Meeting of the Board of Governors and the Federal Advisory Council September 19, 2014

Participants: Vice Chairman Stanley Fischer, Governor Daniel K. Tarullo, and Governor Jerome H. Powell (Federal Reserve Board members); Robert Frierson, Margaret Shanks, Bill English, Wayne Passmore, Robin Prager, Stacey Tevlin, Sarah Gosky, Daniel Grantham, David Reiser, Brian Tait, Della Cummings, Jessica Stahl, Jennifer Gallagher, Jinai Holmes, David Marques-Ibanez, Maria Ling, Jacquelyn Smith, Paula Scharf, and Jon Hiratsuka (Federal Reserve Board staff)

Richard Holbrook, James P. Gorman, Scott V. Fainor, Paul G. Greig, Kelly S. King, O. B. Grayson Hall Jr., David W. Nelms, Ronald J. Kruszewski, Mitch Bleske (alternate), Jonathan M. Kemper, Ralph W. Babb Jr., and J. Michael Shepherd (Council members); Shani Schechter (Deputy Secretary)

Summary: Members of the Federal Reserve Board met with the Federal Advisory Council (the Council), a statutorily created advisory group that is composed of twelve representatives of the banking industry (one member from each Federal Reserve District). The Council ordinarily meets four times a year to provide the Board with information from the banking industry's perspective.

The Council presented its views on incentive compensation in the banking industry, which is also the subject of an interagency proposed rule (Docket No. R-1410). During this discussion, Board members inquired about how forfeiture provisions might be implemented under banks' various approaches to incentive compensation arrangements.

The information collected from the Council at the meeting is summarized in the attachment. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

Incentive Compensation

How have firms changed their approach to incentive compensation since the financial crisis? What are practices with respect to (a) the form of incentive compensation; (b) deferral and vesting; and (c) forfeiture and clawback? Do firms treat different groups of employees differently in fashioning incentive compensation contracts or practices?

Changes in Incentive Compensation

- Bankers have broadly embraced principles-based guidelines that have reduced the potential for excessive risk-taking yet have retained the ability to recruit and motivate a competitive workforce and to effectively manage the business.
- Incentive compensation approaches are materially altered since the financial crisis and resultant guidance. Approaches vary among banks as there is no one solution for all.
- The most uniform and broad-based changes are seen in the areas of governance and oversight. Banks have created oversight committees with cross-functional, senior-level representation reporting to the compensation committee of the Board of Directors. These oversight committees ensure that plans are risk balanced, are in compliance with regulatory and legal requirements, are in conformance with corporate policies, and meet the strategic needs of the businesses. To support these changes, banks have increased spending on incentive compensation management tools to facilitate control, modeling, and simulation abilities, as well as additional levels of documentation and reporting.

Mix of Compensation

- Mix of compensation has changed materially, as firms have placed less emphasis on short-term cash incentives and moved more pay into long-term incentives, particularly for more senior positions that have a greater impact on risk-taking activities.
- Upside potential in both short-term and long-term plans has been reduced by both lowering maximum opportunity as well as creating performance scorecards focused on multiple, balanced metrics to protect against outsized payments based on performance against a single financial metric.
- As a result of decreasing the amount of upside opportunity in both their short-term and long-term performance plans, firms also find themselves in the position of increasing base salaries. Lower incentive opportunity coupled

with the higher resulting base salaries has the effect of decreasing the risk profile of compensation at a firm, but also serves to increase its fixed costs for talent.

Deferral and Vesting

- Long-term incentive plans have seen a dramatic shift from the use of stock options towards restricted stock and performance share grants. Many firms still utilize 3-year vesting schedules in long-term plans, but the trend at some firms has moved towards lengthened vesting schedules, up to as many as 7 years. Firms are also strengthening their equity retention policies, sometimes implementing hold-until-retirement requirements to impact risk-taking.
- The practice of requiring mandatory deferral of a portion of incentive compensation is also increasing at levels below the senior officer level, although this practice is still evolving.
- Vesting schedules have shifted beyond simple time-based vesting to include performance requirements. An increased use of balanced scorecards to measure performance includes both financial and risk-based metrics.

Forfeiture and Clawback

- Firms have strengthened and expanded the authority for forfeitures and clawbacks in their processes. Circumstances that trigger such provisions can include financial losses, financial restatements, inappropriate oversight of risk, violation of risk policies, and personal misconduct.

Treatment for Different Groups of Employees

- Though incentive compensation principles are generally consistent among groups of employees, employee groups are treated based on the different jobs they occupy in the organization.
- Senior officers generally have more significant deferrals, longer deferral periods, more performance-based vesting conditions, and broader clawback provisions. In addition, senior officer incentives are generally driven by corporate performance while employee incentives are based on business unit and/or individual performance.
- Employment contracts for incentive guarantees are limited in use. Guaranteed incentives are used on an exception basis when necessary in the case of new business lines or business lines with long sales cycles, or to recognize time needed for new associates to build a customer base.
- Regulatory requirements in different international jurisdictions can impact employees in similar jobs. The resultant variety within incentive

compensation programs may inhibit market-based activities and result in loss of talent to other industries or other geographic markets.