Supporting Statement for the
Recordkeeping Provisions Associated with the
Guidance on Sound Incentive Compensation Policies
(FR 4027; OMB No. 7100-NEW)

Summary

The Board of Governors of the Federal Reserve System, under delegated authority from the Office of Management and Budget (OMB), proposes to implement the Recordkeeping Provisions Associated with the Guidance on Sound Incentive Compensation Policies (FR 4027; OMB No. 7100-NEW). The Paperwork Reduction Act (PRA) classifies recordkeeping requirements contain in agency guidance as an information collection.[1]

On October 27, 2009, the Federal Reserve published proposed guidance in the *Federal Register* for public comment titled Proposed Guidance on Sound Incentive Compensation Policies (the Guidance).[2] The comment period for this notice expired on November 27, 2009.

The Federal Reserve has identified certain aspects of the proposed guidance (policies and procedures) that may constitute a collection of information. Under Principle 2 of the Guidance (*Compatibility with Effective Controls and Risk Management)* a banking organization should establish strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. Under Principle 3 of the Guidance (*Strong Corporate Governance)* a banking organization's board of directors should review and approve the overall goals and purposes of the firm's incentive compensation system. The board should provide clear direction to management to ensure that its policies and procedures are carried out in a manner that achieves balance and is consistent with safety and soundness.

The Federal Reserve's total annual burden is estimated to be 275,560 hours for the 6,889 banking organizations that are likely to be subject to the Guidance.[3] There are no required reporting forms associated with the Guidance. Additional information about the recordkeeping requirements and how the estimated total annual burden was calculated is discussed below.

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[1] 44 U.S.C. § 3501 et seq.

[2] (74 FR 55227) (OP 1374)

[3] As used in the guidance, the term ''banking organization'' includes U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the United States.

Background and Justification

Incentive compensation practices in the financial services industry were one of many factors contributing to the financial crisis that began in 2007. Banking organizations too often rewarded employees for increasing the firm's short-term revenue or profit without adequate recognition of the risks the employees' activities posed for the firm. More importantly, problematic compensation practices were not limited to the most senior executives at financial firms. Compensation practices can encourage employees at various levels of a banking organization, either individually or as a group, to undertake imprudent risks that can significantly and adversely affect the risk profile of the firm.

The Federal Reserve developed this Guidance to help protect the safety and soundness of banking organizations and promote the prompt improvement of incentive compensation practices throughout the banking industry. The proposed guidance is based on three key principles that are designed to ensure that incentive compensation arrangements at a banking organization do not encourage employees to take excessive risks. These principles provide that incentive compensation arrangements should:

1. provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk;
2. be compatible with effective controls and risk management; and
3. be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles and the guidance are consistent with the Principles for Sound Compensation Practices adopted by the Financial Stability Board (FSB) in April 2009, as well as the Implementation Standards for those principles issued by the FSB in September 2009.

Description of Information Collection

Compatibility with Effective Controls and Risk Management

Principle 2 of the Guidance states that a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. An organization's policies and procedures should:

- identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements;
- identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and
- identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements. Banking organizations also should create and maintain

sufficient documentation to permit an audit of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements.

The Guidance also states that a banking organization should conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed. Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An organization's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements. The results should be reported to appropriate levels of management and, where appropriate, the organization's board of directors.

Strong Corporate Governance

Principle 3 of the Guidance states that the board of directors should review and approve the overall goals and purposes of the firm's incentive compensation system. The board should provide clear direction to management to ensure that its policies and procedures are carried out in a manner that achieves balance and is consistent with safety and soundness.

The board should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and should carefully consider and monitor the effects of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization.

The board should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk management personnel, of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk taking incentives that are consistent with the organization's safety and soundness. These reports should include an evaluation of whether or how incentive compensation practices may be encouraging excessive risk taking. These reviews and reports should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the prevalence and scope of its incentive compensation arrangements. In addition, at banking organizations that are significant users of incentive compensation arrangements, the board should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting excessive risk-taking.

Time Schedule for Information Collection

The documentation required by the Guidance is maintained by each institution; therefore, are not collected or published by the Federal Reserve System. These recordkeeping requirements are documented on occasion. Bank examiners would verify compliance with this recordkeeping requirement during examinations.

Sensitive Questions

This collection of information contains no questions of a sensitive nature, as defined by OMB guidelines.

Consultation Outside the Agency and Discussion of Public Comment

All of the Federal Reserve's rulemaking activities are subject to the notice and comment requirements of the Administrative Procedure Act. On October 27, 2009, the Federal Reserve published a notice in the *Federal Register* (74 FR 55227) requesting public comment for 30 days on the implementation of the proposed FR 4027. The comment period for this notice expired on November 27, 2009.

Legal Status

The Board's Legal Division has determined that this information collection is authorized pursuant to sections 9, 11(a), 11(i), 25, and 25A of the Federal Reserve Act (12 U.S.C. §§ 248(a), 248(i), 324, 602, and 625), section 5 of the Bank Holding Company Act (12 U.S.C. § 1844), and section 7(c) of the International Banking Act (12 U.S.C. § 3105(c)).

The Federal Reserve expects to review the policies and procedures for incentive compensation arrangements as part of its supervisory process. To the extent the Federal Reserve collects information during an examination of a banking organization, confidential treatment may be afforded to the records under exemption 8 of the Freedom of Information Act (FOIA), 5 U.S.C. § 552(b)(8). In addition, the information may also be kept confidential under exemption 4 of the FOIA if the release of this information would cause substantial harm to the competitive position of the banking institutions. 5 U.S.C. § 552(b)(4).

Estimate of Respondent Burden

The total annual burden for the 6,889 institutions[4] regulated by the Federal Reserve is estimated to be 275,560 hours, as shown in the table below. The Federal Reserve estimates that it will take respondents 40 hours (one business week) each year to create and maintain policies and procedures to monitor incentive compensation arrangements. The Guidance represents 4.81 percent of total Federal Reserve System paperwork burden.

	Number of respondents	*Estimated annual frequency*	*Estimated response time*	*Estimated annual burden hours*
Banking institutions	6,889	1	40 hours	275,560
Total				275,560

Based on a rate of $100 per hour, the estimated cost to the public for this information collection is $27,556,000.[5]

Estimate of Cost to the Federal Reserve System

Since records are maintained at the banking organization, the cost to the Federal Reserve System is negligible.

[4] The 6,889 Federal Reserve-supervised respondents were obtained from numbers published in the *Board of Governors of the Federal Reserve System 95th Annual Report 2008*: 5,757 U.S. bank holding companies, 862 State member banks, 60 Edge and agreement corporations, and the 208 U.S. operations of foreign banks with a branch, agency, and 2 commercial lending companies in the United States.

[5] Total cost to the public was estimated using the following formula. Percent of staff time, multiplied by annual burden hours, multiplied by hourly rate: 100% Senior Management @ $100. This hourly rate estimate is an average using data from the Bureau of Labor and Statistics, *Occupational Employment and Wages*, news release."