SRC
Insights

Fourth Quarter 2011 / Volume 16 Issue 2

Federal Reserve Bank of Philadelphia

Pg. 3

The Evolution of Community Bank Supervision in a Post-Crisis World

SRC Insights is published quarterly and is distributed to institutions supervised by the Federal Reserve Bank of Philadelphia. The current and prior issues of *SRC Insights* are available at the Federal Reserve Bank of Philadelphia's website at www.philadelphiafed.org. Suggestions, comments, and requests for back issues are welcome in writing, by telephone (215-574-6633), or by e-mail (katrina.johnston@phil.frb.org). Please address all correspondence to: Katrina Johnston, Federal Reserve Bank of Philadelphia, SRC - 7th Floor, Ten Independence Mall, Philadelphia, PA 19106-1574.

Editor...........Julie D'Aversa
Editor...........Katrina Johnston
Designer......Roberta Nicholson

FEDERAL RESERVE BANK OF PHILADELPHIA

In this Issue...

3

Supervision Spotlight on: The Evolution of Community Bank Supervision in a Post-Crisis World by William W. Lang, Senior Vice President and Lending Officer

7

Suspicious Activity Monitoring in the Lending Function by Maria D. Berry, Assistant Examiner, and Adina A. Himes, Manager

10

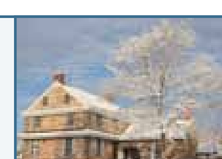
Incentive Compensation: Proposed Guidance to Help Equalize the Risks and Rewards by Ivy M. Washington, Supervising Examiner

15

DFA Today: The Dodd-Frank Act Keeps Rolling Along by Bob Rell, Senior Specialist

ON THE COVER:

Peter Wentz Farmstead, Worcester, Pennsylvania



Supervision Spotlight

The Evolution of Community Bank Supervision in a Post-Crisis World

by William W. Lang, Senior Vice President

William W. Lang, Senior Vice President

In the Chinese language, the word "crisis" is allegedly composed of two characters, one representing danger and the other representing opportunity. The financial crisis and ensuing great recession have created major challenges for bankers and for bank regulators; however, this crisis also presents a unique opportunity to reflect on existing practices, consider the lessons learned from the events that transpired, and adjust accordingly to strengthen the resilience of the financial system.

In response to the crisis, the industry has seen a comprehensive re-thinking and reform of financial regulation, both in the United States and around the world. The Dodd-Frank Act, which has generated major changes in the regulatory framework, has engendered a great deal of analysis and will be a subject of ongoing discussion and debate. This article provides some thoughts on a related, but distinct, issue: the evolution of bank supervision in the aftermath of the financial crisis and the implementation of regulatory reform.

Re-Thinking Bank Supervision: Enhancing the Approach

Bank supervision involves the monitoring, inspection, and examination of banking organizations to assess their condition, risk management capacity, and compliance with relevant laws and regulations. Bank supervision policies and procedures establish a common and consistent framework, but a certain degree of discretion based on reasonable judgment is also inherent in the process.

Many of the fundamental principles that support prudential oversight proved effective and will remain intact. However, lessons learned are already serving as catalysts for change. A prime example is the implementation of a framework to address systemic risks. Based on gaps and weaknesses that became evident during the crisis, important steps in the evolution of the supervisory process will likely take place in the areas discussed below.

Improved Integration of Cross-Firm Quantitative Analytics in the Exam Process

Supervision staff and examiners must have greater access to a broader array of relevant and timely data sources to better conduct horizontal analysis across firms to understand the risks arising within the banking system. Such analytics are not only useful in off-site monitoring of banks between exam events, but they can also provide important input to an examiner's decision-making by providing a comparative baseline. Done properly, this can improve the consistency of supervisory practices without undermining examiners' ability to exercise appropriate judgment that considers the specific circumstances at an individual institution.

For example, information on investment securities valuations can be derived using data available to enable supervisors to see whether the impairments reported by a bank appear to fall within a comparable range. This will enable examiners to determine when more detailed review and discussion are needed. It may turn out that such further review may cause revisions or a logical explanation of the disparity to be made.

Greater use of analytical metrics can also help supervisors review whether similar institutions are being treated similarly. For example, horizontal data analysis can review whether firms with similar characteristics are receiving consistent responses by supervisors. Such analysis may show that a firm is receiving ratings or supervisory findings that differ from banks with similar characteristics. Again, upon further review, it may turn out that these differences can be explained by the individual facts and circumstances at the institution. However, enhanced use of horizontal analytics allows supervisors to better identify where inconsistencies may exist.

By focusing resources on key risks, both the examiners' and the bankers' time can be used more effectively.

While enhanced use of quantitative tools has considerable merit, some limitations need to be considered. Models do not provide a standalone solution; their results are best considered in conjunction with other qualitative assessments. Flexibility in their application is also necessary, since at times, models can be pro-cyclical and undermine the exercise of discretion by supervisors. Ultimately, the analysis is meant to "supplement" the examination process, but not to be a "substitute" for examiner judgment.

Enhancing the Risk-Based Supervision Framework

Risk-based supervision is a "forward-looking approach where the supervisor assesses the various business areas of the bank and the associated quality of management and internal controls to identify the areas of greatest risk and concern. The supervisory focus is directed to these areas to allow the supervisor to identify problems at an early stage."[1]

The bank's individual risk profiles and the macroeconomic context are used to formulate effective supervisory plans. For instance, most types of concentrations are likely to garner attention. By focusing resources on key risks, both the examiners' and the bankers' time can be used more effectively.

When performed well, a risk-focused approach produces benefits for banks and supervisors. However, to maximize the benefits of this approach, banking organizations need to have strong risk management and management information systems. Therefore, banks with strong risk management systems and better data systems can expect a more streamlined examination process.

Improving Understanding of Business Strategy

Given lessons from the financial crisis, there will likely be an increased supervisory emphasis on understanding the sources and sustainability of revenue drivers, the prudence of new areas of pursuit, and the alignment of strategy with the bank's long-term health. Examiners will focus considerable attention of the internal and external factors that influence banker's decisions and risk appetites.

Sarah Dahlgren, head of supervision at the New York Fed, recently stated, "We had always focused on risk controls and risk management. Where we had not had as deep a focus was at the business line level, the front office. Where is a firm's particular strategic advantage, where are they try-

---

[1] Basel Committee on Banking Supervision "Supervisory Guidance on Dealing with Weak Banks: Report of the Task Force on Dealing with Weak Banks," Bank for International Settlements, March 2002, available at www.bis.org/publ/bcbs88.pdf.

ing to make money, where are they actually making money, and how and what does that imply about the risks they are taking?"[2]

Success going forward will continue to be centered on superior risk management practices, including establishing a risk appetite that is well understood and actionable. A bank should be able to demonstrate that exceptional short-term results are being derived using sound underlying banking practices and principles, not being driven by unreasonable risk-taking that creates longer-term vulnerabilities. Examiners will pay increased attention to the role of the board of directors in reviewing business strategy, establishing the risk appetite of the organization, and reviewing the incentive compensation structure of the firm to see that it is consistent with the firm's risk appetite.

Utilizing Stress Analysis

The recent crisis has demonstrated the importance of considering the potential consequences of low-probability, but highly-adverse events. Dodd-Frank now mandates that stress testing be performed periodically at larger banks (e.g., those over $10b). While smaller institutions are not subject to the rule and typically do not need the more sophisticated techniques employed by larger institutions, all institutions should consider how well their bank can withstand unexpectedly-adverse events. All banks are encouraged to incorporate this thinking into their assessment of liquidity, capital, and credit risk. Sophisticated models are not required, but the assessment should reflect the institution's complexity and risk profile.

"The Making of Good Supervision: Learning to Say 'No'" suggests that "Supervisors must form a view not only of how institutions are currently placed, but how they will be able to cope with changing circumstances."[3] For example, bankers today should have a well-formulated assessment of how their bank is positioned for a prolonged or uneven recovery in the economy or housing markets.

Robust Vetting of Exam Findings

A strong vetting process complements the on-site exam process. A robust review of the factual basis, logic, and rationale behind supervisory conclusions by qualified individuals is very important in promoting consistency and high-quality supervisory decisions. Continued enhancement of vetting processes will be an important focus for bank supervisors.

The supervisory process would also benefit from increased interaction, coordination, and discussion with fellow regulatory agencies. The communication aspect is particularly important today, given the structural and responsibility changes associated with regulatory reform.

Timely and Effective Actions to Mitigate Excessive Risk-Taking

Regulators strive to address inadequate risk management, insufficient controls, and excessive risk concentration issues before they become detrimental to the bank. Regulators are sometimes criticized for recognizing risk at early stages, but not mitigating the risk in time to minimize losses. However, determining the optimal technique, timing, and forcefulness of intervention is rarely easy.

Excessive risk buildups often develop during "good times," when favorable conditions support product performance. This can contribute to an overly optimistic perception that the underlying risk will remain benign throughout the

[2] Fest, Glenn, "The Dodd-Frank Effect," *The American Banker*, November 1, 2011, available at www.americanbanker.com/magazine/121_11/dodd-frank-1043336-1.html.

[3] Vinals, Jose, and Fiechter, Jonathan, "The Making of Good Supervision: Learning to Say 'No'," *IMF Staff Position Note*, May 18, 2010, available at www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf.

cycle, and that current concerns are unwarranted. It is unrealistic to expect bank supervision to prevent any serious bank problems or to prevent all bank failures. However, it is reasonable to expect that supervisors will be willing and able to take timely and effective action that reduces the incidence of serious bank problems or bank failures.[4]

Regulators and bankers are working on methods to better assess the future consequences of today's risk exposures. Sufficient lead time is required to curb risk, implement corrective actions, and unwind existing risk in an orderly manner. Therefore, it is crucial to identify potential emerging risks at their earliest stages. Examiners should focus more attention on early signs or leading indicators, such as rapid growth, expanded use of leverage, a shift away from sound credit underwriting, and widespread adoption of financial innovation. Examiners should investigate trends with a healthy skepticism, a "trust but verify" mentality, a balanced outlook, and a will to act when needed.

The challenge of the Federal Reserve and other regulators will be to manage the balance between effective regulation that allows the markets the freedom to innovate and creates the appropriate incentives that will encourage market discipline and self-correction.

The development of innovative products frequently outpaces the regulatory response. Earlier and greater scrutiny of new or emerging product offerings and their potential risks is needed, but must not unduly stifle innovation. The challenge of the Federal Reserve and other regulators will be to manage the balance between effective regulation that allows the markets the freedom to innovate and creates the appropriate incentives that will encourage market discipline and self-correction.

[4] ibid.

Effective and Timely Remediation of Problems

Once significant problems in bank conditions or risk management are identified, examiners should convey clear expectations for remedying the issues, develop actionable items, establish accountability for taking action, and set reasonable deadlines for completion. Both bankers and examiners should take responsibility for ensuring that momentum is maintained and that identified issues transition through the supervisory process until the proper closure is reached. Matters requiring attention should be dealt with proactively and receive timely response. The bank's board should be updated routinely on pertinent developments and remain engaged throughout the process. Banking supervisors should strongly encourage prompt write-downs for losses and encourage banks to conserve or bolster capital when deemed necessary.

Relevant and Timely Training

Many of the basic principles behind supervision remain constant, but examiner and banker skill sets must constantly evolve to keep pace with dynamic changes in an innovative and evolving industry. The sweeping regulatory reform that occurred in the aftermath of the crisis has resulted in a plethora of new regulations. Examiners must keep abreast of the latest developments. In response, brief but frequent supplemental training sessions are being provided to keep examiners updated on key regulatory developments and industry trends. The Federal Reserve Bank of Philadelphia has also maintained its strong commitment to external outreach during this historic time for the banking industry.

Conclusion

We are continuing to navigate through the post-crisis world of supervision. There is much to be learned from the financial crisis experience. The insights gained will be used to bring about constructive changes to the supervision process and, ultimately, to better position the banking industry to avoid or mitigate future crisis.

From the Examiner's Desk

Maria D. Berry, Assistant Examiner

Suspicious Activity Monitoring in the Lending Function

by Maria D. Berry, Assistant Examiner, and Adina A. Himes, Manager

Suspicious activity detection and monitoring at financial institutions should be an enterprise-wide process that considers the entire customer relationship. Institutions of any size and complexity can achieve a strong, customer-focused suspicious activity monitoring function by thinking broadly when opening

At the time of the account opening, the customer's risk should be assessed, and due diligence should be performed based on the perceived level of risk associated with the customer or transaction.

new accounts and monitoring existing accounts. A common oversight at many institutions often includes some of the bank's most basic products and services. While an institution may have a sound process to identify and monitor potentially suspicious activities in deposit account products, formal processes may not exist for the institution's loan accounts. Monitoring a customer's entire relationship can give bankers greater perspective on the legitimacy and legality of a customer's business and transactions, especially when it comes to the lending function.

Risk Controls

A financial institution's Bank Secrecy Act/Anti-Money Laundering (BSA/AML) program is based on its risk assessment. Within the risk assessment, management has evaluated the risks inherent in the bank's products and services, customer base, and the geographies that the customers and transactions touch. Then, appropriate internal controls are developed and implemented based on the perceived level of risk. While financial institutions generally implement strong controls regarding deposit accounts, evaluating BSA/AML risks and establishing controls within the lending function have proven more difficult.

Conceptually, several deposit and loan account controls are similar. The customer acceptance process begins with the customer identification program (CIP),[1] which sets forth the information that must be collected and verified in accordance with law. The bank should also obtain sufficient information to develop an understanding of a customer's normal and expected activities. At the time of the account opening, the customer's risk should be assessed, and due diligence should be performed based on the perceived level of risk associated with the customer or transaction. Both of these controls are critically important for deposit and loan accounts.

[1] The full text of the USA Patriot Act of 2001 is available at www.fincen.gov/statutes_regs/files/hr3162.pdf.

Controls	Deposit Accounts	Loan Accounts
Customer Identification Program	√	√
Customer Due Diligence	√	√
High-Risk Account Monitoring	√	√
Training	√	√

Often, due diligence happens naturally during the loan underwriting process. However, it has been noted that the level of due diligence that is performed for guarantors, signatories, principals, and other loan participants can vary, as CIP compliance may not be required for these parties. If a customer is deemed to be high risk, enhanced due diligence procedures are expected to be performed, just as they would be expected for deposit account relationships. Additionally, one of the most important key controls is the bank's BSA/AML training program that provides for role-specific training and educates bank personnel on the types of activity that are deemed suspicious.

While loans secured by cash collateral and/or marketable securities are typically considered lower risk credits, they can easily be used to hide illegal monies or to obscure the purpose of funds. This is not the only way loans are used to launder money, but this is one of the most common methods. The fact is, any loan can be used to launder money, but understanding the red flags and educating personnel on how to evaluate and monitor loan customers can help to mitigate BSA/AML risk.

Due Diligence Techniques

As mentioned previously, an institution's BSA/AML program should incorporate a comprehensive customer due diligence program. The program's objectives are to enable the institution to know its customer and predict anomalies in customer behavior. The risk-based program should clearly communicate management's expectations and staff responsibilities at account opening. Some simple due diligence techniques could be employed to help personnel understand the customer risk, including the following:

- **Review deposit account activity.** As simple as it sounds, evaluating a borrower's deposit account activity can provide perspective on the nature of the borrower's transactions and the potential riskiness of the relationship with the borrower.
- **Evaluate income relative to the size of cash collateral or cash investment by the borrower.** This commonsense approach will help to evaluate the transaction's reasonableness.
- **Verify the source of any cash collateral or cash investment.** If the source of funds cannot be verified or substantiated, AML risks may be present.
- **Understand the true loan purpose.** If the borrower specifically requests a loan and offers cash as collateral, understand why the borrower prefers this loan structure. Lending personnel should ensure that the stated purpose of the loan makes sense and is consistent with the borrower's background, business, or former businesses.
- **Perform Internet searches**. Basic Internet searches can often produce important information that the institution may not otherwise know.
- **Conduct due diligence on related parties.** High-risk transactions should always require enhanced due diligence that includes all parties to the loan. Understanding all of the individuals and/or businesses involved in the transaction will help to mitigate BSA/AML risk.

In addition to these due diligence techniques, certain situations should raise suspicion when evaluating loan requests, such as the following:

- The loan(s) is to a person(s) located outside the United States.
- The collateral is located outside the United States.
- Multiple collateral transfers have occurred over a short period of time.
- The type of business is considered inherently high risk for money laundering.

Banking institutions are required to identify suspicious activity and submit suspicious activity reports (SARs).

Heavy fines and reputational risk could threaten an institution that does not fully comply, particularly if it is publicly learned that money laundering or terrorist financing was undetected. However, it is not only the due diligence at account opening that is important; the ongoing monitoring of higher-risk loan accounts will help to mitigate the bank's exposure to loss and AML risk.

Best practices for monitoring loan accounts may include, but are not limited to, the following:

- **Review all account relationship activity.** Remember that it is important to monitor the entire borrower relationship. If the customer has other accounts at the institution, much can be learned about the flow of funds and the legitimacy of transactions.
- **Evaluate the loan purpose vs. loan funds usage.** Consider whether the loan funds are being used consistently with the borrower's stated loan purpose. If they are not, it could indicate fraud or BSA/AML risk.
- **Investigate loan payments made with cash.** Consider whether it makes sense for the borrower to make cash payments on the loan. This might be expected for some cash businesses, but cash is generally an unusual method of payment for many loan types, particularly commercial credits.
- **Investigate loan payments made by a third party.** If the loan payments are being made by a person or entity that does not appear to be related to the borrower, it could be considered suspicious.
- **Scrutinize early or sizeable loan payoffs.** Evaluate the reasonableness of payoffs, especially if they are unexpected or completed by companies under duress and absent take-out financing.

Ensuring a Seamless Process

Knowing all of the controls, due diligence techniques, and red flags is not necessarily enough to ensure that an institution is effectively monitoring for and reporting on suspicious activity in the lending function. A control breakdown commonly noted by examiners is ineffective or inefficient reporting of suspicious activity by loan personnel. Not only should loan staff be educated about what to look for, but they should be equally educated on how to report suspicious activity within the institution. This helps to ensure a seamless process that will eventually result in either documentation of rationale supporting why certain activities are not suspicious or the filing of a SAR.

For more information about BSA/AML compliance, please visit www.ffiec.gov (the FFIEC's BSA/AML Infobase) or contact Manager Adina A. Himes (adina.himes@phil.frb.org) at (215) 574-6443.

READ *SRC INSIGHTS* ONLINE!

The online version of *SRC Insights* is generally available several weeks in advance of the print version. Bookmark the home page for *SRC Insights*: <www.philadelphiafed.org/bank-resources/publications/src-insights/>. Please Note: The pdf document of each issue is posted online when the print version is mailed.

To sign up for e-mail subscription service for *SRC Insights* and other Federal Reserve Bank of Philadelphia publications, news, and events, go to: <www.philadelphiafed.org/philscriber/user/dsp_content.cfm>.

Incentive Compensation: Proposed Guidance to Help Equalize the Risks and Rewards

by Ivy M. Washington, Supervising Examiner

Ivy M. Washington, Supervising Examiner

Many factors contributed to the financial crisis that began in 2007, including unsound incentive compensation programs and practices. As a result, financial institutions are beginning to reevaluate their incentive compensation structures to ensure that the financial interests of executives and employees align properly with the overall soundness of the institution. Historically, incentive compensation programs have been tools for the effective management of a financial institution. They provide easy avenues for attracting skillful staff, promoting performance, offering a security cushion for employees at retirement, and giving institutions the ability to better manage personnel costs. While compensation arrangements have clearly been an economic benefit for employees in more recent years, these same arrangements have led financial institution executives and employees to make inappropriate, and often imprudent, risk decisions, causing a misalignment between employee rewards and the institution's risk appetite.

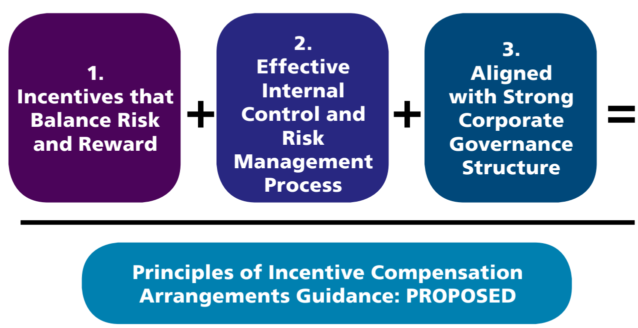
As a result, guidance on incentive-based compensation arrangements was issued to assist banks in dealing with this topic.[1] This article outlines the different elements of both the proposed and final guidance on incentive compensation arrangements, including changes made based on the written responses and the standards aimed at improving the related practices.

[1] Rule on Incentive-Based Compensation Arrangements, Federal Register, Vol. 75, No. 122, Friday, June 25, 2010, available at edocket.access.gpo.gov/2010/pdf/2010-15428.pdf.

The Proposed Guidance

Because incentive compensation programs can pose a significant safety and soundness risk to an institution if not properly structured, the Federal Reserve issued initial guidance on the topic in October 2009. The details of the guidance apply to senior executives and other bank employees, who, either individually or in unison, may expose their banking institution to material risk. The guidance builds on three basic principles:

1. To provide employees with the appropriate incentives that balance risk and reward
2. To be well-matched with an effective internal control and risk management process
3. To be aligned with a strong corporate governance structure, including active and effective board and corporate oversight



Incentive compensation arrangements at many banking institutions were often established to encourage short-term results, even at the cost of an institution's short- and long-term risks. As such, the first principle of this guidance sought to encourage banking institutions to tailor their incentive compensation programs so that employees receiving the benefit from a certain business activity were held accountable for some of the related risk of that activity. For this proposed principle to be fully effective, banking institutions would have to apply this thought process across all business lines and assess the impact of these risk-taking activities on the overall soundness of the institution. The proposed guidance aligns with the Financial Stability Board's principles for sound compensation practices and is consistent with its focus on the containment of excessive risk-taking.

> **As a result, the measurement and monitoring systems for incentive compensation programs should reflect the risk appetite of an individual banking institution.**

Additionally, the proposed guidance provided banking institutions with strategies for implementing the second principle of integrating incentive compensation awards with an institution's internal control and risk management framework. Principally, the guidance encouraged banking institutions to involve the individuals who manage risk with the overall design of the incentive compensation program, with the expectation that it would result in better monitoring and better assessments of whether the arrangements promote imprudent risk-taking. As a part of this principle, the guidance requested banking institutions to track incentive compensation awards, the risk related to an award, and the actual risk outcome in order to understand whether the awards paid were adjusted to reflect any adverse results.

Finally, the third principle of the proposed guidance discussed the necessity of having an informed and active board of directors. These directors should ensure that the compensation program strikes a uniform balance between risk and reward at inception and on an ongoing basis. In conjunction with the responsibility, the guidance requests that members of the board review and approve key elements of the institution's incentive compensation program, review periodic evaluations on the effectiveness of the institution's risk-mitigation objectives, and directly approve compensation arrangements for the institution's senior executives.[2]

While the proposed guidance was issued to protect the safety and soundness of all banking institutions supervised by the Federal Reserve, it was also extended to other federal agencies. Provisions of the guidance reflect the diversity of these banking institutions relative to the complexity of their banking activities and frequency of compensation arrangements. For instance, incentive compensation programs at smaller banking institutions may differ substantially from those programs at larger banking institutions. Smaller banking institutions may utilize an informal approach to rewarding employees, while larger banking institutions tend to implement a more formal compensation plan. As a result, the measurement and monitoring systems for incentive compensation programs should reflect the risk appetite of an individual banking institution.

Changes to the Proposed Guidance

The Federal Reserve received 34 written responses to the proposed guidance from a spectrum of entities, from banking institutions to laborers. The majority of the comments supported the goal of the proposed guidance of ensuring that incentive compensation programs balance reward and risk and do not encourage inappropriate or imprudent risks. In addition, the guidance received support for its principles-based approach. There were also comments asking the Federal Reserve to revise and/or clarify the proposed guidance to include such elements of imposing specific restrictions on banking institutions' incentive compensation practices or mandating certain practices for corporate governance or risk management.

As a result, a number of changes were factored into the final guidance, giving some flexibility to a banking institution in how it constructs its incentive compensation program. Even so, the same key principles delineated in the proposed guidance were retained in the final document. The final

---

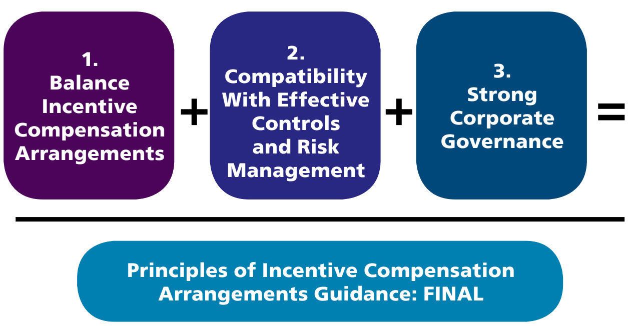
[2] www.mofo.com/files/Uploads/Images/Banking-Agency-Guidance-on-Sound-Incentive-Compensation-Policies.pdf.

document better addressed the safety and soundness risks associated with compensation arrangements, as it focuses on the fundamental problems that compensation programs pose when not structured adequately.

The Final Guidance

Included in the final guidance are three key principles similar to those in the proposed guidance. These principles give banking institutions some flexibility in constructing their incentive compensation programs to achieve their recognition objectives, while still promoting a safe and sound institution. The three principles are now known as:

1. Balanced incentive compensation arrangements
2. Compatibility with effective controls and risk management
3. Strong corporate governance



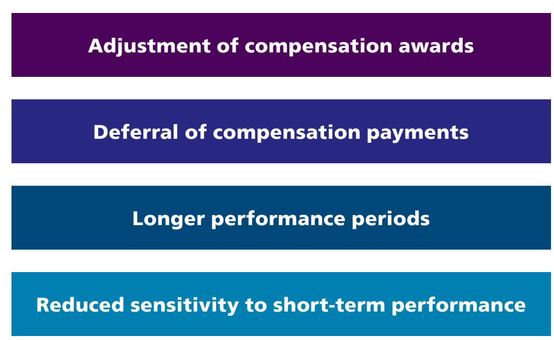
1. Balanced Incentive Compensation Arrangements

This principle of the final guidance requires that compensation arrangements paid to employees appropriately balance risk with financial results. The amount of pay given to a covered employee should be evaluated and adjusted to account for the risk, losses, and gains associated with the employee's activities to ensure that imprudent actions are not taken. The covered employees under this guidance include senior management and others responsible for oversight on a firmwide basis and individual employees or groups of employees whose activities may expose the institution to material risk. This principle was amended to clarify the need to develop compensation arrangements that properly balance risk-taking initiatives. As such, banking institutions are required to implement adjustments to their incentive compensation arrangements that address the full range of risks impacting the institution, which have been primarily credit, market, liquidity, operational, legal, compliance, and reputational risks.

The final guidance recognizes the importance of a strong internal control and risk management environment. Poorly designed incentive compensation programs alone can bring risk upon an institution, undermining the controls enacted and straining risk management oversight. As such, the final guidance outlines four methods to make compensation programs more risk sensitive. These methods are:

- Adjustment of compensation awards
- Deferral of compensation payments
- Longer performance periods
- Reduced sensitivity to short-term performance

Four Methods to Increase Risk Sensitivity of Compensation Programs



Because the aforementioned methods have advantages and disadvantages, they are not considered all-inclusive. Other methods or variations of these may exist or can be developed by banking institutions to achieve the same balanced objective. Each institution is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the institution,[3] and, therefore, should enact governance tailored to their risk profile and complexity.

---

[3] www.fdic.gov/regulations/laws/rules/5000-5350.html.

2. Compatibility with Effective Controls and Risk Management

This second principle of the final guidance affirms that a banking institution's risk management processes and internal control environment should reinforce and support the development of balanced incentive compensation programs by integrating compensation arrangements into both frameworks. Particularly, appropriate personnel, including individuals managing risk, should have input in the design and assessment of compensation arrangements to ensure that they are sufficient to attract and retain qualified personnel based on their achievement of the institution's goals and objectives, rather than based substantially on the financial performance of a given business line.

Monitoring processes, which include creating and maintaining sufficient documentation to permit independent assessment of effectiveness, should be implemented to ensure that compensation arrangements adequately reflect the risks of the institution. As such, compensation rewards should be offered when performance objectives have been met or exceeded and reduced when they have not.

3. Strong Corporate Governance

This last principle of the final guidance requires the support of a strong corporate governance structure, including the active participation of a banking institution's board of directors. Ultimately, the board of directors is responsible for establishing an effective incentive compensation program and ensuring that it utilizes a balanced approach for all covered employees. In turn, members should receive and analyze compensation data that are comprehensive enough to detail whether the overall design and performance of the incentive compensation program is consistent with the institution's risk soundness. Such reviews should be customized appropriately to the size, risk complexity, and risk activities of the institution.

In addition, compensation payments made to senior executives should be approved and monitored by an institution's board of directors, given its critical role in managing the institution's risk activities.

Continuing Supervisory Initiatives

When the proposed guidance on incentive compensation programs was issued in October 2009, two supervisory initiatives were also endorsed by the Federal Reserve. These initiatives include a special horizontal review of incentive compensation arrangements at large banking institutions (LBOs) and a review of incentive compensation practices at other banking institutions as a part of the normal, risk-focused examination process.

Supervisory teams from the Federal Reserve and other federal banking agencies have collected extensive data from LBOs to ascertain the effectiveness of their existing incentive compensation practices and identify any shortcomings relative to the proposed compensation guidance. These horizontal reviews concluded recently, with the key findings shared amongst the federal agencies and LBOs. Some notable findings include the following:

- Institutions need to enhance the compensation process used to identify which employees, either individually or as a group, can expose the institution to material risk.
- Institutions have not fully captured the varying risks with their incentive compensation programs and have not consistently applied risk-sensitive methods to enough employees.
- Institutions have initiated deferral arrangements to adjust risk; however, they have taken a "one size fits all" approach instead of amending these adjustments to the type or duration of institutional risk.

- Institutions have not appropriately documented the use of discretion with incentive compensation arrangements.
- Institutions have not implemented an adequate mechanism to gauge their success in balancing risk in compensation practices.

Some banking institutions have already revised their incentive compensation programs so that they are more risk-sensitive and meet the principles outlined in the final guidance. Other institutions have considerable work to conduct, especially in developing processes that effectively compare risk and reward. These changes are expected to occur throughout the remainder of this year and well into 2012.

Conclusion

Overall, most banking institutions recognize that a strong risk management environment is not enough to protect their institution from undue risk with incentive compensation practices. Accordingly, the federal agencies will continue to regularly review incentive compensation arrangements and related risk management, internal control, and corporate governance practices to promptly identify any deficiencies that may not comply with the final guidance.

A second phase of the horizontal review is under way, aimed at assessing compensation practices at the business line and/or unit levels. Completion of this firm-specific work will provide assurance that all supervisory issues have been reasonably identified and will aid in creating comprehensive supervisory guidance in evaluating incentive compensation programs.

If you have any questions about this article, please contact Supervising Examiner Ivy Washington (ivy.washington@phil.frb.org) at (215) 574-6642.

The Dodd-Frank Act Keeps Rolling Along

by Bob Rell, Senior Specialist

Bob Rell,
Senior Specialist

The Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA or the act) passed its one-year anniversary in July. Trackers indicate that 122 rulemaking deadlines fell on July 16 (360 days after Dodd-Frank's enactment) and July 21 (one year after its enactment). While numerous milestones have been reached, many more remain ahead.

This recurring feature of *SRC Insights* highlights key events associated with the DFA that have transpired since the last issue. Reference links to more detailed information on the subject matter are also provided. If you have any questions regarding this periodic section, please contact Senior Specialist Bob Rell at bob.rell@phil.frb.org.

RULE PROPOSALS AND REQUESTS FOR COMMENT

October 11, 2011
Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds
This is a request for public comment on a proposed rule that would implement Section 619 of the DFA, which contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the Board to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.
www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm

August 31, 2011
Regulation OO - Supervised Securities Holding Companies Registration
This is a request for comment on a proposed rule outlining the procedures for securities holding companies (SHCs) to elect to be supervised by the Federal Reserve. An SHC is a nonbank company that owns at least one registered broker or dealer.
www.federalreserve.gov/newsevents/press/bcreg/20110831a.htm

August 22, 2011
Agency Information Collection
This is a proposal to exempt a limited number of savings and loan holding companies (SLHCs) from initial regulatory reporting using the Federal Reserve's existing regulatory reports and a two-year phase-in period for regulatory reporting for all other SLHCs. Exempt SLHCs would continue to submit Schedule HC, which is currently a part of the Thrift Financial Report, and the OTS H-(b)11 Annual/Current Report.
www.federalreserve.gov/newsevents/press/bcreg/20110822a.htm

August 12, 2011

Regulations LL and MM Savings and Loan Holding Companies

This is a proposed interim final rule setting forth regulations for SLHCs. This interim final rule provides for the corresponding transfer from the OTS to the Board of the regulations necessary for the Board to administer the statutes governing SLHCs.

www.federalreserve.gov/newsevents/press/bcreg/20110812a.htm

July 28, 2011

Retail Foreign Exchange Transactions (Regulation NN)

This is a request for comment on a rule to permit supervised banking organizations to engage in off-exchange transactions in foreign currency with retail customers. The proposed rule also describes various requirements with which banking organizations must comply to conduct such transactions.

www.federalreserve.gov/newsevents/press/bcreg/20110728a.htm

FINAL RULES ADOPTED

October 17, 2011

Final Rule Implementing the Resolution Plan Requirement of the DFA

The Federal Reserve Board announced the approval of a final rule to implement the resolution plan requirement in the DFA. The final rule requires bank holding companies with assets of $50 billion or more and nonbank financial firms designated by the Financial Stability Oversight Council (FSOC) for supervision by the Board to annually submit resolution plans to the Board and the Federal Deposit Insurance Corporation (FDIC).

www.federalreserve.gov/newsevents/press/bcreg/20111017a.htm

September 20, 2011

Final Rule Under Regulation B Regarding Data Collection Compliance Requirements for Motor Vehicle Dealers

The Federal Reserve Board issued a final rule amending Regulation B to provide that motor vehicle dealers are not required to comply with new data collection requirements in the DFA until the Board issues final regulations to implement the statutory requirements.

www.federalreserve.gov/newsevents/press/bcreg/20110920a.htm

July 21, 2011

Final Rule Implementing Transfer of Authority from the OTS to the OCC

To incorporate the transfer of certain functions of the OTS to the OCC, the OCC is adopting amendments to its regulations governing organization and functions, availability and release of information, post-employment restrictions for senior examiners, and assessment of fees. The OCC is also amending its rules pertaining to preemption and visitorial powers, change in control of credit card banks and trust banks, and deposit-taking by uninsured federal branches.

www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-35a.pdf

LEGISLATIVE ACTIONS, HEARINGS, AND LEGAL PROCEEDINGS

August 16, 2011

Field Hearing Entitled "Potential Mixed Messages: Is Guidance from Washington Being Implemented by Federal Bank Examiners?"

Committee on Financial Services

financialservices.house.gov/Calendar/EventSingle.aspx?EventID=254890

July 27, 2011

Hearing Entitled "Oversight of the Credit Rating Agencies Post-Dodd-Frank"

Committee on Financial Services

financialservices.house.gov/Calendar/EventSingle.aspx?EventID=252718

July 21, 2011
Hearing Entitled "Enhanced Oversight After the Financial Crisis: The Wall Street Reform Act at One Year"
United States Senate Committee on Banking, Housing, and Urban Affairs
banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=8dca4578-a3c0-4fd6-b813-2088ad08584b

July 8, 2011
Hearing Entitled "Legislative Proposals Regarding Bank Examination Practices"
Committee on Financial Services
financialservices.house.gov/Calendar/EventSingle.aspx?EventID=249608

GAO AND OTHER NOTABLE REPORT RELEASES SPEECHES, TESTIMONY, AND EVENTS OF INTEREST

October 17, 2011
Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations
www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf

October 4, 2011
Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance
The DFA directed the GAO to conduct a one-time audit of the emergency loan programs and other assistance authorized by the Board of Governors of the Federal Reserve System during the recent financial crisis. This testimony summarizes the results of the GAO's July 2011 report (GAO-11-696) examining the emergency actions taken by the Federal Reserve Board from December 1, 2007, through July 21, 2010.
www.gao.gov/products/GAO-12-122T

July 19, 2011
Mortgage Reform: Potential Impacts of Provisions in the DFA on Homebuyers and the Mortgage Market
The act directed the GAO to assess the effect of mortgage-related provisions on the availability and affordability of mortgage credit and to issue a report by July 2011, but federal agencies are still developing implementing regulations. This report discusses the potential impact of the act's (1) qualified mortgage criteria, (2) credit risk retention requirement, and (3) provisions concerning homeownership counseling and regulation of high-cost loans.
www.gao.gov/products/GAO-11-656

UPDATES ON NEW AGENCIES

Consumer Financial Protection Bureau (CFPB)

October 13, 2011
CFPB Supervision and Examination Manual
The CFPB released the *CFPB Supervision and Examination Manual*, the guide for examiners to use in overseeing companies that provide consumer financial products and services.
www.consumerfinance.gov/guidance/supervision/manual/

October 13, 2011
Mortgage Servicing—Examination Procedures
After completing the risk assessment and examination scoping, examiners should use these procedures, in conjunction with the compliance management system review procedures, to conduct a mortgage servicing examination. The examination procedures contain a series of modules, grouping similar requirements together.
www.consumerfinance.gov/guidance/supervision/manual/mortgage-servicing-examination-procedures/

October 6, 2011

Senate Banking Committee Approves Cordray Nomination as CFPB Head

The Senate Committee on Banking, Housing and Urban Development voted to confirm former Ohio Attorney General Richard Cordray as director of the CFPB. The committee approved the nomination by a party-line vote of 12-10, with all Republican members voting against it.

banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=d9d510a6-c46e-c82f-11bd-f76798a1ab1c

Federal Insurance Office (FIO)

October 17, 2011

Public Input on the Report to Congress on How to Modernize and Improve the System of Insurance Regulation in the United States

The DFA requires the FIO to conduct a study on how to modernize and improve the system of insurance regulation in the United States. To assist the FIO in conducting the study and formulating its recommendations, the FIO is issuing this request for comment.

www.gpo.gov/fdsys/pkg/FR-2011-10-17/pdf/2011-26776.pdf

Financial Stability Oversight Council (FSOC)

October 11, 2011

Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies

Section 113 of the act authorizes the FSOC to require a nonbank financial company to be supervised by the Board of Governors of the Federal Reserve System and be subject to prudential standards if it determines that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States.

www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf

October 6, 2011

The Annual Report of the FSOC

The FSOC annual report fulfills the Congressional mandate to report on its activities, describe significant financial market and regulatory developments, analyze potential emerging threats, and make certain recommendations.

www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf

Committee on Financial Services Hearing

financialservices.house.gov/UploadedFiles/100611geithner.pdf

October 1, 2011

DFA Integrated Implementation Roadmap

This presentation contains a summary of key tasks that the FSOC and its members will take to implement the DFA.

www.treasury.gov/initiatives/Documents/FSOC%20Integrated%20Roadmap%20-%20October%201.pdf

September 26, 2011

Senate Confirmation of S. Roy Woodall

The Senate confirmed the nomination of S. Roy Woodall to be the independent member of the FSOC with insurance expertise. He was named for a six-year term. He will be one of three insurance representatives on the FSOC and the only one with voting power.

Office of Financial Research (OFR)

August 12, 2011

Statement on Progress to Date and Next Steps Forward in the Global Initiative to Establish a Legal Entity Identifier (LEI)

To support the FSOC in identifying connections among market participants and monitoring systemic risk, the OFR intends to standardize how parties to financial contracts are identified in the data it collects on behalf of the FSOC.

www.treasury.gov/press-center/press-releases/Pages/tg1275.aspx

2011 Supervision and Regulation Letters

Supervision and Regulation (SR) Letters are available on the Board of Governors' website at www.federalreserve.gov/bankinforeg/srletters/srletters.htm. The following SR Letters were issued in 2011.

SR 11-14 Supervisory Expectations for Risk Management of Agricultural Credit Risk

SR 11-13 Guidance Regarding Prior Notices with Respect to Dividend Declarations by Savings Association Subsidiaries of Savings and Loan Holding Companies

SR 11-12 Deregistration Procedures for Certain Savings and Loan Holding Companies

SR 11-11/CA 11-5 Supervision of Savings and Loan Holding Companies (SLHCs)

SR 11-10 Interagency Counterparty Credit Risk Management Guidance

SR 11-9 Interagency Supplement to Authentication in an Internet Banking Environment

SR 11-8 Supervisory Guidance on Implementation Issues Related to the Advanced Measurement Approaches for Operational Risk

SR 11-7 Guidance on Model Risk Management

SR 11-6 Guidance on Accepting Accounts from Foreign Embassies, Consulates and Missions (foreign missions)

SR 11-5 Spanish Translation of the *FFIEC BSA/AML Examination Manual*

SR 11-4 Interagency Statement on Reorganization of FinCEN's Bank Secrecy Act Regulations

SR 11-3 De Novo Interstate Branching by State Member Banks

SR 11-2/CA 11-2 Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks

SR 11-1 Impact of High-Cost Credit Protection Transactions on the Assessment of Capital Adequacy

FEDERAL RESERVE BANK
OF PHILADELPHIA

Supervision, Regulation and Credit Department
Ten Independence Mall
Philadelphia, PA 19106

www.philadelphiafed.org

Scan with your smartphone to access *SRC Insights* online

E-Mail Notification Service

Would you like to read *SRC Insights* on our website up to three weeks before it is mailed? Sign up for our e-mail notification service today at <http://www.srcinsights.org/>.