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Legal News

Interagency Guidance on Incentive Compensation

by Jean C. Brooks

The Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation (the "Agencies") recently issued its "Final Guidance on Sound Incentive Compensation Policies" (the "Guidance").

Intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes, the Guidance will form the basis for supervisory examinations of a banking organization's incentive compensation practices and will influence CAMELs ratings.

WHAT AND WHO IS AFFECTED

1. Banking Organizations

The Guidance applies to:

- National banks
- State member banks
- State non-member banks
- Savings associations
- U.S. bank holding companies
- S&L holding companies
- Edge and agreement corporations
- U.S. operations of foreign banking organizations with a branch, agency or commercial lending company in the U.S.

Excluded organizations:

- Credit unions
- Insurance companies
- Mortgage companies
- Broker dealers
- Other entities not regulated by the Agencies

The Guidance places additional requirements on "Large Banking Organizations ("LBO"). LBOs are those classified as "large, complex banking organizations" for supervisory purposes by the Agencies.

The Agencies believe that LBOs and other significant users of incentive compensation warrant the most intensive supervisory attention because flawed compensation arrangements at these organizations are more likely to adversely effect the broader financial system. While each Agency has its own definition of "large and complex", LBOs will most likely include the top 25-30 insured depository institutions (ones with the most assets) and the 25-30 largest and most complex bank holding companies.

The additional requirements for LBOs are woven throughout the Guidance. They are discussed in a separate addendum to this document.

2. Affected Personnel

The Guidance applies broadly to incentive compensation for executive and non-executive employees who, individually or as a group, are in a position to expose an organization to material risks.

- Senior executive officers 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

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may expose the organization to material amounts of risk; and

- Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization 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).

3. Incentive Compensation

In the Guidance, 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.*, level of sales, revenue or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (*e.g.*, salary). In addition, the term does not include compensation arrangements that are determined based solely on an employee's level of compensation and does not vary based on one or more performance metrics (*e.g.*, a 401(k) plan under which the organization contributes a set percentage of an employee's salary). However, broad-based pension plans may be considered incentive plans if contributions or benefits are based on a formula that includes stock compensation or performance-based cash awards.

PRINCIPLES OF A SOUND COMPENSATION SYSTEM

The Guidance consists of three principles rather than specific rules. Under the Guidance, to be consistent with safety and soundness, incentive compensation arrangements at a banking organization should:

- Provide employees incentives that appropriately balance risk and reward;
- Be compatible with effective controls and risk management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

The Guidance requires every banking organization to evaluate its incentive compensation for <u>all</u> employees who, individually or as part of a group, have the ability to expose the organization to material amounts of risks and to evaluate the risk management, control and corporate governance processes related to the incentive compensation arrangements. Incentive compensation must be developed and implemented in a manner consistent with safe and sound business practices even if this conflicts with stockholders' appetites for higher returns that may be generated by higher risk taking by a banking organization's employees.

1. Principle 1 – Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk.

- *Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized.*
  - » risks include credit, market, liquidity, operational, legal, compliance and reputational
  - » risks that have a low probability of being realized but would have highly adverse effects on the organization and risks that do not have reliable quantitative measures must be considered

- *An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.*
  - » adjustment of awards based on measures that take into account the risk that employee activities may pose to the organization
  - » deferral of payment of the award significantly beyond the end of the performance period with adjustments for actual losses or other aspects of performance that are realized or become better known only during the deferral period (often this method is referred to as a "clawback")
  - » longer performance periods which provide for payments to be made after some or all risk outcomes are realized or better known
  - » reduced sensitivity to short-term performance achieved by reducing the rate at which awards increase as an employee reaches relevant performance measures
  - » reduced reliance on incentives based on reaching high targets or stretch goals that may encourage imprudent risk taking

- *The manner in which a banking organization seeks to achieve balanced incentive compensation*

arrangements should be tailored to account for the differences between employees – including the substantial differences between senior executive and other employees – as well as between banking organizations.
  - » risks associated with one group of non-executive employees (*e.g.*, loan originators) may differ significantly from those of another group (*e.g.*, traders) within the organization
  - » equity-based incentives may be more helpful in restraining the risk-taking incentives of senior executives, especially if the payments are for a multi-year period and there is a clawback for performance

- *Banking organizations should carefully consider the potential for "golden parachutes" and vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organization.*
  - » severance payments, "golden parachutes" and other payout arrangements that provide an employee with a guaranteed payment upon departure from the organization regardless of performance, may encourage excessive risk-taking and the organization should consider balancing features to mitigate the potential for imprudent risk taking
  - » banking organization must take into account the effect of so-called "golden handshakes" which are make-whole arrangements offered by a successor employer

- *Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.*

2. Principle 2 – Compatibility with Effective Controls and Risk Management.

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

- *Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk-management and other functions.*
  - » create and maintain sufficient documentation to permit an audit of the effectiveness of the organization's processes for establishing, modifying and monitoring incentive compensation arrangements
  - » smaller organizations should incorporate reviews of these processes into their overall framework for compliance monitoring

- *Appropriate personnel, including risk management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.*
  - » risk management, internal control, human resources, and finance functions can all play a roll in ensuring incentive compensation arrangements are balanced

- *Compensation for employees in risk-management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.*
  - » to preserve independence, the incentive compensation received by risk-management and control function personnel should be based on the achievement of their functions rather than on the financial performance of the business unit or organization

- *Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.*

3. Principle 3 – Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices including active and effective oversight by the board of directors.

- *The Board of Directors should monitor the performance and regularly review the design and function of incentive compensation arrangements.*
  - » the board should receive data and analysis from management or other sources that are sufficient to allow the Board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness
  - » the board should closely monitor the incentive compensation of the senior executives and the sensitivity of those payments to risk outcome
  - » if arrangements include a claw back provision the board's review should include

whether the provision has been triggered and executed as planned
   - » the board should stay abreast of significant and emerging changes in compensation plan mechanisms and incentives in the market place as well as academic research and regulatory advice regarding incentive compensation plans

- *The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.*
   - » the board should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for its organization's activities
   - » the level of expertise may be present collectively from among the board members, may come from formal training or experience or may be obtained through advice from outside advisors

- *A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.*
   - » enough information about the organization's incentive compensation arrangements and related risk-management, control and governance processes should be provided to shareholders to allow them to monitor and take actions to restrain the potential for such arrangements to encourage employees to take imprudent risks

WHAT YOU NEED TO DO NOW

Because the Guidance will be the basis for regulatory examinations of a banking organization's incentive compensation arrangements and practices, the results will influence CAMELs ratings and, moreover, its deposit insurance assessment rates, eligibility for expedited treatment for regulatory applications and approval and exposure to enforcement actions. The Agencies have said that they expect banking organizations to address deficiencies in their incentive compensation and related risk-management and control and governance processes promptly.

What to do now:

- Educate the board of directors and the compensation committee of their new responsibilities under the Guidance.
   - » actively oversee incentive compensation arrangements
   - » evaluate whether these arrangements jeopardize the banking organizations safety and soundness
   - » review the design and function of incentive compensation arrangements regularly

- Identify and address any policies, procedures and processes that may be necessary to rectify any deficiencies in the banking organization's incentive compensation arrangements.

CONCLUSION

The Guidance will require virtually every banking organization regulated by any of the Agencies to examine, and where necessary, adjust their incentive compensation arrangements, programs, plans and practices. The level of effort will vary based on an organization's size, complexity and extent of use of incentive compensation.

The Agencies intend to actively monitor the actions taken by banking organizations in this area and intend to promote further advances in designing and implementing balanced incentive compensation arrangements. Where appropriate, the Agencies intend to take supervisory or enforcement action to ensure that material deficiencies that pose a threat to the safety and soundness of the organization are promptly addressed. Consequently, every banking organization should begin immediately to review its incentive compensation in whatever form and carefully document their analysis, determinations and actions in anticipation of their next regulatory exam.

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Should you have any questions about how the Guidance will affect you and your business, please contact one of the attorneys in our financial institutions practice. They may be reached by calling the Greensboro office at (336) 373-8850 or the Raleigh office at (919) 839-0300.

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Addendum to Interagency Guidance on Incentive Compensation: Requirements for LBOs and Significant Users of Incentive Compensation

by Jean C. Brooks

The following specific requirements are imposed on LBOs and other significant users of incentive compensation:

- Use simulation modeling in advance of implementing incentive compensation arrangements to evaluate likely effectiveness and to ensure the arrangements are risk-balanced.

- Actively monitor new developments in the field of incentive compensation and incorporate new incentive compensation systems or practices to improve the organization's long-term financial well-being and safety and soundness.

- Monitor the effects of golden handshakes to determine whether they are materially weakening the organization's efforts to constrain risk-taking incentives.

- Balance risk and reward by (i) deferral of incentive compensation over a multi-year period that reduces the amount of payment received in the event of poor performance; (ii) substantial use of multi-year performance periods; and (iii) payment in the form of equity-based instruments. (These methods are encouraged but not required by the Guidance.)

- Develop and maintain policies that (i) describe the roles of the personnel involved in the design, implementation and monitoring of incentive compensation arrangements; (ii) identify the source significant risk-related inputs into in the process of design, implementation and monitoring of incentive compensation and establish controls to govern the processes to ensure their integrity; (iii) identify the individuals and control units whose approval is necessary for the establishment of new incentive compensation arrangements or modifications of existing arrangements; (iv) conduct internal reviews by audit, compliance or other personnel to ensure the organization's processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed; and (v) separately conduct audits by the organization's internal audit department of compliance with the organization's established policies and controls relating to incentive compensation arrangements and report findings to management and the board of directors (where appropriate).

- Active oversight by the board of directors of the development and operation of the organization's incentive compensation arrangements and systems and related control processes.

- Review by the board of directors of the overall purposes and goals of the organization's incentive compensation system and provide clear direction to management to ensure goals are carried out in a manner that achieves balance and is consistent with safety and soundness.

- Review by the board of directors no less frequently than annually an assessment by management (with appropriate input from risk-management personnel) of the effectiveness of the design and implementation of the incentive compensation arrangements in balancing risk-taking incentives with safety and soundness. These reports should contain backward-looking analysis of whether the incentive compensation arrangements may be promoting imprudent

risk-taking and forward-looking simulation analysis based on a range of performance levels, risk outcomes and the amount of risk taken.

- Establish a separate, independent compensation committee or ensure that non-executive directors play an active role in the oversight of incentive compensation systems. The compensation committee should work closely with risk and audit committees where the substance of their work overlaps.

- Adopt and follow formal, written policies to:

  » identify employees eligible to receive incentive compensation and whose activities may expose the organization to material risk;

  » identify types and time horizons of risk;

  » assess the potential for the performance measures included in the employees' incentive compensation arrangements to encourage the employees to take imprudent risks;

  » include balancing elements – risk adjustments or deferral periods – within the incentive compensation arrangements that reasonably ensure that the incentive compensation arrangement is risk-balanced;

  » communicate to employees the ways in which their incentive compensation will be adjusted to reflect the risks of their activities to the organization; and

  » monitor incentive compensation awards, payments, risks taken and risk outcomes and modify the arrangements if they are not sensitive to risk and risk outcomes.