Federal Reserve Proposes Incentive Pay Restrictions for Banks

BARBARA-ANN GUSTAFERRO AND DAVID B. MILLER

The authors summarize the important components of recent guidance on incentive compensation practices issued by the Federal Reserve Board.

Recent guidance proposed by the Federal Reserve Board is designed to ensure that incentive compensation practices do not threaten the soundness of financial institutions subject to its supervision.

The proposed guidelines include several principles relating to establishing and monitoring arrangements for incentive compensation in a manner that balances risk and financial results. The guidelines impose no specific paycaps or other restrictions and acknowledge that community banks will not be expected to implement processes and procedures as robust as those appropriate to larger institutions.

The Federal Reserve has already advised executives of the top 28 foreign and domestic firms to begin reviewing their compensation packages as soon as possible — the objective being to have their structures in alignment with the Federal Reserve guidance by February 1, 2010.

Barbara-Ann Gustaferro, special counsel in the Minneapolis office of Faegre & Benson LLP, concentrates her practice in employment benefits, with a particular focus on executive compensation matters. David B. Miller, a partner in the firm's Minneapolis office, represents issuers, underwriters and placement agents in public and private securities offerings. The authors can be reached at BGustaferro@faegre.com and DMiller@faegre.com, respectively.

Published in the January 2010 issue of The Banking Law Journal. Copyright ALEXeSOLUTIONS, INC. 1-800-572-2797.

PROPOSAL WOULD EXTEND FEDERAL RESERVE PAY-REVIEW AUTHORITY

While there are similarities to provisions of TARP Treasury regulations addressing compensation and excessive risk, these guidelines extend the authority of the Federal Reserve and its examiners to review pay well beyond the executive employees of TARP participants to include persons at all 3,000 Fed-regulated organizations responsible for material business lines, employees whose activities expose the organization to material amounts of risk (e.g. traders), and groups of persons who are subject to the same or similar incentive compensation and who collectively may expose the firm to material risk (e.g. loan officers).

Stung by criticism that regulators did not do enough to avert the financial crisis, convinced outsized pay was a key factor in promoting outsized risks — and unconvinced that shareholders alone can police executive compensation practices, or at least do so in a way that satisfactorily addresses safety and soundness risks with which the Federal Reserve is concerned — the Federal Reserve produced a proposal that offers a potentially significant government encroachment on pay.

Editors of *The Wall Street Journal* promptly assailed the Federal Reserve guidelines as "wage controls" and warned they would be a precedent for other areas of the economy. Observers of all political persuasions are skeptical that policies such as this will check either pay or excessive risk.

GUIDELINES RELY ON THREE INCENTIVE COMPENSATION PRINCIPLES

The guidelines aim to curb excessive risk taking in incentive compensation by announcing three principles which attempt to take risk and risk-outcomes into account as a central focus of incentive compensation design and administration.

None of the principles articulated in the guidelines breaks new ground; similar themes are echoed in the TARP standards on executive compensation and corporate governance, as well as the SEC's recently proposed rules requiring proxy disclosure of the ways in which a company's compensation policies affect its risk.

Published in the January 2010 issue of The Banking Law Journal. Copyright ALEXeSOLUTIONS, INC. 1-800-572-2797.

Incentive Compensation Should Not Promote Risk-Taking

The first principle articulated in the guidance is that incentive compensation should not promote excessive risk-taking. For example, incentives that fully pay out in the short term, golden parachutes or accelerated vesting features tend to insulate the employee from poor risk outcomes.

Stressing the need for balanced risk, the guidelines call for longer performance periods, multi-year performance measures, required deferrals of incentive pay and a reconsideration of separation pay arrangements.

The guidelines also urge banks to avoid a "one size fits all" approach in constructing incentive compensation programs. Institutions are encouraged to consider the full range of risks to which the institution is exposed, determine which incentives are most likely to be effective in restraining risk and tailor their programs accordingly.

Incentive Programs Need Strong Controls, Risk-Management Processes

The second principle underscores the need for incentive pay programs to be supported by strong internal controls and risk-management processes. The notion here is that the most diligent efforts to design an appropriate incentive pay program will be for naught if lax controls allow a rogue trader to bring down the entire institution.

To keep employees from evading or undermining processes designed to keep risk in check, the guidelines suggest that institutions must have strong controls and actively monitor incentive compensation programs. They also need qualified personnel competent to assess risk and design incentive compensation programs that are effective in managing risk. It will be necessary for institutions to devise compensation programs that pay sufficiently well to attract such personnel and are structured to avoid conflicts of interest.

Boards Should Take Active Oversight Role

The third principle calls for strong corporate governance in designing and monitoring incentive compensation. In the wake of the stunning collapse of once-vibrant financial institutions, bank boards of directors and their com-

Published in the January 2010 issue of The Banking Law Journal. Copyright ALEXeSOLUTIONS, INC. 1-800-572-2797.

pensation committees have taken some heat for failing to evaluate — or even inquire into — the risks to the institution created by incentive pay structures. In addressing this issue, the guidelines urge boards to be active in their oversight of incentive compensation arrangements. To be effective in this role, boards may need to rethink their structures and must have resources at their disposal in the form of counsel, consultants and other advisers.

For large complex banking organizations ("LCBOs"), the guidelines advocate a systemic approach to incentive compensation and risk management, consisting of formal risk assessments, identification of employees whose incentive pay may affect the risk to which the institution is exposed, plan design tailored to the specific employee group and structured to manage risk, monitoring processes and employee communication.

Noting the SEC's recent initiatives to require enhanced disclosure of risk in setting executive pay, the guidelines also indicate that the Federal Reserve will be working with the SEC to develop improved disclosures for public banks relating to incentive pay.

IMPLEMENTATION OF GUIDELINES

The Federal Reserve itself is launching two supervisory initiatives with the stated goal of spurring institutions into action, advancing the field and identifying emerging best practices.

LCBO Compensation Practices to Be Scrutinized

The first is a formal horizontal review of compensation at LCBOs (meaning they will be compared to one another), where, the guidance states, the need for the most intense scrutiny is warranted. LCBOs will have to submit to the Federal Reserve a description of their current pay practices, oversight processes, and plans — with timetables — for improving the risk sensitivity of their incentive pay practices, their controls and their corporate governance. The review will be led by a multidisciplinary group of staff consisting of economic, legal, financial and accounting experts.

The Federal Reserve has indicated its intention to "work closely" with each LCBO to ensure compensation practices do not encourage excess risk-

Published in the January 2010 issue of The Banking Law Journal. Copyright ALEXeSOLUTIONS, INC. 1-800-572-2797.

taking. It will also monitor the institution's execution of its plan to improve the risk sensitivity of incentive compensation.

Where it perceives an institution to be failing either to submit or follow through on such a plan, the Federal Reserve may "take supervisory action as appropriate." Although it remains to be seen how heavy a hand the Federal Reserve will take in this review process, banking organizations are unlikely to welcome its active participation in designing their incentive compensation programs.

Community Bank Incentive Compensation Also Subject to Review

The second initiative is a more informal review by Federal Reserve supervisory staff of incentive compensation arrangements at community and regional banks, as part of the Fed's regular supervisory process. Where examiners have concerns about a bank's practices, findings may affect the bank's supervisory ratings and supervisory action may be taken.

The Federal Reserve promises to continue "actively monitoring" banking activities in this area, taking supervisory or enforcement action as appropriate to address what it perceives to be "material deficiencies" that threaten an institution's safety and soundness, and to update its guidance as best practices for balanced and effective incentive compensation continue to evolve.

Published in the January 2010 issue of The Banking Law Journal. Copyright ALEXeSOLUTIONS, INC. 1-800-572-2797.