McLagan Alert
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Final Guidance on Sound Incentive Compensation Policies

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On June 21, 2010 the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation (collectively, the "Agencies") issued final guidance on incentive compensation arrangements that apply to all banking organizations. This final guidance replaces the proposed guidance issued by the Federal Reserve on October 22, 2009.

Executive Summary

The primary purpose of the guidance is to assure that the safety and soundness of the United States' financial system is not jeopardized by incentive compensation plans. The guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes. It states that "*aligning employee incentives with the interests of shareholders is not always sufficient to address safety-and-soundness concerns.*"

The guidance has been provided in a principles-based form. As such, the guidance does not contain specific rules of what can and cannot occur in incentive plan design—there are no formulas, caps, or restrictions on types and amounts of compensation. Each organization will need to review the guidelines to determine how they apply to their unique situation.

The guidance is based on three core principles. Incentive compensation arrangements should:

1. Provide employees incentives that appropriately balance risk and reward;
2. Be compatible with effective controls and risk-management; and
3. Be supported by strong corporate governance, including active oversight by the organization's board of directors.

The guidance applies to all U.S. banks and commercial lending operations as well the U.S. operations of foreign banking organizations that use incentive compensation. Distinctions are made between large banking organizations (LBOs), smaller banking organizations as well as "organizations that are significant users of incentive compensation." The Federal Reserve stated that it expects as many as 1,500 banking organizations to spend material time reviewing and modifying their policies.

There are three groups of employees that are a focus of the guidance: senior executives, groups of employees who collectively can have a material impact on a banking organization (e.g., lenders), and individuals, who by their position or authority, can have a material impact on a banking organization (e.g., traders).

The guidance is clear that there is no "one size fits all" approach with respect to application of the guidelines. A bank cannot take another organization's compensation program or methodology and apply it; each bank needs to review its own incentive compensation arrangements within the scope of its particular situation.

A bank that is found to have incentive compensation arrangements that pose a risk to its safety and soundness may be the subject of enforcement action. This action may include the development of an action plan to address the safety and soundness

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deficiencies in the incentive plans or any related processes of risk management, control or governance.

The Agencies expect banks to take prompt action to address any deficiencies in their incentive compensation arrangements or related risk-management, control and governance processes. Federal Reserve Governor Daniel K. Trullo stated, "*The Federal Reserve expects firms to make material progress this year on the matters identified as we work toward the ultimate goal of ensuring that incentive compensation programs are risk appropriate and are supported by strong corporate governance.*"

The Agencies, in order to facilitate and support improvements, will prepare a report after the conclusion of 2010 on the trends and developments in compensation practices at banking organizations.

1. Why Were These Guidelines Created?

Incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in mid-2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the organization. These practices exacerbated the risks and losses at a number of banking organizations and resulted in the misalignment of the interests of employees with the long-term well-being and safety and soundness of their organizations.

2. What Banking Organizations Are Covered by the Guidelines?

The guidelines were issued jointly by the Federal Reserve Board, FDIC, OCC, and OTC and apply to U.S. banks as well as the U.S. operations of foreign banks.

3. Are There Any Exclusions?

This guidance does not apply to banking organizations that do not use incentive compensation.

4. Do the Guidelines Apply Equally to All Organizations?

The analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to the size, complexity, business strategy, and risk tolerance of each organization. The resources required will depend upon the complexity of the firm and its use of incentive compensation arrangements. For some, the task of designing and implementing compensation arrangements that properly offer incentives for executive and non-executive employees to pursue the long-term well-being and that do not encourage imprudent risk-taking is a complex task that will require the commitment of adequate resources.

5. Which Employees Are Covered?

The Guidance applies to incentive compensation arrangements for executive and non-executive employees, who are collectively referred to hereafter as "covered employees" or "employees," including:

- <u>Senior executives</u> and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
- <u>Individual employees</u>, including non-executive employees, whose activities may expose the organization to material amounts of risk (e.g., traders with large position limits relative to the organization's overall risk tolerance); and
- <u>Groups of employees</u> who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material amounts of risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

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Certain employees, such as tellers, bookkeepers, or data processing personnel whose activities do not present a material risk to the organization, would most likely be outside the scope of the guidance based on facts and circumstances.

6. How are Senior Executives Defined?

Senior executives include, at a minimum, "executive officers" within the meaning of the Federal Reserve's Regulation O and, for publicly traded companies, "named officers" within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation. Savings associations should also refer to OTS's rule on loans by saving associations to their executive officers, directors, and principal shareholders.

7. How is Incentive Compensation Defined?

In this guidance, the term "incentive compensation" refers to the following:

- That portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income).
- Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary).
- In addition, the term does not include compensation arrangements that are determined based solely on the employee's level of compensation and does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the organization contributes a set percentage of an employee's salary).

8. How Are Organization-Wide Performance Plans Affected?

Plans that provide for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives.

9. What Types of Risks Should be Considered?

The activities of employees may create a wide range of risks for a banking organization, such as credit, market, liquidity, operational, legal, compliance, and reputational risks, as well as other risks to the viability or operation of the organization. Some of these risks may be realized in the short term, while others may become apparent only over the long term.

10. What Is a Material Risk?

Risks should be considered to be material for purposes of this guidance if they are material to the organization, or are material to a business line or operating unit that is itself material to the organization. Risks may be material to an organization even if they are not large enough to themselves threaten the solvency of the organization.

Importantly, the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure.

Some risks (or combinations of risky strategies and positions) may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized ("bad tail risks"). While shareholders may have less incentive to guard against bad tail risks because of the infrequency of their realization and the existence of the Federal safety net, these risks warrant special attention for safety-and-soundness reasons given the threat they pose to the organization's solvency and the Federal safety net.

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11. Can Incentive Compensation Plans Create Risk?

Poorly designed or managed incentive compensation arrangements can themselves be a source of risk to a banking organization. For example, incentive compensation arrangements that provide employees strong incentives to increase the organization's short-term revenues or profits, without regard to the short- or long-term risk associated with such business, can place substantial strain on the risk-management and internal control functions of even well-managed organizations.

Moreover, poorly balanced incentive compensation arrangements can encourage employees to take affirmative actions to weaken or circumvent the organization's risk-management or internal control functions, such as by providing inaccurate or incomplete information to these functions, to boost the employee's personal compensation.

12. How Is Risk Supposed to Be Evaluated?

Reliable quantitative measures of risk and risk outcomes, where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced. However, reliable quantitative measures may not be available for all types of risk or for all activities, and their utility for use in compensation arrangements varies across business lines and employees.

13. What if We Don’t Have Quantitative Measures of Risk?

The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations should ignore such risks or outcomes for purposes of assessing whether an incentive compensation arrangement achieves balance. As in other risk-management areas, banking organizations should rely on informed judgments, supported by available data, to estimate risks and risk outcomes in the absence of reliable quantitative risk measures.

14. What Is Balanced Incentive Compensation?

An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks (including compliance risks), as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness.

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes.

15. Are Performance Measures & Targets Mentioned?

The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage imprudent risk-taking.

Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above the target or may provide that awards will be granted only if a target is met or exceeded. Employees may be particularly motivated to take imprudent risk in order to reach performance targets that are aggressive, but potentially achievable.

16. How Do We Make Compensation Plans Balanced?

An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes. Four methods are often used to make compensation more sensitive to risk. These methods are:

- Risk Adjustment of Awards: The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities may pose to the organization.
- Deferral of Payment: The actual payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that are realized or become better known only during the deferral period.
- Longer Performance Periods: The time period covered by the performance measures used in determining an employee's award is extended (for example, from one year to two or more years) so that some or all risk outcomes are realized or better known.
- Reduced Sensitivity to Short-Term Performance: The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s).

These methods for achieving balance are not exclusive, and additional methods or variations may exist or be developed. In some cases two or more methods may be needed in combination for an incentive compensation arrangement to be balanced.

The greater the potential incentives an arrangement creates for an employee to increase the risks associated with the employee's activities, the stronger the effect should be of the methods applied to achieve balance.

17. Does One Size Fit All?

The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations. These differences mean that methods for achieving balanced compensation arrangements at one organization may not be effective in restraining incentives to engage in imprudent risk-taking at another organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization.

18. Is the Use of Equity Addressed?

The payment of deferred incentive compensation in equity (such as restricted stock of the organization) or equity-based instruments (such as options to acquire the organization's stock) may be helpful in restraining the risk-taking incentives of senior executives and other covered employees whose activities may have a material effect on the overall financial performance of the organization.

Incentives that align the interests of employees and shareholders of the organization often benefit safety and soundness. However, aligning employee incentives with the interests of shareholders is not always sufficient to address safety-and soundness concerns.

19. What about Golden Parachutes?

Banking organizations should carefully consider the potential for “golden parachutes” and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees. Large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes can provide the employee significant incentives to expose the organization to undue risk.

In appropriate circumstances an organization should consider including balancing features—such as risk adjustment or deferral requirements that extend past the employee's departure—in the arrangements to mitigate the potential for the arrangements to encourage imprudent risk-taking.

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20. What about Communicating with Employees?

Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase. Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk outcomes.

21. How Does the Guidance Impact Controls & Risk Management?

A key goal of this guidance is to encourage banking organizations to incorporate the risks related to incentive compensation into their broader risk-management framework. Risk-management procedures and risk controls that ordinarily limit risk-taking do not obviate the need for incentive compensation arrangements to properly balance risk-taking incentives.

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements. Traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced.

To help prevent damage from occurring, a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements.

Banking organizations should create and maintain sufficient documentation to permit an audit of the effectiveness of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements. Smaller banking organizations should incorporate reviews of these processes into their overall framework for compliance monitoring (including internal audit).

22. How Are Risk Management Personnel Affected?

Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.

Banking organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining imprudent risk-taking.

The performance measures used in the incentive compensation arrangements for risk-management personnel should be based primarily on the achievement of the objectives of their functions (e.g., adherence to internal controls).

23. Is On-Going Monitoring of Performance Required?

Banking organizations should monitor incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes or high levels of risk taken. Results should be reported to appropriate levels of management, including the board of directors where warranted.

The monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation.

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24. What Is the Role of the Board of Directors?

The board of directors of an organization also is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all covered employees—not just senior executives—are appropriately balanced and do not jeopardize the safety and soundness of the organization.

The guidance identifies the following roles and responsibilities of the board:

- Approve Incentive Plans for Senior Executives: Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors of a banking organization should directly approve the incentive compensation arrangements for senior executives.
- Approve and Document Material Exceptions or Adjustments: The board also 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.
- Regularly Monitor Performance and Review Design: The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.
- Receive and Review Data and Analysis: To allow for informed reviews, the board should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. 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.
- Monitor Payments: The board of directors of a banking organization should closely monitor incentive compensation payments to senior executives and the sensitivity of those payments to risk outcomes. In addition, if the compensation arrangement for a senior executive includes a clawback provision, then the review should include sufficient information to determine if the provision has been triggered and executed as planned.

25. What about Use of External Resources?

The board of directors of a banking organization should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities. This level of expertise may be:

- Present collectively among the members of the board,
- May come from formal training or,
- From experience in addressing these issues, including as a director, or
- May be obtained through advice received from outside counsel, consultants, or other experts with expertise in incentive compensation and risk-management. In selecting and using outside parties, the board of directors should give due attention to potential conflicts of interest arising from other dealings of the parties with the organization or for other reasons.

26. Are Banks Required to Make Disclosures to Shareholders?

To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements for executive and non-executive employees and related risk-management, control, and

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governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take imprudent risks. Such disclosures should include information relevant to employees other than senior executives.

27. What Is a Large Banking Organization (LBO)?

LBOs include, in the case of banking organizations supervised by (i) the Federal Reserve, large, complex banking organizations as identified by the Federal Reserve for supervisory purposes; (ii) the OCC, the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (iii) the FDIC, large, complex insured depository institutions (IDIs); and (iv) the OTS, the largest and most complex savings associations and savings and loan holding companies.

28. What Are the General Principles That Apply Specifically to LBOs?

A. Systematic Approach with Formalized Policies, Procedures and Processes: Because of the size and complexity of their operations, LBOs should have and adhere to systematic and formalized policies, procedures, and processes. These are considered important in ensuring that incentive compensation arrangements for all covered employees are identified and reviewed by appropriate levels of management (including the board of directors where appropriate and control units), and that they appropriately balance risks and rewards.

   In several places, this guidance specifically highlights the types of policies, procedures, and systems that LBOs should have and maintain. This is generally not expected of smaller, less complex organizations. LBOs warrant the most intensive supervisory attention because they are significant users of incentive compensation arrangements and because flawed approaches at these organizations are more likely to have adverse effects on the broader financial system.

B. Simulation Analysis: In designing and modifying incentive compensation arrangements, LBOs should assess in advance of implementation whether such arrangements are likely to provide balanced risk-taking incentives. Simulation analysis of incentive compensation arrangements is one way of doing so. Such analysis uses forward-looking projections of incentive compensation awards and payments based on a range of performance levels, risk outcomes, and levels of risks taken. This type of analysis, or other analysis that results in assessments of likely effectiveness, can help an LBO assess whether incentive compensation awards and payments to an employee are likely to be reduced appropriately as the risks to the organization from the employee's activities increase.

C. Monitor Industry Developments in Incentive Practices: Methods and practices for making compensation sensitive to risk are likely to evolve rapidly during the next few years, driven in part by the efforts of supervisors and other stakeholders. LBOs should actively monitor developments in the field and should incorporate into their incentive compensation systems new or emerging methods or practices that are likely to improve the organization's long-term financial well-being and safety and soundness.

D. Incentive Deferrals, Multi-Year Performance Periods, Use of Equity: Incentive compensation arrangements for senior executives at LBOs are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance, substantial use of multi-year performance periods, or both. Similarly, the compensation

arrangements for senior executives at LBOs are likely to be better balanced if a significant portion of the incentive compensation of these executives is paid in the form of equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the organization during the deferral period.

E. <u>Golden Handcuff Arrangements</u>: Provisions that require a departing employee to forfeit deferred incentive compensation payments may weaken the effectiveness of the deferral arrangement if the departing employee is able to negotiate a "golden handcuff" arrangement with the new employer. This weakening effect can be particularly significant for senior executives or other skilled employees at LBOs whose services are in high demand within the market.

   Golden handcuff arrangements present special issues for LBOs and supervisors. For example, while a banking organization could adjust its deferral arrangements so that departing employees will continue to receive any accrued deferred compensation after departure (subject to any clawback or malus), these changes could reduce the employee's incentive to remain at the organization and, thus, weaken an organization's ability to retain qualified talent, which is an important goal of compensation, and create conflicts of interest. Moreover, actions of the hiring organization (which may or may not be a supervised banking organization) ultimately may defeat these or other risk-balancing aspects of a banking organization's deferral arrangements. LBOs should monitor whether golden handcuff arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees. The Agencies will continue to work with banking organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

F. <u>Define Roles</u>: LBOs should have and maintain policies and procedures that (i) 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; (ii) 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 (iii) 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.

G. <u>Conduct Regular Internal Reviews</u>: An LBO also 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 LBO'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.

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29. What Are the Governance Principles that Apply to Both LBOs and to Significant Users of Incentive Compensation?

A. Active Board Oversight: The board of directors of an LBO or other banking organization that uses incentive compensation to a significant extent should actively oversee the development and operation of the organization's incentive compensation policies, systems, and related control processes. The board of directors of such an organization should review and approve the overall goals and purposes of the organization's incentive compensation system. In addition, the board should provide clear direction to management to ensure that the goals and policies it establishes are carried out in a manner that achieves balance and is consistent with safety and soundness.

- The board of directors of such an organization also should ensure that steps are taken so that the incentive compensation system—including performance measures and targets—is designed and operated in a manner that will achieve balance.

B. Evaluation Reports from Management and Risk-Management Personnel: The board of an LBO or other organization that uses incentive compensation to a significant extent 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 increase the potential for imprudent risk-taking.

C. Historical and Forward-Looking Incentive Compensation Reports: The board of such an organization also 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 imprudent risk-taking. Boards of directors of these organizations also should consider periodically obtaining and reviewing simulation analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risks taken.

D. Independent Compensation Committee: If a separate compensation committee is not already in place or required by other authorities, the board of directors of an LBO or other banking organization that uses incentive compensation to a significant extent should consider establishing such a committee—reporting to the full board—that has primary responsibility for overseeing the organization's incentive compensation systems. A compensation committee should be composed solely or predominantly of non-executive directors. If the board does not have such a compensation committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems. The compensation committee should work closely with any board-level risk and audit committees where the substance of their actions overlap.

E. Systematic Approach with Formalized Policies, Procedures and Processes: Large banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.

- At banking organizations with large numbers of risk-taking employees engaged in diverse activities, an ad hoc approach to developing

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balanced arrangements is unlikely to be reliable. Thus, an LBO should use a systematic approach—supported by robust and formalized policies, procedures, and systems—to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. Such an approach should provide for the organization effectively to:

F. Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include (i) senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines; (ii) individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and (iii) groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk;

G. Identify the types and time horizons of risks to the organization from the activities of these employees;

H. Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take imprudent risks;

I. Include balancing elements, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities;

J. Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and

K. Monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

30. How Does the Guidance Relate to the Supervisory Process?

The Agencies will work with LBOs as necessary through the supervisory process to ensure that they promptly correct any deficiencies that may be inconsistent with the safety and soundness of the organization.

Supervisory reviews of incentive compensation arrangements at smaller, less-complex banking organizations will be conducted by the Agencies as part of the evaluation of those organizations' risk-management, internal controls, and corporate governance during the regular, risk-focused examination process. These reviews will be tailored to reflect the scope and complexity of an organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Little, if any, additional examination work is expected for smaller banking organizations that do not use, to a significant extent, incentive compensation arrangements.

31. How Will Supervisory Review Findings Be Reported?

For all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization and included in the relevant report of examination or inspection. In addition, these findings will be incorporated, as appropriate, into the organization's rating component(s) and subcomponent(s) relating to risk-management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.

32. Are There Enforcement provisions?

Enforcement action may be taken against a banking organization if its incentive compensation arrangements or related risk-management, control, or governance processes pose a risk to the safety and soundness of the organization, particularly when the organization is not taking prompt and effective measures to correct the deficiencies.

33. Where Can I Find The Text of the Final Guidance?

The text of the Final Guidance can be found in the Federal Register at the location below. Note a regulatory item such as the Final Guidance only becomes effective once it is published in the Federal Register:

http://edocket.access.gpo.gov/2010/pdf/2010-15435.pdf

The text of the press release by the Federal Reserve can be found at the following location:

http://www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm ■

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