

Meet your new pay consultant the Fed (Part 1)

Agency's guidance focuses on incentive comp plans

PART ONE OF A TWO-PART ONLINE REPORT:

Part two can be read now. A free ABA Banking Journal podcast featuring compensation consultant Susan O'Donnell of Pearl Meyer & Partners is also available now. New Resource: On March 11, ABA will present a two-hour telephone briefing dealing with new compensation issues and the regulators. For program information, [click here](#). Update: Read ABA's comment letter [here](#).

Two-tier approach treats megabanks and all other institutions differently, but both levels stress corporate governance, risk management, audit, and compliance issues

By Steve Cocheo, executive editor, scocheo@sbsp.com

The Federal Reserve has dropped the other shoe, on its much-awaited guidance on banking compensation. Bankers and their compensation advisors have been evaluating the Fed's proposed guidance in recent weeks and already indications are that community bankers don't much care for the fit. However, it may be that they'll have to shoehorn themselves into the proposal, should it become finalized in its present form, in spite of the pain and aggravation of what is being viewed as ill-fitting footwear.

The guidance, under development for some time, follows on the much-publicized reviews and actions of the federal "pay czar." The Fed issued a short list of questions and answers when it released the proposal, and in that it stated that, even though the document was being published for comment, "The Board expects banking organizations to immediately review their incentive compensation arrangements to ensure that they do not encourage excessive risk-taking and to implement corrective programs where needed."

Experts are still parsing the complex document, but gave some initial perspectives in interviews. (Part two of this report will look at their preliminary suggestions for how bankers and their boards can begin to address the proposal's requirements. How much movement there will be from the Fed on the proposal is debatable, as experts point out that the regulator has attempted to act in concert with other international regulators and therefore may not see much room for variance.)

Early assessments mixed

"It's not vague, but it's not precise as to what the Fed is looking for, either," said Brian Dunn, president of McLagan, a subsidiary of AON Corp., and CEO of Global Compensation. By this, he indicated, the Fed was attempting to bring some order to an area that it believes helped bring about the financial crisis, without introducing too much structure or formality. He noted that incentive pay is not a core skill area for the central bank.

“By their own admission, the Fed is not experienced in incentive compensation,” said Dunn. “There will be a bit of trial and error as they get their footing.”

In the short question-and-answer list issued with the proposal, the Federal Reserve rhetorically asked why it wasn’t “suggesting a pay cap or outlawing particular practices.” In answer, it cited international work that sound compensation practices are not a “one size fits all” affair.

“For most banking organizations,” the agency added, “the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to provide at least some employees with incentives to take risks.” (Emphasis added.)

Concerns about employees “gaming the system” show up here and there in the Fed proposal.

Under the proposal, examinations would evolve significantly, especially in regard to compensation, for those community banking organizations covered by it. Consultants note that community banking institutions, especially, have not seen a great deal of attention paid to compensation issues in past exams.

(The proposal does not apply to national banks. It applies to bank holding companies, state member banks, and all the foreign banks, according to a preliminary analysis by ABA. While it would apply to bank holding companies and not to officers of subsidiary bank holding companies, unless they are employed by state member banks, many such officers are dual employees of holding company and bank, so they would be covered, according to an ABA expert.)

For instance, attorney Jeffrey Gerrish of Gerrish McCreary Smith LLC, Memphis, Tenn., notes that interagency safety and soundness guidelines already prohibit “compensation that constitutes an unsafe and unsound banking practice.” (You can find relevant language here. The standards set up in those guidelines address both “excessive compensation” and “compensation leading to material loss.”)

“I’ve had FDIC come after some of our clients with that,” said Gerrish, a veteran banking lawyer who formerly sued boards for FDIC’s resolutions function. On reflection, Gerrish indicated that only a handful of clients have been called out as a result of those guidelines.

“I’m not sure that we need this massive overlay” that the Federal Reserve has proposed, said Gerrish. He noted, as well, that the Sarbanes-Oxley Act already dictates substantial compensation-related duties to public companies.

“When times are good, the regulators pretty much turn a blind eye towards incentive compensation,” said Gerrish.

Still, the proposal comes in the midst of the crisis, as Congress has been considering “say on pay” and related legislation, and in the wake of the Treasury Department’s release earlier this year of its pillars of compensation statement. It also follows the international regulator agreement on key compensation principles. All in all, the Fed’s document shouldn’t come as a great surprise, said Susan O’Donnell, managing director at the Pearl Meyer & Partners consultancy. She added that even clients who believe that they won’t be affected directly by the Fed proposal have called asking for guidance, in the belief that their institutions will eventually need to follow suit simply as a “best practice.”

ABA analysts, still delving into the detailed Fed proposal, find it appropriate that the Fed’s concerns are couched in terms of safety and soundness issues. Nevertheless, the potential burden of the proposal’s approaches, especially on the compensation committees of community banks, are among ABA’s initial concerns about the proposal.

The Fed itself, in a point made in the Q&A mentioned earlier, stated that it saw regulatory agencies as being in the position of “first mover,” in a sense. When individual employers/competitors face the risk of losing talent if they move unilaterally to address misaligned compensation methods, it stated, “supervisors can help counteract these forces by promoting the coordinated movement of the industry toward better practices.”

In other words, if the Fed says everyone must take a step in a given direction, then no competitive change occurs.

Basics of the proposal

The new Fed document, “Proposed Guidance on Sound Incentive Compensation Policies,” was released on Oct. 22 and subsequently published in the Federal Register for a 30-day comment period ending Nov. 27.

The Fed summarized the proposal’s reason for being in a key paragraph in its preface:

“Incentive compensation arrangements are one way that firms can encourage managers and other employees to take actions that are consistent with the interests of shareholders by appropriately rewarding behavior that increases the organization’s revenue, profits, or other measures of performance. However, flawed compensation programs can incentivize employees to take additional risk beyond the firm’s tolerance for, or ability to manage, risk in order to increase the employees’ personal compensation.”

The proposal sets up a two-tier approach to examinations dealing with incentive compensation arrangements. Very large institutions, “large complex banking organizations,” will be subject to special “horizontal reviews” by teams of specialists in various aspects of banking and compensation. On the other hand, all other covered institutions will be examined for compliance with the guidelines’ principles in the course of the risk management portion of their regular risk-focused examinations.

The guidelines in general call for banks to set up incentive compensation programs, no matter what level of employee is involved, such that they don't outstrip the organization's ability to measure the additional risk that their results add to the institution's mix. Effective controls and risk management are urged, and a strong corporate governance program that looks at incentive compensation issues is encouraged. While conceivably any employee's incentive program could come under the guidelines, the document indicates that plan affecting senior management, specialists such as traders whose work can represent large amounts of risk, and groups whose activities can produce large amounts of risk—such as loan officers are of particular interest.

Institutions are given a set of four types of controls that can address the risks of incentive pay plans, including one variation where the payoff per unit of production falls off as the employee reaches higher and higher levels of success.

A great deal of the document dwells on the duties of boards of directors, whether directly or through the Compensation Committee, depending on board structure. At one point, institutions are urged to make sure to pay risk managers sufficiently to permit them to attract the type of talent that can detect problems related to incentive pay plans.

Next instalment: Getting your arms around the proposal's details.

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