Federal Advisory Council

On May 11, 2012, the Federal Advisory Council met with the Board of Governors to discuss the Board's proposed rulemaking concerning incentive compensation arrangements (Docket No. R-1410). During the discussion, some members expressed concern about the number and categories of employees who would be subject to scrutiny under the proposal but whose responsibilities would not expose the bank to material risk. The Council also provided written comments, which are provided below.

Incentive Compensation

What are the views of Council members on the guidance being provided by Board and Reserve Bank staff with respect to incentive compensation practices at banking organizations?

Overview
The Council supports the principles outlined in the Interagency Guidance on Sound Incentive Compensation Practices,[1] including the need to ensure that incentive compensation programs do not encourage employees to take imprudent or excessive risks. Members have had a constructive dialogue with both Board and Reserve Bank staff regarding how the principles embodied in the guidance should be applied in practice. As a result of this dialogue and firms' own internal reviews, banking organizations have made a number of important improvements to their incentive compensation programs, including increasing the amount of deferred compensation (clawbacks), incorporating performance-based vesting features for executives, and improving the governance framework for incentive compensation, including risk-management reviews all the way up to the board.

After considering the feedback provided by Board and Reserve Bank staff on incentive compensation, the Council has the following observations:

- In determining whether a firm's incentive compensation program is appropriately balanced, it is very important to look at each program as a whole and understand how all of its elements work together. Looking at individual components or elements of compensation in isolation can give a misleading picture of the overall balance of a program, as it is an employee's compensation package as a whole that ultimately guides incentives.
- As the Interagency Guidance itself recognizes, there is a variety of methods that may be used for ensuring that incentive compensation programs are "balanced" and do not encourage imprudent risk taking. Methods for achieving balance at one organization may not be necessary or, alternatively, sufficient for achieving balance at another organization due to, for example, differences in plan design, business strategy, or management structures. The Council believes that it is very important for these principles to guide supervisory assessments, since there is no one-size-fits-all approach to ensuring that incentive compensation programs are balanced.
- There appears to be a growing and, in the Council's view, unnecessary tension between the incentive compensation goals of the Federal Reserve and those of shareholders. For

[1] 75 Federal Register 36395 (June 25, 2010).

example, it is commonly perceived that performance goals will be subject to supervisory criticism unless they are highly achievable and avoid rewarding exceptional performance. Shareholders, however, rightfully want to encourage exceptional effort and corresponding performance, and doing so should not be viewed as inconsistent with safety and soundness provided that employees also are exposed to significant downside risks should they seek to achieve above-average performance through imprudent or excessive risk taking.

- Federal Reserve guidance has discouraged the use of relative performance measures. However, that class of incentives can and should play a role, in combination with absolute performance measures and other features, in promoting sound and balanced compensation. All performance measures have strengths and weaknesses. For example, absolute performance measures can encourage employees to "swing for the fences" in years of economic growth in order to maximize their compensation in those years, knowing that absolute performance will decline in years of weaker economic performance. Relative performance measures, on the other hand, incent management to focus on the organization's longer-term performance, by ensuring that disciplined risk taking in growth years is rewarded in down years when the benefits of that discipline becomes more apparent.
- Organizations need sufficient time to implement modifications to their incentive compensation programs and educate executives, employees, and shareholders about those changes. Frequent and rapid changes to incentive compensation programs are not only difficult to implement but also run the risk of confusing participants who need to understand how the programs balance rewards and risk if the program is to be effective in appropriately guiding behavior.
  - As noted above, organizations have already made significant changes to their compensation programs in recent years, and compensation programs for 2012 have already largely been established and communicated to employees. Many organizations, however, only recently received responses to their most recent incentive compensation submissions to the Federal Reserve, and in many cases, these responses raise or highlight topics that were not previously communicated.
  - In light of the foregoing, the Council believes organizations should have the flexibility to implement additional modifications to their programs for the 2013 plan year.
  - In addition, given the magnitude of the improvements already made and those likely to be made this year, the Federal Reserve should allow these new structures to operate for a few years before requesting further substantial changes to program design. This would allow both organizations and the Federal Reserve to assess the effectiveness of these program changes, both individually and in the aggregate, in balancing potential incentives for improper risk taking before determining whether additional changes are necessary or appropriate.
- As ongoing supervision transitions to the Reserve Banks, it would be helpful for the Federal Reserve's experts to remain available to provide guidance to, and respond to questions from, banking organizations as well as available for information requests to provide greater clarity as to the information being sought (which should reduce the incidence of multiple requests).

Any final rules on incentive compensation issued under section 956 of the Dodd-Frank Act should, like the guidance, be principles based and flexible. Prescriptive and rules-based approaches are unlikely to be effective and could have unintended consequences in light of the diversity of programs and institutions.