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Federal Reserve Board Issues Proposed Guidance on Incentive Compensation

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Overview

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On October 22, 2009, the Federal Reserve Board issued for comment a proposal designed to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of their organizations. The Federal Reserve is taking a flexible approach by not dictating pay or specifying what kind of compensation plans banking organizations must adopt. However, the proposal will create a two-tier system of supervising compensation, using different approaches for 28 of the largest banking organizations and thousands of smaller banks, which would be subjected to a review with their regular bank examinations. The comment period is 30 days after publication of the proposed guidance in the Federal Register, but banking organizations are expected to immediately review their incentive compensation arrangements to ensure that they do not encourage excessive risk-taking and to implement corrective programs where needed.

The proposal arises out of the Federal Reserve's view that inappropriate bonus or other compensation practices can incent senior executives or lower level employees, such as traders or mortgage officers, to take imprudent risks that significantly and adversely affect the firm. As such, the Federal Reserve's guidance and supervisory reviews are intended to cover all employees who have the ability to materially affect the risk profile of an organization, either individually, or as part of a group. However, in contrast with the proposal of the Financial Stability Board (FSB) last month, the Federal Reserve has not suggested the imposition of any pay cap in its proposal. The FSB's proposal, which was set out in a report endorsed by the G-20 leaders, suggested deferral of 40% - 60% of bonuses with payout over a number of years, for executives whose actions may have a material impact on a financial institution's risk profile. The Federal Reserve is of the view that best practices for balancing risk and rewards in incentive compensation programs continue to develop and are likely to evolve significantly in the coming years and that for most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to provide at least some employees with incentives to take excessive risks.

Applicability

This proposal is intended to apply to all banking organizations supervised by the Federal Reserve. This includes U.S. bank holding companies (BHCs), 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. State-chartered banks that are not members of the Federal Reserve System would not be covered, although it is possible that state banking regulators might follow the Federal Reserve's lead.

The Federal Reserve's guidance and supervisory reviews are intended to cover all employees at such banking organizations who have the ability to materially affect the risk profile of an organization, either individually, or as part of a group. This would include senior executives and others who are responsible for oversight of the organization's firm-wide activities or business line as well as non-executive employees whose activities may expose the firm to material amounts of risk. Groups of employees 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 would also be covered by this guidance.

Proposed Supervisory Initiatives

In addition to proposing guidance, the Federal Reserve is commencing the following two supervisory initiatives to spur and monitor the industry's progress towards the implementation of safe and sound incentive compensation arrangements, identifying emerging best practices, and advance the state of practice more generally in the industry.

The first supervisory initiative is applicable to 28 large, complex banking organizations (LCBOs). Each firm's policies and practices will be reviewed to determine their consistency with the principles for risk-appropriate incentive compensation set forth in the proposal. Supervisors will assess these firm-specific policies in a special "horizontal review," a coordinated examination of practices at the 28 firms. The LCBOs will provide the Federal Reserve with information and documentation that clearly describes their plans, including relevant timetables, for improving the risk-sensitivity of incentive compensation arrangements and related risk management, controls and corporate governance practices. Policies and implementing practices adopted by these firms in response to the final supervisory principles will become a part of the supervisory expectations for each firm and will be monitored for compliance.

The second supervisory initiative calls for supervisors to review compensation practices at regional, community and other banking organizations not classified as large and complex (non-LCBOs) as part of the regular, risk-focused examination process. These reviews will be tailored to take account of the size, complexity and other characteristics of the banking organization. Similarly, for foreign banking organizations (FBOs), the management of U.S. operations will be assessed with regard to the consistency of incentive compensation arrangements and related processes with the principles set forth in this guidance, taking into account the size and complexity of U.S. operations. (See SR letter 08-9, Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations (Oct. 16, 2008).)

The findings from these reviews will be incorporated, as appropriate, into the banking organization's rating component(s) and subcomponent(s) relating to risk management, internal controls and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating. Such supervisory ratings can affect the organization's ability to make acquisitions or take other actions. In appropriate circumstances, the Federal Reserve may take enforcement action against a banking organization and require such organization to develop a corrective action plan to rectify deficiencies in its incentive compensation programs and processes.

If you have any questions pertaining to this alert, please feel free to call Barbara R. Mendelson at (212) 468-8118 or Judy Mok at (212) 336-4073.