

Principle 1: Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.

- 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.
- 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.
- 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.

Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.

- Reliable quantitative measures of risk and risk outcomes ("quantitative measures"), where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced.
- 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.
- *Large banking organizations.* 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.

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.

- **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. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.
- **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. Deferred payouts may be altered according to risk outcomes either formulaically or judgmentally, subject to appropriate oversight. To be most effective, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance 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). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after 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).

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Each method has its own advantages and disadvantages. Accordingly, 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. Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, strong policies and procedures, internal controls, and ex post monitoring of incentive compensation payments relative to actual risk outcomes are particularly important to help ensure that the arrangements as implemented are balanced and do not encourage imprudent risk-taking.

Large banking organizations. 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.

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.

- Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization.
- 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. The same is not necessarily true for lower level employees.
- For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to result in arrangements that are unbalanced at least with respect to some employees.
- *Large banking organizations.* 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. The portion of the incentive compensation of other covered employees that is deferred or paid in the form of equity-based instruments should appropriately take into account the level, nature, and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the organization and its stock price. Deferral of a substantial portion of an employee's incentive compensation may not be workable for employees at lower pay scales because of their more limited financial resources. This may require increased reliance on other measures in the incentive compensation arrangements for these employees to achieve balance.

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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 while at the organizations.

- Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive 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. Banking organizations should carefully review any such existing or proposed arrangements (sometimes called “golden parachutes”) and the potential impact of such arrangements on the organization’s safety and soundness. In all cases, a banking organization should ensure that the structure and terms of any golden parachute arrangement entered into by the organization do not encourage imprudent risk-taking in light of the other features of the employee’s incentive compensation arrangements.
- *Large banking organizations.* 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 handshake” 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.

Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.

- In order for the risk-sensitive provisions of incentive compensation arrangements to affect employee risk-taking behavior, the organization’s employees need to understand that the amount of incentive compensation that they may receive will vary based on the risk associated with their activities. Accordingly, banking organizations should ensure that employees covered by an incentive compensation arrangement are informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid.
- 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. An organization’s communications should be tailored appropriately to reflect the sophistication of the relevant audience(s).

Principle 2: Compatibility with Effective Controls and Risk-Management

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. Rather, a banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk-management and other functions.

- 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).
- *Large banking organizations.* 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. 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.

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.
- Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to, (i) reviewing the types of risks associated with the activities of covered employees; (ii) approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and (iii) analyzing risk-taking and risk outcomes relative to incentive compensation payments.

Principle 2: Compatibility with Effective Controls and Risk-Management (cont.)

Compensation for employees in risk-management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.

- The risk-management and control personnel involved in the design, oversight, and operation of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles. These skills and experiences should be sufficient to equip the personnel to remain effective in the face of challenges by covered employees seeking to increase their incentive compensation in ways that are inconsistent with sound risk-management or internal controls.
- To help preserve the independence of their perspectives, the incentive compensation received by risk-management and control personnel staff should not be based substantially on the financial performance of the business units that they review. Rather, the performance measures used in the incentive compensation arrangements for these personnel should be based primarily on the achievement of the objectives of their functions (e.g., adherence to internal controls).

Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.

- Results should be reported to appropriate levels of management, including the board of directors where warranted and consistent with Principle 3 below. 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. A banking organization should take the results of such monitoring into account in establishing or modifying incentive compensation arrangements and in overseeing associated controls.

Principle 3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

- 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. 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.
- The board of directors of an organization also is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all covered employees are appropriately balanced and do not jeopardize the safety and soundness of the organization. The involvement of the board of directors in oversight of the organization's overall incentive compensation program should be scaled appropriately to the scope and prevalence of the organization's incentive compensation arrangements.
- *Large banking organizations and organizations that are significant users of incentive compensation.* 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.

The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.

- 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.
- 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.
- The board of directors of a banking organization should seek to stay abreast of significant emerging changes in compensation plan mechanisms and incentives in the marketplace as well as developments in academic research and regulatory advice regarding incentive compensation policies. However, the board should recognize that organizations, activities, and practices within the industry are not identical. Incentive compensation arrangements at one organization may not be suitable for use at another organization because of differences in the risks, controls, structure,

Principle 3: Strong Corporate Governance (cont.)

and management among organizations. The board of directors of each organization is responsible for ensuring that the incentive compensation arrangements for its organization do not encourage employees to take risks that are beyond the organization's ability to manage effectively, regardless of the practices employed by other organizations.

- *Large banking organizations and organizations that are significant users of incentive compensation.* 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. 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.

The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.

- 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. The board of directors of an organization with less complex and extensive incentive compensation arrangements may not find it necessary or appropriate to require special board expertise or to retain and use outside experts in this area.
- 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. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence. While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.
- *Large banking organizations and organizations that are significant users of incentive compensation.* 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

Principle 3: Strong Corporate Governance (cont.)

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.

A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.

- 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 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. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.

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 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:

- 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;
- Identify the types and time horizons of risks to the organization from the activities of these employees;
- Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take imprudent risks;
- 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;
- 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
- 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.

FDIC press release and full text of interagency guidance can be found at:
<http://www.fdic.gov/news/news/press/2010/pr10138.html>