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Clients&FriendsMemo

Federal Reserve Board Proposes Guidance on Incentive Compensation

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On October 22, 2009 the Board of Governors of the Federal Reserve System ("**Board**") released proposed Guidance on Sound Incentive Compensation Policies (the "**Compensation Guidance**") applicable to certain banking organizations as described below.[1]

The proposal puts forth three key risk management principles that banking organizations must observe in developing and implementing incentive compensation arrangements.[2] Broadly speaking, these principles require affected banking organizations to (i) develop incentive compensation arrangements that do not encourage employees to take "excessive" risk, (ii) structure their risk management programs to effectively monitor risk exposures created by incentive compensation arrangements, and (iii) place responsibility on the Board of Directors for establishing appropriate incentive compensation arrangements. These three key principles, as well as the applicability and scope of the Compensation Guidance, and its supervisory implications for affected banking organizations, are discussed in detail below.

Public comment on the Compensation Guidance must be received by the Board by November 27, 2009. A number of criticisms of the guidance can be made: (i) "large-complex banking organizations" ("**LCBOs**")[3] likely will face significant costs in restructuring compensation arrangements to comport with the principles outlined in the guidance (e.g., consultancy fees in developing these new arrangements are likely to be significant); (ii) it may become difficult for banking organizations subject to the guidance to retain or acquire staff in competition with

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[1] *Proposed Guidance on Sound Incentive Compensation Policies*, 74 Fed. Reg. 55227 (October 27, 2009), *available at* http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf.

[2] The proposal only addresses incentive compensation and does not, by its terms, address what might be called "management by disincentives" such as the imposition of adverse consequences, such as demotion, pay cuts, or termination, if targets are not met.

[3] "LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their regulatory structures, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one key financial market." *See Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations* SR 08-9 (October 16, 2008), *available at* http://federalreserve.gov/boarddocs/srletters/2008/SR0809.htm.

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organizations not subject to the guidance; (iii) certain aspects of the guidance will make tax planning more complicated for the bank and for bank employees receiving "incentive compensation;" and, most importantly, (iv) the increased uncertainty of incentive compensation is likely to increase overall compensation expenses in the banking industry generally.[4] Although the Board touts the guidance as a better alignment of compensation and the long-term performance of the organization, there are reasonable questions as to whether the guidance can or would achieve this.[5]

I. Supervisory Aspects of the Guidance

As the legal basis for the Compensation Guidance, the Board cites its general authority to regulate the "safety and soundness" of institutions for which it is the primary federal prudential regulator.[6] The Board can therefore bring enforcement action against banking organizations that fail to observe the Compensation Guidance.[7] Enforcement action generally would require the organization to submit a remedial plan to correct deficiencies, and may involve the issuance of a cease-and-desist order.

In fact, safety and soundness standards for compensation already exist. Regulation H prohibits "excessive" compensation and compensation that "could lead" to a "material financial loss."[8] It is thus interesting that the Compensation Guidance is being issued as a standalone set of guidelines, rather than as an amendment to Regulation H. In this regard, it is instructive to refer to the Regulation H Adopting Release:

> Section 39(c) of the FDI Act, as amended by the CDRI Act, continues to require the agencies to establish standards (1) prohibiting as an unsafe and unsound practice the payment of excessive compensation or compensation that could lead to material financial loss to an institution; and (2) specifying when compensation, fees, or benefits are excessive.
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> The agencies' joint proposal relied upon the statutory language in formulating the standards required under section 39(c). *Commenters strongly supported the use of the factors set forth in section 39(c) as the sole standard in defining excessive compensation. Commenters believed that more detailed*

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[4] Indeed, this seems already to be occurring, as the largest banks are on track to reach record compensation levels again this year. *See* Aaron Lucchetti & Stephen Grocer, *Wall Street On Track To Award Record Pay*, WALL ST. J. at A1, Oct. 14, 2009, *available at* http://online.wsj.com/article/SB125547830510183749.html.

[5] "Measuring risk . . . is art not science; people may still win payouts and end up causing losses." ECONOMIST at 44 (Nov. 22, 2008).

[6] 12 U.S.C. § 1831p-1(c). The federal banking agencies are required by statute to prescribe compensation standards that are consistent with "safety and soundness."

[7] 12 U.S.C. §§ 1818(b)(1) authorizes the Board to issue cease and desist orders when an institution is engaged in unsafe and unsound practices.

[8] *See* 12 C.F.R. Part 208, Appendix D-1.

> *standards would constitute micro-management of an institution's management practices*. Accordingly, the agencies' Guidelines include the compensation standards as proposed.[9]

Perhaps the Board no longer believes that prescribing compensation standards via regulation constitutes "micro-management." However, as outlined below, the risk management principles of the Compensation Guidance will nevertheless have a significant impact on the structure of compensation at banking organizations.

It should also be noted that the Board's authority to regulate compensation is separate from the authority of the Troubled Asset Relief Program ("**TARP**") "Special Master" on Executive Compensation, Kenneth Feinberg, to regulate the compensation of executives at institutions that have received "exceptional assistance" by way of funds allocated under the Emergency Economic Stabilization Act of 2008 ("**EESA**").[10] The authority of the Special Master to regulate compensation is limited to those organizations that have received "exceptional assistance," and such authority lasts only so long as the organization has TARP-related obligations to the U.S. Treasury outstanding. The Board's authority to regulate compensation, however, has no expiration date, based as it is on safety and soundness.[11]

II. Applicability and Scope

The Compensation Guidance applies only to (i) incentive compensation paid (ii) to specified employees (iii) at organizations for which the Board is the primary prudential regulator.

Incentive Compensation. The Compensation Guidance applies to "incentive compensation arrangements." Unfortunately, the guidance does not provide a very clear definition of "incentive compensation."[12] This is problematic because, to some extent, all compensation is incentive compensation (i.e., the bank will pay the employee a minimum wage if he or she shows up for work), but such wage and salary payments are probably not intended to be covered by the guidance, and

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9 *See Standards for Safety and Soundness and Interagency Guidelines Establishing Standards for Safety and Soundness*, 60 Fed. Reg. 35674, 35678 (July 10, 1995).

10 *See generally TARP Standards for Compensation and Corporate Governance*, 74 Fed. Reg. 28394 (June 15, 2009), *available at* http://www.treas.gov/press/releases/reports/ec%20ifr%20fr%20web%206.9.09tg164.pdf; *see also Summary of Executive Compensation Requirements Applicable to Recipients of TARP Funds*, Cadwalader Clients&Friends Memo (April 23, 2009), *available at* http://www.cadwalader.com/docs/042309_Executive_Compensation_Chart.pdf.

11 The Compensation Guidance is focused on processes to be adopted whereas the Special Master's actions focus on substance of actual compensation decisions. Yet another distinction is that the Special Master's actions relate to total executive compensation and not just incentive compensation, whereas the Board's proposal is limited to incentive compensation.

12 The guidance states in passing that "[i]ncentive compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the firm." 74 Fed. Reg. 55232. It defines "incentive compensation" as that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g. sales, revenue, income), but does not include compensation awarded solely for continued employment (e.g. salary).

so should be explicitly excluded. On the other hand, a portion of compensation that is contingent on the employee achieving certain specified targets (perhaps that would function as an appropriate definition for "incentive compensation") will only have a significant influence over the behavior of the employee if such incentive compensation is substantial in relation to the employee's "non-incentive" compensation; and to arrive at a comparison between the two, one requires a line dividing the two types.[13]

Employees Covered. The guidance generally applies to "senior executives as well as other employees who, either individually or as part of a group may expose the organization to "material amounts of risk." Employee coverage is thus very broad – the Compensation Guidance only specifically carves out personnel with essentially clerical duties (tellers, bookkeepers, couriers, data processing personnel). The Board outlined three particular categories of employees who would be covered by the guidance:

- Any employee responsible for oversight of the organization's firm-wide activities or material business lines

- Any employee whose activities may expose the organization to "material amounts of risk" (e.g., traders with large position limits)

- Groups of employees who are subject to 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 firm to material risk (e.g., retail loan officers)

Organizations Affected. The proposed guidance applies to U.S. bank holding companies ("BHCs"), state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the United States. Thus, technically, the guidance does not apply to national banks, nonmember state banks, thrifts, credit unions, or federal branches and agencies, but other bank regulators are likely to adopt similar guidance.

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[13] See, for example, the request for comment, which asks whether there are "types of incentive compensation plans, such as firm-wide profit sharing plans that provide for distributions in a manner that is not materially linked to the performance of specific employees or groups of employees, that could and should be exempted from, or treated differently under, the guidance because they are unlikely to affect the risk-taking incentives of all, or a significant number of, employees? If so, what are the features of these plans and the types of employees for which they are unlikely to affect risk-taking behavior?" 74 Fed. Reg. 55229.

It should be noted that the Board normally applies proscriptions applicable to BHCs to all nonbank subsidiaries of the BHC.[14] Thus, broker-dealer and investment adviser subsidiaries of BHCs **will be subject** to the Compensation Guidance unless they are subsidiaries of the bank. Although the guidance does not expressly state that the incentive compensation principles are intended to apply across an entire banking organization regardless of the "functional regulator"[15] of any particular entity within the organization, it is clear from the guidance's focus on LCBOs and consolidated supervision that the Board intends to apply the Compensation Guidance to all entities within the BHC.[16]

The guidance also would **not apply** to the foreign operations of foreign banks. In the European Union, regulators are adopting a more prescriptive approach to these matters, and, thus, one could envision the guidance's process-oriented approach to create an incentive for foreign banks possibly to move trading operations from Europe to New York.[17]

The guidance generally indicates that an organization should tailor its incentive compensation arrangements to the scope and complexity of the bank's activities – i.e., LCBOs, as "significant

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[14] It should be kept in mind that such "consolidated supervision" of the BHC would exclude supervision of the bank and subsidiaries of the bank, as the Board leaves prudential regulation of the bank itself to the bank's chartering institution – i.e., the Office of the Comptroller of the Currency for national banks and the Federal Deposit Insurance Corporation for insured state chartered banks.

[15] Generally, the Board's prudential and supervisory authority over "functionally regulated subsidiaries" is limited to measures "necessary" to prevent an "unsafe or unsound practice" that poses a "material risk to the financial safety, soundness, or stability" of a depository institution or the domestic or international payment system, and the Board must find that it is not reasonably possible to protect effectively against the material risk at issue through action directed at or against the affiliated depository institution or against depository institutions generally. *See* 12 U.S.C. § 1848a.

[16] *See Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations* SR 08-9 (October 16, 2008), *available at* http://federalreserve.gov/boarddocs/srletters/2008/SR0809.htm.

[17] On November 10, 2009, the Council of the European Union (its main decision-making body) agreed on a general approach to a draft Directive on, inter alia, "preventing remuneration policies that generate unacceptable levels of risk." *See EU Finance Ministers Agree to Bump up Bank Capital*, REUTERS, Nov. 10, 2009, *available at* http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSLA69101620091110. The Directive would impose binding obligations on banks and investment firms to have remuneration policies and practices that accord with sound risk management and bring remuneration policies within the scope of supervisory review (meaning that supervisors could require firms to take rectifying measures if they find remuneration policies lacking or inappropriate, and impose penalties for failures to comply). The EC Commission had earlier issued a non-binding Recommendation. *See Commission Recommendation on remuneration policies in the financial services sector*, Com(2009) 211 (fin), *available at* http://ec.europa.eu/internal_market/company/docs/directors-remun/COM%282009%29_211_EN.pdf.

Meanwhile, the UK's Financial Services Authority ("FSA") has published its Code of Practice on Remuneration Policies, effective January 1, 2010. *See* FSA Draft Code On Remuneration Practices, *available at* http://www.fsa.gov.uk/pubs/other/remuneration.pdf. This Code will apply to larger banks, building societies and broker-dealers, and once again, is concerned with the promulgation of remuneration policies and practices that are consistent with and promote effective risk management. The provisions of the Code include the appointment and functions of a remuneration committee, the use of non-financial performance measures, and importantly, the need to defer payment of the majority of "significant" bonuses.

users of incentive compensation arrangements," should expect to receive greater scrutiny from the Board, particularly in light of the fact that a failure of such organizations is more likely to have adverse effects on the broader financial system.[18] Indeed, the Board proposes to conduct "horizontal reviews" of the 28 largest affected banking organizations (partially to educate itself about details of current practices, understand roles, and identify best practices).[19] In contrast, the guidance indicates that incentive compensation arrangements, risk management systems, and compensation review procedures of small banking organizations will be "substantially less extensive, formalized, and detailed" than those at LCBOs.[20]

"Horizontal reviews" will be led by Board staff, specifically a team with experts not only in supervision, risk management, and finance, but also economics,[21] law, and accounting. The team would be privy to horizontal incentive compensation reviews of other banking organizations and thus be able to help transmit best practices. The team would be a resource to supervisory staff throughout the Fed system.

In the case of smaller banking organizations, the supervisory process would be part of the examination process. In all cases, incentive compensation findings would find their way into ratings.

III. Key Principles For Incentive Compensation at Banking Organizations

The guidance would modify incentive compensation arrangements throughout affected banking organizations: (a) bankers will have to agree to receive a different package of compensation in return for their services; (b) in the risk management department, risk managers must continuously evaluate the impact of incentive compensation on the behavior of deal-makers and traders at the bank; and (c) at the Board of Director level, Directors must take responsibility for approval and review of all incentive compensation arrangements.

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[18] *See Risk-Focused Supervision of Large Complex Banking Organizations* SR 99-15 (June 23, 1999), *available at* http://www.federalreserve.gov/boarddocs/srletters/1999/SR9915.htm.

[19] There has already been public disagreement as to whether the results of these reviews should be made public; opponents of such transparency have suggested that making compensation information public would facilitate the hiring away of executives by competitors.

[20] The guidance notes that it would apply to approximately 3002 "small banking organizations" (i.e., those with $175 million or less in total consolidated assets). The guidance does not specify which institutions will fit within the category of LCBO, but it does note that the initial supervisory review of incentive compensation arrangements at LCBOs will involve 28 such institutions. *See* Press Release, *Federal Reserve Issues Proposed Guidance on Incentive Compensation* (October 22, 2009), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm.

[21] It is unusual for the Board to bring its economics experts in to the bank supervisory process. However, the Board recently designated one of its senior economists to lead its bank supervisory efforts, some thought in order to bring systemic risk focus to bank supervision, and that appears to be the beginning of a trend.

A. Compensation Arrangements Must Not Encourage "Excessive" Risk-taking ("*Principle 1*").

The theory behind the Compensation Guidance is that riskier activities yield higher short-term revenue – thus, if an employee seeks greater short-term revenue without regard to "tail" risks, an employee will expose the organization to unsafe and unsound levels of risk. The guidance assumes that a desirable balance can only be achieved if incentive payments take such risks into account: two employees that generate the same amounts of short-term revenue should receive different amounts of incentive compensation if they expose the bank to a materially different set of risks.[22]

What risks should be considered in setting incentive compensation? The Board specifically mentions that the cost and amount of capital and liquidity needed to support risks should not be disregarded. Banks, particularly LCBOs, should use scenario analysis (which should create demand for Basel II operational risk experts who can be available to work closely with the army of compensation consultants that banks will vie to hire to help them comply with the guidance.)

Principle 1 requires banks to formulate incentive compensation arrangements with three essential features in mind: (a) incentive compensation should be "haircut" to account for the possibility that future performance outcomes do not match present incentive compensation payments; (b) incentive compensation arrangements should provide for "clawbacks" and/or payment deferrals where actual outcomes differ materially from the performance assumptions on which past incentive compensation determinations have been made; and (c) certain incentive structures are singled out as favored or disfavored.

The Measurement Risk Haircut[23]. The incentive compensation "haircut" seems to operate in the following way: (i) the bank calculates the increased profit that may be generated by incentivizing an employee to achieve some target; (ii) the bank calculates the amount of increased profit it wants to share with employees who achieve those targets; and (iii) (this is the new part) the bank must haircut the incentive compensation to account for potential miscalculations in item (i). The risk that the guidance addresses is thus the potential mismatch between current performance measures and actual future results (we will call it "**Measurement Risk**" for lack of a better term).[24]

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[22] For example, an employee making subprime loans may bring in the same short-term revenue as an employee making prime loans, but because the set of risks the bank is exposed to under a subprime loan is greater (i.e., more difficult to measure) than in the case of prime loans, the employee making the subprime loans should receive less incentive compensation than the employee making prime loans.

[23] The Board also suggests that a bank may balance incentive compensation by reducing the award's sensitivity to short-term performance, which we believe is a subtle variation of what we call the "Measurement Risk Haircut".

[24] Such haircutting seems to be an adaptation of "scenario analysis," as the Board mentions in the guidance. *See* 74 Fed. Reg. 55223.

The guidance provides examples of arrangements that would have higher and lower Measurement Risk: arrangements that use long term, firm-wide profit as a performance measure have a low Measurement Risk, while those that use short-term performance measures or measures limited to business generated by the employee have high Measurement Risk. Further, the guidance suggests that, where Measurement Risk is more reliable, an organization should rely more heavily on such risk haircuts (as opposed to clawbacks and payment deferrals) to achieve a balanced incentive compensation arrangement.

Clawbacks and Payment Deferrals. The payment deferral and clawback elements of Principle 1 are intended to permit the bank to observe whether it has done a good job measuring the value added by the incentivized activity in situations where Measurement Risk is very high and/or difficult to determine (such as in the case of newer financial products).[25] Where the value realized in connection with the incentivized activity is less than originally expected, the payment can be clawed back or the deferred payment can be reduced, accordingly.[26] As is generally the case with the guidance, the bank's decision as to the use of a payment deferral or a clawback in any particular case should depend on which manner of payment would most effectively influence the behavior of the employee.[27] Often this may depend on the extent to which the employee understands how his/her compensation is being measured and how actual profit outcomes at the bank will impact such compensation over the measurement period.[28]

The Board also suggests the desirability of paying incentive compensation to senior executives in the form of equity, but not doing so in the case of lower level employees because lower level employees may not believe their action will materially affect stock price. Thus, a single formulaic approach bank-wide will not work. The Board even suggests that, in the case of senior executives of LCBOs, banking organizations should defer a "substantial portion" of incentive compensation over a multi-year period to reduce the amount of compensation in the event of poor performance.

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[25] *See* 74 Fed. Reg. 55233. The Board also discusses as an option extending the time periods covered by performance measures, which seems to be a form of payment deferral or clawback.

[26] It should be noted that banks will need to structure payment deferrals in a manner that is either exempt from, or compliant with, § 409A of the Internal Revenue Code, which imposes strict limitations on the payment of nonqualified deferred compensation. On the other hand, current payments that are subject to future clawback will be includible in income in the year of receipt (unless payment and clawback occur in the same taxable year, in which case no income would be recognized). If a payment is clawed back in a later taxable year, the employee will be entitled to a loss deduction in such year, but solely to the extent the clawback and other business expenses for the year exceed 2% of the employee's adjusted gross income and possibly subject to additional limitations on deductibility. In addition, if the individual is in a lower tax bracket in the year the payment is clawed back (so that the deduction in that year is worth less than the inclusion in the prior year), § 1341 of the Internal Revenue Code may provide some relief.

[27] *See* 74 Fed. Reg. 55233, Fn. 12.

[28] The guidance points out that effectively influencing employee behavior is particularly difficult in the case of lower-level employees, who may have little belief that their actions materially impact the profit of the organization.

The guidance specifically states that senior executives at LCBOs are likely to receive the proper incentives if a "significant portion" of their pay consists of equity-based instruments that vest over multiple years. Notably, the Board has avoided the specificity of the incentive compensation guidelines that the Financial Stability Forum and the G-20 issued in April 2009 ("FSF Compensation Guidelines"),[29] which recommended that senior executives receive 40-60 percent or more of incentive compensation in the form of deferred compensation, and 50 percent or more in the form of equity-linked instruments. The Board has not suggested any such guidelines and specifically stated that all incentive compensation arrangements should be tailored to the risk profile of the organization.[30]

Favored and Disfavored Incentive Structures. "Golden parachutes" and "golden handshakes" receive a nod of disapproval in the guidance, as such arrangements can provide "significant incentives to engage in undue risk-taking."[31]

B. Monitoring Incentive Compensation Arrangements ("*Principle 2*").

Principle 2 requires ongoing monitoring of incentive compensation arrangements – specifically, the design, implementation, and monitoring of incentive compensation should ensure the arrangement is not a mere lever for employee pay but a meaningful measure of value added.

The organization's policies and procedures should (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. Documentation, as always, should be maintained to facilitate audits as regular internal reviews are expected.

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[29] FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES (April 2009), *available at* http://www.financialstabilityboard.org/publications/r_090925c.pdf.

[30] The Board has, however, indicated that it believes the Compensation Guidelines are "consistent" with the FSF Compensation Guidelines. *Compare Goldman Sachs' Compensation Principles*, *available at* http://www2.goldmansachs.com/our-firm/investors/corporate-governance/corporate-governance-documents/compensation-doc.pdf *with Credit Suisse Compensation Structure for 2009 and 2010*, *available at* https://www.credit-suisse.com/news/en/media_release.jsp?ns=41331. The appearance of industry-led standards does not appear to have deterred the Board from stepping in to regulate the area.

[31] The guidance acknowledges that an organization cannot control whether other organizations are luring its employees with the payment of "golden handshakes," but this appears to be a not-so-subtle suggestion to the industry that golden handshakes are disfavored.

Risk management personnel must be involved at an appropriate level (consistent with the complexity of the organization) in the design of incentive compensation arrangements, and their compensation should be set independently of the business units for which they are performing risk management functions.[32] That compensation should be sufficient to attract qualified personnel and, of course, ought not to be based on the performance of business units they review.

C. Responsibility of the Board of Directors (“*Principle 3*”).

The Board of Directors (or its appropriate designee) is ultimately responsible for the effect of incentive compensation arrangements on the safety and soundness of the organization and, thus, should “actively oversee” the development of such arrangements. The board is to give clear direction to management to “ensure” balance and consistency with safety and soundness. Again, it is to “ensure” that the compensation system is designed and operated in a manner that will achieve balance. It is an open question what personal risk board directors may take in “ensuring” the balanced operation of the compensation system.

This includes a number of specific requirements.

(a). The board must review and approve (i) the goals and purposes of the incentive compensation system; (ii) performance measures and targets for business units and individuals that may expose the organization to large amounts of risk; (iii) the incentive compensation arrangements for senior executives; and (iv) management’s annual assessment of the effectiveness of the design and operation of incentive compensation arrangements. “Significant users of incentive compensation arrangements” (i.e., LCBOs) should also review periodic reports that detail incentive compensation payments in light of subsequently observed performance outcomes.

(b). The board must monitor incentive compensation payments to senior executives.

(c). The board should consider establishing a compensation committee (if not already required to do so by applicable law), and such committee should be composed solely or predominantly of non-executive directors. In addition, LCBOs and “large regional banking organizations” should have at least one board member with expertise in risk management and compensation practices in the industry. The compensation committee is to work closely with board risk and audit committees.

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[32] Interestingly, the guidance seems to suggest that banks consider whether they are adequately compensating risk management personnel. As a practical matter, one would expect bank CEOs to direct the bank’s Human Resources executive to provide the CEO an annual report comparing industry standards on compensation of risk managers to the compensation of the bank’s risk managers.

The guidance also notes that banking organizations should disclose an appropriate amount of information regarding incentive compensation arrangements to shareholders to permit them to monitor governance at the organization.[33] However, in a footnote, the Board observes that compensation arrangements that are in the interests of shareholders **may not** be consistent with safety and soundness. The Board states that it will work with the SEC to improve disclosures by bank holding companies.

IV. A Dynamic Guidance

The Board expects that incentive compensation practices will continue to evolve significantly. Thus, it reserves the right to review and update the guidance in the future. Nonetheless, the Board voices the expectation that banks should start complying with the guidance now, even before it is finalized.

V. Reflections

Reading the guidance, one comes away with the perception that the regulators would be satisfied were banks to eliminate risk altogether. Surely, that is not the intention, and the Board certainly would vigorously disclaim such an intention. Nonetheless, risk is not something banking organizations will anxiously undertake after studying the guidance. Call it "reading between the lines" or "reading the subtext", the signal seems to be that, after what the economy has been through, bankers need to be risk—averse.

That may not bode well for economic growth, initiative, innovation, and creativity. It also used to be said that a bank that experiences no losses and thus takes no risk is not fulfilling its proper function as an intermediary channeling capital into business ventures, using its unique knowledge of borrowers and their capabilities.

Business managers incent conduct with compensation, and incenting the direction senior management decides to take has usually been done by compensation. If the Board and the banks are able to implement the guidance with clarity despite such vague notions as "excessive" risk, it should go a good way toward reducing systemic risk. However, the Board and the banks will need to be very careful indeed not to go too far and essentially drive all risk out of the system (thereby essentially reducing future economic growth), or to drive the most talented individuals out of banking organizations altogether.

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[33] *Cf. Proxy Disclosure and Solicitation Enhancements* 74 Fed. Reg. 35076 (July 17, 2009).

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