

Highlights of Federal Reserve Report Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations

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On October 5, 2011 the Federal Reserve issued its report: *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations*. The primary purpose of the horizontal review was to guide firms in implementing the interagency guidance on incentive compensation originally issued by the Federal Reserve in 2009 and adopted by all of the federal banking agencies in June 2010. The Federal Reserve's report provides a summary of progress made to date by the large banking organizations in implementing and complying with the guidance and highlights areas for future improvement and next steps.

The body of the report is structured around two overarching principles of the guidance with four subtopics under each principle. Below is a brief overview of the key observations by Topic Area.

BALANCING INCENTIVES AT LARGE BANKING ORGANIZATIONS

- **Topic 1: Risk Adjustment and Performance Measures:** Most firms have made progress in incorporating risk adjustment into performance measurement
 - Federal Reserve highlighted assessing a capital charge against internal profit measures to reflect liquidity risk as a "leading edge" performance measurement practice
 - Where firms use qualitative approaches, the report indicated that developing appropriate policies and procedures to guide judgmental adjustments of incentive compensation awards was an area where further work was needed
- **Topic 2: Deferred Incentive Compensation:** Most companies are requiring deferral of a significant portion of their incentive compensation, particularly for senior executives
 - Federal Reserve wants to ensure that performance-based deferrals adjust for risk outcomes, either quantitatively or through well defined judgment
 - In a footnote, the report indicated that a trigger of reducing the amount of deferred compensation that vests if the firm or a business unit has a net loss could be an appropriate adjustment
- **Topic 3: Other Methods that Promote Balanced Risk-Taking Incentives:** Report discussed using multi-

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year backward looking performance measurement and reduced sensitivity to movement above and below plan. Discussion was less robust than other sections of the report

- **Topic 4: Covered Employees:** Most firms have gone through the process of identifying covered employees, but the Federal Reserve's view is that some firms need to strengthen the process and cited an overreliance on materiality thresholds as a common area of weakness
- **Risk-Management, Controls and Corporate Governance**
- **Topic 5: Risk-Management and Control Personnel and the Design of Incentive Arrangements:** Most firms have moved to incorporate risk management personnel into the incentive compensation design and review process and should continue to increase their participation in the process over time
- **Topic 6: Incentive Compensation for Staff in Risk-Management and Control Roles:** Most firms have substantially complied with the Federal Reserve guidance by delinking incentive compensation for these professionals from business unit incentive pools and focusing their compensation on their own activities
- **Topic 7: Practices Promoting Reliability:** This is an area where the Federal Reserve sees a need for a significant amount of work by all organizations in the horizontal review on an ongoing basis
 - Conduct internal reviews and audits of compliance with well developed policies and procedures
 - Undertake "backtesting"/monitoring of compensation programs to ensure that incentive compensation outcomes are consistent with the original intent of the design
- **Topic 8: Strong Corporate Governance:** Firms in the horizontal review have generally made good progress in ensuring that their Compensation Committees review the relationship between incentive compensation and risk more broadly. This will be an area of continued development over time

The Federal Reserve's horizontal review indicates that firms have made significant progress in implementing the interagency guidance on incentive compensation practices; however, areas where additional work is required remain for full compliance to be achieved.

CONCLUSION

The Federal Reserve's horizontal review indicates that firms have made significant progress in implementing the interagency guidance on incentive compensation practices; however, areas where additional work is required remain for full compliance to be achieved. In addition, the Federal Reserve recognizes that many of the compensation programs and processes being put in place are new and will need to be monitored and refined over time to ensure effectiveness in balancing risk and financial results.

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