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Banking Law Alert

Interagency Final Guidance on Incentive Compensation

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On Monday, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation (collectively, the "Agencies") issued final guidance designed to "ensure that incentive compensation arrangements at financial organizations take into account risk and are consistent with safe and sound practices"1 and to "assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes."[2] The Federal Reserve proposed the guidance last year, as discussed in our October 22, 2009 client alert, and was joined by the other banking regulators in issuing the final guidance. The guidance, which applies to all banking organizations that the Agencies supervise, will be effective upon publication in the *Federal Register*.

[1] Federal Reserve, OCC, OTS and FDIC joint press release announcing the final guidance, available at http://www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm.
[2] OCC, Federal Reserve, FDIC and OTS Guidance on Sound Incentive Compensation Policies (final release), available at http://www.occ.gov/ftp/release/2010-68a.pdf.

I. General

Like the proposed guidance, the final guidance applies not only to senior executives, but also to other employees "who, either individually or as part of a group, have the ability to expose the [applicable] banking organization to material amounts of risk." Also like the proposed guidance, the final guidance is organized around three key principles, namely, that to be consistent with safety and soundness, a banking organization's incentive compensation arrangements should: (i) provide employees incentives that appropriately balance risks and rewards; (ii) be compatible with effective controls and risk management; and (iii) be supported by strong corporate governance, including active and effective board oversight. We discuss each of these principles in more detail below.

With respect to smaller banking organizations, the final guidance recognizes that reviews, policies, procedures and systems implemented by various banking organizations will differ based on their scope and complexity as well as the prevalence and scope of their incentive compensation arrangements, and that smaller banking organizations or those with limited incentive compensation arrangements are likely to have policies, procedures and systems in such regard that are "less extensive, formalized, and detailed" than those of large banking organizations. In order to reduce the burden on smaller banking organizations and those that do not have significant incentive compensation arrangements, the guidance, among other things, specifically identifies various policies, procedures and systems that the Agencies expect large, complex banking organizations (and in some cases, those that have significant incentive compensation arrangements), but not other banking organizations, to maintain. In the final adopting release containing the guidance, the Agencies even recognize that the guidance "will generally have less impact on smaller banking organizations, which typically are less complex and make less use of incentive compensation arrangements than larger banking organizations." Further, the Agencies' supervisory review of incentive compensation arrangements and related policies and procedures at such organizations will be part of their regular supervisory review, although, as with all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization and incorporated into the appropriate rating component, including its overall supervisory rating.

Like the proposed guidance, the final guidance does not cap the amount or limit the forms of incentive compensation. The final guidance also includes some important clarifications, including with respect to which jobs or categories of employees have the ability to expose a banking organization to material risk, who qualifies as a "senior executive," and that "incentive compensation" does not include arrangements, like 401(k) plans with an employer contribution based on salary levels, that are based solely on the employees' level or compensation and do not vary based on the organization's performance.

Pursuant to the final guidance, the Agencies expect banking organizations to regularly review their executive compensation arrangements as well as their related risk management, control and governance processes, and address any deficiencies or arrangements or processes inconsistent with safety and soundness.

II. Balanced Risk-Taking Incentives

According to the guidance, "[i]ncentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks." In this regard, incentive compensation arrangements should take into account both the risks (which can include credit, market, liquidity, operational, legal, compliance and reputations risks, among others) and the financial benefits from the applicable employees' activities as well as the impact of such activities on the safety and soundness of the organization. All else being equal, an employee "whose activities create materially larger risks for the organization should receive less [in incentive payments] than" an employee who generates the same amount of revenue or profit while exposing the organization to less risk.

Further, banking organizations need to consider not just the risks associated with an employee's duties, but the time period during which such risks may be realized (short-term vs. long-term). The guidance outlines four non-exclusive methods to make unbalanced incentive compensation arrangements more sensitive to risk when necessary: (i) adjusting the amount of incentive compensation awarded based on measures that take risk into account; (ii) deferring payment of incentive compensation so that the amount paid is adjusted for actual performance; (iii) extending the time period used to determine the incentive compensation payment; and (iv) reducing sensitivity to short-term performance by reducing the rate at which awards increase as higher levels of performance measures are achieved.

Also in this regard, the final guidance discusses the need for incentive compensation arrangements to be tailored to account for differences between senior executives and other employees as well as between banking organizations, the potential for compensation paid upon a change in control of the organization ("golden parachutes") to affect risk taking, and effective communication with employees with respect to the ways in which their incentive compensation can increase or decrease under the organization's programs.

III. Compatibility with Effective Controls and Risk Management

According to the final guidance, "[a] banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements." This goes beyond traditional risk management controls, and includes strong controls governing the process, design, implementation and monitoring of incentive compensation programs and the maintenance of

sufficient documentation to allow their audit. For smaller banking organizations, the guidance anticipates the incorporation of reviews of these processes into their overall compliance monitoring.

It is important that incentive compensation arrangements reflect any downside of risks, such that employees' compensation is reduced when thresholds are not met as well as increased when goals are achieved; employees may be encouraged to take large risks to increase their potential compensation if there is little downside risk to them personally when their risk-taking negatively impacts the organization.

With respect to incentive compensation programs, banking organizations should ensure that the appropriate personnel, including risk-management personnel, have appropriate input into the design and assessment of the organization's incentive compensation arrangements, which personnel should be compensated based on the achievement of their objectives (for example, adherence to internal controls) and not on financial performance. Finally, banking organizations should continually monitor their compensation programs and make adjustments when incentive payments do not appropriately reflect risk.

IV. Strong Corporate Governance

The guidance provides that "[b]anking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors." In this regard, the board should directly approve senior officer compensation arrangements, approve and document any material exceptions or modifications to such arrangements, monitor incentive compensation trends in the industry, and have, or have access to, an appropriate level of risk management expertise and experience, including via outside advisors as appropriate. In addition, a banking organization's disclosure with respect to its incentive compensation practices should support safety and soundness. This includes communications with stockholders to "allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take imprudent risks."

V. Conclusion

The Federal Reserve has completed its first round of in-depth analysis of incentive compensation practices at large, complex banking organizations, which it announced it would undertake when it released the proposed guidance, and the Agencies will be conducting additional reviews going forward. In addition, the Agencies intend to actively monitor actions taken by banking organizations with respect to their incentive compensation arrangements and "will promote further advances in designing and implementing balanced incentive compensation arrangements." The Agencies will also, as appropriate, take supervisory or enforcement action to ensure that material deficiencies that pose safety and soundness concerns are promptly addressed, and will update

the guidance to incorporate "best practices" as they develop. In the meantime, the Agencies expect all "banking organizations to take prompt action to address deficiencies in their incentive compensation arrangements or related risk-management, control, and governance processes." We suggest that any banking organization with any incentive compensation arrangements promptly undertake a review of such arrangements, including their related policies, procedures and systems, and make any necessary revisions to ensure they are in compliance with the final guidance.

This Client Alert contains only a general overview of the Agencies' final guidance with respect to incentive compensation arrangements, and should not be construed as providing legal advice. If you have any questions about the information in this Client Alert, please contact Frank C. Bonaventure at 410.347.7305, Penny Somer-Greif at 410.347.7341, or your Ober|Kaler attorney.

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