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## Final Guidance on Sound Incentive Compensation Policies Applicable to Banking Organizations

*The agencies responsible for supervising banking organizations have issued final guidance on sound incentive compensation policies to assist banking organizations in designing and implementing incentive compensation arrangements that effectively consider potential risks and risk outcomes. The final guidance retains the same key principles as in proposed guidance issued in October 2009, but includes clarifications to address issues raised by commenters.*

### Background

The economic downturn has generated considerable focus on the compensation practices at financial institutions. Last year, the Federal Reserve and other agencies proposed compensation guidelines for banking organizations under their supervisory authority. (See our October 29, 2009 [For Your Information](#).) Now, the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision have issued [final guidance](#), which like the proposed guidance, centers around three core principles –

- Incentive compensation arrangements should balance risk and financial results so as not to encourage employees to take imprudent risks.
- Arrangements should be compatible with effective controls and risk-management.
- Arrangements should be supported by strong corporate governance.

### Guidance on Sound Incentive Compensation Policies

We summarize below the key provisions of the agencies' final guidance applicable to incentive compensation arrangements maintained by both large and small banking organizations.

#### Covered Employees

Based on the premise that incentive arrangements covering all employees, either individually or as part of a group, have the ability to expose the banking organization to material amounts of risk, the guidance applies to the following employees –

- senior executives and others responsible for oversight of the organization's firm-wide activities or material business lines
- individual employees, including non-executives, whose activities may expose the organization to material amounts of risk (e.g., traders with large position limits relative to the organization's overall risk tolerance)
- groups of employees subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization 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).

Although tellers, bookkeepers, couriers, or data processing personnel would not generally have the ability to expose the organization to material risks, the guidance does not exempt these employees outright. Organizations are cautioned to consider the full range of inherent risks arising from, or generated by, an employee's activities, even if the organization uses risk-management processes or controls to limit them.

## **Expectations Imposed on Banking Organizations**

The agencies note that an incentive plan design that is in alignment with the interests of shareholders may not always sufficiently address safety and soundness concerns, particularly because the federal safety net may make shareholders in some cases willing to tolerate a higher degree of risk than is inconsistent with the organization's safety and soundness. Thus, the expectation is that banking organizations will –

- maintain incentive compensation practices that are consistent with safety and soundness, even when these practices go beyond those needed to align shareholder and employee interests
- regularly review incentive compensation arrangements for all covered employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk, as well as to regularly review related risk-management, control, and corporate governance processes
- immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness
- ensure that incentive compensation arrangements are consistent with the principles described in the guidance
- take prompt action to address deficiencies in their incentive compensation arrangements or related risk-management, control, and governance processes.

## **Principles of a Sound Incentive Compensation System**

We discuss below the three principles outlined in the guidance.

**Principle 1: Balanced Risk-Taking Incentives.** Incentive compensation arrangements should provide employees incentives that appropriately balance risks and rewards in a manner that does not encourage imprudent risk-taking.

**Risks in Employee Activities.** The amount of incentive pay being paid to covered employees should take account of and adjust for the risks and losses – as well as gains – associated with employees' activities. Under a balanced arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation because the risks taken by the employees in generating that revenue or profit differ materially – the employee whose activities create materially larger risks for the organization should receive less than the other employee, all else being equal.

***BUCK COMMENT.** Mitigating risk by adjusting pay commensurate with the level of risk taken will be a challenging task facing companies and their 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. The impact of this will be greater or less based on the risk profile of the company and the markets in which it competes.*

**Full Range of Risks.** The guidance says in balancing adjustments to incentive compensation arrangements, the full range of risks that employees' activities may pose for the organization, including credit, market, liquidity, operational, legal, compliance, and reputational risks, should be taken into account.

**Modifications.** When an arrangement is unbalanced, features must be modified to bring it into balance. As in the proposed guidance, the final guidance outlines the following four methods to make compensation more sensitive to risk –

- *Risk Adjustment of Awards.* The amount of an incentive compensation award for an employee may be adjusted based on measures that take into account the risk the employee's activities may pose to the organization. These measures may be quantitative or set judgmentally, subject to appropriate oversight.
- *Deferral of Payment.* The actual payout of an award to an employee may be delayed significantly beyond the end of the performance period, and the amounts paid adjusted for actual losses or other aspects of performance that are realized or become better known only during the deferral period.
- *Longer Performance Periods.* The time period covered by the performance measures used in determining an employee's award may be extended.
- *Reduced Sensitivity to Short-Term Performance.* The rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s) may be reduced.

The guidance indicates that in some cases, two or more methods may be needed in combination to ensure that an incentive compensation arrangement properly balances risk and reward.

**Employee Differences.** A balanced arrangement should take into account differences between employees, including the substantial differences between senior executives and other employees. For example, the payment of deferred incentive compensation in the form of equity (such as restricted stock or stock options) may be helpful in restraining the risk-taking incentives of senior executives. However, this reward structure may not be effective in restraining lower-level covered employees from taking risks because they would be unlikely to believe that their actions will materially affect the organization's stock price.

**"Golden Parachutes" and "Golden Handshakes."** Similar to the proposed guidance, the final guidance indicates that banking organizations should consider how "golden parachutes," "golden handshakes" and other vesting arrangements for deferred compensation affect risk taking.

**Communication to Employees.** The guidance provides that organizations should effectively communicate to employees how compensation awards will be reduced as risks increase. Where feasible, these communications should include examples of how payments may be adjusted to reflect projected or actual risk outcomes.

**Principle 2: Compatibility with Effective Controls and Risk-management.** A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements. Traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced.

**Appropriate Controls.** Banking organizations should have strong controls on processes for designing, implementing and monitoring incentive compensation arrangements and should maintain sufficient documentation to audit the effectiveness of their processes for establishing, modifying, and monitoring these arrangements.

**Input of Risk Management Personnel.** The guidance indicates that appropriate personnel, including risk management personnel, should have input into designing arrangements and assessing their effectiveness. Risk managers can help achieve balanced arrangements by, among other things, reviewing the types of risks associated with the activities of covered employees, approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements, and analyzing risk-taking and risk outcomes relative to incentive compensation payments.

**Qualified Risk Management Personnel.** Compensation for employees in risk-management and control functions should attract and retain qualified personnel, while avoiding conflicts of interest. To help preserve their independence, the incentive compensation of these employees should not be based substantially on the financial performance of the business units they review.

**Monitoring Performance.** Banking organizations should monitor performance of incentive compensation arrangements and revise them if they do not reflect risks. Incentive compensation awards and payments, risks

taken, and actual risk outcomes should be monitored to determine whether incentive compensation payments to employees appropriately reflect adverse risk outcomes or high levels of risk taken.

**Principle 3: Strong Corporate Governance.** Banking organizations should have strong and effective corporate governance, including active and effective oversight by the board of directors. The board should directly approve incentive compensation arrangements for senior executives and should approve and document any material exceptions or adjustments to the arrangements. Further, it should monitor the effects of exceptions on the risk-taking incentives of senior executives and the safety and soundness of the organization. As the board is ultimately responsible for ensuring incentive compensation arrangements for all covered employees are appropriately balanced, its involvement should be scaled to the scope and prevalence of these arrangements.

**Monitoring and Reviewing Arrangements.** The board should monitor the performance and regularly review the design and function of an incentive compensation plan. This would include receiving data and analysis from management or other sources, closely monitoring incentive compensation payments to senior executives and the sensitivity of those payments to risk outcomes, and ensuring that clawback provisions are in place and operational.

**Board's Organization, Composition and Resources.** The organization, composition, and resources of the board should permit effective oversight. It should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities.

**Disclosure Practices.** The banking organization's disclosure practices should support safe and sound incentive compensation arrangements. An appropriate amount of information on these arrangements for executive and non-executive employees and the related risk-management, control, and governance processes should be provided to shareholders.

**LBOs.** Large banking organizations (LBOs) should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements. LBOs must maintain formalized policies, procedures, and systems that enable the organization to effectively do all of the following –

- identify employees eligible to receive incentive compensation and whose activities may expose the organization to material risks
- identify the types and time horizons of risks to the organization from the activities of these employees
- assess the potential for the performance measures included in the incentive compensation arrangements to encourage employees to take imprudent risks
- include balancing elements, such as risk adjustments or deferral periods, that are reasonably designed to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities

- communicate to employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks
- monitor incentive compensation awards, payments, risks taken, and risk outcomes and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

## Enforcement

The appropriate federal supervisor may take enforcement action against a banking organization if its incentive compensation arrangements are not compliant with the guidance. Enforcement action will vary depending on the whether or not an organization falls into the LBO category. Because of the size and complexity of their operations, LBOs need to adhere to “systematic and formalized” policies, procedures, and processes (as noted above).

The policies, procedures, and systems of smaller banking organizations are expected to be less extensive, formalized, and detailed than those of LBOs. Thus, reviews of incentive compensation arrangements at smaller, less-complex banking organizations will be conducted as part of the evaluation of those organizations’ risk-management, internal controls, and corporate governance during the regular risk-focused examination process. Little, if any, additional examination work is expected for smaller organizations that do not use, to a significant extent, incentive compensation arrangements. The guidance notes that a firm-wide profit-sharing or bonus plan based on the bank’s profitability will not cause a smaller banking organization to be considered a significant user of incentive compensation arrangements even if it covers all or most of the organization’s employees.

## Conclusion

In light of the final guidance, all banking organizations, large and small, should start to take 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.

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*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.*