What Does the Fed Really Want?

Horizontal Review Update

By Brian Dunn and Greg Loehmann
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All financial institutions have been besieged by a plethora of new rules coming from domestic and, in many cases, foreign regulators. The volume of compliance work is only outweighed by the collective concern about what these regulations will do to profitability, compensation and shareholder return. At the same time, the Federal Reserve's (the Fed) position is quite simple and reasonable—they want to prevent compensation from contributing to a future financial crisis. In order to achieve this result, they have established the following:

There is a group of employees whose decisions individually or collectively can pose "unreasonable" risk. They are simply asking the banks to have a systematic process to identify these individuals. They have also made clear that the banks need to be comprehensive in the identification of these individuals and that the process needs to auditable.

1) Once the "covered employees" have been identified, banks need to review all incentive plans for which those individuals are eligible and modify them to reduce risk—either on a current basis (ex ante) of through deferrals and claw backs (ex post).

2) Finally, the banks need to systematically stress test their incentive plans to ensure that under extreme circumstance the plans do not create even greater risk.

It is hard to argue with the concept, but as the saying goes, the devil is in the details. Many of the firms included in the Fed's Horizontal Review are currently in the process of responding to feedback letters that arrived in March and April. As has been the case in the past, these letters build on the now 18-month-long inquiry by the Fed into pay practices among the nation's Large Complex Banking Organizations (LCBOs). Key points in the latest letters were structures, "concerns," and expectations intended to push firms into compliance by the end of 2011 and in time for this year's performance awards. To ensure attainment of this goal, the Fed has indicated that this year will feature ongoing communication and investigation into changes planned and underway. In addition, a group of LBOs (large banking organizations) have received notice that they will now be going through the process and will be required to have their first self assessment completed by September 1st.

For a variety of reasons, previous communications have failed to convince regulators that the LCBOs have made sufficient progress. In some areas, the firms themselves acknowledge that additional progress is needed. In others, the gap seems to relate to plans that are in fact balanced, but not presented in a way that is sufficiently clear. In this Alert, we hope to help the LCBOs consider these two scenarios and provide a clear understanding that could mean the difference between repositioning a plan to the Fed with a better description and modifying the plan itself.

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For firms not included in either the first or the more recently initiated Horizontal Review but still subject to the Guidance, this overview should provide useful insights into the evolution of pay in the financial services sector as it is being driven by the regulators. In effect, the Fed is setting standards through its ongoing work with the LCBOs. For the next tier of banks, an awareness of that process should prove invaluable.

Our discussion addresses four categories which are aligned with the most prominent topics in the latest round of Fed letters.

- Covered Employees
- Balanced Incentives
  - The Total Picture
  - Ex-Ante Risk Adjustment
  - Ex-Post Risk Adjustment
- Clawback Policies
- Simulation Analysis

It is important to note that the latest round of feedback from the Fed focuses far less on effective controls and risk management and governance than in the past. Firms have made greater progress in these areas since the Guidance was initially released and for this reason, we do not discuss them in this Alert.

Covered Employees

The identification of covered employees is an area where the Fed has expressed ongoing disappointment. This is driven in part by banks attempts to limit the number of employees given the “covered” designation. There is also a growing sense that the definition itself is a moving target. While the Guidance clearly seeks identification of “material” risk takers, attempts to quantify materiality and exclude groups of employees have been poorly received by the Fed. This leaves banks facing the difficult prospect of proposing inclusion of large numbers of employees in credit and trading functions, regardless of level or degrees of influence in the risk taking process.

In many cases, the Fed has delivered pointed comments to firms relating to its expectation that the identification of covered employees will be a top priority. Without this, any assertion that incentives are balanced will be undermined by the Fed’s view that entire groups of employees are likely to be excluded from the discussion. It is still hard to predict where the market will land with respect to covered employees.

As a first pass, the group is clearly expanding from a year ago and will include all loan officers, traders and significant revenue producers. On the other hand, control staff who are not function leaders are less of a focus. Whether any bank will propose a threshold for materiality that the Fed accepts remains an open question. To date, the majority of banks are proposing groups consisting of 1-3% of total employees. This is a long way from being resolved and continues to vex most banks.

Balanced Incentives — The Total Picture

Assuming that the covered employees can be identified, the next step is to validate that their incentive plans are balanced. In order to do this efficiently and effectively, we strongly encourage banks to address incentives for groups of employees rather than

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individual plans. In previous responses to the Fed, many firms described individual plans without painting a cohesive picture regarding how different elements of pay combine to create an overall program that is balanced for groups of employees. This approach has generated some confusion and a lack of clarity in the review process.

For example, many firms may need to include both traders and executives who are compensated from different incentive and deferral programs and have very different approaches to performance measurement and risk adjustment. However, both groups may be subject to the same clawback policy. By addressing each group separately and painting a clear picture of their total program, rather than focusing on the plans themselves, there is an opportunity to clearly state why the pay for that group is balanced. Based on the feedback we have seen, this approach should align more closely with the Fed's thought process.

Balanced Incentives — Ex-Ante Risk Adjustment

In the category of ex-ante risk adjustment, there are a few points and policies many firms are, or should be, considering in order to adapt existing programs with the least amount of change. First, where quantitative adjustments are used, be explicit in the nature of the calculation as well as the role the adjustment is meant to play. Be sure to point out where risk adjustments are applied at the division, group, or even desk level as the employee's line-of-sight to the process is clearly a major point of focus. Also, if this risk adjustment is only one portion of the balancing mechanism for all or a group of employees, clearly articulate this point. This should help deflect criticism of the current approach and demands for enhancement.

At many firms, quantitative risk adjustments are enhanced with judgment-driven adjustments based on input from the firm's control functions and senior leadership. Where this is the case, we recommend the development of a policy document that guides what information will be reflected in the qualitative assessment and, where possible, a discussion of the expected impact of the findings of this analysis. While most firms are reluctant to express an explicit link between pay and a discretionary policy, we expect that the Fed would respond favorably to high level guidelines regarding the general magnitude and direction of any impact that may arise from varying outcomes of the a subjective assessment process. This is analogous to the types of documentation firms are adding around individual performance assessments and the risk review process.

Validation of the approach on a backward looking basis would also help to strengthen the case that risk adjustments are effective. For example, to validate discretionary adjustments at the individual level, firms might present an analysis that shows a relationship between pay and performance reviews for otherwise equal groups of employees. This may go a long way toward supporting the notion, in the Fed's mind, that qualitative risk adjustments at the individual level do create an effective link between pay and non-financial performance. It is clear that the Fed is interested in being able to replicate decisions given the same set of facts. This is consistent with their orientation to audit outcomes.

Balanced Incentives — Performance-Based Vesting/Clawback

When regulations were first announced and the word "clawback" was featured prominently, the initial thought in the market was Sarbanes Oxley. However, from the viewpoint of balanced incentives, the clawback has evolved past the malfeasance approach and into the notion of performance-based vesting.

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Malfeasance clawbacks – While not viewed as a negative, malfeasance clawbacks do not appear in the Fed's definition of features that serve to balance incentives.

Discretionary performance-based clawback – While a discretionary approach can work, a key to gaining buy-in from the Fed will be providing documentation regarding the firm's expectation for how the program will be implemented. The Fed has shown little willingness to accept an open-ended policy with no commitment by the firm to actually use the policy.

Formulaic performance-based clawbacks – Thought of interchangeably as a clawback or performance-based vesting, a method where forfeitures are driven by pre-established outcomes is the favored approach. By setting up formulaic triggers, the firm has gone one step beyond the discretionary approach and made an explicit commitment to enforce the clawback in select circumstances. However, banks are VERY concerned with the reliance on a single formulaic metric to determine the release of deferred plans. As we have learned in the past, this approach can, and often does, lead to unintended outcomes.

Performance-based vesting is an approach many banks have resisted, but the Fed has shown signs of persistence on this particular issue. Adding to the pressure for larger organizations, the proposed rule 956 implementation for Dodd-Frank will require performance-based vesting for mandatory deferrals.

Interestingly, the Fed continues to push a middle-of-the-road approach to performance-based vesting. On the one hand, deferrals for which vesting is based on performance levels believed by the Fed to be difficult to achieve are viewed as a negative because of the probability that employees will increase risk taking to achieve the vesting provisions. On the other hand, performance goals based on a material downgrade in financial performance, including a downturn that pushes the firm toward insolvency, are also viewed as insufficient. Instead, the stated preference is for an approach that falls somewhere in the middle: more modest levels of achievement which, if not met, lead to forfeiture. An example would be positive earnings at the corporate, division or business unit level. This is an opportunity to introduce the notion of scenario testing, which would clearly show the various combinations of financial performance for which the incentive plan would vest or would not vest.

Simulation Analysis

One last area worth mentioning—and the subject of many questions and confusion—is the requirement of simulation analysis. The expectations here remain unclear and few, if any, banks have yet developed a robust methodology. In this area, our recommendation is to begin with a relatively simple approach and to remember the goal - to ensure that outcomes in incentive programs are aligned with performance outcomes, particularly outcomes where poor performance is driven by risk.

One place to start is with the simple question of whether pay goes down when risk taking increases and financial performance is otherwise the same. While we've seen many firms begin by modeling compensation after the award date, few have taken steps to model quantitative risk adjustments. This relates to the relative ease and established methodologies around share price modeling. However, we believe the Fed would be receptive to modeling that shows, for example, the magnitude of an RWA-driven cost of equity charge across a broad range of risk levels. If risk taking does go up, RWA will increase and the charge will follow. For a given level of net revenue, the Fed will look to see whether the charge increases by enough to leave the incentive pool equal as risk taking increases.

Beyond the grant date, one approach would rely on the simple premise that increased risk taking drives a broader range of potential outcomes. For the employee, this introduces the possibility of greater windfalls. However, this can be demonstrated to work against the employee through the potential for greater losses in equity deferrals and/or forfeitures under a performance-based vesting program. This analysis could be summarized with a comparison of expected values under varying risk level scenarios. While not overly precise, banks could produce meaningful and relevant information that clearly depicts relationships between risk, performance and pay. These concepts may work well as a starting point in an area of the Guidance where progress has been extremely slow.

Conclusion

As has been the case in the past, firms have been given 45 days to respond to the Fed. However, in contrast to last year, the December 2011 end-point for compliance is now not that far off. Firms can clearly expect a greater level of attention through the summer and leading up to year end. Getting off on the right foot with the current response will be essential. We hope that this Alert will prove useful as you shape your response and look forward to continuing to work with you as you adapt to this new regulatory environment. ■

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