

# Client Alert

November 4, 2009

## Federal Reserve Proposes Unprecedented Oversight of Pay Programs at Financial Organizations

### More Employees Covered, Closer Attention to Risk-Related Incentives

Expanding its traditional role in ensuring financial companies' safety and soundness, the Federal Reserve has proposed guidance<sup>1</sup> that would impose an unprecedented level of influence over compensation practices of certain banking organizations. Although focused on institutions regulated by the Federal Reserve, the new rules are likely to eventually affect every U.S. banking organization. Banking organizations covered by the guidance should immediately begin establishing a process to review and, as needed, restructure their incentive programs to conform to what are intended to become industry-wide best practices.

In a nutshell, the proposed regulations:

- Are intended to force improvement to any incentive compensation arrangements (ICAs) deemed contrary to the safety and soundness of banking organizations
- Apply to incentive programs for executive and non-executive employees
- Are based on three guiding principles
  - Balanced risk-taking incentives
  - Effective controls and risk management
  - Strong corporate governance
- Call for the Fed to review ICAs at 28 "large complex banking organizations" (LCBOs)
- Require community and regional banks to conduct risk assessment reviews that include analysis of their ICAs

The Federal Reserve has invited public comment until November 27, 2009, with the final guidance becoming effective as of the date it is adopted in its final form. However, the regulators expect all banking organizations subject to the guidance to begin evaluating their ICAs and related risk management, control and corporate governance processes to address deficiencies related to safety and soundness.

The new guidance is generally consistent with other governmental compensation initiatives such as those being considered by Congress and the Obama Administration's initiatives to reform executive compensation. However, in contrast to other initiatives, the Fed's guidance is more granular in that it provides specific examples, situations and corrective actions that can be implemented.

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<sup>1</sup> See <http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf> for full text of guidance.

***PM&P Observation:*** Unlike the Special Master of Compensation's rulings with respect to certain TARP recipients, the Federal Reserve's guidance does not impose strict limits on levels of compensation. Rather, it presents a principles-based approach to ICAs, eschewing one-size fits all requirements and emphasizing the importance of tailored compensation programs.

### ***Applicability***

The proposed rules would affect "incentive compensation" of "covered individuals" of "bank organizations," each of which is defined as follows:

**Incentive Compensation:** Current or potential compensation that is tied to achievement of one or more specific metrics (e.g., sales, revenue, or income). It excludes any payment that is awarded solely for, and is contingent on, continued employment (e.g., salary).

**Covered Individuals:** Unlike the traditional SEC and TARP focus on a small group of the senior-most executives, the guidelines cover the ICAs of an expanded group of individuals including:

- Senior executives and others 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)
- Groups of employees with the same or similar ICAs and who, *in the aggregate*, may expose the firm to material amounts of risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk)

***PM&P Observation:*** Carried to its extreme, it is arguable that aggregating the actions of any large group of employees, at any level, could expose a firm to material risk. The Federal Reserve has excluded functions such as tellers, bookkeepers, courier or data processing personnel from coverage, but other functions will need to be scrutinized.

**Banking Organizations:** All banking organizations supervised by the Federal Reserve, 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 United States. It would exclude state-chartered banks that are not members of the Federal Reserve System, although state banking regulators might follow the Federal Reserve's lead.

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

The guidance sets forth three principles for designing and implementing ICAs for banking organizations:

#### **Principle #1: Balanced Risk-Taking Incentives**

ICAs should balance risk and financial results so that covered individuals are not motivated to take excessive risks, based on the following principles:

- *Full Range of Risk:* All risks associated with an employee's activities should be considered, including but not limited to credit, market, liquidity, operational, legal, compliance and reputational risks. Even low probability risks should be considered if they would have highly adverse effects.
- *Time Horizon of Risk:* Similar to the Administration and Treasury's pronouncements over the past year, the Federal Reserve wants banking organizations to consider the time horizon over which those risks may be realized in assessing whether ICAs are balanced. It suggests that short-term financial criteria are inherently flawed.
- *Fixing Unbalanced Arrangements:* The guidance provides tips for balancing arrangements, to be used individually or in combination as appropriate to the situation:
  - Adjusting awards based on risk
  - Deferring payouts (with adjustment for losses during deferral period, or clawbacks)
  - Extending performance periods
  - Flattening the incentive payout curve for higher levels of performance
- *Quantitative Measures:* If available, use quantitative measures of risk and risk outcomes to assess the balance of ICAs. The use of scenario analysis (i.e., evaluation of payments on a forward-looking basis based on a range of performance levels, risk outcomes, and levels of risks taken) is encouraged to help assess whether certain ICA features are likely to achieve balance over time.
- *Risk Motivating Factors:* Eliminate ICA design features that might encourage undue risk-taking behavior, including:
  - Where incentive compensation is a large portion of total compensation
  - Where substantially all of a covered individual's potential incentive compensation is paid even when risk, or risk outcomes, are materially worse than expected
  - Where a covered employee's incentive compensation payments are closely tied to business generated by the employee (versus basing payments on measures such as firm-wide profit that are only distantly linked)

**PM&P Observation:** Ironically, some of the factors the Federal Reserve ties to adverse risk-taking are often cited as promoting a pay-for-performance philosophy.
- *Tailored Programs:* Balancing risk is not a one-size-fits-all process. ICAs should be tailored to different employees – including the substantial differences between senior executives and other employees – and different banking organizations. For example, a deferred ICA equity payout may help reduce risk-taking among senior executives who have a material effect on the overall financial performance of the firm. However, it may be less effective for lower-level employees who do not think their actions materially affect the organization's stock price.

- *Golden Parachute Arrangements:* Providing windfalls upon termination of employment or change-in-control may encourage undue risk-taking by essentially providing a safety net against risky outcomes. Such arrangements should be carefully reviewed.
- *Communication:* Banking organizations should effectively communicate to employees the ways in which ICAs and payments will be reduced as risks increase. The sophistication of the communication should be tailored to the respective audience.

## **Principle #2: Effective Controls and Risk Management**

Banking organizations should have appropriate controls governing the processes for designing, implementing and monitoring ICAs.

- *Policies and Controls:* Policies and procedures should:
  - Identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of ICAs
  - Identify the source of significant risk-related inputs into these processes and establish appropriate controls over their development and approval
  - Identify the individual(s) and department(s) whose approval is necessary for the establishment of new ICAs or modification of existing arrangements
  - Create and maintain sufficient documentation for an audit of the organization's processes for establishing, modifying, and monitoring ICAs
- *Frequent Reviews, Reporting and Adjustments by Appropriate Personnel:* Regular internal reviews should be conducted by audit, compliance, human resources or other personnel, as appropriate. The results should be reported to management and/or the Board, and ICAs should be monitored and revised as needed.
- *Substance of Review:* A risk assessment process of ICAs should include, but not be limited to:
  - Reviewing the types of risks associated with the activities of employees covered by an ICA
  - Approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements
  - Analyzing risk-taking and risk outcomes relative to incentive compensation payments
- *Adequate and Independent Resources:* The guidelines provide that adequate resources will be needed to implement this principle. Compensation for risk management and control functions should be sufficient to attract and retain qualified employees and avoid a conflict of interest.

### Principle #3: Strong Corporate Governance

Strong and effective corporate governance is needed to ensure sound compensation practices.

- **Board Involvement:** The Board, Compensation Committee or other committee with primary responsibility over compensation should be actively involved in developing and approving ICAs for senior executives and all covered individuals. Those responsibilities include:
  - Monitoring performance and regularly reviewing the design and function of ICAs
  - At least annually, reviewing an assessment by management (with appropriate input from risk-management personnel) of the effectiveness of the design and operation of the ICAs in promoting appropriate risk-taking
  - Examining reviews of ICAs and risk-related payments on a forward- and backward-looking basis, using scenario analysis as appropriate
  - Staying abreast of significant marketplace changes in compensation plan mechanisms and incentives
- **PM&P Observation:** This directive substantially broadens the Board's (or Committee's) historic compensation-related responsibilities from just senior executives to all individuals covered by the guidelines
- **Board Composition and Resources:** The Board should have a separate Compensation Committee that consists solely or predominately of independent Directors. Where feasible, at least one member of the Committee should have expertise and experience in risk management and compensation practices in the financial services industry that is appropriate to the nature, scope and complexity of the organization. The Board should also maintain authority to select, compensate and use outside counsel, independent consultants, or other experts with expertise in incentive compensation and risk management.
- **Disclosure:** Appropriate information concerning ICAs and related risk management, control and governance processes should be provided to allow shareholders to restrain the potential for excess risk. The Federal Reserve intends to work with the SEC to improve banking organizations' compensation-related disclosures.
- **Tailored Governance Programs:** Once again, the Federal Reserve recognizes that a one-size-fits-all approach with respect to corporate governance is not appropriate. For example, LCBOs with many risk-taking employees engaged in diverse activities require a formalized, robust and systemic approach to developing and overseeing their compensation practices. In contrast, smaller regional and community banking organizations should tailor their approaches to their size, complexity, activities, and the prevalence and scope of their own ICAs.

**PM&P Observation:** While larger organizations may be required to do more under the guidance, in most cases they already have the recommended infrastructures in place to satisfy these requirements. In contrast, smaller organizations may face a more onerous task, as they often lack internal resources or have not previously budgeted for funding to retain outside advisors.

## ***Supervisory Initiatives***

The Federal Reserve says it will take two supervisory initiatives 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.”

### **Initiative #1: Horizontal Review of LCBOs**

The Federal Reserve will conduct a formal "horizontal review" of ICAs at 28 LCBOs. This review is designed to: (i) enhance supervisory understanding of current practices; (ii) assess the strength of controls and whether actual payouts under ICAs are effectively monitored; (iii) understand the roles played by various parties; and (iv) identify emerging best practices. The review will be conducted by Federal Reserve Board Staff, working with relevant Federal Reserve Bank supervisors, to create a multidisciplinary group of experts in banking, risk management, finance, law, accounting, and other areas, as appropriate.

LCBOs must provide the Federal Reserve with documentation of: (i) the structure of their current ICAs; (ii) their existing processes to oversee these arrangements; and (iii) the organization's future plans to improve risk sensitivity. The Federal Reserve will work closely with each organization to link planned compensation structures with principles of safety and soundness that can be implemented expeditiously.

If the LCBO fails to submit or develop effective plans, the Federal Reserve may take enforcement or supervisory action such as limiting incentive awards.

### **Initiative #2: Review of Community and Regional Banking Organizations**

ICAs will be examined as part of the regular supervisory reviews for over 6,000 community and regional banking organizations. The reviews will be conducted in connection with the review of each organization's risk management, internal controls and corporate governance processes and will be tailored to reflect the scope and complexity of the bank's activities and scope of ICAs. While the process will be less extensive and formalized than for the LCBOs, the Federal Reserve will take supervisory action against the organization to address deficiencies.

## ***Consequences and Further Actions***

The review findings will be factored into each banking organization's supervisory rating, although the specific results will not be publicly available. As noted above, the Federal Reserve may also take enforcement action if ICAs are deemed to jeopardize an organization's safety and soundness, and the organization does not take prompt remedial actions, including but not limited to development of a corrective action plan.

The Federal Reserve also plans to release a report by the end of 2010 documenting trends and developments in compensation practices at all banking organizations.

## ***Comment Period***

Comments have been requested as to all aspects of the proposed regulations by November 27, 2009. Items for which the Fed seeks comment include:

- Whether the three core principles described in the guidance are appropriate and sufficient to ensure ICAs do not threaten the safety and soundness of banking organizations. Are additional or different principles needed to achieve this goal?
- Whether, and to what extent, current ICAs are consistent with the proposed guidance. Are there any legal, regulatory or other impediments that might delay implementation?
- Whether a more formulaic approach for determining and paying incentive compensation would better promote the long-term safety and soundness of banking organizations.
- Whether "golden parachute" or "golden handshake" arrangements present challenges for banking organizations in developing and maintaining balanced ICAs.
- Whether the proposed guidance would impose undue burdens on banking organizations, particularly regional and small organizations.
- Whether some types of ICAs (e.g., firm-wide profit sharing plans) should be exempted.

## ***Conclusion***

It is unlikely the Fed will depart from its principles-based, flexible and less formulaic approach to compensation. This contrasts sharply with the Financial Stability Board's proposal (recently endorsed by the G-20 leaders), which would impose rigid restrictions on pay such as mandatory deferrals of 40% to 60% of executive bonuses with payouts over a number of years. While the Fed's proposed guidance will entail rigorous review of incentive compensation and ensure strong controls protecting safety and soundness, bank organizations should be relieved that strict pay limits have not been included.

If they have not already begun to do so, banking organizations covered by the guidance should immediately begin establishing a process for review and consider restructuring their ICAs. This may require an overhaul of the institution's overall compensation philosophy, administration and oversight – a time-consuming and costly endeavor for most organizations.

While the Federal Reserve's principles-based guidance is immediately applicable only to the banking organizations specified, it is very likely that these principles will cascade down to all financial organizations, and become part of the list of compensation best practices that have rapidly been developing and evolving over the past year.

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