Balancing the Risks and Rewards of Incentive Compensation:

Preparing for Bank Examinations after the Interagency Guidance on Incentive Compensation Practices

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With the goal of promoting incentive compensation structures that promote the safety and soundness of the banking industry, the Board of Governors of the Federal Reserve System, the FDIC, the OCC and the OTS (the "Agencies") issued final guidance on incentive compensation policies on June 21, 2010 (the "Interagency Guidance"). Compliance with the principles described in the Interagency Guidance is expected to be a part of bank examinations starting immediately. As a result, financial institutions should revisit their incentive compensation policies and practices and be prepared to justify these policies and practices during their next examination.

Scope

The Interagency Guidance broadly defines "incentive compensation" to include any compensation that is tied to achievement of one or more specific metrics (*e.g.*, a level of sales, revenue or income), but excludes compensation that is based solely on continued employment, such as base salary, or that is based solely on levels of compensation and does not vary based on one or more performance metrics, such as 401(k) plan matching contributions.

The Interagency Guidance is potentially applicable to all employees, including:

- senior executives and others who are responsible for oversight of organization-wide activities or material business lines;
- individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and
- groups of employees participating in similar incentive compensation arrangements who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk.

Principles-Based Approach

The Interagency Guidance requires that incentive compensation practices be aligned around the following three principles.

- Principle #1: Incentive compensation should provide employees with incentives that appropriately balance risk and reward.
    - > Prior to adopting, implementing or modifying an incentive compensation program, a banking organization should: (i) consider the full range of risks associated with the employee's activities and the time horizon over which those risks may be realized; (ii) assess, if possible, whether the program is likely to balance risk-taking incentives and is appropriately tailored for the participants; and (iii) discuss with internal risk personnel whether to include additional components to appropriately reflect risk and make the program more risk sensitive.

   - In order to balance risk-taking incentives, incentive compensation programs may: (i) adjust payouts to account for risk; (ii) subject payment to clawback; (iii) extend performance periods; or (iv) avoid excessive focus on single performance metrics or duplication of performance metrics across plan.

   - Banking organizations should consider the effect of "golden parachute" severance payments on risk-taking incentives and "golden handshake" recruitment packages on the effectiveness of risk-balancing strategies.

- Principle #2: Incentive compensation programs should be compatible with effective controls and risk management.

   - The board of directors should adopt policies and procedures ensuring that risk-management personnel have an appropriate role in establishing and monitoring incentive compensation programs and assessing their effectiveness in restraining imprudent risk-taking.

- Principle #3: Incentive compensation programs should be supported by strong corporate governance, including active and effective oversight by the board of directors.

   - The board must have (or have access to) a level of expertise and experience in risk-management and compensation practices appropriate for the nature, scope and complexity of the organization's activities.

   - The board should monitor and approve the incentive compensation programs (including material exceptions or adjustments) for senior executives.

   - The board should provide appropriate disclosure of incentive compensation programs, including risk-management processes, to shareholders.

Enforcing Compliance

All banking organizations should expect that incentive compensation policies practices will be reviewed during their periodic banking examinations – and should be prepared to justify these policies and practices within the framework of the Interagency Guidance. Certain large banking organizations and other "significant users" of incentive compensation are required to adopt more formal and extensive policies, procedures and systems consistent with these principles.

Action Steps

All banking organizations should establish a process for evaluating their incentive compensation policies and practices in light of the three principles described above and document how the process was implemented.

Generally, in conducting this evaluation, an institution should:

- Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks.

- 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 imprudent risks.

- Include balancing elements within the incentive compensation arrangement for these employees that are reasonably designed to ensure that the arrangements will be balanced in light of the size, type and time horizon of the inherent risks of the employee's activities.

- 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.

- 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.

Vorys has provided education and training to boards of directors and assisted a number of clients prepare for and conduct systematic evaluations of their incentive compensation policies and practices. Please contact your Vorys relationship attorney or any of the individuals identified in this Client Alert if you would like more information about Vorys' capabilities or if you would like assistance in developing a framework to review your incentive compensation policies and practices.
