LUSE GORMAN

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LEGAL UPDATES AND NEWS

Inter-Agency Guidance on Sound Incentive Compensation

The Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of Thrift Supervision ("OTS") (collectively, the "Agencies") issued final Guidance (the "Guidance") regarding incentive compensation arrangements at banking organizations. The Guidance was originally proposed by the Federal Reserve in October 2009. The Guidance is intended to ensure that incentive compensation arrangements do not provide incentives for employees to take risks that may jeopardize the safety and soundness of the organization.

According to the Guidance, the analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to the size, complexity, business strategy and risk tolerance of each organization. The policies, procedures and systems of small banking organizations that use incentive compensation arrangements are expected to be less extensive, formalized and detailed than those for large banking organizations ("LBOs").[1] For all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization and included in the report of examination and incorporated into the supervisory rating system and the organization's overall supervisory rating. For smaller banking organizations, the expectation is that there will be very limited, if any, targeted examination work or supervisory follow-up.

Applicability of the Guidance

The Guidance applies to all banking organizations regulated by the Agencies, including national banks, state member banks, state nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, the U.S. operations of foreign banks with a branch, agency or commercial lending company subsidiary in the United States (collectively, "banking organizations"). However, the Guidance is expected to have less impact on smaller banking organizations, which typically are less complex and make less use of incentive compensation arrangements than LBOs.

The Guidance applies to incentive compensation arrangements for executive officers and for other employees who have the ability to expose the organization to material amounts of risk. These executive officer and non-executive personnel are referred to in the Guidance as "covered employees" and include:

- Senior executives 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 may expose the firm to material amounts of risk; and

[1] LBOs include, in the case of banking organizations regulated by: (i) the Federal Reserve, large, complex banking organizations as identified by the Federal Reserve for supervisory purposes; (ii) the OCC, the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (iii) the FDIC, large complex insured depository institutions; and the OTS, the largest and most complex savings associations and savings and loan holding companies. The term "smaller banking organizations" refers to banking organizations that are not LBOs under the relevant agency's standards.

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

The Guidance is "principles based" and does not impose salary caps or limits on compensation arrangements. The Guidance applies solely to incentive compensation, defined as the portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income) and would include bonuses, stock awards and deferred compensation awards. Incentive compensation does not include compensation (such as salary) that is awarded solely for, and the payment of which is tied to, continued employment. In addition, the term does not include compensation arrangements that are determined solely on the employee's level of compensation and does not vary based on one or more performance metrics (*e.g.*, a 401(k) plan). Moreover, the Guidance states that incentive arrangements that provide for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives.

The Federal Reserve's Three Principles of Sound Incentive Compensation

To be consistent with safety and soundness, incentive compensation arrangements at a banking organization should:

- Balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks;
- 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.

Principle 1: Balanced Risk-Taking Incentives

- Incentive arrangements are "balanced" when the amounts paid appropriately take into account the risks, as well as the financial benefits, from the employee's activities and the impact of those activities on a company's safety and soundness.
  - E.g., two employees who generate the same amount of revenue/profit should not receive the same amount of incentive compensation if the risks related to the activities are materially different, *i.e.,* greater risk, less incentive compensation.
- Banking organizations should consider the full range of risks associated with an employee's activities (e.g., credit, market, liquidity, operational, legal, compliance and reputational risks), as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.
  - E.g., future revenues that are booked as current income may not materialize and profit-and-loss measures may not appropriately reflect differences in risks associated with revenue from different sources.
  - The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations should ignore such risks or outcomes for purposes of assessing whether the incentive arrangement achieves balance.
- The Guidance identifies four methods currently in use to make incentive compensation more sensitive to risk:

- Risk adjustment of awards;
- Deferral of payment;
- Longer performance periods; and
- Reduced sensitivity to short-term performance.

- The greater the potential incentives an arrangement creates for employees to increase the risks associated with the employee's activities, the stronger the effect should be of the methods applied to achieve balance.

  - The Guidance notes that performance targets may have a material effect on risk-taking incentives, may offer greater rewards for increments of performance that are above target and may motivate employees to take imprudent risk to reach performance targets that are aggressive, but potentially achievable.

- The manner in which a banking organization achieves balanced incentive compensation arrangement should be tailored to account for the differences between employees – including the differences between senior executives and other employees – as well as between banking organizations (one size does not fit all).

  - E.g., the payment of deferred incentive compensation in equity may be effective in restraining risk-taking initiatives by senior executives whose activities are perceived to have a material effect on the overall performance of the firm, but less effective for lower-level employees who are unlikely to believe that their actions will materially affect the firm's stock price.
  - The use of a single, formulaic approach to making incentive compensation arrangements appropriately risk sensitive is likely to provide at least some employees with incentives to take excessive risks.

- Incentive compensation arrangements for senior executives of LBOs are likely to be better balanced if a substantial portion of the incentive compensation is deferred over a multi-year period, or if multi-year performance periods are used, or both, and if a significant portion is paid in the form of equity-based instruments that vest over a multi-year period.

- Banking organizations should carefully consider the potential for golden parachute arrangements and the vesting provisions for deferred compensation to affect risk-taking behavior. Consideration should be given to including balancing features, such as risk adjustment or deferral provisions that extend past the employee's departure.

  - In addition, LBOs have been tasked with monitoring the effect of "golden handshakes," e.g., an arrangement with a new employer to make-up deferred compensation forfeited upon departure from a prior employer, to determine if such arrangements materially weaken the organization's efforts to constrain risk-taking incentives of employees.

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

Principle 2: Compatibility with Effective Controls and Risk Management

- Banking organizations should have appropriate controls to ensure the processes for achieving balanced incentive compensation arrangements are followed and to maintain the integrity of risk management functions.

- ➢ A banking organization should have strong controls governing its process for designing, implementing and monitoring incentive compensation arrangements and should create sufficient documentation to permit an audit of the effectiveness of the organization's processes.
- ➢ Smaller banking organizations should incorporate reviews of these processes into their overall framework for compliance monitoring (including internal audit).
- ➢ Audit, compliance and other personnel of LBOs should conduct regular internal reviews consistent with its overall framework for compliance monitoring to ensure that the LBOs processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed.
- ➢ The results should be reported to the appropriate levels of management, and where appropriate, to the board of directors or compensation committee.

- Risk management procedures and risk controls do not obviate the need for incentive compensation arrangements to properly balance risk-taking incentives.

- Appropriate personnel, including risk management personnel, should have input into the process for designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk taking.

- Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.

  - ➢ The incentive compensation received by risk management and control staff should not be based substantially on the financial performance of the business units they review, but rather on the achievement of the objectives of their function (e.g., adherence to internal controls).

- Performance should be monitored and arrangements revised as needed if payments do not appropriately reflect risk.

  - ➢ A smaller banking organization that uses incentive compensation only to a limited extent should find that it can appropriately monitor its incentive arrangements through normal management processes.
  - ➢ Banking organizations should track incentive compensation awards and payments, the risks taken, and actual risk outcomes to determine whether compensation payments to employees have been reduced to reflect adverse risk outcomes.

<u>Principle 3: Strong Corporate Governance</u>

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

  - ➢ A board of directors should directly approve the incentive compensation arrangements of senior executives, approve and document any material exceptions or adjustments and consider and monitor the effects of any approved adjustments on the balance of the arrangement, the risk-taking incentives and the safety and soundness of the organization.
  - ➢ The involvement of the board should be scaled appropriately to the scope and prevalence of an organization's incentive compensation arrangements.

- The board of an LBO or other banking organization that uses significant incentive compensation should actively oversee the development and operation of the incentive compensation policies, systems and related control processes.
- The board's duties can be accomplished through an appropriate committee structure.

- The board of directors should monitor performance, and regularly review the design and function, of the organization's incentive compensation arrangements.

    - On an annual or more frequent basis a board should review data and analysis from management and other sources, with appropriate input from risk-management personnel, to assess whether the design and performance are consistent with the organization's safety and soundness.
    - The review and analysis should be appropriately scaled to the size and complexity of the organization's activities.
    - The board should monitor incentive compensation payments and their sensitivity to risk outcomes on both a backward-looking and forward-looking scenario analysis.
    - If there are "clawback" agreements, the review should include sufficient information to determine if the provision has been triggered and executed as planned.

- The organization, composition and resources of the board should permit effective oversight.

    - The board members should have, or have access to, a level of experience and expertise in risk management and compensation practices in the financial services industry. This may be present collectively among the board, and may come from formal training or from experience (including as a director) and may be obtained through advice received from outside advisors.
    - Special expertise on the board and/or the retention of outside experts may not be necessary or appropriate for an organization with less complex and extensive incentive compensation arrangements.
    - The board should exercise caution to avoid allowing outside parties to obtain undue levels of influence.

- Disclosure practices should support safe and sound incentive compensation arrangements, and appropriate information concerning incentive compensation and related risk management should be provided to shareholders to allow them to monitor and take actions to restrain arrangements that potentially encourage excessive risk taking.

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For further details regarding this newsletter, please contact any of the persons listed below.

Eric Luse ■ (202) 274-2002
John J. Gorman ■ (202) 274-2001
Beverly J. White ■ (202) 274-2005
Larry Spaccasi ■ (202) 274-2037
Alan Schick ■ (202) 274-2008
Kip Weissman ■ (202) 274-2029