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Fed Proposes Executive Compensation Guidance for Banks

The Federal Reserve Board has issued proposed guidance intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of their organizations. 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. In brief, the guidance offers three principles and would apply to senior executives and to others who could expose the firm to material amounts of risk. It discusses various ways that compensation plans can be made more sensitive to risk but does not provide specific caps or outlaw any specific practices.

The proposed guidance would apply to all banking organizations supervised by the Federal Reserve Board (the Board). As used in the guidance, the term "banking organization" includes U.S. bank holding companies, including those life insurance companies who fall within bank regulation, 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.

The proposed guidance is based on three principles. These principles provide that incentive compensation arrangements at a banking organization should::

- Provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk;
- Be compatible with effective controls and risk management; and
- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

In this guidance, the term "incentive compensation" refers to that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is tied to, continued employment (e.g., salary).

The Federal Reserve Board also announced that it is commencing two supervisory initiatives. One, applicable to 28 large, complex banking organizations, will review each firm's policies and practices to determine their consistency with the principles for risk-appropriate incentive compensation set forth in the proposal. Second, supervisors will review compensation practices at regional, community, and other banking organizations not classified as large and complex as part of the regular, risk-focused examination process.

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).

In addition, the preamble to the proposed guidance noted that some have suggested that one or more formulaic limits be adopted for some or all banking organizations, and, in particular, have suggested consideration of an approach in which at least 60 percent of all incentive compensation received by senior executives of all large, complex banking organizations be deferred and at least 50 percent of incentive compensation be paid in the form of stock, options, or other equity-linked instruments. The Board did not adopt these suggestions in the proposed guidance, but asked for comments on the proposed guidance in general, and specifically with respect to these suggestions. The comment period will remain open for 30 days.

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