BNA, INC.

PENSION & BENEFITS

BNA Employee-Owned Since 1947

DAILY

Damned if You . . . *Don't:* Bank Directors Called to Account for Incentive Compensation

BY MARK POERIO

Over the past 18 months, U.S. and global governments and regulators have been consistent in their identification of the general principles by which to better structure executive compensation. There is near universal agreement that incentives should reflect long-term performance, that ill-gotten gains should be subject to forfeiture or clawback, that decisionmakers should be independent, and that imprudent risk-taking should be discouraged through intelligent program design. The move from generalities to specifics has now come for U.S. financial institutions, from their primary regulators. The Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (together, the *Regulators*) have jointly issued ''Guidance on Sound Incentive Compensation Policies'' (the *2010 Guidance*), effective June 25, 2010.[1]

Mark Poerio is a partner in the Washington, D.C., office of Paul Hastings Janofsky & Walker LLP. His practice focuses on executive compensation and employee benefit matters, especially from a business and corporate governance and securities perspective.

The 2010 Guidance is laden with action items that board members should be considering during the second half of 2010, whether or not their company is subject to banking regulation. The stakes are indeed high. From a banking perspective, the Regulators have warned that their future exams and audits will focus on assessing compliance with the 2010 Guidance, and that enforcement actions will occur if bank directors do not immediately correct any unsafe or unsound incentive arrangements. Separately, the FDIC has just announced plans to proceed with linking its evaluations of incentive pay structures to the size of premiums that institutions must deposit into the FDIC's insurance fund. For all companies, board members face public scrutiny under standards that more and more often call for best practices . . . with increased risk of personal liability for poor decisions, processes, or monitoring at the board level.

The 2010 Guidance has its genesis in a policy proposal that the Federal Reserve Board released in October 2009.[2] That proposal identified three over-arching

[1] The 2010 Guidance became effective on its publication date in the *Federal Register*, which occurred on June 25, 2010. 75 Fed. Reg. 36,395 (June 25, 2010).

[2] For further information, see Poerio, *Fed Tells Banks: Act Now or Risk Intervention* (93 BBR 1109, 12/1/09)(93 BNA Banking Report 1109, 12/1/2009).

principles that carry forward into, and organize, the detailed discussion set forth in the 2010 Guidance. Its specifications are directed to boards of directors (or any board committee that has primary responsibility for overseeing incentive compensation arrangements),[3] and are intended to be scaled to the ''nature and complexity of the organization and its incentive compensation arrangements.'' The source for the foregoing quotation, and all those below, is the 2010 Guidance.

Presented below is a checklist drawn from the 2010 Guidance. Note that the 2010 Guidance complements existing safety and soundness rules under which the Agencies prohibit excessive compensation. Pending financial reform legislation will extend this prohibition to the holding companies for banks and savings and loan associations, with all public companies being subject to more stringent executive compensation requirements relating to compensation committee independence, clawbacks, anti-hedging rules, and enhanced disclosures relating to pay-for-performance and to pay equity. Overall, the board members of all public companies should beware of the continuing sensitivity to all matters relating to executive and incentive compensation. Fulsome review, independent action, and thoughtful documentation will best demonstrate appropriate levels of diligence.

Principle #1: Incentive compensation arrangements should not encourage short-term profits at the expense of short- and longer-term risks to the financial institution.

Action Items (drawn from the 2010 Guidance):

1. Identify each incentive compensation arrangement (*Incentive Arrangement*) that is applicable to any executive or nonexecutive employees ''who, individually or as part of a group,[4] have the ability to expose the organization to material amounts of risk.''

2. Identify material safety and soundness risks to the organization. At a minimum, bank directors should consider the impact of any Incentive Arrangement on ''credit, market, liquidity, operational, legal, compliance, and reputational risks'' (footnote 1 within the 2010 Guidance singles these out by way of example).

3. Make Incentive Arrangements more risk-sensitive, through avoiding ''one-size-fits-all'' approaches, and instead tailoring deferral and vesting to the type or duration of the risk involved (Source: Press Release for 2010 Guidance).

4. Assure that the performance measures for each Incentive Arrangement have integrity, do not encourage imprudent risk-taking, and do not allow for inappropriate manipulation.

Note: the 2010 Guidance acknowledges that incentives based on organization-wide performance are generally unlikely to provide employees (other than senior executives) with unbalanced risk-taking incentives , while deferred incentive compensation, e.g. restricted stock, ''may be helpful in restraining the risk-taking incentives of senior executives.''

5. Implement Incentive Arrangements so that actual payments vary based on risks or risk outcomes.

6. Carefully review severance and golden parachute arrangements for safety-and-soundness implications, and consider modifying them to incorporate balancing features such as risk-adjusting amounts or deferring payment past the employee's departure date in order to mitigate the risk of imprudent risk-taking.

7. Communicate with affected executives and employees about the risk controls attributable to their Incentive Arrangements.

8. For large banking organizations (*LBOs*): (1) design and modify Incentive Arrangements based on simulation analysis, including forward-looking projections; (2) provide a significant portion of incentives in the form of equity awards that vest over a multi-year period, with adjustment of amounts received to reflect organizational performance over the vesting period; and (3) consider golden handshake risks under which new employers may lure away senior talent by providing substitutes for incentives that are deferred and at-risk.

Note: non-LBOs should also consider taking the foregoing precautions, as well as those set forth below for LBOs, to the extent the precautions are relevant and feasible (including from a cost perspective).

Principle #2: The governance of incentive compensation should be integrated with risk-management and internal control frameworks to assure better monitoring and control of associated enterprise risks.

9. Establish strong risk-management controls governing the processes for designing, implementing, and monitoring Incentive Arrangements; include policies by which risk-management personnel (and perhaps others, such as HR and finance) assist in the design and assessment of appropriately balanced Incentive Arrangements.

10. Gauge the organization's monitoring processes to the size and complexity of the organization, and make ongoing modifications to reflect consideration of past outcomes.

11. Assure that risk-management and control personnel have appropriate skills and experience, with compensation for them (1) at levels sufficient to attract the right levels of talent, and (2) based on performance measures relating to the adherence to internal controls, as opposed to the financial performance of the business units they review.

12. For LBOs: (1) actively monitor methods and practices by which to make incentive compensation more sensitive to risk, and incorporate changes that are likely to improve the organization's safety and soundness; (2) establish procedures covering several requirements set forth in the 2010 Guidance; and (3) provide for internal audits, and for reports to senior management and to board members where appropriate.

13. Document all of the above to permit auditing of its effectiveness.

Note: Thoughtful refinement of a Compensation Committee's charter or by-laws could establish the framework for all of the above.

Principle #3: Boards of directors should play an informed and active oversight role to ensure a proper balance between risk and profit not only when an incentive compensation program begins, but on an ongoing basis.

14. Specifically approve and monitor the Incentive Arrangements for all executive officers, ensuring that

[3] See footnote 19 of the 2010 Guidance, 75 Fed. Reg. at 36,412..

[4] Regarding potentially risky incentives among nonexecutives and groups, the 2010 Guidance singles out (i) traders with large position limits relative to the organization's overall risk tolerance, (ii) loan officers that account for a material amount of the organization's credit risk, and (iii) a structured-finance unit that is material to the organization.

they are ''appropriately balanced and do not jeopardize the safety and soundness of the organization.''

15. Regularly review all Incentive Arrangements, and the corporate governance processes relating to them. *Note: board members will need to identify the frequency of review that is warranted for each Incentive Arrangement.*

16. ''[I]mmediately address any identified deficiencies'' in any Incentive Arrangements or processes if they present safety and soundness concerns.

17. Tailor the analysis and governance methods for assessing Incentive Arrangements to the ''size, complexity, business strategy, and risk tolerance'' of the organization.

18. Evaluate whether any clawback rights are triggered and, if so, executed as planned.

19. For LBOs: (1) establish and adhere to systemic and formalized policies and procedures, at a minimum vetting the six items[5] singled out in the 2010 Guidance; (2) review and approve overall goals and purposes of Incentive Arrangements; and (3) provide ''clear direction to management to ensure that the goals and policies it establishes are carried out in a manner that achieves balance and is consistent with safety and soundness.''

20. Receive data and analysis from management or other sources as needed to make the above determinations.

21. Have a level of expertise and experience in risk-management and compensation practices (or access to such expertise) that is appropriate based on the nature, scope, and complexity of the organization's activities.

Note: independent expert advice is the best defense against second-guessing, and is generally recommended in view of the importance of considering peer practices and data, as well as the expectation that board members stay abreast of emerging trends and best practices.

22. Give due attention to potential conflicts of interest from the use of outside advisors, and use caution to avoid undue levels of outside influence.

23. Be ready for audit attention to all of the above during regular bank regulatory exams.

24. Provide appropriate shareholder disclosures regarding Incentive Arrangements, related risk-management control, and associated governance processes.

For the correction of deficiencies, the 2010 Guidance discusses four approaches, namely: (1) adjusting potential incentive award amounts to take into account the risks associated with the associated employee activities; (2) delaying the payout of the incentives until ''significantly beyond the end of the performance period'' and adjusting for actual losses or other performance outcomes that arise after the performance period ends; (3) lengthening performance periods, to better reflect the risk period for the underlying incentives; and (4) reducing the sensitivity to short-term performance, by reducing the magnitude of the incentives that may be earned.

Conclusion.

The 2010 Guidance makes it clear that ''the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.'' In its press release relating to the 2010 Guidance, the OCC warned as follows relating to its expectations:

> For all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization in the relevant supervisory letter or report of examination. In addition, these findings will be incorporated, as appropriate, into the organization's rating component(s) and subcomponent(s) relating to risk management, internal controls, and corporate governance under the CAMELS rating system, as well as the organization's overall composite rating.[6]

For nonbanking entities, the 24 items listed above generally indicate good governance, subject to being adapted to the circumstances of non-banking entities.

Overall, and in view of today's intense scrutiny of executive and incentive compensation decisions, those who are accountable at the board level would be wise not only to consider the above checklist, but also to generally record their diligence (in case shareholders or regulators later raise questions).[7]

---

[5] The items are: (1) identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks; (2) identify the time horizons of risk to the organization from the activities of these employees; (3) assess the potential for the performance measures included in the relevant incentive compensation arrangements to encourage the employees to take imprudent risks; (4) include balancing elements, such as risk adjustments or deferral periods, within the incentive compensation arrangements that are reasonably designed to ensure that the arrangements will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities; (5) communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and (6) monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes. 73 Fed. Reg. at 36,413.

[6] OCC Bulletin 2010-24, available at http://www.occ.treas.gov/ftp/bulletin/2010-24.html.

[7] For instance, although the SEC's 2009 refinement of its proxy statement disclosure rules does not require discussion of risk assessment practices for executive compensation, the SEC has been routinely seeking confirmation from reporting companies that risk assessments are indeed occurring.