

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

December 7, 2009

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

Federal Reserve Issues Proposed Guidance on Incentive Compensation

The Federal Reserve Board issued a proposal on October 22, 2009 designed to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of their organizations.

The proposal includes two supervisory initiatives. One, applicable to 28 large, complex banking organizations, will review each firm's policies and practices to determine their consistency with the principles for risk-appropriate incentive compensation set forth in the proposal. These firm-specific policies will be assessed by supervisors in a special "horizontal review," a coordinated examination of practices at the 28 firms. The policies and implementing practices adopted by these firms in response to the final supervisory principles will become a part of the supervisory expectations for each firm and will be monitored for compliance.

Second, supervisors will review compensation practices at regional, community, and other banking organizations not classified as large and complex as part of the regular, risk-focused examination process. These reviews will be tailored to take account of the size, complexity, and other characteristics of the banking organization.

Flaws in incentive compensation practices were one of many factors contributing to the financial crisis. Inappropriate bonus or other compensation practices can incent senior executives or lower level employees, such as traders or mortgage officers, to take imprudent risks that significantly and adversely affect the firm. With that in mind, the Federal Reserve's guidance and supervisory reviews cover all employees who have the ability to materially affect the risk profile of an organization, either individually, or as part of a group.

The findings from these reviews will be incorporated into the banking organization's supervisory ratings. In appropriate circumstances, the Federal Reserve may require an organization to develop a corrective action plan to rectify deficiencies in its incentive compensation programs and processes.

To monitor and encourage improvements, Federal Reserve staff will prepare a report after the conclusion of 2010 on trends and developments in compensation practices at banking organizations.

The public had 30 days from October 27, 2009 to provide their comments on the draft guidance. The comment period ended on November 27, 2009.

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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