DON'T BANK ON THE STATUS QUO: FEDERAL RESERVE TO REGULATE INCENTIVE COMPENSATION

October 26, 2009

To Our Clients and Friends:

In an effort to get banks to address perceived deficiencies in their incentive compensation systems and to ensure that compensation practices do not encourage excessive risk taking, the Federal Reserve Board ("FRB") issued proposed guidance last week setting forth principles for sound incentive compensation practices for banking organizations. These guidelines will apply to all banking organizations supervised by the FRB, including banking organizations that did not receive federal assistance under TARP and the U.S. operations of foreign banks with a branch, agency or commercial lending company subsidiary in the United States.

Although the supervisory guidance was issued in proposed form and is open for public comment, the FRB made clear that it expects banking organizations to review their compensation arrangements immediately to ensure that those arrangements do not promote excessive risk taking. The FRB also announced that it will immediately begin reviewing compensation arrangements at banking organizations to ensure that the arrangements conform to the announced principles.

HIGHLIGHTS

No caps or numerical guidelines. The FRB's proposed guidelines do not impose pay caps or dictate the manner in which compensation is paid. Instead, they set forth broad principles to be used in the design, implementation and monitoring of compensation arrangements. Although stated to be consistent with the Financial Stability Board's Principles for Sound Compensation that were endorsed by the G-20 nations in September as discussed in the Debevoise & Plimpton October Financial Institutions Report,[1] the guidance contains no formulaic approach to the percentages of compensation to be deferred or paid in the form of equity. Interestingly (and unlike the determinations issued the same day by the Office of the Special Master for TARP Executive Compensation regarding the institutions that received the largest federal bailouts), the proposed guidance does not appear to prefer stock-based programs to cash-based programs. The guidance also makes no mention of limiting variable compensation as a percentage of total net revenues. While the absence of pay caps, required

[1] *See* http://www.debevoise.com/files/Publication/0c6805e9-e2f6-4a6c-b984-34f1d5fa9422/Presentation/PublicationAttachment/904ed8bb-4c5a-490a-852e-7c615db317af/FIReportOctober2009.pdf

equity allocations and other mandates or specific rules should be a relief to the industry, the FRB's approach potentially exposes banking institutions to additional uncertainty in the examination process and the potential for enforcement actions.

The covered compensation goes deep into banking organizations. The proposed guidelines apply far deeper in banking organizations than the limits imposed on TARP recipients, covering senior executives, non-executive employees (such as traders and loan officers) who either individually or as a group have the ability to expose the bank to material risks, and risk-management and control personnel.

Special review of compensation practices at large complex banking organizations ("LCBOs"). In advance of finalizing the guidelines, the FRB's Washington staff will conduct a special horizontal review of incentive compensation practices at 28 LCBOs, including U.S. operations of foreign LCBOs. The review will look at practices at all of the LCBOs as a whole in an effort to identify industry best practices across organizations and business lines that could then be applied to both the LCBOs and the broader group of banking organizations.

As part of this review, the FRB will require LCBOs to provide extensive information and documentation relating to the structure of their incentive compensation programs. LCBOs will need to gather this information promptly. (As a second project, the FRB also will review incentive compensation at non-LCBO banking firms, but only as part of risk management reviews in the normal examination process.)

THE PRINCIPLES

Balanced risk taking incentives. The proposed guidance outlines a process for ensuring that incentive compensation arrangements appropriately balance risk and financial results, without encouraging excess risk taking. Incentives should be designed in a manner that takes into account risk levels involved in generating revenues and profits, with employees creating larger risks receiving less than employees who generate the same revenue or profit at a lower risk level. Accordingly, in designing compensation, banking organizations should consider all of the risks associated with an employee's activities (including both level and probability of risk), the time horizon over which the risks may be realized and the cost and amount of capital necessary to support those risks. Balance also may require adding or modifying features that adjust the ultimate payouts to reflect risk and risk outcomes, including through risk-adjusted awards at the outset, longer performance periods, deferral of payment beyond the performance period with amount of payment adjusted for risk outcome and reducing the impact of short-term performance on award levels. Interestingly, the proposed guidance suggests that low base compensation and high incentive compensation may create incentives to take excessive risk, which supports the actions of those banking institutions that significantly increased base salaries in connection with the financial crisis. Increasing fixed

compensation and reducing the amount of compensation that is contingent on performance runs counter what had been generally accepted to be best practices.

There is no one-size-fits-all approach to achieving the appropriate balance, either across different organizations or within individual organizations. Banking organizations should tailor their incentives to an individual's role and account for differences among employees (including senior executives and other employees), recognizing that firm-wide incentives may not always provide an appropriate risk adjustment for non-executive-level employees whose activities are less likely to materially impact overall profitability. Banking organizations should make sure that employees understand how their compensation will vary based on the risks associated with their activities.

Banking organizations should also be concerned about the potential impact on the safety and soundness of arrangements that provide for large additional payments, accelerated payments of deferred amounts without regard to risk outcomes, or other vesting that occurs on termination or change in control. In other words, employees should not be able to walk away (or be forced away) from their risks without consequence. In a surprising statement, and unlike the recent determinations by the TARP Special Master mentioned above, the guidelines discourage forfeiture of incentive compensation on voluntary termination because of the perceived ability of highly sought-after employees to negotiate lucrative sign-on deals with their new employers that replace the forfeited awards. While not limiting the ability to offer sign-on guarantees, banking organizations will need to consider whether their hiring packages materially weaken their risk control efforts.

Compatibility with effective controls and risk management. A banking organization needs strong internal controls and risk-management processes to support the balanced incentive process. Processes should be implemented to preclude employees from doing an end-run around the balanced risk incentives by obtaining waivers or other adjustments to their compensation. In this regard, the banking organization should clearly identify and describe the role of the personnel involved in designing, implementing and monitoring incentive compensation or whose approval is necessary to create or modify incentive arrangements. These processes will need to be created and documented in a manner that will permit auditing. Risk-management personnel should be involved in both the design and monitoring of incentive compensation to ensure effectiveness in controlling excessive risk-taking. This involvement may include reviewing the risk profile of various employees or groups, approving risk measures and analyzing risk outcomes relative to incentive compensation payments. The performance and risk outcomes should be carefully tracked and compensation arrangements adjusted if the payments do not appropriately reflect the actual risk involved.

Strong corporate governance. Appropriate incentive compensation must be accompanied by effective corporate governance. As part of this process, the board of directors should

actively oversee the development and operation of incentive compensation arrangements, including by reviewing and approving the overall goals and purposes of the incentive compensation system and the related risk profile. The board also should closely monitor the performance and outcome of incentive compensation to assess whether the compensation remains consistent with safety and soundness. Frequent (at least annual) assessments of the design and operation of incentive compensation programs by management with input of risk-management personnel should be provided to the board. Disclosure practices should match these efforts by providing sufficient information to shareholders to allow them to monitor and, where appropriate, take action to restrain practices that may encourage employees to take excessive risks.

Systematic approach. The proposed guidance would require that, in developing balanced compensation programs, LCBOs take a systematic approach to (i) identify employees who may expose the organization to material risks; (ii) identify the time horizons of those risks; (iii) assess the impact of the performance measures in incentive compensation arrangements on encouraging those risks; (iv) include measures to balance the incentive compensation plan design with the risk profile; (v) communicate to employees the ways in which incentive awards or payments are adjusted to reflect risks; and (vi) monitor awards, payments, risks taken and risk outcomes and modify arrangements if payments do not appropriately reflect the risk and risk outcomes.

Comments on the FRB's proposed guidelines are due within 30 days after their publication in the Federal Register.

Please feel free to contact us with any questions.

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