

## **GUIDANCE ON SOUND INCENTIVE COMPENSATION POLICIES**

### **I. Introduction**

Incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis. Banking organizations too often rewarded employees for increasing the firm's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the firm. These practices exacerbated the risks and losses at a number of banking organizations and resulted in the misalignment of the interests of employees with the long-term well being and safety and soundness of their organizations.

This document provides guidance on sound compensation practices to banking organizations supervised by the Agencies.<sup>1</sup> Alignment of the incentives provided to employees with the interests of shareholders of the organization often also furthers safety and soundness. However, aligning those interests is not always sufficient to address safety and soundness concerns. Because of the presence of the federal safety net, shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness.<sup>2</sup> Accordingly, the Agencies expect banking organizations to maintain incentive compensation practices that are consistent with safety and soundness, even when these practices go beyond those needed to align shareholder and employee interests.

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

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<sup>1</sup> As used in this guidance, the term "banking organizations" 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 in the United States.

<sup>2</sup> Risks that may present a threat to the organization's safety and soundness include credit, market, liquidity, operational, legal, compliance, and reputational risks.

- Provide employees incentives that appropriately balance risk and reward;
- 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.

These principles, and the types of policies, procedures, and systems that banking organizations should have to help ensure compliance with them, are discussed in Part II of this guidance.

The Agencies expect banking organizations to regularly review their incentive compensation arrangements for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the firm to material amounts of risk and review the risk management, control, and corporate governance processes related to these arrangements. Banking organizations should immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in this guidance and do not encourage employees to expose the organization to imprudent risks that may pose a threat to the safety and soundness of the organization.<sup>3</sup>

Designing and implementing compensation arrangements that properly incent executive and non-executive employees to pursue the organization’s long-term well being and that do not encourage excessive risk-taking is a complex task and one that requires the commitment of adequate resources. The Agencies recognize that incentive

<sup>3</sup> In this guidance, the term “incentive compensation” refers to that 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). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary). In addition, the term does not include arrangements that provide employees an amount of compensation that is determined based solely on the employees’ level of compensation and does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the organization contributes a set percentage of an employee’s salary).

compensation arrangements often seek to serve several important and worthy objectives. For example, incentive compensation arrangements may be used to help attract skilled staff, promote better overall firm and employee performance, promote employee retention, provide retirement security to employees, or provide a closer tie between compensation expenses and revenue on a firm-wide basis. The analysis and methods for making incentive compensation arrangements take appropriate account of risk also should be tailored to the size, business strategy, risk tolerance, and complexity of each firm. Thus, achieving and sustaining adherence to sound practices will present challenges.

While the issues are complex, the Agencies are committed to moving banking organizations forward to incorporate the principles described in this guidance into incentive compensation practices. Accordingly, the Agencies intend to conduct special reviews of incentive compensation arrangements and related risk-management, control, and corporate governance practices of large complex banking organizations (LCBOs) to assess the potential for these arrangements or practices to encourage excessive risk-taking, the actions an organization has taken or proposes to take to correct deficiencies, and the adequacy of the organization's compensation-related risk management, control, and corporate governance processes.<sup>4</sup>

The Agencies will work with these organizations as necessary through the supervisory process to ensure that they promptly correct any deficiencies that may be inconsistent with the safety and soundness of the organization. LCBOs warrant the most

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<sup>4</sup> The Federal Reserve has established a coordinating group led by Board staff working with Reserve Bank supervisors responsible for LCBOs. The coordinating group is comprised of staff with expertise in banking supervision, risk management, economics, finance, and law, and will have access to specialists in other areas (such as accounting and human resources) as appropriate. The group is designed to promote consistency and leverage resources.

intensive supervisory attention because they are significant users of incentive compensation arrangements and because flawed approaches at these institutions are more likely to have adverse effects on the broader financial system.

Reviews at regional and community banking organizations will be conducted as part of the evaluation the firm's risk management, internal controls, and corporate governance during the regular, risk-focused examination process.<sup>5</sup> These reviews will be conducted in accordance with special examination procedures designed for small [and regional] banking organizations. These procedures, and any reviews conducted pursuant to these procedures, will be tailored to reflect the scope and complexity of the organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Little, if any, additional examination work is expected for small banking organizations that do not have material incentive compensation arrangements. In addition, the compensation-related policies, procedures, and systems at a small banking organization that does use incentive compensation arrangements should be substantially less extensive, formalized, and detailed than those of an LCBO that uses incentive compensation arrangements extensively. The Agencies expect to provide examiners with separate examination guidance on incentive compensation that is tailored to community and regional banking organizations.

For all banking organizations, supervisory findings related to incentive compensation will be included in the relevant report of examination or inspection and communicated to the organization.<sup>6</sup> In addition, these findings will be incorporated, as

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<sup>5</sup> Thus, for example, reviews at bank holding companies with total consolidated assets of \$5 billion or less will be conducted in accordance with the risk-focused supervision program for these organizations. See SR letter 02-1, Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less (Jan. 9, 2002).

<sup>6</sup> See SR letter 08-1, Communication of Examination/Inspection Findings (Jan. 24, 2008).

appropriate, into the organization's rating component(s) and subcomponent(s) relating to risk management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.<sup>7</sup>

In appropriate circumstances, the primary federal regulator may take enforcement action against a banking organization if its incentive compensation arrangements or related risk management, control, or governance processes pose a risk to the safety and soundness of the organization and the organization is not taking prompt and effective measures to correct the deficiencies. For example, the primary federal regulator may take an enforcement action it considers appropriate against an LCBO if material deficiencies are found to exist in the organization's incentive compensation arrangements or related risk management, control, or governance processes and the organization fails to promptly develop, submit, or adhere to an effective plan designed to ensure that its incentive compensation arrangements do not encourage excessive risk taking and are consistent with principles of safety and soundness. As provided under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), an enforcement action may, among other things, require an organization to develop a corrective action plan that is acceptable to the primary federal regulator to rectify deficiencies in its incentive compensation arrangements or related processes. Where warranted, the primary federal regulator may require the organization to take affirmative action to correct or remedy deficiencies related to the organization's incentive compensation practices until its corrective action plan is implemented.

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<sup>7</sup> For example, supervisory findings for bank holding companies in the areas discussed in this guidance should be incorporated into the assessment of the appropriate subcomponent(s) for the BHC's "Risk Management" rating component in the RFI (Risk Management, Financial Condition, and Impact) rating. See SR letter 04-18, Bank Holding Company Rating System (Dec. 6, 2004).

Effective and balanced incentive compensation practices are likely to evolve significantly in the coming years, spurred by the efforts of banking organizations, supervisors, and other stakeholders. The Agencies will review and update this guidance as appropriate to incorporate best practices that emerge from these efforts.

### **Principles of a Sound Incentive Compensation System**

The incentive compensation arrangements and related policies and procedures of banking organizations should be consistent with principles of safety and soundness.<sup>8</sup> This guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively take account of potential risks and risk outcomes.<sup>9</sup> Incentive compensation arrangements for executive officers as well as for non-executive personnel who have the ability to expose a banking organization to material amounts of risk, may, if not properly structured, pose a threat to the organization's safety and soundness. Accordingly, this guidance applies to incentive compensation arrangements for:

- Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;<sup>10</sup>

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<sup>8</sup> In the case of the U.S. operations of foreign banks, the organization's policies, including management, review, and approval requirements, for its U.S. operations should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls. The policies for the organization's U.S. operations also should be consistent with this guidance.

<sup>9</sup> This guidance and the principles reflected herein are consistent with the Principles for Sound Compensation Practices issued by the Financial Stability Board (FSB) in April 2009, and with the FSB's Implementation Standards for those principles, issued in September 2009.

<sup>10</sup> Senior executives include, at a minimum, "executive officers" within the meaning of the Board's Regulation O (see 12 CFR 215.2(e)(1)) and, for publicly traded companies, "named officers" within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation (see 17 CFR 229.402(a)(3)).

- Individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk (e.g., traders with large position limits relative to the firm’s overall risk tolerance); and
- Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the firm to material amounts of risk, even if no individual employee is likely to expose the firm to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of credit risk).

For ease of reference, these executive and non-executive employees are collectively referred to as “employees.” Depending on the facts and circumstances of the individual organization, jobs and job families that are outside the scope of this guidance because they do not have the ability to expose the organization to material risks may include, for example, tellers, bookkeepers, couriers, or data processing personnel.

In determining whether an employee, or group of employees, may expose a banking organization to material risk, an organization should consider the full range of risks arising from, or generated by, the employee’s activities, even if the organization uses risk management processes or controls to limit the risks such activities ultimately may pose to the firm. Moreover, risks should be considered to be material for purposes of this guidance if they are material to the organization, or are material to a business line or operating unit that is itself material to the organization.<sup>11</sup> For purposes of illustration, assume that a banking organization has a structured finance unit that is material to the organization. A group of employees within that unit who originate structured finance transactions that may expose the unit to material risks should be considered “employees” for purposes of this guidance even if the transactions must be approved by an independent risk function prior to consummation, or the organization uses other processes

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<sup>11</sup> Thus, risks may be material to an organization even if they are not large enough to themselves threaten the solvency of the firm.

or methods to limit the risk that such transactions may present to the organization. Strong and effective risk management and internal control functions are critical to the safety and soundness of banking organizations. However, poorly designed or managed incentive compensation arrangements can themselves be a source of risk to a banking organization. For example, incentive compensation arrangements that provide employees strong incentives to increase the organization's short-term revenues or profits, without regard to the short- or long-term risk associated with such business, can place substantial strain on the risk management and internal control functions of even well managed organizations.

Moreover, poorly balanced incentive compensation arrangements can encourage employees to take affirmative actions to weaken the organization's risk management or internal control functions, such as by providing inaccurate or incomplete information to these functions, to boost the employee's personal compensation. Accordingly, sound compensation practices complement and, indeed, are part of, strong risk management and internal control functions. A key goal of this guidance is to encourage firms to incorporate the risks related to incentive compensation into their broader risk management framework. Risk management procedures and risk controls that ordinarily limit risk-taking do not obviate the need for incentive compensation arrangements to properly balance risk-taking incentives

**Principle 1: Balanced Risk-Taking Incentives**

Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their firms to risks that are beyond the organization's ability to effectively identify and manage.



Incentive compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the firm. However, short-run revenue or profit can often diverge sharply from actual long-run profit because risk outcomes may become clear only over time. Activities that carry higher risk typically yield higher short-term revenue, and an employee who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to take more risk.

An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks (including compliance risks), as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness. As an example, under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially. The employee whose activities create materially larger risks for the organization should receive less than the other employee, all else being equal.

The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage excessive risk-taking. For example, if an employee's incentive compensation payments are closely tied to short-term revenue or profit of business generated by the employee, without any adjustments for the risks associated with the business generated, the potential for the arrangement to encourage excessive risk-taking may be quite strong. For instance, traders who work with positions that close at year-end could be incentivized to take large risks toward the end of a year ("swing for the fences")

if there is no mechanism for factoring how such positions perform over a longer period of time. The same result could ensue if the performance measures themselves lack integrity or can be manipulated inappropriately by the employees receiving the incentive compensation.

On the other hand, if an employee's incentive compensation payments are determined based on performance measures that are only distantly linked to the employee's activities (e.g., for most employees, firm-wide profit), the potential for the arrangement to encourage the employee to take excessive risks on behalf of the organization may be weak. For this reason, plans that provide for awards based on overall firm performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the firm's overall risk profile, with unbalanced risk-taking incentives.

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes. If, for example, employees are paid substantially all of their potential incentive compensation even when risk or risk outcomes are materially worse than expected, employees have less incentive to avoid excessively risky activities.

- **Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.**

The activities of employees may create a wide range of risks for a banking organization, such as credit, market, liquidity, operational, legal, compliance, and reputational risks, as well as other risks to the viability or operation of the firm. Some of

these risks may be realized in the short term, while others may become apparent only over the long term. For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (e.g., the higher credit or compliance risk associated with subprime loans versus prime loans).<sup>12</sup> In addition, some risks may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized (“bad-tail risks”). While shareholders may have less incentive to guard against bad-tail risks because of their infrequency and the existence of the federal safety net, these risks warrant special attention for safety-and-soundness reasons given the threat they pose to the organization’s solvency and the federal safety net.

Banking organizations should consider the full range of current and potential risks associated with the activities of employees, including the cost and amount of capital and liquidity needed to support those risks, in developing balanced incentive compensation arrangements. Reliable quantitative measures of risk and risk outcomes (“quantitative measures”), where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced. However, reliable quantitative measures may not be available for all types of risk or for all activities, and their utility for use in compensation arrangements varies across business lines and employees. The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations

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<sup>12</sup> Importantly, the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure. For example, the ongoing reinvestment of funds by a cash management unit in commercial paper with a one-day maturity not only exposes the organization to one-day credit risk, but also exposes the organization to liquidity risk that may be realized only infrequently.

should ignore such risks or outcomes for purposes of assessing whether an incentive compensation arrangement achieves balance. For example, while reliable quantitative measures may not exist for many bad-tail risks, it is important that such risks be considered given their potential effect on safety and soundness. As in other risk-management areas, banking organizations should rely on informed judgments to estimate risks and risk outcomes in the absence of reliable quantitative risk measures.<sup>13</sup>

LCBOs should consider using scenario analysis to help assess whether the features included in incentive compensation arrangements are likely to achieve balance over time. Scenario analysis of incentive compensation arrangements involves the evaluation of payments on a forward-looking basis based on a range of performance levels, risk outcomes, and the levels of risks taken. This type of analysis can help an LCBO assess whether incentive compensation payments to an employee are likely to be reduced appropriately as the risks to the organization from the employee's activities increase. Other banking organizations may find scenario analysis a useful tool depending on, among other things, the organization's resources and the prevalence and scope of its incentive compensation arrangements.

- **An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.**

If an incentive compensation arrangement may encourage employees to expose their banking organization to excessive risks, the organization should modify the arrangement as needed to ensure that it is consistent with safety and soundness. Four

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<sup>13</sup> Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, strong internal controls and ex post monitoring of incentive compensation payments relative to actual risk outcomes are particularly important to help ensure that the arrangements as implemented do not encourage excessive risk-taking.

methods currently are often used to make compensation more sensitive to risk. These methods are:

- Risk Adjustment of Awards: The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities may pose to the organization. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.
- Deferral of Payment: The actual payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that become clear only during the deferral period.<sup>14</sup> Deferred payouts may be altered according to risk outcomes either formulaically or judgmentally, though extensive use of judgment might make it more difficult to execute deferral arrangements in a sufficiently predictable fashion to influence employee behavior. To be most effective, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.
- Longer Performance Periods: The time period covered by the performance measures used in determining an employee's award is extended (for example, from one year to two or more years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes are realized or better known.
- Reduced Sensitivity to Short-Term Performance: The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives.<sup>15</sup>

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<sup>14</sup> The deferral of payment method is sometimes referred to in the industry as a "clawback." The term "clawback" also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur. Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7243), which applies to chief executive officers and chief financial officers of public banking organizations, is an example of this more specific type of "clawback" requirement.

<sup>15</sup> Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above the target or may provide that awards will be granted only if a target is met or exceeded. Employees may be particularly motivated to take excessive risk in order to reach performance targets that are

These methods for achieving balance are not exclusive, and additional methods or variations may exist or be developed. Moreover, each method has its own advantages and disadvantages. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for excessive risk-taking. This is because risk adjustment potentially can take account of the full range and time horizon of risks, rather than just those risk outcomes that occur or become evident during the deferral period. On the other hand, deferral of payment may be more effective than risk adjustment in mitigating incentives to take hard-to-measure risks (such as the risks of new activities or products), particularly if such risks are likely to be realized during the deferral period. Accordingly, in some cases two or more methods may be needed in combination for an incentive compensation arrangement to be balanced. The greater the potential incentives an arrangement creates for an employee to increase the risks associated with the employee's activities, the stronger the effect should be of the methods applied to achieve balance. Thus, for example, risk adjustment used to counteract a materially unbalanced compensation arrangement should have a material impact on the incentive compensation paid under the arrangement.

Methods and practices for making compensation sensitive to risk are likely to evolve rapidly during the next few years, driven in part by the efforts of supervisors and other stakeholders. A banking organization should monitor developments in the field and should incorporate into its incentive compensation systems new or emerging methods or practices that are likely to improve the organization's long-term financial well being and safety and soundness.

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aggressive, but potentially achievable.

- **The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.**

Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. For example, activities, risks, and incentive compensation practices may differ materially among banking organizations, based on, among other things, the scope or complexity of activities conducted by the organizations and the business strategies pursued by the organizations. These differences mean that methods for achieving balanced compensation arrangements at one organization may not be effective in restraining incentives to engage in excessive risk taking at another organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization.

Moreover, the risks associated with the activities of one group of non-executive employees (e.g., loan originators) within a banking organization also may differ significantly from those of another group of non-executive employees (e.g., spot foreign exchange traders) within the organization. In addition, reliable quantitative measures of risk and risk outcomes are unlikely to be available for a banking organization as a whole, particularly a large complex organization. This can make it difficult for banking organizations to achieve balanced compensation arrangements for senior executives who have responsibility for managing risks on a firm-wide basis solely through use of the risk adjustment of award method.

Moreover, the payment of deferred incentive compensation in equity (such as restricted stock of the organization) or equity-based instruments (such as options to acquire the organization's stock) may be helpful in restraining the risk-taking incentives of senior executives and other employees whose activities may have a material effect on the overall financial performance of the firm[, depending on circumstances and on the relative impact on compensation of upside versus downside outcomes for the firm]. However, equity-related deferred compensation may not be as effective in restraining the incentives of lower-level employees (particularly at large organizations) to take risks because such employees are unlikely to believe that their actions will materially affect the organization's stock price.

Banking organizations should take account of these differences when constructing balanced compensation arrangements. For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to result in arrangements that are unbalanced at least with respect to some employees.<sup>16</sup>

Incentive compensation arrangements for senior executives at LCBOs are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance, substantial use of multi-year performance periods, or both. Similarly, the compensation arrangements for senior executives at LCBOs are likely to be better balanced if a significant portion of the incentive compensation of these executives is paid in the form of equity-based instruments that vest

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<sup>16</sup> For example, spreading payouts of incentive compensation awards over a three-year period may not be sufficient by itself to balance the compensation arrangements of employees who may expose the organization to substantial longer-term risks.



over multiple years, with the number of instruments ultimately received dependent on the performance of the firm during the deferral period.

The portion of the incentive compensation of other employees that is deferred or paid in the form of equity-based instruments should appropriately take into account the level, nature, and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the firm and its stock price. Deferral of a substantial portion of an employee's incentive compensation may not be workable for employees at lower pay scales because of their more limited financial resources. This may require increased reliance on other measures in the incentive compensation arrangements for these employees to achieve balance.

- **Banking organizations should carefully consider the potential for “golden parachutes” and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.**

Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes, can provide the employee significant incentives to engage in undue risk-taking. For example, an arrangement that provides an employee with a guaranteed payout upon departure from an organization, regardless of performance, may neutralize the effect of any balancing features included in the arrangement to help prevent excessive risk taking. Banking organizations should carefully review any such existing or proposed arrangements (sometimes called “golden parachutes”) and the potential impact of such arrangements on the organization's safety and soundness. In appropriate circumstances an organization should consider including balancing features -- such as

risk adjustments or deferral requirements -- in the arrangements to mitigate the potential for the arrangements to encourage excessive risk taking. In all cases, a banking organization should ensure that the structure and terms of any golden parachute arrangement entered into by the organization do not encourage excessive risk-taking in light of the other features of the employee's incentive compensation arrangements.

Provisions that require an employee to forfeit deferred incentive compensation payments upon departure from the organization also may weaken the effectiveness of the deferral arrangement in achieving balance if the departing employee is able to negotiate a "golden handshake" arrangement with the employee's new firm that compensates the employee for some or all of the estimated, non-risk-adjusted value of the deferred incentive compensation forfeited by the employee upon departure from the organization.<sup>17</sup> "Golden handshake" arrangements present special issues for banking organizations and supervisors. For example, while a banking organization could adjust its deferral arrangements so that departing employees will continue to receive any accrued deferred compensation after departure (subject to any risk-adjustments), these changes could weaken an organization's ability to retain qualified talent, which is an important goal of compensation, and create conflicts of interest. Moreover, actions of the hiring firm (which may or may not be a supervised banking organization) ultimately may defeat these or other risk-balancing aspects of a banking organization's deferral arrangements. Banking organizations should monitor whether golden handshake arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees, and the Agencies will continue to work with banking

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<sup>17</sup> This weakening effect can be particularly significant for senior executives or other skilled individuals whose services are in high demand within the market.

organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

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

In order for the risk-sensitive provisions of incentive compensation arrangements to affect employee risk-taking behavior, the organization's employees must understand that the amount of incentive compensation that they may receive will vary based on the risk associated with their activities. Accordingly, banking organizations should ensure that the employees covered by an incentive compensation arrangement are informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid. Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk-outcomes. An organization's communications should be tailored appropriately to reflect the sophistication of the relevant audience(s).

#### **Principle 2: Compatibility with Effective Controls and Risk Management**

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

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

In order to increase their own compensation, employees may seek to evade the processes established by a banking organization to achieve balanced compensation arrangements. Similarly, an employee covered by an incentive compensation

arrangement may seek to influence the risk measures or other information or judgments that are used to make the employee's pay sensitive to risk in ways designed to increase the employee's pay.

If successful, these actions may significantly weaken the effectiveness of an organization's incentive compensation arrangements in restricting excessive risk-taking. These actions can have a particularly damaging effect on the safety and soundness of the organization if they result in the weakening of risk measures, information, or judgments that the organization uses for other risk management, internal control, or financial purposes. In such cases, the employee's actions may weaken not only the balance of the organization's incentive compensation arrangements, but also the risk management, internal controls, and other functions that are supposed to act as a separate check on risk-taking. For this reason, controls alone do not eliminate the need to identify employees who may expose the firm to material risk, nor does it obviate the need for the incentive compensation arrangements for these employees to be balanced.

To help prevent this damage from occurring, a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. For example, an organization's policies and procedures should (i) identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements; (ii) identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and (iii) identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new

incentive compensation arrangements or modification of existing arrangements. Banking organizations also should create and maintain sufficient documentation to permit an audit of the effectiveness of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements.

A banking organization should conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed. Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An organization's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements. The results should be reported to appropriate levels of management and, where appropriate, the organization's board of directors.

Reviews conducted by regional or community banking organizations should be tailored to the management, internal control, compliance, and audit framework for the organization, as well as the scope and complexity of the organization's activities and its use of incentive compensation arrangements. For example, where a banking organization has only a limited number of incentive compensation arrangements for employees below the senior executives, reviews by the organization's audit, compliance, or other functions may be less frequent and more tailored in scope.

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

Developing balanced compensation arrangements and monitoring arrangements to ensure they achieve balance over time requires an understanding of the risks (including compliance risks) and potential risk outcomes associated with the activities of the relevant employees. Accordingly, banking organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining excessive risk-taking.<sup>18</sup> Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to, (i) reviewing the types of risks associated with the activities of employees covered by an incentive compensation arrangement; (ii) approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and (iii) analyzing risk taking and risk outcomes relative to incentive compensation payments.

Other functions within an organization, such as its control, human resources, or finance functions, also play an important role in helping ensure that incentive compensation arrangements are balanced. For example, these functions may contribute to the design and review of performance measures used in compensation arrangements or may supply data used as part of these measures.

- **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 risk management and control personnel involved in the design, oversight, and operation of incentive compensation arrangements should have appropriate skills and

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<sup>18</sup> Involvement of risk-management personnel in the design and monitoring of these arrangements also should help ensure that the organization's risk-management functions can properly understand and address the full range of risks facing the organization.

experience needed to effectively fulfill their roles. These skills and experiences should be sufficient to equip the personnel to remain effective in the face of challenges by employees seeking to increase their incentive compensation in ways that are inconsistent with sound risk management or internal controls. The compensation arrangements for employees in risk management and control functions thus should be sufficient to attract and retain qualified personnel with experience and expertise in these fields that is appropriate in light of the size, activities, and complexity of the organization.

In addition, to help preserve the independence of their perspectives, the incentive compensation received by risk management and control personnel staff should not be based substantially on the financial performance of the business units that they review. Rather, the performance measures used in the incentive compensation arrangements for these personnel should be based primarily on the achievement of the objectives of their functions (e.g., risk-adjusted performance or adherence to internal controls).

- **Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.**

Banking organizations should monitor incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes. Results should be reported to appropriate levels of management, including where warranted and consistent with Principle 3 below, the board of directors. A banking organization should take the results of such monitoring into account in establishing or modifying incentive compensation arrangements and in overseeing associated controls. If, over time, incentive compensation paid by a banking organization does not appropriately reflect risk outcomes, the organization should review and revise its

incentive compensation arrangements and related controls to ensure that the arrangements, as designed and implemented, are balanced and do not provide employees incentives to take excessive risks.

### **Principle 3: Strong Corporate Governance**

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices.

- **The board of directors of a banking organization should actively oversee incentive compensation arrangements.**

Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors of a banking organization should directly approve the incentive compensation arrangements for senior executives.<sup>19</sup> The board also should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and should carefully consider and monitor the effects of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization.

The board of directors of an organization also is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all material risk takers are appropriately balanced and do not jeopardize the safety and soundness of the organization. The involvement of the board of directors in oversight of the organization's overall incentive compensation program should be scaled appropriately to the scope and prevalence of the organization's incentive compensation arrangements. Thus, for

<sup>19</sup> As used in this guidance, the term "board of directors" is used to refer to the members of the board of directors who have primary responsibility for overseeing the incentive compensation system. Depending on the manner in which the board is organized, the term may refer to the entire board of directors, a compensation committee of the board, or another committee of the board that has primary responsibility for overseeing the incentive compensation system.



example, the board of directors of a banking organization that uses incentive compensation to a material extent should actively oversee the development and operation of the organization's incentive compensation systems and related control processes. For example, the board of directors should review and approve the overall goals and purposes of the firm's incentive compensation system. In addition, the board should provide 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.

In addition, the board of directors of an organization that uses incentive compensation to a material extent should ensure that steps are taken so that the compensation system--including performance measures and targets--is designed and operated in a manner that will achieve balance.

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

To allow for informed reviews, the board should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. For example, the board of an organization that uses incentive compensation to a material extent should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness. These reports should include an evaluation of whether or how incentive compensation practices may increase the potential for excessive risk-taking. These reviews and reports

should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the prevalence and scope of its incentive compensation arrangements.

In particular, at banking organizations that are significant users of incentive compensation arrangements, the board should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting excessive risk-taking. Boards of directors of these organizations also should consider periodically obtaining and reviewing scenario analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risks taken.

The board of directors of all banking organizations should closely monitor incentive compensation payments to senior executives and their sensitivity to risk outcomes. In addition, if the compensation arrangement for a senior executive includes a clawback provision, then the review should include sufficient information to determine if the provision has been triggered and executed as planned.

The board of directors of all banking organizations should seek to stay abreast of significant emerging changes in compensation plan mechanisms and incentives in the marketplace. However, the board should recognize that institutions, activities, and practices within the industry are not identical. Incentive compensation arrangements at one firm may not be suitable for use at another firm because of differences in the risks, controls, structure, and management among firms. The board of directors of each organization is responsible for ensuring that the incentive compensation arrangements for

its organization do not encourage employees to take risks that are beyond the firm's ability to manage effectively, regardless of the practices employed by other firms.

- **The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.**

If a separate compensation committee is not already in place or required by other authorities,<sup>20</sup> the board of directors of a banking organization that uses incentive compensation to a material extent should consider establishing such a committee--reporting to the full board--that has primary responsibility for overseeing the organization's incentive compensation systems. A compensation committee should be composed solely or predominantly of non-executive directors. If the board does not have such a compensation committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems.

At LCBOs and large regional banking organizations, the board of directors should have, or have access to, a level of expertise and experience in risk management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities. This level of expertise 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 received from outside counsel, consultants, or other experts with expertise in incentive compensation and risk management. It is recognized that the board of directors of an organization with less complex and extensive incentive compensation arrangements, such as many smaller regional and community banking organizations, may

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<sup>20</sup> See NYSE Listed Company Manual Section 303A.05 (a); Nasdaq Listing Rule 5605(d); Internal Revenue Code section 162(m) (26 U.S.C. 162(m)).

not find it necessary or appropriate to require board expertise or to retain and use outside experts in this area.

In selecting and using outside parties, the board of directors should give due attention to potential conflicts of interest arising from other dealings of the parties with the firm or for other reasons. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence. While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness. The compensation committee should work closely with any board-level risk and audit committees where the substance of their actions overlap.

- **A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.**

If a banking organization's incentive compensation arrangements provide employees incentives to take risks that are beyond the tolerance of the organization's shareholders, these risks are likely to also present a risk to the safety and soundness of the organization.<sup>21</sup> To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements and related risk management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take excessive risks. The scope and level of the information disclosed by the organization should be

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<sup>21</sup> On the other hand, as noted previously, compensation arrangements that are in the interests of the shareholders of a banking organization are not necessarily consistent with safety and soundness. This is because the federal safety net bears some of the downside of risks taken by organizations with access, directly or through a subsidiary, to the safety net.

tailored to the nature and complexity of the organization and its incentive compensation arrangements.<sup>22</sup>

- **Large, complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.**

At banking organizations with large numbers of risk-taking employees engaged in diverse activities, an ad hoc approach to developing balanced arrangements is unlikely to be reliable. Thus, an LCBO should use a systematic approach--supported by robust and formalized policies, procedures, and systems--to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. Such an approach should provide for the organization effectively to:

- Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include (i) senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines; (ii) individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk; and (iii) groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the firm to material amounts of risk;
- Identify the types and time horizons of risks to the organization from the activities of these employees;
- Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take excessive risks;
- Include balancing elements, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced;

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<sup>22</sup> A banking organization also should comply with the incentive compensation disclosure requirements of the federal securities law, if applicable. . See, e.g., 74 Federal Register 68334 (Dec. 23, 2009).

- Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and
- Monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

Regional and community banking organizations should develop and implement appropriate policies, procedures, and systems in a manner that is tailored to the size and complexity of the organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. When examiners determine that a small banking organization is not currently using material amounts of incentive compensation, such organizations will be excluded from further evaluation.

## **II. Conclusion**

Banking organizations are responsible for ensuring that their incentive compensation arrangements promote prudent risk-taking behavior and are consistent with the safety and soundness of the organization. The Agencies expect banking organizations to take prompt action to address deficiencies in their incentive compensation arrangements or related risk management, control, and governance processes.

The Agencies expect to actively monitor the actions taken by banking organizations in this area and will promote further advances in designing and implementing balanced incentive compensation arrangements. Where appropriate, the Agencies will take supervisory or enforcement action to ensure that material deficiencies that pose a threat to the safety and soundness of the organization are promptly addressed. The Agencies also will update this guidance as appropriate to incorporate best practices as they develop over time.

