U.S. Banking Regulators Issue Final Guidance on Incentive Compensation

SUMMARY
On June 21, 2010, 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 jointly issued comprehensive final guidance designed to ensure that incentive compensation policies do not undermine the safety and soundness of banking organizations by encouraging employees to take imprudent risks. The Guidance finalizes the proposal issued by the Federal Reserve in October 2009.

The Guidance, which is effective today, applies to all banking organizations supervised by the Federal Reserve, the OCC, the OTS or the FDIC, including national banks, state member banks, state nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, Edge and agreement corporations and the U.S. operations of foreign banking organizations with a branch, agency or commercial lending company in the United States (each a “banking organization”). Like the Proposal, the Guidance covers executive and non-executive employees who, either individually or as part of a group, have the ability to expose the banking organization to material amounts of risk.

The Guidance continues the principles-based approach set out in the Proposal and does not prohibit or limit any particular type of incentive compensation. The three guiding principles remain basically the
same. To be consistent with safety and soundness, incentive compensation at banking organizations should:

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

Although the Guidance is very similar to the Proposal, key differences are:

- Greater emphasis on the potential need for specifically tailored arrangements depending on a particular employee’s or group’s ability to expose the organization to risk (noting that a “one-size-fits-all” approach is unlikely to achieve an appropriate balance).
- A warning that strong and active risk management procedures and controls do not obviate the need for the proper risk/reward balancing to be an integral part of incentive compensation arrangements.
- A clarification of the Agencies’ expectations that the impact of the Guidance will vary based on an organization’s size, complexity and use of incentive compensation (in this regard, large banking organizations, called “LBOs”, and other banking organizations that are significant users of incentive compensation will be expected to have a more systematic and formalized approach to compliance).
- Additional reinforcement of the need for active and effective board of director oversight of compensation practices.

The Agencies state that they expect to continue monitoring and assessing incentive compensation arrangements as experience, studies and development of best practices warrant. In this regard, the press release announcing the Guidance noted that the Federal Reserve’s initial “horizontal review” of the incentive compensation arrangements at large, complex banking organizations will result in follow-up in a number of areas of perceived deficiencies communicated to these firms, such as: the processes to identify the employees whose incentive compensation could pose risks; the methods used to risk-adjust compensation; the use of “one-size-fits-all” deferral arrangements not tailored to the type or duration of risks; and inadequate systems to evaluate outcomes. We expect that the scope and application of the Guidance will be clarified through the horizontal review and the examination processes.

I. BACKGROUND

The Guidance is based on the view that “incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007” and that “aligning employee incentives with the interests of shareholders is not always sufficient to address safety-and-soundness
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concerns.” The Guidance is “designed to help ensure that incentive compensation policies at banking organizations do not encourage imprudent risk-taking and are consistent with the safety and soundness of the organization” and will be the basis for supervisory findings (and potential enforcement actions) related to a banking organization’s incentive compensation practices. Like the Proposal, the Guidance is designed to be consistent with the Financial Stability Board’s *Principles for Sound Compensation Practices* issued in April 2009 and its *Implementation Standards* for those principles issued in September 2009.  

II. THE GUIDANCE

A. INCENTIVE COMPENSATION PRINCIPLES

The Guidance sets forth three key principles to help ensure that incentive compensation arrangements do not encourage employees to take imprudent risks that are inconsistent with the safety and soundness of banking organizations. The three principles provide that a banking organization’s incentive compensation arrangements should:

- *Provide incentives that do not encourage employees to expose their organizations to imprudent risks.* This principle was reworded from the Proposal, which provided that banking organizations should provide employees incentives that do not encourage imprudent risk-taking “beyond the organization’s ability to effectively identify and manage risk.” The deletion of the quoted language was “made to clarify that risk-management procedures and control functions that ordinarily limit risk-taking do not obviate the need to identify covered employees and to develop incentive compensation arrangements that properly balance risk-taking incentives.” This principle is discussed further in Section II.C below.

- *Be compatible with effective internal controls and risk management.* This principle is discussed further in Section II.D below.

- *Be supported by strong and effective corporate governance, including active and effective oversight by the organization’s board of directors.* This principle is discussed further in Section II.E below.

The Agencies expect all banking organizations to review regularly their incentive compensation arrangements based on these three principles. Where there are deficiencies in the incentive compensation arrangements, they should be promptly addressed. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management


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June 25, 2010
control or governance processes, pose a risk to the organization’s safety and soundness, particularly if the organization is not taking prompt and effective measures to correct the deficiencies. Like the Proposal, the Guidance adopts a principles-based approach rather than a prescriptive or formulaic approach, and does not impose specific requirements, such as mandatory pay caps, clawbacks or allocation between cash and equity, or prohibit specific forms of compensation, such as golden parachutes or golden handshake arrangements. The Guidance does, however, discuss considerations relevant to the development and implementation of these and other arrangements.

Consistent with the Proposal, the Guidance broadly defines “incentive compensation” as that portion of an employee’s current or potential compensation that is tied to achievement of one or more specific metrics, such as sales, revenue or income. “Incentive compensation” does not include compensation tied solely to continued employment, such as salary, or arrangements that are based solely on the employee’s level of compensation and do not vary based upon any performance metric, such as a 401(k) plan under which a banking organization contributes a set percentage of an employee’s salary.

The Guidance expressly differentiates between LBOs and non-LBOs (emphasizing a concept inherent in the Proposal), noting that smaller banking organizations are less complex and less likely to be significant users of incentive compensation and therefore should not be subject to the same burdens as LBOs. Certain of the more significant higher standards imposed on LBOs are noted in the following discussion.

**B. COVERED EMPLOYEES**

Like the Proposal, the Guidance covers all employees who have the ability to subject the organization to material amounts of risk, either individually or as part of a group. The Guidance notes that risks should be considered “material” for this purpose not only if they are material to the organization but also if they are material to a business line or operating unit that is itself material to the organization. This broad view means that risks may be deemed material to an organization in this context even if they are not large enough to threaten the solvency of the organization or otherwise would be viewed as material on a consolidated basis.

In addition, in determining whether an employee or group of employees may expose a banking organization to material risk, the organization should consider the full range of inherent risks arising from

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3 For purposes of the Guidance, LBOs include: (i) in the case of banking organizations supervised by the Federal Reserve, large, complex banking organizations as identified by the Federal Reserve for supervisory purposes; (ii) in the case of banking organizations supervised by the OCC, the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (iii) in the case of banking organizations supervised by the FDIC, large complex insured depository institutions; and (iv) in the case of banking organizations supervised by the OTS, the largest and most complex savings associations and savings and loan holding companies.
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the employee’s activities, even if risk-management processes limit the risks such activities ultimately may pose. The Guidance provides that, regardless of the quality of risk management, poorly designed or managed incentive compensation arrangements may be a source of risk for a banking organization.

More specifically, covered employees are those who fall into one of the following three groups:

- Senior executives and other employees who are responsible for the oversight of the organization’s firm-wide activities or material business lines. The Guidance provides that “senior executives” include, at a minimum, “executive officers” within the meaning of Federal Reserve Regulation O4 and, for publicly traded companies, “named executive officers” within the meaning of the SEC proxy rules.5 The Guidance directs savings associations to the OTS’s rule on loans by savings associations to their executive officers, directors and principal stakeholders for guidance in determining their “senior executives.”6

- Individual employees, including non-executive employees, whose activities may expose the banking organization to material amounts of risk. An example cited in the Guidance is traders with large positions relative to the banking organization’s overall risk tolerance.

- Groups of employees who are subject to 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 a material amount of risk. An example cited in the Guidance is loan officers who, as a group, originate loans that account for a material amount of the organization’s credit risk.

The Guidance does not explicitly exclude any class of employees from coverage by the Guidance, but it does recognize that, depending on the facts and circumstances of the individual organization, bank

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4 For purposes of the Federal Reserve’s Regulation O, “executive officers” means those individuals who participate or have authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank, whether or not: the officer has an official title; the title designates the officer an assistant; or the officer is serving without salary or other compensation. The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a company or bank are considered “executive officers,” unless the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate in major policymaking functions of the bank or company. “Executive officers” is not intended to include persons who may have official titles and may exercise a certain measure of discretion in the performance of their duties, including discretion in the making of loans, but who do not participate in the determination of major policies of the bank or company and whose decisions are limited by policy standards fixed by the senior management of the bank or company.

5 For purposes of the SEC’s proxy rules, “named executive officers” includes: all individuals serving as the company’s principal executive officer or principal financial officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; the company’s three other most highly compensated executive officers who were serving as executive officers at the end of the last completed fiscal year; and up to two more individuals for whom disclosure would have been provided as one of the next three highest paid but for the fact that the individual was not serving as an executive officer of the company at the end of the last completed fiscal year. See Item 402(a)(3) of the SEC’s Regulation S-K.

6 See 12 C.F.R. § 563.43.
tellers, bookkeepers, couriers and data processing personnel would likely not expose the organization to material risks.

C. BALANCED RISK-TAKING INCENTIVE COMPENSATION ARRANGEMENTS

Under the first principle, incentive compensation arrangements should “balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.” A balanced incentive compensation arrangement is described as an arrangement that takes into account the risks (including compliance risks) and financial benefits from the employee’s activities and the impact of those activities on the banking organization’s safety and soundness. As in the Proposal, the Guidance uses the example of two employees who generate the same amount of short-term revenue or profit where the risks taken to generate that revenue or profit differ materially; the Guidance provides that, all else being equal, the employee whose activities created materially greater risks should receive less incentive compensation.

To determine whether incentive compensation arrangements appropriately balance risk and reward, the Guidance, like the Proposal, provides a number of guidelines:

- Banking organizations should consider the full range of risks (including, credit, market, liquidity, operational, legal, compliance and reputational) associated with an employee’s activities, as well as the time period over which the risks may be realized.
- The relevant time horizon for a risk outcome may extend beyond the stated maturity of an exposure and special attention should be directed to “bad tail” risks (i.e., those that have a low probability of being realized but have highly adverse effects if they are).
- There is an important distinction between “reliable” quantitative measures that are available for some risks and “informed judgment” that is used for other risks. In the latter case, there is a need for strong policies and procedures, internal controls and ex post facto monitoring. Also, the Guidance makes it clear that there must be policies and procedures that describe how any judgment should be exercised to achieve balance.
- Unbalanced incentive arrangements may be moved toward balance by a variety of methods, including:
  - risk-adjusting the payments;
  - deferring payment so as to adjust actual payments based on actual outcomes;
  - lengthening performance periods; and
  - reducing sensitivity to short-term performance, including reducing the rate at which awards increase as higher levels of performance are achieved.
- Incentive arrangements should take into account differences among employees, particularly the difference between senior executives and other employees. In this regard, the Guidance notes that equity compensation may not be expected to be as effective in restraining risk incentives for lower level employees as for senior executives, because lower level employees may be unlikely to believe that their actions will materially affect the organization’s stock price.
- Careful consideration should be given to how “golden parachutes” and the vesting of deferred compensation may affect risk-taking behavior. The Guidance suggests that an appropriate
risk-balancing safeguard for “golden parachutes” may include deferral requirements past an employee’s departure from the banking organization.

- Banking organizations should effectively communicate to employees the ways that incentives will be reduced as risks increase.

The Guidance specifically addresses balanced risk-taking incentive compensation arrangements for LBOs and sets forth a number of guidelines only for LBOs:

- LBOs should consider using simulation analyses to assess in advance of implementing an incentive compensation arrangement (or modifications to an existing arrangement) whether the arrangement is likely to provide balanced risk-taking incentives.
- LBOs should actively monitor industry developments in incentive compensation arrangements and practices and should incorporate new developments into their organizations that are likely to improve the organization’s long-term financial well-being, and safety and soundness.
- Incentive compensation arrangements for senior executives at LBOs are likely to be better balanced if they involve deferral of a “substantial portion” of incentive compensation over a multi-year period and payment of a “significant portion” in equity-based instruments vesting over multiple years.
- “Golden handshake” arrangements (that is, those offered by subsequent employers to compensate employees for forfeited awards from a prior employer) should be monitored to determine whether they are weakening the banking organization’s efforts to limit risk-taking incentives. In particular, the Guidance states that provisions that require a departing employee to forfeit deferred incentive compensation payments may also weaken the effectiveness of a deferral arrangement if the departing employee is able to negotiate a “golden handshake” arrangement with the employee’s new organization. The Agencies state that they will continue to work with banking organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

D. COMPATIBILITY WITH EFFECTIVE CONTROLS AND RISK MANAGEMENT

Under the second principle, a banking organization’s risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements. The Guidance advises that:

- Appropriate controls should be in place to ensure that the processes for achieving balanced incentives are followed and to maintain the integrity of the risk management function. A banking organization should create and maintain sufficient documentation to permit an audit of the banking organization’s processes for establishing, modifying and monitoring incentive compensation arrangements.
- Risk management employees and other appropriate personnel should have input into the organization’s processes for designing incentive compensation arrangements and assessing effectiveness in limiting imprudent risk-taking.
- Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified employees and avoid conflicts of interest (including by not having their incentives based substantially on the financial performance of the units that they review).
• Incentive arrangements should be monitored and modified to the extent necessary to provide balanced incentives.

LBOs should also have policies that:

• Identify and describe the roles of the personnel, business units and control units authorized to be involved in designing, implementing and monitoring incentive compensation.

• Identify the source of significant risk-related inputs and develop controls governing the development and approval of these inputs to help ensure their integrity.

• Identify individuals and control units whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements.

In addition to regular internal reviews to ensure the processes for achieving balanced incentive compensation arrangements are followed, LBOs should also conduct regular internal audits of their incentive compensation arrangements and report the results of the audits to management and, where appropriate, to the board of directors.

E. EFFECTIVE CORPORATE GOVERNANCE

Under the third principle, 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. This principle primarily relates to the role of the banking organization’s board of directors and board committees but also includes guidance related to processes for designing incentive compensation and disclosure to shareholders of pay practices. The Guidance states that:

• The board\textsuperscript{7} should regularly review the design and function of incentive compensation arrangements. The board should directly approve incentive compensation arrangements for senior executives, and approve and document material exceptions, and should monitor incentive compensation payments to senior executives and the sensitivity of those payments to risk. If “clawbacks” are applicable to senior executives, the board’s review should include sufficient information to determine if the provision was triggered and properly enforced. Directors should stay up-to-date with emerging changes to the compensation arrangements in the marketplace and incorporate new developments to the extent they are appropriate for the banking organization.

• The directors should have the organization, composition and resources in order to permit effective oversight of incentive compensation. In an important difference from the Proposal, the Guidance does not mandate that one or more members of the board of directors have experience and expertise in risk management and compensation practices. Rather, the Guidance recognizes that the knowledge necessary for implementing sound compensation

\textsuperscript{7} The Guidance uses the term “board of directors” to mean the members of the board of directors who have primary responsibility for overseeing the incentive compensation system, which could be the entire board, the compensation committee of the board or another committee of the board. In the case of foreign banking organizations, the term refers to the relevant oversight body for the organization’s U.S. operations, consistent with the organization’s overall corporate and management structure.
practices may be present collectively among the members of the board, may come from formal training or from experience in addressing these issues, including as a director, or may be obtained through advice from outside advisors, such as outside counsel, consultants or other experts with expertise in incentive compensation and risk management.

- Disclosure to shareholders of incentive compensation arrangements should appropriately describe such arrangements and related risk management, control and governance processes to allow shareholders to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take imprudent risks. The disclosure should include information relevant to employees other than senior executives. While the Guidance notes that banking organizations should also comply with the incentive compensation disclosure requirements of the SEC, if applicable, the Guidance is unclear whether the disclosure requirements of the Guidance go beyond those of the SEC.

The Guidance also prescribes additional requirements for LBOs, as well as non-LBOs that “are significant users of incentive compensation.” The boards (or compensation committees) of these banking organizations should:

- “[R]evue and approve the overall goals and purposes of the organization’s incentive compensation system” and give “clear direction to management to ensure that the goals and policies it establishes are carried out in a manner that achieves balance and is consistent with safety and soundness.”

- Review, at least annually, assessments by management, with appropriate input from risk management personnel, of the effectiveness of the design and operation of the organization’s incentive compensation system, including an evaluation of whether or how incentive compensation practices may increase the potential for imprudent risk-taking. The board should also receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to assess the appropriateness of the organization’s incentive compensation arrangements, and should consider obtaining periodic reports that simulate compensation on a forward-looking basis based on a range of performance levels, risk outcomes and amount of risk taken.

- Consider establishing a compensation committee composed solely or predominately of non-executive directors. If a compensation committee is not in place, take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems.

- Use a systematic approach to developing a compensation system supported by robust and formalized policies, procedures and systems.

F. FOREIGN BANKS

As noted above, the Guidance applies to the U.S. operations of a foreign banking organization with a branch, agency or commercial lending company in the United States. The incentive compensation policies of the U.S. operations of foreign banks should be:

- Coordinated with the bank’s group-wide policies.

- Developed in accordance with the rules of the bank’s home country supervisor.

- Consistent with the bank’s overall corporate and risk management structure and controls.
III. CONCLUSION AND FUTURE GUIDANCE

The Guidance states that the Agencies are committed to ensuring that banking organizations incorporate the three basic principles into their incentive compensation policies. To that end, the Federal Reserve, together with the OCC, OTS and the FDIC, is continuing to work on its horizontal review of the incentive compensation policies and arrangements of LBOs, which was first announced in the Proposal. The incentive compensation policies and arrangement of non-LBOs will also be reviewed, but the review will be “scaled appropriately to the size and complexity of the organization and its incentive compensation arrangements.” In addition, the Guidance states it will be updated as best practices emerge from these reviews or otherwise.

We expect that the obligation under the Guidance for directors to monitor developments in compensation arrangements, together with the results of the horizontal review and ongoing examinations, will cause compensation practices to evolve in response to the Guidance over time.

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June 25, 2010

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