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Final Guidance on Sound Incentive Compensation Policies - What Community Banks Need to Know

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The joint banking regulators recently issued [Final Guidance on Sound Incentive Compensation Policies](#) that is applicable to all federally insured financial institutions (the “Guidance”). This issuance has been largely overshadowed by the looming regulatory thunderstorm that will inevitably result from the recently enacted [Dodd-Frank Wall Street Reform and Consumer Protection Act](#). During this brief calm before the financial reform storm, however, we wanted to shift attention back to the Guidance and certain of its key provisions, especially as they apply to community banks. We believe that these provisions will be the focus of upcoming regulatory examinations, and therefore should not be overlooked.

What Community Banks Need to Know

In later sections of this article, we discuss in more detail the key provisions of the Guidance. If you don’t read the entire article, however, we hope that you will at least consider the following implications and recommendations for compliance that we believe will be most important for community banks in light of our review of the Guidance.

- The Guidance does not contain any formulaic or one-size-fits-all requirements or restrictions for incentive compensation policies of community banks. The regulatory agencies have clarified that their intent is not to dictate what institutions can and cannot pay to employees. Instead, the regulatory review of compensation arrangements for smaller institutions (generally, those institutions that are not considered by the regulatory agencies to be “large banking organizations”) will be based on relevant facts and circumstances, and will focus on risk-management, effective controls and strong corporate governance.

- The Guidance has a broad scope with respect to employees covered. It is not limited to incentive compensation of executive officers, but applies generally to any incentive compensation paid to any employee whose activities, either individually or in the aggregate with other employees, may expose the institution to material risk.
- In light of the Guidance, Boards of Directors should make a conscious *and well-documented* effort to review and identify any risk inherent in their institution’s incentive compensation policies. It may be appropriate to form a formal compensation committee of the Board, or to have the full Board (excluding members of bank management) act as a compensation committee for the purposes of this review. We recommend that this review be performed as soon as possible, and the process should be repeated on at least a bi-annual basis.
- Where the Board (or Compensation Committee) determines that any incentive compensation policy is not aligned with the related risks, or where related internal controls or corporate governance practices are not consistent with safety and soundness and the principles of the Guidance, the Board should take immediate action to correct identified deficiencies. This may include revisions to existing policies, compensation agreements or the implementation of “clawbacks.”
- Financial institutions that have participated in the U.S. Treasury’s Capital Purchase Program (the “CPP”) and that are in compliance with the requirements of the U.S. Treasury’s [Interim Final Rule on Tarp Standards for Compensation and Corporate Governance](#) (the “TARP Compensation Rule”) are probably already complying with the requirements of the Guidance.
- If you are a member of an institution’s Board of Directors or Compensation Committee that is responsible for compliance with the Guidance, you should *not* stop reading here. For a better understanding of the Guidance and the requirements for compliance, we recommend that you also read the following, more comprehensive summary of the key provisions of the Guidance.

Summary of Key Provisions of the Guidance

Core Principles. As stated above, the Guidance does not recommend any systematic compliance approach for financial institutions that are not “large banking organizations.” The incentive compensation policies of smaller institutions will be reviewed on a facts and circumstances basis to ensure that they are consistent with the three core principles stated in the Guidance. Those core principles are:

- Incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk;
- Incentive compensation arrangements should be compatible with effective controls and risk-management; and
- Incentive compensation arrangements should be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

Employees Covered. The Guidance is applicable to all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organizations to material amounts of risk. The Guidance breaks these employees into three principle groups, including:

- Senior executives (including, at a minimum, executives who are covered under Federal Reserve Regulation O) 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 organization to material amounts of risk (e.g., traders with large position limits or loan officers relative to the organization’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 organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization’s credit risk).

The Guidance points out that, although tellers, bookkeepers, couriers or data processing personnel would not typically have the ability to expose a financial institution to material risk, those employees are not expressly exempted. This is due to the desire of the regulatory agencies to consider the full range of risks that could arise from any employee’s activities, even if the institution has controls in place to mitigate such risks.

General Guidelines for Compliance. The Guidance discusses several general guidelines for compliance.

- Banking organizations will be expected 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,” the Guidance directs that incentive compensation arrangements should be consistent with the core principles stated above. (More detailed instructions for compliance with each of these principles are discussed below.)

- Banking organizations are encouraged to regularly review incentive compensation arrangements for all covered employees. Although no specific frequency for this review is included in the Guidance, the TARP Compensation Rule requires CPP participants to conduct a risk-management review of incentive compensation policies on at least a bi-annual basis. Consequently, a bi-annual review will likely also satisfy the Guidance’s recommendation for a “regular” review.
- After completing the regular risk-management compensation review, financial institutions are directed to immediately address any deficiencies that have been identified in their incentive compensation policies or related risk-management, control or corporate governance processes.

How to Balance Incentives and Risks. The Guidance elaborates on what the regulatory agencies intended when advising that incentives should appropriately balance risks and rewards in a manner that does not encourage imprudent risk-taking. Specifically targeted in this area are incentive compensation arrangements that encourage actions resulting in greater short-term revenue or profits for the organization, without regard to risk. If the compensation arrangement is appropriately balanced, two employees who generate the same amount of short term revenue or profit should not receive the same amount of incentive compensation when the risks taken by those employees in generating that profit differ materially. In this situation, the employee who creates more risk for the organization should receive less, assuming everything else is equal.

When an incentive compensation program is found to be unbalanced, the Guidance requires the institution to take action to bring the program back into balance. The following four methods are recommended for balancing risk and incentives in compensation programs. (This list is not exclusive, and two or more methods in combination may be appropriate to ensure a properly balanced system of incentives and rewards.)

- Risk Adjustment of Awards. The amount of an incentive compensation award for an employee can be 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 could be determined subjectively, subject to appropriate oversight.

- Deferral of Payment. By deferring an incentive payment significantly beyond the related performance period, the actual payments made to employees may be adjusted for actual losses or other performance aspects that are more accurately measured with the benefit of hindsight.
- Longer Performance Periods. By extending performance periods related to incentive payments, there is a longer time for risks taken by employees in achieving those incentives to come to light.
- Reduced Sensitivity to Short-Term Performance. By reducing the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s), the magnitude of the incentive related to the short-term risk is diminished.

Significantly, the Guidance clarifies that incentive plans providing for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives.

The Guidance emphasizes that financial institutions should effectively communicate with employees regarding adjustments that will be made to compensation plans in an effort to appropriate balance incentives with the risks.

How to Ensure Effective Controls and Risk-Management Procedures. In addition to balancing risk and reward, the Guidance emphasizes the importance of having strong risk-management processes, internal controls and corporate governance. Compliance with this recommendation will involve the following:

- Internal Controls. Financial institutions should implement tight controls on the processes for designing, implementing and monitoring incentive compensation. Organizations 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. Smaller banks should incorporate reviews of these processes into their overall framework for compliance monitoring (including internal audit).
- Input from Risk-Management Employees. Banks should ensure that appropriate personnel, including risk management personnel, have an opportunity to provide input in the design, and in evaluating the effectiveness, of incentive compensation arrangements.
- Appropriate Resources, Including Qualified Personnel. The Guidance directs banks to dedicate sufficient resources to attract and retain qualified risk-management personnel.

To avoid conflicts of interest and to ensure independence, the incentive compensation of those individuals should not be tied to the performance of the business units they review.

Ensuring Strong Corporate Governance Related to Incentive Compensation. The following are methods that Boards may employ to ensure strong corporate governance related to incentive compensation.

- Periodic Board Review of Compensation Arrangements. As mentioned above, Boards of Directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements. During its review, the Board should consider relevant data from bank management or other sources. This data should be sufficient to allow the Board to monitor incentive compensation payments and the sensitivity of those payments to risk outcomes. For example, if the compensation arrangement includes a clawback provision, then the review should include sufficient information to determine whether the provision has been triggered and is operating as planned.
- Board Composition and Resources. The organization, composition and resources of the board of directors should permit effective oversight of incentive compensation. There should be expertise and experience on the Board (or available to the Board) relating to risk-management and industry compensation practices that is appropriate for the nature, scope and complexity of the organization's activities.
- Appropriate Shareholder Disclosures. Banking organizations should disclose to shareholders an amount of information about incentive compensation arrangements, risk-management, controls and governance processes that is sufficient to allow shareholders to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take imprudent risks. Such disclosures should include information relevant to employees other than senior executives. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.

Interplay with TARP Compensation Rules

The recommendations in the Guidance will probably sound familiar to many banking organizations that are also CPP participants and that are already subject to the TARP Compensation Rule. Although the Guidance does not contain the same types of prohibitions on certain types of incentive compensation (*i.e.*, the TARP Compensation Rule's outright prohibition on payment of any incentive compensation to certain of the CPP participants' most

highly compensated officers), the Guidance *does* require all federally insured financial institutions to undertake the same types of risk-management, process and control reviews that are already required of CPP participants. CPP participants that are in full compliance with the TARP Compensation Rule can breathe easy. It appears that compliance with the TARP Compensation Rule would also result in compliance with all of the recommendations included in the Guidance.

Significantly, even though institutions that are not CPP participants are not subject to the additional requirements of the TARP Compensation Rule, the TARP Compensation Rule can still provide some clarification regarding some of the Guidance's frustratingly vague recommendations. For example, where the Guidance recommends a "regular" review of incentive compensation, the TARP Compensation Rule is specific in its requirement for a bi-annual review. Accordingly, a bi-annual review is probably sufficient to comply with the Guidance's recommendation for a "regular" review.

Conclusions

The clearest message conveyed by the Guidance is that incentive compensation arrangements *will* be a focus of future safety and soundness examinations. Boards of Directors should begin taking action to comply with the Guidance's three core principles, including conducting an immediate evaluation of incentive compensation plans, as well as an evaluation of the related risk management and corporate governance processes. These evaluations should be conducted by the Board of Directors or by the Board's compensation committee. The review effort and the resulting findings should be well documented, and any identified deficiencies should be addressed immediately.

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