

Economic Stabilization Report: October 22, 2009

Federal Reserve Proposes Guidance on Incentive Compensation

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The Federal Reserve today issued its “**Proposed Guidance on Sound Incentive Compensation Policies**” (the Guidance). The Federal Reserve is soliciting comment on the Guidance for a thirty-day period following publication in the Federal Register.

The 45-page document, which has been expected for some time, is a remarkable departure from past practice, but reflects principles set forth in the Financial Stability Board’s pronouncements on the subject earlier this year. As a guideline, the Guidance will not be a binding requirement but outlines an extensive compliance regime for the compensation process at bank holding companies, state member banks and their affiliates that will set the bar for any institution that seeks to maintain favorable examination ratings on its management. Favorable management examination ratings at a bank are a prerequisite to the maintenance by a company that qualifies as a ‘Financial Holding Company’ of its authority to conduct a wide range of businesses. Despite its nonbinding nature, the Guidance will receive close attention.

The Federal Reserve also announced the commencement of two supervisory initiatives. A special horizontal review of incentive compensation practices at large, complex banking organizations; and a review of incentive compensation practices at other banking organizations as part of the regular risk-focused examination process for these organizations. Supervisory findings will be included in examination reports and the Federal Reserve will rely upon its enforcement authority to compel remedial action by institutions in appropriate circumstances. The Guidance specifically notes that the horizontal review will be led by staff of the Board in Washington, working with the local Reserve Banks, “to promote consistency” and leverage resources.

The Guidance establishes three objectives of safe and sound incentive compensation arrangements and devotes the majority of its bulk to explaining how an institution would seek to achieve these objectives. Detailing the substance of that explanation is beyond the scope of this summary, but the three objectives are to:

- 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.

The scope of the guidance is not limited to senior executives, but would include individuals and in some cases classes of individuals. It would apply to:

- 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 (e.g., 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 (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

The Guidance will apply to all institutions regardless whether they are an issuer of TARP preferred stock. The Federal Reserve announcement was independent of the announcement by the Special Master for TARP Executive Compensation of compensation rulings for certain issuers of TARP stock to the United States Treasury.

To view the press release and the "Federal Reserve Proposed Incentive Compensation Guidance Questions and Answers," please click [here](#).