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Volume 32 | Issue 72 | October 29, 2009

# Federal Reserve Proposes Supervisory Initiatives Over Compensation Practices at Banks

*Last week, the Board of Governors of the Federal Reserve System issued proposed guidance designed to ensure incentive compensation policies at U.S. banking organizations do not encourage excessive risk-taking and are consistent with a bank's safety and soundness. Notably, the guidance proposes that the Federal Reserve Board (FRB) would have expanded supervisory authority over the incentive compensation practices of large complex banking organizations (LCBOs) and would routinely oversee the practices of smaller banking organizations during its usual risk-focused examination process. The FRB could take enforcement action if an organization is not taking prompt and effective measures to correct deficiencies, which could, among other things, require an organization to develop a corrective action plan that the FRB deems acceptable. The FRB requests comments on the proposed guidance by November 27, 2009*.

## Background

Since the economic downturn began, there has been considerable interest in reining in executive and other compensation practices, in particular at large financial institutions. The Emergency Economic Stabilization Act included restrictions on the executive pay practices of institutions receiving governmental bailout funds under the Troubled Asset Relief Program (TARP). (See our October 20, 2008 *For Your Information*.) The American Recovery and Reinvestment Act, enacted in February, included amendments to the TARP executive pay restrictions (see our March 2, 2009 *For Your Information*) and final guidance was issued in June. (See our June 22, 2009 *For Your Information*.)

Now the Federal Reserve Board (FRB) is entering the arena and has proposed its own compensation guidelines for banking organizations under its supervisory authority, including 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 subsidiary in the U.S. It also proposes a strict supervisory scheme for large complex banking organizations (LCBOs). In determining LCBO status, the guidelines refer to SR-08 (Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations). It appears that LCBO status would apply to large domestic and foreign banking organizations with complex operations and dynamic risk profiles.

The new guidance is generally consistent with the Implementation Standards for the Principles for Sound Compensation Practices adopted by the Financial Stability Board (FSB) as endorsed by the G-20 nations following its summit held in September 2009.

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***BUCK COMMENT**. The FSB, a group of central bankers and other regulators from more than 20 major countries, issued recommendations before last month's G-20 meeting calling for stricter controls on pay, including deferring more than half of the pay of top executives for a number of years and/or paying up to half of the bonus in equity linked instruments. The group said that for the standards to work, they "must be rigorously and consistently implemented by significant financial institutions throughout the world."*

*One criticism of imposing pay restrictions on U.S. banks is that they will push the most talented executives to take positions at foreign-owned banks overseas, but most of the countries that host major financial hubs are considering tougher restrictions than those proposed under FRB's guidelines. For example, in the UK, senior executives and employees who manage risk at banking institutions must defer 40% to 60% of their compensation over three years, and at least 50% should be in equity. The FRB has requested comments on whether similar formulaic limitations and equity-linked payment requirements would promote the long-term safety and soundness of banking organizations.*

## Federal Reserve Proposed Guidance

### Three Key Principles for Incentive Compensation

The proposed guidance is based on three key principles. These principles, which apply to senior executives as well as other individuals and groups of employees, are briefly discussed below.

**Principle 1: Balance Risk-Taking Incentives.** Incentive compensation arrangements should balance risk and financial results without providing incentives for employees to take excessive risks. In assessing whether the incentives are balanced, organizations need to consider the full range of risks and the time horizon over which they may take place. If the arrangement is determined to be unbalanced, the organization can use the following methods to bring it in to balance –

- adjust the award, either quantitatively or judgmentally, based on the risk the employee poses to the organization
- defer the payment significantly beyond the end of the performance period and adjust for actual losses or other performance issues – i.e., a "clawback"
- extend the performance period for determining an award (e.g., from one year to two)
- reduce sensitivity to short-term performance by reducing the rate at which awards increase as an employee achieves higher levels of the performance measures.

The FRB notes that to achieve balanced arrangements, the differences between employees (senior executives versus others) and between banking organizations should be taken into account.

The full range of risk and the associated time horizons will need to be understood. The activities of employees may create a wide range of risks including credit, market, liquidity, operational, legal, compliance, and reputational. Some of these risks may occur in the short term, while others may become apparent only over the



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long term.  For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (e.g., the higher credit or compliance subprime loans versus prime loans).  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").

The guidelines suggest that reliable quantitative measures of risk and risk outcomes would need to be used, and if unavailable, more discretionary measures would be employed.  The guidelines also suggest that LCBOs use a forward-looking analysis to assess whether the features included in incentive compensation arrangements are likely to achieve balance over time.  The evaluation of payments based on a range of performance levels, risk outcomes, and the levels of risks taken, will help the organization assess whether incentive compensation payments are likely to be reduced appropriately as the risks to the organization from the employee's activities increase.

The guidelines further provide that organizations need to communicate to employees how incentive compensation will be reduced as risks increase.  Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk outcomes.

> ***BUCK COMMENT.*** *The concept of mitigating risk by adjusting pay commensurate with the level of risk taken will be a challenging task facing compensation committees.  Risk management involves the interplay between policies, management processes, monitoring systems, and infrastructure.  Further, a fundamental element of a profitable enterprise is the astute balancing of returns and risk.  If the primary focus in designing pay packages is risk aversion (or in fact the approach penalizes employees who, all other things being equal, are involved in functions that inherently bear greater risk), business opportunities, innovation, and growth initiatives may be diminished.*

Further, the guidelines indicate that banking organizations should consider how "golden parachutes," "golden handshakes" and other vesting arrangements for deferred compensation affect risk taking.  The FRB raises the issue that forfeiture provisions can create risks by removing the employee's financial exposure to the risk outcomes of the employee's activities.  This effect can be significant for individuals whose services are in high demand and could negotiate "golden handshake" arrangements with new employers that would compensate them for the value of the forfeited amounts.

> ***BUCK COMMENT.***  *Much attention has been focused on how accelerated vesting of incentives (e.g., upon a change in control or some other event) can drive short-term behaviors of executives and thus create risks to an organization.  On one hand, there is concern that the acceleration of vesting of deferred compensation could provide an incentive to engage in undue risk taking.  On the other hand, there is concern that provisions that require forfeiture of deferred compensation can also create undue risks.  This could put a bank in a difficult position as they seek to comply.*



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**Principle 2: Compatibility with Effective Controls and Risk Management.** The banking organization should maintain risk-management processes and internal controls that reinforce and support balanced incentive compensation arrangements. For example, the organization should maintain policies and procedures that identify all personnel and units involved in setting and monitoring incentive compensation, identify sources of risk-related input and the individuals and units that have authority to approve changes. And, it should conduct regular internal reviews. Appropriate personnel, including those in risk management, should have input into the design of incentive compensation and its effectiveness in restraining excessive risk-taking. Those in risk management should be properly compensated to assure that they are qualified and can avoid conflicts of interest.

Finally, banking organizations need to monitor their incentive compensation arrangements and make whatever changes are necessary if payments do not appropriately reflect risks.

> ***BUCK COMMENT.*** *Many line-of-sight incentives attempt to eliminate all inputs and factors not controlled by the individual. This often results in breaking value-creating performance down into discrete, measurable components (and corresponding metrics). Ensuring that these measured components of performance add up to the desired aggregate result requires a highly effective organization, processes, and structures, and superior performance monitoring capabilities. .*
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> *For example, a financial services organization that creates collateralized mortgage obligations must rely on a lengthy value chain. It begins with those who acquire mortgages with the desired characteristics, evaluators who assess the mortgages, packagers who aggregate the mortgages, structurers who define the tranches and evaluate the expected risk and return, credit evaluators who determine the expected credit rating, legal and marketing staff to represent the security properly, and so on. Ensuring that the actual result is consistent with the intended result requires highly effective monitoring systems along the entire value chain, particularly if potentially conflicting incentives occur at various stages.*
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> *For additional discussion on this issue, see Buck's* InsightOut*:* Facilitating Dysfunction: The Dominance of Line-of-Sight and Near-Term Incentives *(August 2009).*

**Principle 3: Strong Corporate Governance.** The banking organization's board of directors needs to actively oversee incentive compensation arrangements to assure that they are balanced and do not jeopardize the organization's safety and soundness. It should monitor performance and regularly review the design and function of the arrangements. To assure that the banking organization's board of directors is appropriately organized and has resources to provide effective oversight, the FRB recommends establishment of a separate compensation committee for those that do not already have one. Disclosure practices should assure that shareholders have sufficient information to monitor and take appropriate actions to rein in the potential of incentive compensation to encourage excessive risks. The FRB indicates that LCBOs should follow a systematic approach, supported by "robust and formalized" policies, procedures and systems, in developing a balanced compensation system.

## Federal Reserve Supervisory Initiative

The FRB is also proposing a two-tiered supervisory initiative.



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**Large Complex Banking Organizations.** The FRB believes that LCBOs warrant more supervisory attention because they use more incentive compensation arrangements and are more likely to adversely affect the financial system as a whole. Therefore, it proposes to conduct a formal "horizontal" review of LCBOs' incentive arrangements to assure that they are aligned with its principles. The FRB will use a multi-disciplinary team of experts from the fields of banking supervision, risk management, economics, finance, law, accounting, and other areas as appropriate. LCBOs will be expected to provide information and documentation describing –

- the structure of the current arrangements
- the process for overseeing current arrangements
- the organization's plans, including timetables, for improvement of risk sensitivity for incentive arrangements and related risk management, controls and corporate governance practices.

The FRB can take appropriate supervisory action if it deems that the organization is not meeting its outlined principles, including establishing limitations on the incentive awards.

**Community and Regional Banking Organizations.** Reviews at regional and community banking organizations will be conducted as part of the evaluation of the firm's risk management, internal controls, and corporate governance during the regular examination process. These reviews will be tailored to reflect the scope and complexity of the organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Thus, the compensation-related policies, procedures, and systems at a small banking organization that uses incentive compensation arrangements on a limited basis will be substantially less extensive, formalized, and detailed than those of an LCBO that uses incentive compensation arrangements extensively.

### Comments Requested

The FRB is seeking comments on whether the proposed guidance would impose undue burdens on, or have unintended consequences for, banking organizations and, particularly, regional and small organizations. It has been estimated that the proposed guidance, if adopted in final form, would apply to 3,002 small banking organizations (defined as banking organizations with $175 million or less in total assets). Comments are requested by November 27, 2009.

## Conclusion

In light of the FRB's proposed guidelines, all banking organizations, large and small, should start to take immediate steps to evaluate their incentive compensation arrangements and related risk management, control, and corporate governance processes and immediately address deficiencies. Buck's consultants are available to help affected organizations take necessary steps.

*This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.*



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