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What Does the Fed Really Want?

Practical Ways to Meet the Fed's Guidelines

By Brian Dunn
October 4, 2011

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For the better part of two years the Federal Reserve Bank and the nation's largest banks (also known as "LCBOs"—Large Complex Banking Organizations) have been trying to come to agreement on the best way to minimize the possibility that incentive plans would encourage executives and employees to put the bank's balance sheet at risk for their own personal gain. In short, they want to ensure that compensation is not a contributing factor to future financial crises.

The Fed (unlike most other international financial regulators) took the position that they were going to employ a "guidance-based" as opposed to a "rules-based" approach. With this announcement, there was a collective sigh of relief in the United States as firms saw the opportunity to avoid the heavy-handed and punitive compensation regulations being imposed on their European counterparts.

That was the good news. The bad news is that the banks had to figure out what the Fed really wanted. For that to happen, the Fed itself had to figure out what they wanted. In reasonably short order the Fed issued a set of guidelines that in the abstract made sense.

But, as we all know, the devil is in the details. And so began a two year journey between the banks and the Fed composed of lots of meetings interspersed with a series of written communications from the Fed to the banks and vice versa. While the process took much longer than expected, a lot was learned by both sides; however, after nearly two years both sides are looking for closure—the banks want to move on and the Fed has a new set of banks they want to begin the process with.

The real challenge has been the guidance-based approach and the Fed's insistence that "there is no right way" and therefore "no safe harbor". But, the banks live in a very competitive world and want to do nothing that will somehow disadvantage their shareholders or employees. This means making significant changes in isolation is just bad business.

Over the last 30 days, we have consulted with some of the best compensation and risk minds at nearly all of the LCBOs. We have spoken to them individually and collectively in an effort to capture what they have learned. Our intent was to define thoughtful and balanced practices that will:

- Address the Fed's concerns
- Ensure that shareholders continue to get a fair and reasonable return
- Optimize tax and accounting treatment
- Provide equitable and competitive compensation to employees

Outlined below are a set of practical guidelines, combining observations of past market practice, along with our recommendations for meeting these important objectives.

COVERED EMPLOYEES

Early on the Fed introduced a concept that their rules should only apply to those individuals who individually or collectively could take material risk that could adversely affect the safety and stability of the institution and / or a material business unit. These evolved into three classes of employees known as Tier 1, Tier 2 and Tier 3. They were collectively known as "covered employees". The challenge then became how to decide who was "in" and who was "out".

While the Fed's guidance provided a helpful starting point, it is far from clear as to which employees should be covered. As a result, a set of techniques evolved to help with the identification process. Banks typically looked at four criteria when determining who was covered and who was not: role / responsibility, business unit, organizational level and / or compensation (form, level, mix). First they looked at either specific roles and / or broad businesses functions and applied the following screens:

1. Are they involved in taking risk (credit, liquidity, market, reputational, legal / compliance, operational or business)?
2. Can they individually (tier 1 and 2) or collectively (tier 3) make the risk decision?
3. Are the risks material?

Through this process individuals in roles and / or businesses / functions were identified as being potential covered employees. Then most banks applied another test or tests to see if they somehow missed someone. For example, does anyone whose has not yet been included:

1. Earn above a certain threshold (e.g., $1,000,000)?
2. Serve on an important committee (e.g., credit, customer selection, etc.)?
3. Work at a certain organizational level (e.g., operating committee, band A, etc.)?

While the Fed seems more comfortable using these criteria to capture only "senior" people who would have otherwise been missed, we believe that the materiality screen should also be used to eliminate those that could not possibly have an adverse impact. For example:

1. Does the person / position have no or de minimus incentive pay (e.g. <10%)?
2. Is the individual / role non-exempt with no decision-making authority?

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When this was all said and done, most firms identified "covered employees" that constituted between 2-4% of their total population. The largest swing factors were the extent to which they had large / significant populations in one or more of the following areas:

1. Mortgage Origination and Underwriting
2. Capital Markets / Sales and Trading
3. Commercial Real Estate
4. Corporate Banking
5. Commissioned sales force

If a bank had none of these groups, its percentage would likely have dropped below 2%. If a bank had a heavy concentration of one or more of these businesses and no significant retail and / or wealth business, their percentage could have gone as high as 6-10%. The percentage of covered employees in a given business / function was as follows:

Vast Majority (except very junior people)

- Treasury
- FX / Derivatives Traders
- Mortgage
- Commercial Real Estate
- Capital Markets / Sales & Trading
- Commissioned sales staff
- Executive Management

Greater 10% but Less than 50%

- Corporate/Community Banking
- Asset Management
- Wealth Management
- Credit Review/Approval
- Audit
- Risk
- Finance
- Underwriting
- Compliance

Very Few (except most senior leaders)

- Retail Banking
- Human Resources
- Legal
- Operations
- Marketing
- Technology

Within the population of covered employees it was important to identify the Tier 1 and Tier 2 staff that were able to make material risk decisions individually. These determinations were made on the following basis:

Tier 1

Executive Management, such as the Operating / Executive Committee and / or all employees reporting to the CEO. Depending on the organizational structure of the bank, this could include the next level reports and all individuals running a material business / function. This population typically ranges from 15-50 people.

Tier 2

Those running significant businesses/functions, all those individuals with significant authority over credit, VAR, RWA, trading limits or investment decisions plus all those that serve on significant and important bank-wide committees. This population can range anywhere from 50 to over 500 depending on the mix of business. Those with large capital markets/sales and trading businesses will be at the higher end of this spectrum.

Tier 3

All other covered employees who can influence risk only in combination with the actions of others.

COMPENSATION CHANGES

Once the covered employees have been identified, along with the risks and the risk timeframes, the incentive programs should be reviewed and possibly modified to ensure that nothing in those incentive plans encourages unreasonable risk.

For those Tier 1 and Tier 2 covered employees, a key component of this process, as far as the Fed is concerned, is having the ability to take back / reduce / cancel incentives when, with the benefit of 20/20 hindsight, we know that earnings were either not what we originally thought they were and / or were achieved by taking excessive risk. Banks were encouraged to adopt some form of incentive vehicle that does the following:

1. Places some portion of incentive compensation in a "deferred account" for a period of at least 3 years

2. Allows for the reduction / elimination of that amount based on future results

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Banks have historically accomplished something along these lines by using:

1. Mandatory deferral of bonuses (e.g., 50% of bonus is paid in current cash and 50% is deferred for 3 years)
   OR
2. Awarding of performance units / shares (e.g., a $100,000 grant is made today, but the ultimate value can range between $0 and $200,000 based on the achievement of pre-set absolute or relative performance targets)

In our view, neither of these concepts in their current configuration fully meet the spirit of the Fed's guidelines for "performance vesting" compensation. In the case of mandatory deferrals, there is typically only a time condition (as opposed to a performance condition) to determine vesting.

For the long term performance plans there are two issues—firstly, there is an upside as well as a downside and secondly, the hurdle rates are high (e.g., in order to maximize the outcome real risks may need to be taken). Our recommended solution is to either create new plans or add new conditions to existing plans.

The basic premise would be no payout of either mandatory deferred bonuses and / or long-term performance plans *unless* a second hurdle was achieved. There would be no upside to this component; all or part of the award could be forfeited based on performance compared to the secondary hurdle. This hurdle would constitute a meaningful measure such as net profit, return on economic capital or return on risk-weighted assets.

The minimum threshold to trigger 100% vesting would be somewhat pedestrian (e.g., reflect approximately 90% chance of a achievement) and would be set after back testing, such that it would have NOT been met (and subsequently paid out on) in the event of a significant financial setback (e.g., 2008 / 2009 for most banks). The advantage of this "double hurdle" is that the underlying incentive would continue to reflect what the business believes to be important and motivational, BUT it would not ultimately be delivered unless such actions turned out to be aligned with principals of safety and soundness.

Our preference would be to have the performance vesting determination made on the basis of sound business judgment by the compensation committee, looking at a collection of important pre-determined measures with the ability to consider other material factors with the benefit of hindsight. We have learned the hard way that people are smarter than formulas and would therefore encourage banks and the Fed to leave these ultimate decisions in the hands of those best equipped to make them.

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We recognize that this design could trigger variable accounting if it is applied to stock. Full consideration should be given to the balancing of unfavorable accounting versus optimal plan design.

The Fed has also taken issue with the pro-rata vesting that most banks have applied to mandatory deferrals, restricted stock grants and / or performance plans. One compromise could be for banks to continue to use the pro-rata vesting for “ownership” purposes (e.g., the award is available post termination), but the delivery and ultimate value is determined at the end of the term.

We believe the most appropriate vesting period is 3-4 years. Less than that and there is not sufficient time to truly consider that implications of previous decisions—longer than that and employees discount the value to such an extent that it becomes less of an incentive and throws the cost:benefit relationship out of alignment.

Another important question is how much of the total incentive should be subject to this “second hurdle” or performance vesting. Our best thinking is that 30-60% of the *total incentive* of Tier 1 executives should be deferred and at least 20-30% of the *total incentive* of Tier 2 employees should be deferred.

For Tier 3 employees (those who can take risks only as a group) it gets a little more complicated because there are so many different types of employees in this group, as well as such varied incentive practices. As a rule, we believe that the adjustments to incentive plans should be ex ante and only require some form of deferral when they are engaged in large long tail risks. Barring that, we believe that the following kinds of adjustments / modifications / additions should be sufficient:

- Introducing a “claw back” provision that makes all incentive compensation subject to recapture if it is deemed to have been earned under faulty assumptions or by taking excess risk
- Applying a risk-weighted capital charge to all profit / revenue-based plans that reflects the excess capital required to offset incremental risk
- Using economic profit calculations for incentive funding purposes
- Incorporating a risk review / compliance scorecard as part of the performance management process and requiring a minimum score in order for employees to be eligible for incentive compensation

- Creating a risk / compensation committee to approve all new plans and programs, review the ongoing process, resolve disputes and inform the independent compensation committee. This committee could be composed of senior leaders such as the CHRO, CFO, CLO and the CRO

In addition we suggest consideration of the inclusion of other language / provisions in ***all*** incentive plans that apply to both covered and non-covered employees. These would include provisions to:

- allow ex-post modification of vesting or amount based on individual "bad behavior" and / or institutional catastrophic performance
- subject all incentives, prior to payment, to a potential risk review that could result in the negative modification or elimination of the award

OTHER ISSUES

There are a number of other key considerations that the Fed must acknowledge:

- **Communications**
  Banks need sufficient lead time to adequately communicate to staff. Effective communication around design changes will be key in bringing risk-consequences into the decision making process; complex changes that are not well understood will defeat the purpose of the changes.
- **Scenario and Back Testing**
  The Fed has requested that the banks create the capabilities to "stress test" their incentive plans to understand the sensitivity of the incentive plans to wide variations of performance. They also expect banks to be able to "back test" the outcomes of incentive compensation and compare it to actual results. There is a real lack of clarity as to how this can actually be accomplished. Given that incentive funding, allocation, vesting and valuation is a multi-dimensional and non-linear process, it is virtually impossible to create a model that would incorporate all the variables that go into an individual incentive realization (or for that matter total incentive spend) that could demonstrate a "cause and effect" relationship. Therefore, we suggest that the Fed lead a consortium of banks in the development of the necessary testing techniques.
- **Performance Management**
  The Fed has indicated a strong preference for an integrated performance management system that supports the risk management process. We whole heartedly agree; however, it would be helpful to get a detailed explanation of how this differs from the current performance management programs.

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- **Documentation**

  Taken literally, much of the Fed guidance would lead you to believe that every step in the incentive funding and allocation process ought to be documented as to how and why each decision was made. This is not only a practical impossibility (due to the iterative nature of the process), but so burdensome as to reduce any element of judgment in the process.

- **Exceptions**

  Real and unique circumstances have a way of getting in the way of any well-intended plan design. We suggest that the leadership of banks be empowered to deal with special circumstances in a practical and realistic fashion. Special circumstances would include such things as acquisitions, new hires and retirements.

MULTIPLE CONSTITUENCIES

Another significant barrier to the final determination of appropriate plan revisions is the Fed's laser focus on safety and soundness. While critically important, it ignores the other very important constituencies that banks must deal with: other regulators (both domestic and international), shareholders, tax and accounting authorities and of course, employees.

- **Regulators**

  While theoretically working under the banner of the international Financial Stability Board (FSB), in-country regulators have reached very different conclusions about the unreasonable / excessively risky compensation conundrum. In many jurisdictions the regulators have been more directive about who should be included and how their compensation should be modified. Global banks must reconcile these differences to ensure both fairness and efficiency of operations. Even within the United States there are clear differences in the views (and actions) across the Fed, OCC, SEC and FDIC. Glossing over these differences is not productive and before expecting the banks to make final decisions around "whom" and "how", the regulators must agree to either speak with one voice or designate a lead regulator.

- **Shareholders**

  Shareholders are looking for a reasonable return on their investment and therefore want to employ the best, most motivated and properly directed staff. They like measures like ROE, EPS and TSR. If they believe executives are directed to focus on other issues and the best talent chooses to work elsewhere because of confining and / or restricted compensation plans, they will vote with their money—depriving the bank of a critical source of capital. Banks need to balance the Fed's concerns with those of shareholders.

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- **Tax and Accounting Authorities**
  The design of compensation plans have very real tax and accounting implications that affect both the individual and the bank. Plan redesign simply must take these factors into consideration. Ignoring them will either reduce reported income, corporate or individual tax rates or even possibly run afoul of other regulations such as 409a.

- **Employees**
  At the end of the day a bank is simply reputation, people and capital. It cannot survive without any one of them. Changing compensation plans in a way that disadvantages employees is a sure way to lose people. The Fed understands this issue but has yet to give banks a consistent message as to what is acceptable. Without it, a real reluctance to make meaningful change will persist.

TIMING

It is clear that the Fed expects this process to be completed and changes implemented by year-end. Most banks do not share that view. They do not have final approval from the Fed as to who should be covered and what changes are necessary. They are also highly concerned that making changes for 2011 compensation so late in the year will subject them to at best serious employee relations concerns and at worst lawsuits and violations of state laws.

More likely, if the Fed responds quickly to bank's August submissions there can be agreement around what 2012 compensation will look like and who will be covered. Over the course of 2012, banks will be able to introduce further refinements—particularly for Tier 3 incentive plan modification.

CONCLUSION

It is time to move beyond the limbo stage and into the "post-crisis" world. Hard and practical decisions need to be made by the banks and the Fed needs to acknowledge the very real constraints and considerations the banks face. This paper was intended to set out a clear path to follow to allow banks to move from the theoretical to the practical. If the Fed continues its openness to progressive change, we can see improvements in prospective 2012 pay decisions.

ABOUT THE AUTHOR

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