# *Client Alert:* Fed Report Offers Insight into Compliance with Interagency Guidance on Sound Incentive Compensation Practices

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**CLIENT ALERT** | 11.10.2011

In June 2010, the federal banking regulators jointly issued guidance (the "Interagency Guidance") recommending that all banking organizations organize their incentive compensation programs for covered employees around the following three principles:

- First, incentive compensation should balance risk and financial results in a manner that does not encourage employees to expose the organization to imprudent risks;
- Second, risk management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation; and
- Third, sound incentive compensation practices should be supported by strong and effective corporate governance, including active oversight by the board of directors.

In October 2011, the Federal Reserve released a report describing the results of a "horizontal review" assessing the compliance by 25 large banking organizations with the Interagency Guidance. This report offers insight into the regulatory expectations for complying with, as well as the practical experiences of banking organizations in implementing, the Interagency Guidance.

***Results of Report***

The report contains a number of useful observations regarding implementation of the Interagency Guidance, particularly with respect to the identification of covered employees and the use of various "balancing" mechanisms to make incentive compensation programs more risk sensitive. These observations are discussed in greater detail below.

**Identification of Covered Employees**

The compensation of the following "covered employees" must be evaluated under the Interagency Guidance:

- Senior executives; and
- Individual employees able to take or influence material risk; and
- Groups of similarly compensated employees who, in the aggregate, can take or influence material risk.

The report noted that many organizations struggled to identify groups of mid- and lower-level employees, such as mortgage originators, commercial lending
officers and traders with large positions, whose compensation programs must be evaluated under the Interagency Guidance.

The report endorses the following two methods to identify covered employees:

- The first method involves systematically identifying the types of risk that each employee (or group of employees) takes or influences and assessing the materiality of that risk and, based on this analysis, identifying the compensation plans in which these employees participate.
- The second method involves casting a wide net by designating a very large set of employees as "covered" (such as all employees receiving incentive compensation) and evaluating their incentive compensation plans.

Generally, the report dismisses the use of mechanical materiality thresholds (such the ability to commit capital or compensation) to determine covered employees as excluding employees who influence risk but do not make final risk decisions and groups of employees who may affect risk.

**Balancing Compensation Programs**

The Interagency Guidance requires that the compensation programs of covered employees appropriately balance risk-taking and financial reward.

The Interagency Guidance specifically identifies the following four methods that can be used to make compensation programs more risk sensitive:

- Adjusting payouts based on risk outcomes; or
- Deferring payment; or
- Lengthening performance periods; or
- Reducing sensitivity to short-term performance.

Of these four methods, the report notes that most organizations adjusted payouts based on risk outcomes and deferred payments. The report concluded that lengthening performance periods or reducing sensitivity to short-term performance did not effectively balance risk-taking incentives unless used in conjunction with another balancing method.

The report notes that effective risk-based adjustments:

- Are supported by robust written policies and procedures that, among other things, clearly identify the weight given to risks taken; and

- Are documented to ensure consistency; and
- Consider likely losses under stressed conditions, such as by calculating internal profits measures for liquidity risk under stressed conditions.

When deferral is used as a balancing method, the report concludes that the deferred payouts must be adjusted to account for risks that become known during the deferral period. With respect to deferred awards:

- Deferral periods ranged from between three and five years, with a mix of cliff and ratable vesting.
- Approximately 60% of awards for senior executives were deferred, with the percentage increasing to 80% for the most senior executives, whose awards were further subject to additional retention requirements.

The report dismissed the use of clawback policies as a balancing mechanism, noting that most risk outcomes do not result in recovery (i.e., clawback is triggered by malfeasance, etc.).

***Next Steps***

The large banking organizations that are the subject of the report are expected to be in compliance with the Interagency Guidance by December 31. Compliance by other banking organizations will be addressed through the annual bank examination process.

Vorys provides specialized advice to banking organizations relating to compensation practices, including on compliance with the Interagency Guidance. Vorys can assist banking organizations:

- Educate Boards of Directors and Compensation Committees about their new responsibilities;
- Recommend how to integrate risk management personnel into decisions involving incentive compensation for 2012 and beyond;
- Establish a framework for evaluating incentive compensation plans in which covered employees participate to ensure that the plans are appropriately balanced; and
- Develop policies and procedures governing the adoption, implementation and administration of incentive compensation plans.

If you would like more information about the Interagency Guidance or would like to have a Vorys attorney speak to your management team, Board of Directors or Compensation Committee, please contact your Vorys relationship attorney.