

Federal Reserve's Report on Incentive Compensation Practices ? A Progress Report?

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The Federal Reserve recently released a [report](#) detailing its horizontal review of incentive compensation practices at 25 large banking organizations. The findings and recommendations are expressed in highly general terms, and set forth the Fed's views on what financial institutions are and should be doing to identify practices effective in balancing incentive compensation arrangements and risk and formulate next steps in developing these practices. Because the interagency rule on incentive compensation in the financial sector may provide a roadmap for future regulation in this area extending beyond financial institutions, the insight offered by the report may be helpful in structuring incentive compensation policies at any company.

Based on the report, the Fed would like to see companies implement the following practices when using risk adjustments and deferred compensation to achieve balance between risk and financial reward in compensation arrangements:

- Well-developed and robust compensation policies that clearly identify the weight given to risks taken during the performance year, and improved monitoring of these policies to ensure the effective and consistent use of risk adjustments (this is particularly important for incentive-based deferred compensation plans because, to have a significant impact on risk-taking behavior, plans need to provide employees with a clear understanding of the risk-taking decisions that impact plan payouts);
- Where adjustments to the size of annual bonus pools are used as a risk adjustment mechanism, adjustments in connection with individual incentive compensation awards if individual employees in a single pool have varied levels of impact on risk; and
- Deferral practices that are broader than traditional clawback arrangements – although clawbacks are considered useful in creating balanced risk-taking incentives by discouraging specific types of behavior, the Fed considers their focus (typically, malfeasance, violations of policies, and a material restatement of financial results) too narrow to impact most risk-related decisions.

In the report the Fed makes clear that it expects boards to actively oversee the development and operation of incentive compensation policies and be attentive to risk taking incentives created by the incentive compensation process. The Fed also expects directors to monitor carefully the effectiveness of incentive compensation arrangements in balancing risk-taking incentives, for example, through reviewing periodic reports that monitor incentive compensation awards and payments relative to risk outcomes. Note that the Fed's expectations for board responsibility and oversight are not limited to incentive compensation of senior executives, but extend to incentive arrangements throughout the employee ranks. This could result in a significant expansion of the board and/or compensation committee process at many companies.

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

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