Federal Reserve Risk Oversight Includes Guidance on Sound Incentive Compensation Policies

No matter how the rest of the legislative and regulatory landscape shakes out, it appears clear that the Federal Reserve (FRB) is stepping up its oversight of bank risk practices. Placing banks in two categories, Large Complex Banking Organizations (LCBO) and others, the FRB is laying out the framework for short term and longer range changes to its oversight of compensation and risk practices and policies. The expectations outlined by the FRB apply to all those the FRB supervises including, "US bank holding companies, state member banks, Edge and Agreement corporations, and US operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the United States."

In outlining its guidance on sound compensation policies, the FRB has said that reviews of bank practices with respect to compensation will impact both ratings and enforcement.

Regarding ratings, the FRB findings will be incorporated into the bank's ratings related to risk management, internal controls and corporate governance. Relating to enforcement, the FRB has stated that it may take enforcement action if it deems that a bank's "compensation arrangement or related risk management, control, or governance processes poses a risk to the safety and soundness of the organization." (Federal Reserve Proposed Guidelines, October 22, 2009)

There are several key areas of guidance that impact the design of compensation programs and bank operations.

- **Performance metrics are key.**

According to the guidelines, "The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees."

- **Incentive compensation should consider risk and reward and different payments should be made for different levels of risk.**

According to the guidelines, "An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks, as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness." [Employee refers to executives and non-executives whose activities impact the risk in the business.] "Under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially." According to the guidelines, programs "should be implemented so that actual payments vary based on risks or risk outcomes."

- **All risks should be considered.**

According to the guidelines, banks "should consider the full range of current and potential risks associated with the activities of employees, including the cost and amount of capital and liquidity needed to support those risks" …"including credit, market, liquidity, operational, legal, compliance, and reputational risks" …"as well as the time horizon over which those risks may be realized."

- **New incentive compensation program features should be implemented, as needed, and existing program features should be reviewed and revised.**

Suggested program features for consideration in the new incentive compensation programs include the use of risk adjustment of awards, deferral of payment, longer performance periods and reduced sensitivity to short-term performance. Existing program features such as "Golden parachutes and the vesting arrangements for deferred compensation should be reviewed for their impact on "risk-taking behavior".

- **Communications to employees are important to ensuring the incentive compensation programs' success.**

Communications regarding the relationship between risk and payment should be a high priority.

- **Supporting the incentive program design should be appropriate risk management practices and board involvement and oversight.**

Integrity in the risk measures must be ensured. There should be regular reviews and oversight of the compensation programs. including the input of relevant parties related to risks. The guidance states, "The board of directors of an organization is ultimately responsible for ensuring that the organization's incentive compensation arrangements are appropriately balanced and do not jeopardize the safety and soundness of the organization." The board should receive regular reports that review compensation programs and awards relative to risk outcomes. "While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness."

- **A systematic approach, particularly for large organizations, is recommended.**

The systematic approach includes: identifying employees who may expose the organization to material risks, either singly or as a group; identifying the types and time horizons of risks impacted; identifying and including performance measures and other mechanisms to address risk taking; communicating with employees about the plan; and monitoring, oversight, and modification of the programs over time.

Next Steps to Take

For some banks, compliance with the guidance will take more effort than for others. Banks who have engaged in some risk quantification efforts, in the past, will find the requirements outlined by the FRB represent an extension of those efforts into the management system of the bank i.e. planning, budgeting, metrics and rewards.

We had the experience of being the first to develop programs of this kind here in Ohio beginning in the late 1990s. While the process may seem foreign to some banks, the type of program design being articulated in this guidance is actually workable and, properly implemented, will add value to the firm's strategy processes and risk management structures overall.

The first step to doing this well, seemingly easy to state, is the challenge of clearing the mental hurdle of wanting to make the change. To some extent, the FRB, by setting out the guidance, creates that will. However, even with the stated objective, each bank will need to work on laying the groundwork: mental readiness.

Next, based on our experience, the steps outlined by the FRB as a systematic approach make sense.

Determining the groups to be covered, such as relationship managers and executives, helps to set the parameters for the risk and metrics quantification. Risk quantification should then come next. (If the bank is new to this, this is one of the most time consuming elements of the process.)

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Developing the performance metrics comes next and should include a careful review of the consequences, intended or not, of any metric designed. For example, many banks are familiar with RAROC (risk adjusted return on capital) measures. These measures serve a purpose but are not suitable for incentive design due to the unintended consequences they create, such as a tendency to shrink profitable (on a risk adjusted basis) business.

Only after the performance metrics have been properly designed should the focus turn to the time horizon parameters in the compensation program. These include considerations of the time horizon for payouts and methods for establishing the amounts. The "draft" program as designed should then be tested through scenario analysis and revised as needed.

Once it has received all sign-offs, including board acceptance, clear communications materials should be distributed to staff along with meetings to discuss the changes. (In advance of this, the bank may want to conduct metrics training so that the staff is better prepared to absorb the compensation changes when they occur.) The board should ensure the integrity of the process from metrics through design and establish mechanisms to ensure the integrity throughout the reporting cycles.

When implemented properly, the bank will gain benefits in both the short and long term. It may be a bit trying for banks during implementation, but the structure recommended will strengthen our banking system. Before that happens, one outcome that will probably happen quickly? Changes in pricing for bank services as more banks revise and update their risk management capabilities and outlooks.

About the Author:

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