

Federal Reserve Bank of San Francisco  
101 Market Street, San Francisco, California 94105

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To State Member Banks, Bank  
Holding Companies, Financial Holding  
Companies, and Foreign Bank Offices  
in the Twelfth Federal Reserve District

**Federal Reserve, OCC, OTS, FDIC Issue Final Guidance on Incentive Compensation**

The Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) issued final guidance on June 21, 2010 to ensure that incentive compensation arrangements at financial organizations take into account risk and are consistent with safe and sound practices. The guidance was originally proposed by the Federal Reserve last year. The OCC, OTS, and FDIC are joining in issuing the final version.

The guidance is designed to ensure that incentive compensation arrangements at banking organizations appropriately tie rewards to longer-term performance and do not undermine the safety and soundness of the firm or create undue risks to the financial system. Because improperly structured compensation arrangements for both executive and non-executive employees may pose safety and soundness risks, the guidance applies not only to top-level managers, but also to other employees who have the ability to materially affect the risk profile of an organization, either individually or as part of a group.

The Federal Reserve, in cooperation with the other banking agencies, has completed a first round of in-depth analysis of incentive compensation practices at large, complex banking organizations. Recently, the Federal Reserve delivered assessments to the firms that included analysis of current compensation practices and areas requiring prompt attention. Firms are submitting plans to the Federal Reserve outlining steps and timelines for addressing outstanding issues to ensure that incentive compensation plans do not encourage excessive risk-taking.

During the next stage, the banking agencies will be conducting additional cross-firm, horizontal reviews of incentive compensation practices at the large, complex banking organizations for employees in certain business lines, such as mortgage originators. The agencies will also be following up on specific areas that were found to be deficient at many firms, such as:

- Many firms need better ways to identify which employees, either individually or as a group, can expose banking organizations to material risk;
- While many firms are using or are considering various methods to make incentive compensation more risk sensitive, many are not fully capturing the risks involved and are not applying such methods to enough employees;
- Many firms are using deferral arrangements to adjust for risk, but they are taking a "one-size-fits-all" approach and are not tailoring these deferral arrangements according to the type or duration of risk; and
- Many firms do not have adequate mechanisms to evaluate whether established practices are successful in balancing risk.

In addition to the work with the large, complex banking organizations, the agencies are also working to incorporate oversight of incentive compensation arrangements into the regular examination process for smaller firms. These reviews are being tailored to take account of the size, complexity, and other characteristics of these banking organizations.

Federal Reserve staff will prepare a report, in consultation with the other federal banking agencies, after the conclusion of 2010 on trends and developments in compensation practices at banking organizations.

The guidance will become effective when published in the Federal Register, which is expected shortly.

**Additional Information**

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's website, at <http://www.frbsf.org/banking/letters>.

For additional information, please contact:

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**Attachment:** [Guidance on Sound Incentive Compensation Policies](#)