Federal Reserve Issues Report on Incentive Compensation Practices: Results of Horizontal Review of Practices at Large Complex Banking Organizations

Partners

Aubrey Bout
Chris Carstens
John R. Ellerman
John D. England
R. David Fitt
Patrick Haggerty
Jeffrey W. Joyce
Ira T. Kay
Donald S. Kokoskie
Diane Lerner
Eric Marquardt
Jack Marsteller
Richard Meischeid
Steve Pakela
Jaime Pludo
Lane T. Ringlee
John Sinkular
Christine O. Skizas
Bentham Stradley
Jon Weinstein

In 2010, the federal banking agencies[1] adopted final guidance originally proposed by the Federal Reserve on incentive compensation design ("Sound Incentive Compensation Policies"). This guidance is based upon a principles-based approach governing banking organizations' incentive compensation arrangements and related processes, and is founded on three key principles:

- Balanced risk-taking incentives
- Compatibility with effective risk controls and management
- Strong corporate governance.

The interagency guidance identified four areas of potential design, administration and oversight initiatives that firms could take to improve the linkage between risk and incentive compensation:

1. Adjust incentive awards or pools to reflect measurement of risk
2. Defer payment of incentives and adjust incentive accruals to reflect known performance risks
3. Implement longer-term performance periods to ensure "long-tail" risks are reflected in performance
4. Reduce the sensitivity of incentives to short-term performance.

Key issues raised by the guidance included recommendations that organizations tailor incentive programs and risk adjustments to reflect differences across firms (relating to business strategies, unit focus, and timing risks) and not rely upon common structures or formulaic approaches. The guidance also placed significant emphasis on the role and involvement of risk management and internal control functions in the development of balanced incentive structures.

To further development and implementation of these guidelines, the Federal Reserve announced a review of incentive compensation practices at 25 large, complex banking organizations (LCBOs) in 2009. The results of this review can be found at http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf and are summarized here.

Balancing Risk-Taking Incentives

1. Risk Adjustment and Performance Metrics

- Use of risk adjustments is common but varies across businesses and may take the form of quantitative and qualitative adjustments to performance
  - May be applied to incentive pools and/or individual awards
- Judgment is used throughout the incentive decision-making process and firms have made progress in developing policies, processes and procedures for applying risk-related adjustments. Well-developed guidelines for using judgment are critical for ongoing consistency in application
- Formulaic risk adjustments are commonly made by offsetting financial performance (e.g. profits) with risk charges or charges for liquidity risk, then using the adjusted profitability result to determine incentive awards
  - A common approach utilizes a formulaic or quantitative measurement of risk as a consideration when applying judgment to incentive compensation decisions. This is viewed as the approach most likely to result in a consistent, balanced approach to risk adjustments
  - Non-quantitative views of risk are commonly used for risk-based adjustments
- Adjustments to incentives commonly take the form of a blend of "top-down" aggregate pool adjustments and "bottoms-up" adjustments to individual awards.

Pay Governance expects that firms will increase their focus on risk-adjustment of incentive pools.

2. Deferrals

- Deferrals of incentive awards are common, and the length and amount of deferrals are significant: senior executives defer over 60% of incentive compensation and those at the highest executive levels defer 80% or more, often in combination with stock retention requirements
- Payment of deferred amounts occurs 3 to 5 years from determination, with 3 years being the most common
  - Deferred amounts are often converted to time-vested equity (stock and options) or performance units
  - The Federal Reserve noted a potential concern regarding risk-taking actions that occur after conversion of cash to equity and the impact—positive or negative--of those actions on the value of equity awards
- Most firms use a performance adjustment during the deferral period that is a combination of formulaic and judgment-based evaluation of how much or when vesting will occur
- Clawback features are also common, but their limitations are recognized and cannot be used as the sole risk-mitigation feature.

Pay Governance believes that very good progress has been made on implementing deferrals at LCBOs.

3. ***Additional Design Approaches to Mitigate Risk and Definition of Covered Employees***

- Firms are using longer performance periods to evaluate performance and pay incentive awards; this allows for improved recognition of potential risks and for risk outcomes to materialize
- The use of reduced incentive slope (slower accrual of incentive compensation for each additional unit of performance above target) and caps on incentive payouts is also common
- Firms have defined materiality thresholds for determining employees who individually or in combination with other employees in a group or unit may expose the firm to excessive risks. Note that the report identifies common weaknesses to these thresholds: 1) they fail to capture the complete extent of risks; 2) they may exclude certain employees (e.g. who lack decision-making authority, but may influence risk decisions) and 3) they may exclude groups of similar employees.

Pay Governance expects that critical areas of focus and change will occur in defining materiality thresholds, covered employees and stock ownership guidelines. The latter, in particular, will help mitigate moral hazard among covered employees and key risk takers.

4. ***Risk Management and Governance***

- Risk management and control personnel are often involved in the design, operation and monitoring of incentive compensation plans, and provide quantitative information or input to decision-making
- Management committee structures to oversee incentive compensation are also being used, and these committees have multi-functional representation to provide broad perspectives. Similarly, internal reviews and audits will continue to be led by the internal audit function, but with broader representation of other functions
- Incentive compensation plans and metrics for risk management staff reflect their functional duties rather than performance of the businesses they supervise. Firms will increase the independence of these functions by establishing separate incentive plans or pools, rather than rewarding for business unit performance
- Board compensation committees are increasingly involved in overseeing incentive plan administration and the results of risk reviews of incentive plans.

Pay Governance believes that very good progress has been made by most organizations on integrating risk management and control function monitoring of incentive plans as well as involvement in ongoing oversight. Additionally, Boards are highly engaged in compensation risk reviews.

Next Steps and Implications

The Federal Reserve will continue to monitor and review progress of the LCBOs to achieving compliance with the guidelines by the end of 2011. We expect that the design trends established by these firms to achieve compliance with the Federal Reserve guidance will influence incentive compensation trends in the broader financial services industry.

1. Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision

---

Pay Governance LLC is an independent executive compensation advisory firm. Our focus is on providing sound advice and counsel on how pay programs attract, retain, and motivate executives to create shareholder value. The firm helps compensation committees and management ensure that compensation programs align pay with performance, while being supportive of appropriate corporate governance and risk structures.

©2011 Pay Governance LLC