

Federal Reserve Proposed Guidance: Aligning Incentive Compensation with Safety and Soundness Concerns

Table of Contents

Introduction.....	1
Principles of a Sound Incentive Compensation System.....	2
Principle 1: Balanced Risk-Taking Initiatives.....	2
<i>Short-Term Financial Criteria As Inherently Flawed.....</i>	<i>2</i>
<i>Use of Quantitative Measures.....</i>	<i>2</i>
<i>Special Attention to Low Probability Catastrophic Risk Factors.....</i>	<i>3</i>
<i>Ways to Balance Unbalanced Arrangements.....</i>	<i>3</i>
<i>Tailored Compensation.....</i>	<i>3</i>
<i>Golden Parachute Arrangements.....</i>	<i>3</i>
Principle 2: Compatibility with Effective Controls and Risk Management.....	3
Principle 3: Strong Corporate Governance.....	4
Supervisory Initiatives.....	5
Horizontal Review at Large Complex Banking Organizations.....	6
Review at All Other Banking Organizations.....	6
Consequences of Review.....	6
Request for Comments.....	7
References.....	8

Introduction

The Federal Reserve proposed on October 22 a new regulatory framework that would for the first time put compensation practices at the heart of the U.S. financial regulatory regime. The proposed guidance is likely to impact the way that all U.S. banking organizations, whether or not directly regulated by the Federal Reserve, establish and administer compensation standards for executive and non-executive employees.

Banking organizations in the U.S. have historically been largely left alone with respect to their pay practices, based on the assumption that disclosure to shareholders would lead to market discipline. This approach came under widespread criticism in light of the financial crisis, and the initial regulatory response, as evidenced by the regulations designed for TARP recipients, was sweeping and prescriptive.

The Federal Reserve's framework, which is arguably consistent with the Financial Stability Board principles endorsed at last month's G-20 meetings,¹ by contrast, is relatively nuanced, is grounded in principles rather than rules and allows for considerable judgment and variation.

- Unlike the TARP regulations, and unlike current French and German regulatory proposals, the Federal Reserve guidance avoids blunt instruments like formulas, pay caps and automatic deferrals, including requirements that a portion of pay be in equity-based awards. It imposes the responsibility on management to craft compensation programs that are appropriate for their organizations.
- Rather than the traditional SEC focus on a small group of the most senior executives, the proposed guidance looks to those employees, whether executive or non-executive, who individually or as part of a group, have the ability to expose the banking organization to material amounts of risk. The shift in focus from title and income to duties and responsibilities and risk impact reflects an appreciation for the inherent structural complexity of many banking organizations. It will challenge banking organizations to characterize the risk profiles of different positions

¹ Financial Stability Forum Principles for Sound Compensation Practices (April 2, 2009), http://www.financialstabilityboard.org/publications/r_0904b.pdf; Financial Stability Board Principles for Sound Compensation Practices – Implementation Standards (Sept. 25, 2009), http://www.financialstabilityboard.org/publications/r_090925c.pdf. The Financial Stability Forum was composed of major national financial authorities such as finance ministries, central bankers, and international financial bodies. The Financial Stability Board is a successor to the Financial Stability Forum and includes G-20 members who were not members of the Financial Stability Forum.

and organizations and to implement compensation programs that contribute to risk management.

Compliance with the guidance is likely to be a highly subjective and iterative process that will play out in the non-public arena of negotiations with Federal Reserve bank examination staff. Results of the Federal Reserve's review will be communicated to each organization and incorporated into its supervisory ratings. To the extent the findings affect an organization's "well-managed" status, they can also affect its ability to make acquisitions or take other actions. The Federal Reserve may take enforcement actions where it concludes that the failure to implement or adhere to the incentive compensation principles poses a risk to the safety and soundness of an organization.

Comments on the guidance are requested and may be submitted until November 27, 2009. We will continue monitoring developments in this area and issue updates from time to time.

Banking Organization:

In the proposed guidance, "banking organization" includes 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 United States.

U.S. Operations of Foreign Banks:

For U.S. operations of foreign banks, the organization's policies, including management, review and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

Principles of a Sound Incentive Compensation System

The guidance sets forth three principles for "banking organizations", as defined in the sidebar, for designing and implementing incentive compensation arrangements.

Principle 1: Balanced Risk-Taking Initiatives

Incentive compensation arrangements should balance risk and financial results so that employees do not have incentives to take excessive risks.

Short-Term Financial Criteria As Inherently Flawed

Under the guidance, organizations must be sensitive not only to the risks of employees' activities but also the time horizon over which risks may be realized. Short-term revenue or profit-linked compensation schemes are presumed to be flawed if a short-term criterion is the only metric driving compensation. For example, a "risky" compensation practice would be to link incentive compensation with the short-term revenue generated by an employee, and a less risky practice would be to link compensation to firm-wide profit where the actions of an individual employee are less likely to have a material impact.

Use of Quantitative Measures

If available, quantitative measures of risk and risk outcomes should be used in developing balanced compensation arrangements. Scenario analyses – the evaluation of payments on a forward-looking basis based on a range of performance levels, risk outcomes and the levels of risk taken – are recommended. However, a lack of reliable quantitative measures does not relieve organizations from taking risk outcomes into account in assessing the balance of incentive compensation arrangements.

Incentive Compensation:

- In the proposed guidance, the term “incentive compensation” refers to 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)
- It does not include compensation that is awarded solely for, and the payment of which is tied to, continued employment (e.g., salary)

The Proposed 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).

Special Attention to Low Probability Catastrophic Risk Factors

Special attention should be given to risks with a low probability of being realized but which would have highly adverse effects on the organization if realized.

Ways to Balance Unbalanced Arrangements

The proposed guidance notes that unbalanced arrangements can be made more balanced by adding or modifying the following features:

- Risk adjustment of awards
- Deferral of payment (with adjustment for losses during deferral period)
- Longer performance periods
- Reduced sensitivity to short-term performance

Tailored Compensation

Incentive compensation arrangements should be tailored to account for differences between employees, including differences between senior executives and other employees, and banking organizations. As an example, the payment of deferred compensation in equity may be effective in restraining risk-taking for senior executives and other employees whose actions are perceived to materially affect the financial performance of the organization, whereas equity may not be as effective in restraining risk-taking for lower level employees who do not believe their actions will materially affect the organization’s stock price.

Golden Parachute Arrangements

Consistent with Treasury’s targeting of golden parachute arrangements and the Financial Stability Board principles endorsed by the G-20, banking organizations are directed to review compensation arrangements that provide, upon termination of employment or a change in control of the organization, large additional payments or accelerated payment of deferred amounts without regard to risk or risk outcomes.

Principle 2: Compatibility with Effective Controls and Risk Management

The guidance requires a banking organization to have in place strong controls governing its processes for designing, implementing and monitoring incentive compensation arrangements. Such controls must limit the ability of employees to evade processes established by the banking organization or to influence risk measures or other judgments used to set incentive compensation. The Federal Reserve clearly contemplates the commitment of adequate resources to implementing this principle.

In order to make sure such controls are effective, the guidance recommends regular internal reviews conducted by audit, compliance or other personnel.

In designing effective incentive compensation programs, banking organizations should make sure:

- Appropriate personnel, including risk-management, human resources and finance personnel, are involved;
- Such personnel should have the requisite skills and experience to perform their duties effectively and should receive compensation sufficient to attract and retain qualified personnel; and
- Performance measures for the incentive compensation of such personnel should be based primarily on the achievement of the objectives of their functions and not on the financial performance of the business units they review.

Banking organizations should track incentive compensation awards and payments to determine if their incentive compensation arrangements are properly taking risk into account. The resulting data should be reported to appropriate levels of management, including the board of directors if warranted, and arrangements should be revised if compensation paid does not appropriately take risk into account.

Principle 3: Strong Corporate Governance

Banking organizations should have a strong and effective corporate governance structure in place to oversee and monitor compensation practices.

Specifically, the Federal Reserve directs the board of directors of each banking organization not only to participate actively in developing and approving the organization's incentive compensation arrangements, especially those of senior executives, but also to review and evaluate on an ongoing basis the suitability of these arrangements. This directive is consistent with the historical mandate of the board of directors with respect to the compensation of senior executives, but is a change in broadening this responsibility to a larger group of employees.

To ensure that the board of directors has adequate resources for effective oversight, the Federal Reserve suggests certain processes one would generally expect to be in place for public companies and may or may not be in place for other organizations, such as establishing a separate compensation committee (of primarily non-executive directors) to oversee the organization's compensation program, enlisting internal and outside help with incentive compensation and risk management expertise as necessary, and providing adequate disclosure about compensation practices and oversight mechanisms to shareholders.

- In issuing its recommendations, the Federal Reserve recognizes that, because large complex banking organizations often have large numbers of risk-taking employees engaged in diverse activities, they should adopt a more formal, systematic approach in developing and overseeing their compensation practices.
- Smaller regional and community banking organizations should tailor their approaches to the size and complexity of each

organization's activities as well as the prevalence and scope of that organization's incentive compensation arrangements.

Two Supervisory Initiatives:

- Coordinated horizontal review of compensation practices at 28 large complex banking organizations
- Review of compensation practices at regional, community and other banking organizations during regular risk-based examination cycle

While larger banking organizations may be required to do more under the proposed guidance, in most cases they either already have the recommended systematic infrastructures in place or at least have the resources (e.g., various committees on the board of directors that specialize in a range of corporate governance issues) to develop such infrastructures. Smaller banking organizations, on the other hand, may face a burdensome task under the proposed guidance as they often lack internal resources or have not previously budgeted for funding to retain outside help needed to devise a comprehensive compensation solution that comports with the guidance.

Large Complex Banking Organizations :

Characterized by:

- Scope and complexity of domestic and international operations
- Participation in large volume payment and settlement systems
- Extent of custody operations and fiduciary activities
- Complexity of regulatory structure, both domestically and in foreign jurisdictions

To be designated as a large complex banking organization, an organization must meet specified criteria to be considered a significant participant in at least one *key financial market*.

Key financial markets include:

- Markets for federal funds, foreign exchange, and commercial paper
- Markets for U.S. Government and agency securities
- Markets for corporate debt and equity securities
- Broader U.S. capital market activity, including underwriting, securitization, derivatives, and trading
- Retail financial services
- International financial markets

Supervisory Initiatives

In recognition of the fact that the facts and circumstances are different for large complex banking organizations and superregional, regional and smaller banks, the Federal Reserve has proposed two supervisory initiatives designed to “spur and monitor progress toward safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.”

The two initiatives are:

- A special horizontal review of compensation practices at 28 large complex banking organizations; and
- A review of compensation practices at regional, community and other banking organizations not classified as large complex banking organizations.

In addition to the two initiatives, the Federal Reserve will also monitor all banking organizations' compliance with the principles of safety and soundness on an ongoing basis.

While the new guidance applies only to those banking organizations within the regulatory purview of the Federal Reserve, we believe the Federal Reserve will also be able to directly affect the compensation practices of the holding company, any of its non-bank subsidiaries, any state member bank subsidiary and any subsidiaries of such a state member bank. As a technical matter, state-chartered non-member banks, whose primary federal regulator is the FDIC, credit unions and thrifts and thrift holding companies, for example, are not covered. We believe, however, that other primary federal banking regulators are likely to follow these guidelines for those elements of the U.S. banking system that are not directly under the purview of the Federal Reserve. Moreover, we believe it likely that any systemic risk regulator or council will view compensation guidelines as a systemic issue and apply these standards to “Tier 1 FHCs” as well. As a result, banking organizations not directly affected by the Federal Reserve's guidance should also study these guidelines.

Intended Goals of Horizontal Review:

- Gain better supervisory understanding of current compensation practices of large complex banking organizations
- Evaluate the strength of control mechanisms over current incentive compensation arrangements
- Understand the roles of board of directors, compensation committees and risk-management functions in designing, approving and monitoring incentive compensation systems
- Identify, through comparison, best practices among large complex banking organizations

Information the Federal Reserve Expects from a Large Complex Banking Organization:

- Structure of the organization's current incentive compensation arrangements
- Methods used by the organization to oversee and help discourage excessive risk-taking
- Organization's plan and timeline for improving the risk sensitivity of its incentive compensation arrangements and related risk management, controls and corporate governance practices

Horizontal Review at Large Complex Banking Organizations

Under this initiative, each of the 28 large complex banking organizations will provide documentation to the Federal Reserve that describes its current and future plans, including relevant timetables, regarding incentive compensation arrangements along with existing oversight mechanisms used to rein in excessive risk-taking over these arrangements. Using that information, the Federal Reserve will work closely with each organization in an effort to link planned compensation structures with principles of safety and soundness so that they can be implemented expeditiously. The review team will be led by Federal Reserve staff working with relevant Federal Reserve Bank supervisors, making up a multidisciplinary staff group with expertise from banking and risk management to law and accounting.

The horizontal nature of the review, through which the Federal Reserve will have access to incentive compensation information and related analyses from all banking organizations, implies that the Federal Reserve intends to compare compensation practices and policies at different institutions as part of its review.

The Federal Reserve justifies its close scrutiny of the compensation practices at these large complex banking organizations by noting their extensive use of incentive compensation arrangements, which, if flawed, could negatively affect the broader financial system.

Review at All Other Banking Organizations

The initiative to review compensation practices at other banking organizations that are not large complex banking organizations will take place as part of the regular, risk-focused examination of banking organizations. Similar to other aspects of the regular examination process, the scope of the Federal Reserve's review of compensation practices at each banking organization will parallel the scope and complexity of that organization's activities and incentive compensation arrangements. The Federal Reserve has noted that the review, policies, procedures and systems implemented by these organizations may be substantially less extensive, formalized and detailed than at their large complex counterparts that use incentive compensation extensively. We would expect, however, that the lessons drawn from the horizontal review by the Federal Reserve staff will be communicated to the bank examination staff and, to the extent relevant, will inform the examination process.

Consequences of Review

Findings from reviews under both supervisory initiatives will be factored into each banking organization's supervisory rating. As part of the examination process, the results of the reviews are confidential supervisory matters and will not be shared publicly. As a result of treating compensation as a component of the examination report, the Federal Reserve can require that a banking organization implement a corrective action plan to remedy its deficiencies in compensation practices. The Federal Reserve may take formal or informal enforcement action against a banking organization whose compensation practices are deemed to be inconsistent with principles of safety and soundness. Theoretically, a lack of corrective

action could lead to a memorandum of understanding or a cease and desist order. At an extreme, a lack of attention and corrective action in the compensation arena could jeopardize an organization's "well-managed" status and financial holding company eligibility.

To further monitor and encourage changes, the Federal Reserve plans to release a report by the end of 2010 that will document trends and developments in compensation practices at all banking organizations.

Request for Comments

Comments have been requested on all aspects of the proposed guidance summarized above, including the following:

- Whether the three core principles are appropriate and sufficient to ensure the safety and soundness of banking organizations and whether additional or alternate principles are necessary to achieve the stated goals.
- The current state of incentive compensation programs, specifically the extent to which they are currently consistent with the proposed guidance and the existence of any impediments (which could be legal or regulatory, or could take the form of market practices such as golden parachutes) that may delay the implementation of programs consistent with the principles.
- Whether the proposed guidance would impose undue burdens or have unintended consequences for banking organizations, in particular regional and small organizations, and whether any such burdens could be addressed in a manner consistent with safety and soundness.
- Whether a formulaic approach that would regulate the components, structure, amount and timing of payment of incentive compensation would be better suited to achieve the stated goals of the proposed guidance.
- Whether financial service industry practices such as "golden parachute" and "golden handshake" arrangements present challenges for banking organizations in developing and maintaining balanced incentive compensation arrangements.

While it is unclear what types of comments will be received on these issues and how the Federal Reserve will revise the guidance in response, any change to the guidance that would include a formulaic approach to setting incentive compensation would be a significant departure from the Federal Reserve's principles-based approach set forth in the proposed guidance, as well as the general approach of the Financial Stability Board.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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[Financial Stability Forum Principles for Sound Compensation Practices](#) (April 2, 2009)

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