LEGAL UPDATES

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Federal Reserve Board Provides Guidance on Incentive Compensation Practices

On October 22, 2009, the Federal Reserve Board (FRB) released proposed supervisory guidance designed to ensure that banking organizations do not encourage excessive risk-taking through incentive compensation policies that are inconsistent with the safety and soundness of the organization. While not an official rule-making, the FRB explained its action as an important supervisory tool to focus attention on risk issues particularly when significant differences may exist between banking organizations. The FRB expects its examiners to use the principles announced in the guidance to evaluate a covered institution's safety and soundness. Deficiencies will be factored into the organization's supervisory ratings, which can affect its ability to make acquisitions or take other actions. In addition, the FRB may take enforcement action against an organization to force remediation under certain circumstances. Banking institutions are expected to have begun reviewing their incentive compensation programs within the context of the guidance as proposed.

The guidance is divided into sets of "Supervisory Initiatives" and "Principles of a Sound Incentive Compensation System." The initiatives are structured to encourage the industry to "implement safe and sound incentive compensation arrangements, identify emerging best practices and advance the state of practice more generally in the industry." The principles are intended to assist organizations in creating arrangements that "effectively take account of potential risks and risk outcomes." Each of these areas is detailed below. The FRB invited comments on the proposal until November 27, 2009, but does not expect they will result in significant modification to the guidance.

Supervisory Initiatives

The proposal introduces the following two supervisory initiatives:

The FRB has begun conducting a "horizontal review" of the incentive compensation practices at 28 large complex banking organizations (LCBOs) to understand the details of current practices, assess the strengths of controls and consistency of payouts, understand the role of boards of directors, compensation committees and risk management functions, and identify emerging best practices. As significant users of incentive compensation arrangements, the FRB chose to focus particular attention on the LCBOs for direct supervision. The LCBOs are expected to cooperate by providing the FRB with information and documentation describing their plans for improving the risk-sensitivity of incentive compensation arrangements and related risk management, controls and corporate governance practices.

The FRB supervisory staff will begin reviewing the compensation practices at regional, community and other banking organizations not classified as LCBOs as part of its regular, risk-focused supervisory process. These reviews will be tailored to take account of the size, complexity, and other characteristics of the banking organizations

Guiding Principles

The guidance sets forth the following principles to be incorporated into banking organizations' incentive compensation arrangements:

Provide employees with incentives that do not encourage risk-taking behavior in excess of the banking organization's ability to identify and manage risk effectively and that effectively balance risk-taking incentives;

Be compatible with an organization's effective controls and risk management; and

Be supported by strong corporate governance practices, including active and effective oversight by the board of directors or compensation committee

Who Will Be Subject to the Compensation Guidance?

The FRB's guidance applies to all banking organizations supervised by the Federal Reserve, which includes U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency or commercial lending company subsidiary in the United States.

Because incentive compensation arrangements for executive and non-executive personnel may expose a banking organization to risk, the guidance applies to incentive compensation arrangements for:

Senior executive officers and other employees with responsibility for oversight of the organization's firmwide activities or material business lines;

Individual employees whose activities may expose the organization to material risks; and

Groups of employees with the same or similar incentive compensation arrangements that, in the aggregate, could 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)

To review the complete proposal, click here.

How is the Guidance Related to the Troubled Asset Relief Program (TARP) Regulations?

The FRB guidance is separate from the compensation requirements set forth in the TARP rules and regulations. As a result, any banking organization that has participated in TARP must comply with the FRB guidance and the TARP regulations.

What This Means to You
Banking organizations are advised to begin considering the potential impact of the FRB's guidance by examining their current incentive compensation arrangements and risk-management procedures.

Contact Info
If you have any questions about this or any other banking matter, please contact your Husch Blackwell Sanders attorney.

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