

## **Federal Reserve Board Issues Proposal on Incentive Compensation**

On October 22, 2009, the Federal Reserve Board issued a proposed guidance (“Proposed Guidance”) designed to ensure that the incentive compensation policies of banking organizations (including holding companies) do not undermine safety and soundness.

According to the Proposed Guidance, incentive compensation arrangements should be compatible with effective controls and risk management, be supported by strong corporate governance practices (including board supervision), and not encourage excessive risk-taking beyond the institution’s ability to identify and manage risk.

The Proposed Guidance advises institutions to evaluate their incentive compensation arrangements for executive and non-executive employees who have the ability to materially affect the risk profile of an organization, either individually or as part of a group. Those arrangements that present excessive risk or are otherwise inconsistent with safe and sound practices should be revised accordingly.

The Proposed Guidance only covers incentive compensation that is related to achievement of certain metrics and does not cover periodic salaries. However, it encourages the review of “golden parachutes” and other deferred compensation vesting arrangements in light of their effects on employee behavior.

Twenty-eight large, “complex” banking organizations will be subject to a coordinated review of their incentive compensation practices in connection with the Proposed Guidance. For all other institutions (including their bank holding companies), supervisors will review compensation practices as part of the regular, risk-focused examination process. The findings from these reviews will be incorporated into the banking organization’s supervisory ratings. In appropriate circumstances, the Federal Reserve may then require an organization to develop a corrective action plan to rectify deficiencies in its incentive compensation programs and processes.