

Federal Reserve Proposed Incentive Compensation Guidance

Questions and Answers

1. What is a guidance? What does it do? How is it enforced?

Supervisory guidance is one of the Federal Reserve's most important supervisory tools for focusing attention on risk issues and for articulating supervisory expectations to the banking organizations that it supervises. It is particularly useful in addressing risks in areas where there may be significant differences among banking organizations or a variety of approaches that may be used by banking organizations to achieve the desired goal. In such cases, a formal rule runs the risk of being potentially too broad or too narrow.

This guidance sets clear expectations for banking organizations concerning their incentive compensation arrangements and related risk-management, control, and governance processes. As explained in the guidance, Federal Reserve examiners will review whether the arrangements and processes of banking organizations are consistent with the guidance and safety and soundness. Deficiencies will be factored into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions or take other actions. In addition, the Federal Reserve in appropriate circumstances may take enforcement action against a banking organization. Such an action may require the organization to develop and promptly implement a plan to correct deficiencies in its incentive compensation arrangements or related processes.

2. What happens next?

The Board will accept comments on the guidance for 30 days. Nevertheless, the Board expects banking organizations to immediately review their incentive compensation arrangements to ensure that they do not encourage excessive risk-taking and to implement corrective programs where needed.

To help spur action, the Federal Reserve also will move forward with the two supervisory initiatives outlined in the guidance. For example, as part of a horizontal review, large, complex banking organizations (LCBOs) will provide the Federal Reserve with information and documentation that clearly describes their plans, including relevant timetables, for improving the risk-sensitivity of incentive compensation arrangements and related risk management, controls, and corporate governance practices. We will work closely with the LCBOs on these plans and will monitor their adherence to the plans and associated timetables.

3. Why is the Federal Reserve not suggesting a pay cap or outlawing particular practices?

As noted in the Principles for Sound Compensation Practices issued by the Financial Stability Board in April 2009, "one size does not fit all" firms or employees. Best practices for

balancing risk and rewards in incentive compensation programs continue to develop and are likely to evolve significantly in the coming years.

For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to provide at least some employees with incentives to take excessive risks. 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. Further experience may reveal specific compensation practices that may appropriately be required or prohibited. In the Federal Register notice proposing the guidance, the Federal Reserve has asked for comment on this point.

4. Why is the Fed doing this? What authority does the Fed have to oversee compensation?

Recent events have highlighted that inappropriate compensation practices can contribute to safety and soundness problems at banking organizations and to financial instability. Traditionally, banking organizations and supervisors relied on strong risk management, internal controls and corporate governance to help constrain risk-taking. However, the financial crisis has illustrated that the incentives created by poorly designed and implemented incentive compensation arrangements can be powerful enough to overcome risk controls.

While organizations, their shareholders and others are examining compensation practices, the Federal Reserve has an important role to play as well. Because of the presence of the federal safety net, shareholders of a banking organization may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Thus, aligning the interests of employees and shareholders may not be sufficient to protect the safety and soundness of the organization or financial stability.

Supervisors also can play a critical role in addressing the "first mover" problem that may make it difficult for individual firms to act alone in addressing misaligned incentives for fear of losing valuable employees and business to other firms. Supervisors can help counteract these forces by promoting the coordinated movement of the industry toward better practices.

The Federal Reserve has clear authority to act in this area. Section 8 of the Federal Deposit Insurance Act authorizes the Federal Reserve to take action against a banking organization if the organization is engaged, or is about to engage in, any unsafe or unsound practice. The Federal Reserve and the other Federal banking agencies regularly issue supervisory guidance based on the authority in section 8 of the FDI Act. Guidance is used to identify practices that the agencies believe would ordinarily constitute an unsafe or unsound practice and identify risk-management systems, controls, or other practices that the agencies believe would ordinarily assist banking organizations in ensuring that they operate in a safe and sound manner.

5. Who will be subject to this compensation guidance?

The guidance will apply to all banking organizations supervised by the Federal Reserve. This 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 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, the 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;
- Individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk (for example, 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 (for example, loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

6. How is this guidance related to recent work by international bodies like the Group of Twenty or the Financial Stability Board?

The guidance is consistent with the Financial Stability Board's (FSB) Principles for Sound Compensation Practices issued in April 2009 and with the FSB's recent Implementation Standards. Both documents mention a number of possible methods of improving compensation arrangements for individual employees. The Federal Reserve will focus on whether compensation arrangements provide employees incentives to take excessive risks that could threaten the safety and soundness of the banking organization. The Federal Reserve will continue to work with representatives of other nations to achieve a level playing field with respect to compensation incentives.