bonus
 - Risk reduction through use of long-term stock vs. short-term rewards
 - Pay for performance, but confined to avoid incentivizing risky behaviors

- ★ **Observations**
 - FRB Guidance adds another layer of considerations for banking organizations, whether in or out of TARP.

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FRB Incentive Compensation Guidance Overview of Proposal

Topics of Conversation

- ★ Background to FRB guidelines
 - Three principles
 - Safety and soundness considerations
 - “First mover” concept
- ★ Supervisory guidance applicability
 - Types of banks
 - Types of employee groups
 - Types of compensation arrangements
- ★ Three Principles
 - Principle #1: Balanced risk-taking incentives
 - Principle #2: Compatibility with effective controls and risk management
 - Principle #3: Strong corporate governance
- ★ Supervisory initiatives – Review of incentive practices at:
 - Large complex banking organizations (LCBOs)
 - Other banking organizations

Background to FRB Guidance – Three Principles

★ Overview

- To be consistent with safety and soundness requirements, incentive compensation arrangements at a banking organization should:
 1. Provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk;
 2. Be compatible with effective controls and risk management; and
 3. Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

★ Observations

- These are the three principles that appear throughout the entire FRB proposal.

Background to FRB Guidance – Safety & Soundness

★ Overview

- Aligning the interests of shareholders and employees often promotes safety and soundness. However, aligning those interests *is not always sufficient* to address the safety and soundness concerns.
- Shareholders may be willing to tolerate risk that is inconsistent with safety and soundness, exposing the federal safety net.

★ Question

- Is the FRB overriding the broadly recognized goal of aligning the interests of employees with those of shareholders?

★ Observations

- Yes. The FRB clearly states 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.
- FRB expects banking organizations to maintain the FRB-desired incentive compensation practices even if beyond those needed to align shareholders and employee interests.

Background to FRB Guidance – First Mover Concept

★ Overview

- Most employers, including banking organizations, are often unwilling to make unilateral changes to pay practices because doing so might mean losing valuable employees and business to other firms.
- FRB believes supervisory action can play a critical role in addressing this "first mover" problem by requiring the industry to act to address misaligned incentives.
- By dictating principles with across-the-board applicability, the FRB believes it can help to better align the interests of managers and other employees with the long-term health of the organization, and reduce firms' concerns that making prudent modifications to their incentive compensation arrangements might have adverse competitive consequences.

★ Question

- Can the FRB supervise the compensation practices at 6,889 banking organizations?

★ Observations

- The guidance, at present, does not apply to all banking organizations & non-banking competitors. Therefore, this isn't a comprehensive first mover solution.
- The FRB is clearly going to have to get into the compensation business if it is to truly achieve across-the-board compliance.
- While the FRB acknowledges the "first mover" situation and hopes the threat of supervisory action will spur changes, there is still a good deal of flexibility and uncertainty embedded in "principles" (as opposed to "dos" and "don'ts") that may make banking organizations hesitant to make changes.
- Long-term dictating "dos" and "don'ts" or a specific list of best practices/examples may be the only way to efficiently achieve broad-based compliance.

FRB Guidance Applicability – Types of Banks

★ Overview

- What is a “banking organization”?
 - U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company in the United States
- Estimated number of banks impacted by FRB guidance:
 - 6,889 banking organizations; majority of which are under \$200 million in assets
 - No exceptions for size

★ Question

- How should banks not regulated by the Federal Reserve view the FRB action? For example, state chartered banks with no holding company, or unitary thrifts regulated by OTS?

★ Observations

- It appears unusual that there was not a joint release by all regulatory bodies: Federal Reserve, FDIC, OCC, OTS
- Non-FRB regulated institutions should not expect a permanent “loop hole” where they will be able to avoid guidance.

FRB Guidance Applicability – Employee Groups

★ Overview

- This 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).

★ Observations

- These guidelines apply to all employees; there is no “executive” versus “staff” exemption.
- The employee group definition, when combined with broad applicability to 6,889 banking organizations, is clearly seen as “leveling the playing field” between TARP and non-TARP banks.

FRB Guidance Applicability – Incentive Compensation

★ Overview

- The FRB Guidance only applies to “incentive compensation.”
- “Incentive compensation” refers to that portion of the 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 for which is tied to, continued employment (e.g., salary).

★ Question

- Do traditional “incentive” pay arrangements, such as time-vested stock options or restricted stock, or the Pay Czar’s fully-vested “salary stock” arrangements, fall outside the scope of the FRB guidance?

★ Observations

- Yes, apparently so. It remains to be seen whether this is intended to encourage more “fixed” compensation or is a potential loop hole that will encourage the use of higher salaries and fully-vested or time-vested awards to minimize the compliance burden.

Principle #1 – Balanced Risk-Taking Incentives

★ Overview

- 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.
- 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.

★ Question

- Does the absence of across-the-board guidance and examples on which “fixes” are preferred from a regulatory standpoint leave banking organizations unclear on the requirements?

★ Observations

- Yes, given the numerous ways to assess risk and adjust compensation, many banking organizations will be hesitant to be the “first mover.”

Principle #1 – Balanced Risk-Taking Incentives

✦ 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.

✦ Question

- Will wholesale changes to pay practices be needed to meet these requirements?

✦ Observations

- Yes. As noted, the need for “balanced” approaches is likely to cause a migration towards greater fixed pay, and a reduced focus on business unit or individual performance.

Principle #1 – Balanced Risk-Taking Incentives

★ Overview

- 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: 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 risk outcome.
 - 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.

★ Observations

- FRB notes no clear preference for one approach or the other.
- FRB recognizes that methods and practices for making pay sensitive to risk taking will evolve over the next few years, driven by regulators and other stakeholders.

Principle #1 – Balanced Risk-Taking Incentives

★ Overview

- Banking organizations must identify risks associated with employee activities, including the cost and amount of capital and liquidity needed to support the risks in developing balanced arrangements.
- Banks should use scenario analysis to understand the payouts associated with certain risks and risk outcomes.
- Where judgment plays a role in the upfront design, strong internal controls and monitoring of payments in relation to actual outcomes are important.

★ Observation

- Use of capital, credit level, and long-term performance measures are likely to become the preferred approach for measuring performance, risk levels, risk outcomes and appropriate payouts.

Principle #1 – Balanced Risk-Taking Incentives

★ Overview

- The manner for achieving balance will differ among employee groups and substantially differ between senior executives and other employees.
- Deferred payment of equity or equity-based awards may be more effective for controlling senior executives than employees who have less impact on stock price.
- For senior executives at LCBOs, a better balance can be achieved by deferring a substantial portion of incentive compensation over a multi-year period with appropriate clawback (reduction) for poor performance or other multi-year performance periods.
- A single, formulaic approach across all employee groups may not be appropriately risk-sensitive and thus may leave open the chance some employees will have incentive to take excessive risks.

★ Observations

- FRB clearly prefers use of deferral for senior executives.
- FRB acknowledges its intent to mirror the U.K. regulators, who call for long-term deferral payout of 50% to 60% of incentive compensation.

Principle #1 – Balanced Risk-Taking Incentives

★ Overview

- Golden parachutes and vesting provisions for deferred payments must be examined for their effect on risk-taking behavior.
- Payouts upon departure without regard to risk or risk outcomes can provide incentive for undue risk-taking.
 - Golden parachute arrangements that result in full payment upon a transaction or involuntary termination may negate the performance measures or risk adjustment features of the incentive.
- Similarly, 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.
 - This is so because a senior executive or skilled employee may be able to negotiate a “golden handshake” at a new employer that pays the non-risk -adjusted value of the forfeited deferred incentive compensation.

★ Observations

- While the FRB acknowledges the flight risk associated with skilled executives and employees, the suggestion that vesting schedules increase risk is misplaced.
- Unvested incentives create a hurdle-price for firms looking to recruit the executive, thereby promoting continuity of management which reduces overall risk to the organization.
- If unvested amounts “ride” and vest even though the executive has departed, the executive can “double-dip” if he or she leaves.

Principle #2 — Compatibility with Effective Controls and Risk Management

★ Overview

- 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.
- 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 FRB 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.

★ Question

- Is the FRB suggesting banks must construct yet another set of policies and procedures around compensation?

★ Observations

- To some extent yes, although most banking organizations with active boards and compensation committees may already have established policies and procedures that are responsive to this FRB concern.

Principle #2 — Compatibility with Effective Controls and Risk Management

★ Background

- 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 FRB is looking for risk personnel to 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

★ Question

- Is the FRB suggesting that the construction of incentive compensation arrangements is a group exercise?

★ Observations

- The FRB 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.

Principle #2 — Compatibility with Effective Controls and Risk Management

★ Overview

- Compensation for personnel in risk functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.
- FRB acknowledges the need to provide competitive compensation to the risk personnel and those involved in controls.
- To avoid conflicts, FRB 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)

★ Question

- Is the FRB suggesting separate incentive compensation arrangements for risk and control personnel?

★ Observations

- Yes, the FRB is concerned about the appearance of conflicts of interest and is expecting banking organizations to use “soft goals” as opposed to financial performance goals as the primary performance measure.
- Perhaps surprisingly, the FRB does not express a similar concern with respect to financial personnel.

★ Overview

- 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.
- FRB expects banking organizations to track incentive payouts, risks actually taken and actual results from those risks.
- The question to be answered from this review is whether incentive payments are appropriately reduced to reflect adverse risk outcomes.

★ Question

- Does the FRB suggest a framework for conducting such review?

★ Observations

- No, the FRB leaves for individual banking organizations the development of the approach to conducting these reviews.
- As banking organizations did in coming up with the TARP risk review, the organizations will need to wade into when and how to conduct these reviews.

Principle #3 – Strong Corporate Governance

★ Overview

- The board of directors (or a board committee) should actively oversee incentive compensation arrangements.
 - For example, the board or committee should approve the overall goals and purposes of incentive compensation plans.
 - The board or committee should clearly direct management to ensure that the policies and procedures that achieve balance and safety and soundness are carried out.
 - Given the role of senior executives, the board or committee should approve senior executive incentive compensation.
- The board or committee should actively monitor the performance and regularly review the design of the incentive compensation arrangements.
 - The board or committee should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk personnel, of the effectiveness of the design and operation of the incentive compensation system relative to risk taking and safety and soundness.

★ Observations

- In essence, the TARP-required governance and risk reviews will continue, with or without TARP funds.

Principle #3 – Strong Corporate Governance

★ Overview

- The board or committee should also receive periodic reports that review incentive compensation payouts relative to risk outcomes on a backward-looking basis.
- Incentive compensation payments to senior executives should be closely monitored, including backward-looking and forward-looking scenario analysis.
- If pay is subject to a clawback or reduction, adequate information to determine if clawback or reduction is triggered should be provided.
- While the board or committee must keep abreast of market developments, it must ensure that the incentive compensation arrangements do not encourage risk-taking beyond the firm's ability to manage risk effectively, regardless of practices at other firms.

★ Observations

- Board and committee attention to monitoring incentive compensation will substantially increase under the FRB guidance.
- The guidance is silent on whether backward-looking or scenario-analysis is required for existing incentive compensation arrangements or is prospective-only.
- The guidance is clear that boards and committees cannot simply justify its program by the fact that the firm's plans are in line with market.

Principle #3 – Strong Corporate Governance

★ Overview

- If a separate compensation committee is not already in place, the board should consider appointing one.
- The committee should be solely or predominately non-executive directors.
- At LCBOs and large regional banking organizations, the committee should have one or more members with expertise and experience in risk management and compensation practices in the financial services industry appropriate for the nature, scope and complexity of the organization.
- 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

- At LCBOs and large regional banking organizations, the FRB is suggesting that boards have a “Financial Services Industry Risk Expert” and “Financial Services Industry Compensation Expert” much like the audit committee “Financial Expert.”

Principle #3 – Strong Corporate Governance

★ Overview

- To 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.
- In addition, the FRB plans to review its regulatory reporting forms to determine what information the FRB should collect and make publicly available.

★ Observations

- The FRB-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 FRB-reporting forms have the potential to be more invasive than current disclosure requirements because FRB guidance applies to all employees and not just senior executives.

Principle #3 – Strong Corporate Governance

★ Overview

- Banking organizations with large numbers of risk-taking employees will be required to have a systematic approach to ensuring balance and consistency with safety and soundness.
- The approach must require steps consistent with those outlined in the three principles.
- Regional and community banks should develop and implement appropriate policies and procedures tailored to the size and complexity of the organization.

★ Observations

- FRB examiners will be looking for detailed process plans and documentation of adherence with those plans.

Supervisory Initiatives

★ Overview

- The FRB is commencing two supervisory initiatives to spur and monitor the industry's progress toward implementation of safe and sound incentive practices, identify emerging best practices and advance the state of practice more generally in the industry.
- LCBOs will get the most attention initially as the FRB conducts a horizontal review of incentive compensation practices at all 28 LCBOs. The goal of the review is to enhance the FRB's understanding of current practices, the roles of boards, committees, senior executives and outside advisors, and emerging best practices.
 - LCBOs will be required to provide extensive data to the FRB, including plans for improving risk-sensitivity of incentive compensation arrangements.
 - The FRB plans to work closely with the LCBOs to ensure compliance with the supervisory guidelines, and may take supervisory action if necessary.
- For non-LCBOs, supervisory staff will review incentive compensation arrangements as part of the regular, risk-focused supervisory process. These reviews will be part of the review of risk management, internal controls and corporate governance.
 - The FRB's expectations for processes, documentation, etc. will be tailored to the size and complexity of the organization.
 - Results of reviews will be reflected in the supervisory ratings, where warranted, supervisory action may be taken.

★ Observations

- Initial focus on LCBOs is likely to result in trickle-down of required big bank practices to the regional and community banks.

Compensation Horizon

★ Federal Reserve Guidance

- 30-day comment period ends November 27, 2009
- There will be another round of guidance post-comment period
- Applicability 6,889 banking organizations

★ SEC Proxy Revisions

- Comment period ended September 14, 2009
- Expectation of final regulations before end of 2009
- Applicability is every public filing/SEC filing institution

★ TARP Regulations

- Comment period on Interim Final Rule ended August 14, 2009
- Expectation of next round of IFR or Final Rule by, hopefully, end of 2009
- Applicability to 648 TARP banking organizations

★ Legislative Initiatives (H.R. 3269 et al)

- This is Congress; however, expectation by end of 2009 there will be legislation
- Applicability to both all public filers and potentially all banking organizations > \$1 B assets

Federal Reserve Compensation Guidance Webinar Questions & Answers



Contact Information



CONTACTS	1-866-280-3720	www.amalficonsulting.com
<hr/>		
Minneapolis		
Todd Leone	1-952-893-6711	todd.leone@amalficonsulting.com
Gayle Appelbaum	1-952-893-6795	gayle.appelbaum@amalficonsulting.com
Matt Brei	1-952-893-6705	matt.brei@amalficonsulting.com
<hr/>		
Dallas		
Mike Point	1-972-745-1978	mike.point@amalficonsulting.com
<hr/>		
Boston		
Jean Riley	1-508-630-1565	jean.riley@amalficonsulting.com

Contact Information

VEDDER PRICE®

CONTACTS

Chicago

Thomas P. Desmond	1-312-609-7647	tdesmond@vedderprice.com
Robert J. Stucker	1-312-609-7607	rstucker@vedderprice.com
Michael A. Nemeroff	1-312-609-7858	mnemeroff@vedderprice.com
Daniel C. McKay, II	1-312-609-7762	dmckay@veddereprice.com
James A. Kane	1-312-609-7533	jkane@vedderprice.com
Daniel O'Rourke	1-312-609-7669	dorourke@vedderprice.com

New York

Sara Stewart Champion	1-212-407-7785	schampion@vedderprice.com
Stewart Reifler	1-212-407-7742	sreifler@vedderprice.com



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Todd Leone

President & Founder
todd.leone@amalficonsulting.com
(952)893-6711

Tom Desmond

Managing Shareholder
tdesmond@vedderprice.com
(312)609-7647