

Meet your new pay consultant the Fed (Part 2)

Agency's proposed guidance focuses on incentive comp plans

PART TWO OF A TWO-PART ONLINE REPORT

Compensation experts suggest approaches to reviewing Fed's late October proposal, which focuses on incentive pay, risk management, and corporate governance

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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 on this issue [here](#).

In understanding the Federal Reserve Board's recent proposed guidance on incentive compensation, it's helpful to consider a quote from a speech by Fed Governor Daniel Tarullo. In his Nov. 2 speech on the Oct. 30 proposal, he explained that:

"The interest and role of the Federal Reserve is both broader and more targeted than the issue of executive compensation as such. It is more targeted in that our concern with compensation matters rests squarely on our statutory responsibility to ensure the safety and soundness of the banking organizations we regulate. It is broader in that we are concerned not only with the compensation of executives, but also with compensation arrangements of employees other than executives where those arrangements may adversely affect the safety and soundness of their firms."

Changing times, changing focus

The proposed guidance blends incentive compensation, risk management, and corporate governance issues, and even for community banking institutions that would be covered by the proposed document, boards would find their duties potentially broadened and deepened. Tarullo neatly summarized the trio of guiding principles behind the proposal as follows:

1. "Incentive compensation arrangements at a banking organization should not provide employees with incentives to take risks that are beyond the organization's ability to effectively identify and manage."

2. "Incentive compensation arrangements should be compatible with effective risk management and controls. Banking organizations should ensure that risk-management personnel have an appropriate role in designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk-taking."

3. "Incentive compensation arrangements at banking organizations should be supported by strong corporate governance practice, including active and effective oversight by boards of directors."

Regarding the latter, Tarullo noted that the Fed's intent is that boards go beyond traditional consideration of executive compensation. "Boards of directors, or their compensation committees, should regularly review the design and functioning of the firm's incentive compensation practices to ensure their consistency with safety and soundness."

While it is only the very largest players that will face the special "horizontal reviews" mentioned in the first part of this report, experts say it is clear that the proposal, as it stands at this writing, will impose more duties on boards of directors and on a broader range of bank officials, even in community banking institutions covered by the proposal.

"Certainly, policies, practices, and controls are where community banks will have some challenges," says Susan O'Donnell, managing director at the Pearl Meyer & Partners compensation consultancy. "There's a lot in the Fed proposal that suggests fairly significant aspects of process and risk management and control." (Click here for a podcast based on excerpts from our interview with O'Donnell, who will be speaking about compensation issues for directors at ABA's 2010 National Conference for Community Bankers in February.)

Experts point out that many community banking institutions don't use incentive pay nearly so deeply nor broadly as larger organizations, but that management and boards will, as the proposal is written, still have to go through an exercise of evaluation and monitoring of what they do have in place.

O'Donnell says that many of the community banks she works with, even those not covered by the Fed's proposal, feel they must pay close attention to what covered organizations will face. She says they appear to feel that whatever is finalized will come to be regarded as a set of "best practices." She says they believe that "this is coming down the pike."

Adds O'Donnell about the highly detailed proposed guidance: "The devil's in the details, on this."

And there is a bigger picture, even beyond the Fed, with all this, points out Brian Dunn, president of McLagan, a subsidiary of AON Corp., and CEO of Global Compensation. In the wake of the Treasury Department's movements on compensation, including its summer release of compensation principles, and regulatory moves, "the litmus test will be whether Congress thinks there has been significant reform."

Priorities for the boardroom and the corner office

If your bank's board and management want to begin work on the proposal's strictures, here is the beginning of a framework, based on the expert's input:

1. Address structure for board. Experts point out that the Fed proposal calls on the board, for instance, to consider the impact bankwide of incentive compensation programs. Many community bank boards have tended to leave most anything beyond the officer level to top management.

Thus the roles, going forward, for the bank's board and the board's compensation committee must be considered. The Fed recognizes, in its proposal, that some boards rely on committees, while others tend to use the full board for many matters under consideration. But it will have to be determined where the bank wishes to have responsibility for this proposed regimen reside.

"This responsibility is fairly wide ranging and that's an issue that has to be addressed," says O'Donnell. A key consideration will be the background of board members and of compensation committee members, she explains. Compensation issues can become complex.

2. Address structure for staff. O'Donnell points out that increasingly even community banks that are covered by the guidance will find it helpful to form inter-departmental teams to review and act on concerns raised, in maintaining compliance. Traditionally, she points out, any type of compensation beyond the executive suite was the purview of senior management working in conjunction with the bank's human resources function. With the Fed's emphasis on risk-management and controls in compensation, this would change.

Among the functions that O'Donnell believes will need to be involved at the staff level are: Risk Management, Internal Audit, Compliance Management, Finance, and Human Resources.

"All of those folks have to come together to make sure this comes together appropriately," says O'Donnell.

3. Get ready for renewed focus on compensation in examinations. As touched on in the first part of this report, while compensation issues were fair game—and are—in regulatory exams, now covered institutions will face a much more explicit, risk-management-oriented approach.

“As a consultant to banks,” says O’Donnell, “I’ve never been asked on behalf of a client [among community banks] for help because they are under review by the regulators, to support them on that.” But going forward, she adds, “I expect to hear more from my [community bank] clients on this.”

To a degree—and this is what appears to irk community bankers who have started to look at the Fed proposal—community bank management and boards will be going through a lot of activity to demonstrate effort and compliance, although many aren’t maintaining the types of incentive programs at issue.

“Most of the smaller banks probably don’t have programs that would be considered as motivating risk-taking,” notes O’Donnell.

But consultant Brian Dunn points out that the focus mustn’t be mistaken in this area. “This is not a compensation issue, really,” he advises. Instead, it’s much more about the measurement and pricing of risk arising from compensation.

Tarullo did address the issue of tailoring supervision to bank size: “We certainly do not expect smaller banking organizations that use incentive compensation arrangements on a limited basis to have the same type of formalized and detailed program for managing the risk of such arrangements as we expect to see at LCBOs. We will also have an ongoing coordination process for developing and clarifying guidance for the non-LCBO institutions.”

4. Review special group incentive programs. Experts note that the Fed is also concerned about programs that reward individual players, such as traders, and groups of employees who fall under special incentive pay plans. The two groups that come up for discussion in the community bank context include commercial lenders and mortgage originators.

“If the bank doesn’t have the proper practices, policies, procedures, governance, and controls—if it can’t manage credit practices as to how such loans are approved and processed—that is where the incentive program could have an impact that you don’t want,” says O’Donnell. Controls, she adds, are a key area illustrating how compensation has gone beyond its traditional home in H.R.

5. Consider in a community banking context the four methods suggested by the Fed for aligning incentive compensation with risk. The Fed goes into these in some depth, but in brief, they are:

- Adjusting performance awards to reflect the risks of employee activities.
- Deferring payments of awards and adjusting actual payments to reflect outcomes.
- Using longer periods for measuring the performance on which awards are based.

• Reducing the sensitivity of performance measures to short-term revenues or profits.

Some of these are relatively new for banking in general, and some are certainly new for community banking institutions. O'Donnell points out that there are some multi-year plans, but while there has been much talk about deferrals, "we don't see a lot of that at the community banking level."

Consultant Brian Dunn believes it would be a good exercise for banks covered by the proposal to do a risk assessment of their existing compensation programs, to get a better fix on their status quo. This is similar to efforts that were required of TARP banks.

Concerns going forward

As banks evaluate the proposal, and the Fed weighs comments, two issues that will play a role are motivation and competition.

Experts point out that, while incentive pay may have hit some extremes, the intentions behind it remain sound. Motivation of performance is an obvious factor, but there is another not always taken under consideration: efficiency of motivation.

O'Donnell points out that in the 1970s and 1980s, the emphasis, especially for senior positions, was on high salaries and benefits.

"It was only after time that we realized that that approach was driving fiscal costs up, and that that wasn't in the best interests of companies or shareholders," O'Donnell says. As a result, pay for actual performance caught on—and "don't produce, don't get high pay, in other words.

An ongoing concern here is competition, the fear of "brain drain" to players who will pay more, especially players not falling under rules such as the Fed's proposed guidance. To a degree, the Fed has covered that, in its thinking, as putting its action out as one that casts the agency as a "first-mover," in its own words. The idea is, if the Fed makes the rule that everyone must follow, then everyone remains at the same competitive balance—so goes the theory, anyhow.

"Financial institutions tend to be reasonably uniform in how they pay," says Dunn. "And banks are incredibly conscious and well-informed about their peer information—and nobody likes to be an outlier."

How well all this will play out in the community banking sector, remains to be seen.

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ADDITIONAL RESOURCES FOR BANKERS:

• 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](#).

• ABA just published its 2009 Compensation and Benefits Survey. [Read more about it and order it online.](#)

From ABA's website: "In all, 407 banks provided valuable data on 191 jobs in 23 categories. Our 36th annual edition makes available the latest compilation of industry and regional data to help you recruit, reward and retain your most valuable asset-your employees."

• Consultant Brian Dunn, quoted above, wrote a helpful article on how to rethink incentive pay programs earlier this year. [Read it now](#)

• The September ABA Banking Journal featured a special cover report on compensation.

[Read it now](#) (requires latest version of Adobe Flash)

• Treasury's compensation principles, from Summer 2009, reviewed by ABA. [Read about them now.](#)

• Community Bank Directors Workshop manual #6: The Role of the Compensation Committee: [Read more about this boardroom training resource from ABA](#)