

## **Federal Reserve Board Guidance Relating to Risk-Based Compensation June 2010**

As we are all aware, one of the side effects of the nation's recovery from the financial crisis has been a dramatic increase in financial institution regulation from Congress, the executive branch and from the Federal Reserve Board ("FRB"). One of the primary areas of the FRB's focus has been the compensation practices of member banks. In October, 2009, the FRB issued proposed guidance relating to compensation programs for banks, and on June 21, 2010, the FRB (in conjunction with the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation), issued its *Final Guidance on Sound Incentive Compensation Policies* (the "Guidance"). This brief article will summarize some of the key points of the 47 pages of guidance that the FRB issued.

### **The FRB's Review of Banking Practices to Date**

The FRB reviewed the incentive compensation arrangements of many of the large banking organizations (LBOs) and found that they were deficient in the following areas related to incentive compensation programs and risk to the institution:

- Identification of employees who could expose the institution to risk
- Designing risk-sensitive incentive compensation plans that fully captured the risks involved and applying the design to a sufficient number of employees
- Tailoring deferral programs according to duration of risk or type, instead of applying the same design to all programs
- Determining whether established programs successfully balance risk

While these findings were the result of studies of LBOs, the principles outlined should work for any financial institution,

### **The Guidance's Principles**

The Guidance's purpose is to make sure that incentive compensation arrangements at banking organizations (the Guidance applies to all banking organizations under the supervision of any of the agencies referred to above—approximately 8,700) do not encourage excessive risk-taking or undermine the safety and soundness of the organization.

There are three key principles:

1. *Balanced Risk Taking Incentives*: Incentive compensation programs should balance risk and financial results so that employees do not expose the institution to imprudent risks. The institution should consider the full range of risks associated with an employee's

activities, as well as the time horizon over which the risk could be realized. The FRB believes that short term programs are inherently more risky than long term programs. If an arrangement is viewed to be too risky, it should be modified—modifications could include payment deferral (until we are certain that the risk will not come to pass), longer performance periods, claw backs; risk adjustment of rewards; reduced sensitivity to short-term performance; or, changing the incentive payment structure. The terms of programs should differ for different levels of employees, not only in the amount of reward, but in vesting and payment terms. Particular care should be taken with ‘golden parachute’ provisions, which could cause acceleration of payments in the event of a change in control—these programs could lead to risk taking to increase the organization’s apparent value and effectuate a sale to accelerate the time of payment.

2. *Risk Management Programs / Internal Controls:* Risk management personnel should have input into the creation of incentive compensation programs, and should have some responsibility for monitoring the results. Incentive program performance should be monitored by the banking organization, and the programs should be revised if the payments are not appropriately reflecting risk. If risk management personnel participate in an incentive program, their program should not be predominantly tied to the financial performance of the lines of business that they review.
3. *Improved Corporate Governance:* Boards of directors should become more involved in monitoring the performance of incentive programs, and regularly review their design and operation. To do this, boards should have access to the resources necessary to perform this task. The board of directors should directly approve compensation arrangements involving senior executives and monitor such payments and their sensitivity to risk.

### **Administrative Details**

These principles and the final guidance apply to senior executives as well as other employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk; therefore, many bank employees will not be subject to these provisions.

Shareholders should receive information relating to incentive compensation arrangements and related risk-management, control, and governance processes.

The final guidance, which will be effective in early July, 2010, can be found at the following link: <http://www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm>

### **Next Steps**

Young & Associates, Inc. has developed an approach that can help banks analyze whether their incentive compensation programs could put the bank at risk; if there are problem programs, we can assist in creating programs to monitor and reduce that risk. We would be pleased to assist

you in this process. For more information, please contact Mike Lehr, Hr Consultant, at 1.800.525.9775 or [mlehr@younginc.com](mailto:mlehr@younginc.com). For more information on the types of Compensation Services that we offer, [click here](#).