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MEMORANDUM

June 21, 2010

To Our Clients and Friends

Re: Agencies' Guidance on Incentive Compensation Policies

The Federal banking agencies¹ ("Agencies") have issued guidance regarding incentive compensation arrangements at financial organizations. The guidance, which was proposed by the Federal Reserve Board last year, requires financial organizations to tie compensation programs to longer-term performance and ensure that they are otherwise consistent with safe and sound practices. The guidance is effective upon publication in the *Federal Register*, which is expected shortly.

DISCUSSION

According to the Agencies, flawed incentive compensation practices in the financial industry were a factor contributing to the recent financial crisis. The Agencies believe that banking organizations too often rewarded employees for increasing revenue or short-term profit without adequate recognition of the risks the activities presented. Accordingly, they have adopted guidance on what they consider to be appropriate standards applicable to incentive compensation programs of financial organizations. The guidance is based upon the following principles:

- Incentive compensation arrangements are to provide employees with incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk;
- Arrangements are to be compatible with the organization's internal controls and risk-management processes; and
- Arrangements are to be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

¹ Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation and Office of Thrift Supervision.

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Because of their size and complexity, large banking organizations are expected to develop systematic and formalized policies, procedures, and processes.² The policies, procedures and systems of smaller banking organizations may be less extensive, formalized, and detailed than those of large banking organizations. The Agencies stated that they will regularly review incentive compensation arrangements and related risk management, control and corporate governance practices of large banking organizations. Supervisory reviews of incentive compensation programs at smaller banking organizations will be conducted by the Agencies as part of the evaluation of those organizations' risk-management, internal controls and corporate governance during the regular examination process. The Agencies' assessments will be incorporated into the organization's examination ratings relating to risk management, internal controls and corporate governance, as well as into the organization's overall supervisory rating. Moreover, an Agency may take enforcement action against a banking organization if its incentive compensation arrangements or related risk-management, control, or governance processes pose a risk to the safety and soundness of the organization.

A copy of the guidance can be found at our website at <http://www.schwartzandballen.com>

If you have any questions, please call Gilbert Schwartz, Robert Ballen, Tom Fox or Heidi Wicker at (202) 776-0700.

² It should be noted that the guidance does not apply to banking organizations that do not use incentive compensation.