**EM-31.4**

**Category:** **Board & Management Operations**
**Topic:** **Human Capital Management**
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## Overview

The *Human Capital Management* topic provides guidance on evaluating a Farm Credit System (System) institution's human capital management practices. Human capital management is an approach to staffing that recognizes people as assets or human capital that can be invested in and managed to maximize their value to the institution. It involves planning, overseeing, developing, and compensating the institution's workforce. Effective human capital management results in recruiting and retaining a high-quality, diverse staff that aligns with the institution's goals and contributes to successfully accomplishing the institution's mission.

Human capital management is not an isolated element of management; it occurs as part of planning, directing, and controlling activities in all operational areas. As such, it is an examination consideration when evaluating most topics. However, this Examination Manual section focuses on specifically evaluating the following distinct components of human capital management:

- The human capital plan and strategies, including succession planning and affirmative action program plans.
- Performance management, including job descriptions, performance standards and evaluations, and training and development.
- Employee compensation and benefits programs.
- Board compensation and the structure, operations, and effectiveness of the board's Compensation Committee.

Human capital management practices may vary based on an institution's size, business model, complexity, and risk. Accordingly, institutions may use a variety of practices to satisfactorily develop, implement, monitor, and document their human capital activities. Examiners should consider this as they apply the concepts and guidance outlined below. Institutions may outsource to gain expertise and aide in human capital functions. Even when these processes are outsourced, the responsibility for effective human capital management remains with the board and management. Refer to the *Third-Party Risk Management* procedure in the *Direction & Control of Operations* Examination Manual topic for information on examining an institution's outsourcing processes.

## Examination Procedures and Guidance

### General

***1. Plan & Strategies:***

Evaluate management's assessment of human capital needs and determine if strategies and actions are sufficient to ensure an effective, diverse, and inclusive workforce.

Guidance:

Strategic human capital planning is necessary to ensure the continued development of a workforce that is high-performing and aligned with the System's mission. The issues facing System institutions are complex and require a broad range of skills, experiences, and backgrounds that are also sought after by many businesses. Therefore, implementing a strategic human capital plan is a key step in building and maintaining an effective organization by recruiting, developing, and retaining a high-performing and diverse workforce.

Farm Credit Administration (FCA) Regulation 618.8440(b)(7) requires each institution to adopt a human capital plan. Plan content and format will vary by institution, depending on factors such as size and scope of operations. However, the plan must include a description of the institution's workforce and management and an assessment of their strengths and weaknesses. In addition, the plan must include a description of the institution's workforce and management succession programs.

Institutions must incorporate strategies and actions into their human capital plans to strive for diversity and inclusion, as required by FCA Regulation 618.8440(b)(7)(iii). A diverse range of employees may more effectively reach a broader and more diverse base of producers, thereby increasing the customer base. Moreover, diverse employees bring different perspectives to the institution and may result in the development of more creative and innovative products and services that increase the customer base. To flourish, diversity requires an inclusive environment using the talents of people of different backgrounds, experiences, and perspectives to help the institution achieve its business goals. Greater diversity and inclusion promote more effective and innovative businesses, as well as opportunities to serve a wider range of customers and enterprises.

Evaluative questions and items to consider when examining human capital plans and strategies include:

- ***Strategic Direction:*** **Has the board and management developed a strategic direction for human capital planning?** Strategic human capital planning focuses on the short- and long-term acquisition, development, and deployment of human resources to achieve the institution's mission and strategies. Effective strategic direction for human capital planning identifies the board's overall philosophy and vision for the kind of workforce needed. It should provide a coherent framework of human capital policies, programs, and practices to directly support the institution's strategic plan. A clear strategic direction will enable management to develop effective human capital strategies.

- ***Workforce Assessment:*** **Has the institution effectively studied its workforce and management and evaluated their strengths and weaknesses, as required by FCA Regulation 618.8440(b)(7)(i)?** To develop effective strategies and actions and comply with the regulation, management must study and know its workforce and incorporate a thorough and accurate assessment into the human capital plan. This process generally starts with collecting and reviewing key documents (e.g., workforce demographics, workforce analysis, budget, skill gap analysis) and workforce data (e.g., turnover and retirement rates, labor market information). Institutions should also take an honest look at staff's skills and capabilities, giving consideration to whether the workforce assessment results are consistent with staff performance evaluations and institution results. In addition, most institutions should already be evaluating their workforce through the affirmative action program analysis, if applicable. This analysis, along with the information from other key documents as discussed above, should enable the institution to evaluate its current and future human capital needs to achieve its mission and aid in the development of succession programs. Examples of human capital needs include the size of the workforce, its placement across the institution, and the knowledge, skills, and abilities needed. Refer to the *Affirmative Action Program Plan* procedure for additional evaluative criteria.

- ***Succession Programs:*** **Did the human capital plan incorporate workforce and management succession programs?** FCA Regulation 618.8440(b)(7)(ii) requires institutions to include a description of their workforce and management succession programs in the human capital plan. Refer to the *Succession Planning* procedure for additional evaluative criteria.

- ***Strategies and Actions:*** **Has the institution developed appropriate human capital strategies and taken actions to implement those strategies? Has sufficient focus been placed on identifying diversity and inclusion strategies and actions?** The strategic direction and workforce assessment discussed above will help institutions develop human capital strategies. These strategies will tend to be categorized around major human capital topics, such as talent management, leadership and succession, training and development, and performance and recognition. Once strategies are established, actions should be developed that outline how the strategies will be implemented. Actions should have enough specificity to ensure they will reasonably accomplish the intended strategies. Examiners should specifically evaluate whether each institution has made good faith efforts in developing strategies and actions to strive for diversity and inclusion within its workforce and management, as required by FCA Regulation 618.8440(b)(7)(iii). Good faith efforts are generally viewed as strategies and actions institutions take that may not always result in the specific desired results but, over time, lead to tangible improvements in workplace diversity and inclusion.

- ***Board Reporting:*** **Does the board receive sufficient reports on progress made in accomplishing human capital plan strategies and actions?** The reporting should be sufficient to inform the board of any significant problems, delays, or adjustments needed in implementing strategies and actions. Report content and frequency should be consistent with board policy or process requirements, and comply with FCA Regulation 618.8440(c)(1). While the regulation requires reporting at least annually, the board should consider more frequent reporting as discussed in the *Providing Business Planning and Strategic Direction* section of The Director's Role. More ongoing reporting will enable the board to ensure accountability and formulate new strategies and actions, if necessary.

Note: Institutions may use other documents (e.g., affirmative action program, succession plans, workforce plan, recruitment plan, etc.) as part of meeting the human capital plan regulatory requirements. However, these documents must be approved by the board annually and be summarized in, and incorporated by reference into, the human capital plan. Also, it is important to remember the FCA business planning regulation does not require an institution to:

- Establish quotas.
- Disclose confidential or sensitive information in public documents.
- Hire persons who are not the best qualified for the position for which they are applying.
- Gather or record data on employee characteristics that is not currently legally gathered or recorded.
- Implement strategies or actions that extend beyond its labor market.
- Implement strategies or actions inconsistent with existing employment laws and rules.

Refer to the following documents for additional guidance and information:

- Preamble to the 2012 Business Planning Regulation amendments
- Frequently Asked Questions on Business Planning for Diversity and Inclusion
- FCA Board Policy Statement 62 – Equal Employment Opportunity and Diversity
- Title 41 CFR Parts 60-2, 60-300, and 60-741 – Affirmative Action Program Regulations
- Department of Labor Sample Affirmative Action Program

### *2. Succession Planning:*

Evaluate the adequacy of succession planning for the chief executive officer (CEO) and other key positions.

Guidance:

Succession planning is a strategic approach to ensure the necessary talent and skills are available and essential knowledge and abilities are maintained for when employees in key positions leave. Succession planning strategies can involve both internal staff development and hiring from outside. Effective succession planning is critical to reduce the likelihood of operational disruptions due to vacancies in key positions and to ensure long-term success of an institution. The succession planning process involves the board, executive management, and all other employees who manage staff. Institutions may outsource to gain expertise and help develop succession plans. Even when these processes are outsourced, the responsibility for effective succession planning remains with the board and management. The process can vary depending on an institution's needs and structure; however, the main objectives are to:

- Identify critical workforce positions, proactively develop a diverse pool of potential successors, and encourage a culture that supports knowledge transfer and employee development.

- Build human resource programs that attract and retain qualified individuals to the institution.

- Implement a framework that identifies the competency requirements of critical positions, evaluates potential candidates, and develops required competencies, skills, and qualifications through planned development initiatives.

Evaluative questions and items to consider when examining succession planning include:

- ***Regulatory Compliance:*** **Did the human capital plan incorporate a description of the institution’s workforce and management succession programs as required by FCA**

**Regulation 618.8440(b)(7)(ii)?** Succession planning is critical to mission success and creates a process for recognizing, developing, and retaining a diverse talent pipeline to ensure leadership continuity. The institution should identify key positions needing succession, analyze gaps in the current pipeline, and develop succession programs to ensure a diverse pool of potential applicants to meet current and future needs.

- ***Identifying Key Positions:* Did the institution appropriately identify key positions in its succession programs?** A key position is one that would have a significant impact on the institution's ability to conduct normal business if it were vacant. Typical key positions are at the executive level, such as CEO, chief financial officer (CFO), chief credit officer (CCO), chief risk officer, and chief information officer. However, key positions are not limited to executive-level positions and may include managers or positions that require a particular expertise or institutional knowledge. The impact to the organization could be considered in terms of how the vacancy might affect safety and soundness, financial operations, organizational efficiency, or reputation risk.

- ***Requirements for Key Positions:* Did the institution adequately identify the competencies, skills, and qualifications required for key positions?** Succession planning should look at identifying and building the competencies, skills, and qualifications for current and future institutional needs. An inventory of the most important requirements can serve as a basis to evaluate an employee's current competencies, skills, and qualifications and focus training and development or recruitment efforts. For example, if an institution is planning for the succession of its CFO, it should define the competencies, skills, and qualifications required to fulfill that specific job. These might include financial and accounting knowledge, educational minimums or preferences, and professional certifications, along with relevant leadership experience and knowledge of the industry.

- ***Successors for Key Positions:* Has the institution identified potential successors for key positions?** Institutions should identify individuals with the potential to fill key positions. Management should consider building an inventory of employees' skills, experience, and career goals. This enables management to identify diverse individuals with relevant competencies and qualifications from multiple levels who are at varying stages in their careers. Institutions should use various tools to assess an employee's potential to help reduce biased selection practices and minimize subjectivity. Potential tools include performance reviews, behavioral-based interviews, and 360-degree feedback. The board has a fiduciary duty to work toward identification and mitigation of major business risks, including the loss of executive management. As such, the board should be directly involved in CEO succession planning.

- ***Succession Management Strategies:* Has the institution identified sufficient succession management strategies?** Succession strategies should look at methods to build the core competencies, skills, and qualifications for current and future needs. Institutions may choose from various human resource strategies, including developing internal talent pools, onboarding, and recruitment to address succession planning. It is important to incorporate strategies for training and development and transferring of institution knowledge within succession planning. Institutions may look to their internal staff or outside candidates. Looking externally can be beneficial in that it presents the opportunity to bring in new and diverse talent. Strategies could also include temporarily filling positions with contracted employees.

- ***Review of Succession Programs:* Are succession programs reviewed periodically for effectiveness and updated as needed?** Once developed, institutions should keep the succession program current. To ensure that succession planning efforts are successful, it is important to monitor workforce data, evaluate strategies, and adjust when necessary. This is especially important following organizational changes, changes in priorities, restructuring, retirements, promotions, and resignations.

- ***Board Involvement:* Was the board sufficiently involved in succession planning?** The board has a fiduciary responsibility to identify and mitigate major business risks, including the loss of executive management. The board should be directly involved in considering a CEO successor, and at a minimum should be informed on succession planning activities for key positions like the CFO, CCO, and other key officers. The board should also hold executive management accountable for succession planning, and receive periodic reporting consistent with board policy or process requirements.

### *3. Affirmative Action Program Plan:*

Evaluate the adequacy of the affirmative action program plan.

Guidance:

Section 4.38 the Farm Credit Act of 1971, as amended (the Act), requires each System institution with more than 20 employees to establish and maintain an affirmative action program (AAP) plan. Although System institutions are not government contractors, the AAP plan must apply the same affirmative action standards that are applied to contractors of the federal government. FCA applies the substantive standards in the Department of Labor's Office of Federal Contract Compliance Program's regulations as criteria to evaluate an AAP plan for compliance with the Act. These regulations include:

- Title 41 Part 60-2 – Affirmative Action Programs (this section addresses women and minorities)

- Title 41 Part 60-300 – Affirmative Action and Nondiscrimination Obligations of Federal Contractors and Subcontractors Regarding Disabled Veterans, Recently Separated Veterans, Active Duty Wartime or Campaign Badge Veterans, and Armed Forces Service Medal Veterans

- Title 41 Part 60-741 – Affirmative Action and Nondiscrimination Obligations of Federal Contractors and Subcontractors Regarding Individuals with Disabilities

The AAP plan is a management tool designed to help ensure equal employment opportunity. Institutions should customize their AAP plans to reflect their organizational structure, policies, practices, programs, and data. This will help ensure all qualified applicants and employees are receiving an equal opportunity for recruitment, selection, advancement, and other terms and privileges associated with employment. Institutions may outsource to gain expertise and help develop the AAP plan. Even when these processes are outsourced, the responsibility for an effective AAP plan remains with the board and management.

Section 4.38 was added to the Act by the Agricultural Credit Act of 1987. Since then, institutions have been subject to the substantive requirements in Title 41 Part 60-2 (which focuses on employing minorities and women) and its predecessors. The requirements in Title 41 Parts 60-300 and 60-741 became effective in 2014. In addition to adding a focus on veterans and individuals with disabilities, these newer regulations impose substantive requirements on institutions that are different from those in Part 60-2. Institutions must ensure that their AAP plans incorporate all applicable, substantive requirements. Institutions may choose to have one AAP plan integrating all the above regulations or separate plans for each part of the regulations.

Institutions may use their AAP plans to comply with the human capital plan requirements in FCA Regulation 618.8440(b)(7)(i). However, if an institution uses its AAP plan in this manner, the AAP plan must contain the information specified in the regulation, be approved by the board annually, and be summarized in, and incorporated by reference into, the human capital plan.

Evaluative questions and items to consider when examining an AAP plan under Title 41 Part 60-2 (women and minorities) include:

- ***Quantitative Analyses:* Has the institution adequately completed the required quantitative analyses to appropriately evaluate workforce composition and compare it to the labor pool composition?** The institution's AAP plan must include the following quantitative analyses:

    - *Organizational Profile* – An overview of the staffing within an institution (possibly displayed in a chart or list) used to determine areas in the workforce where minorities or women are underrepresented or concentrated. [41 CFR 60-2.11]

    - *Job Group Analysis and Placement of Incumbents* – Job groups should be formed by combining job titles with similar duties and responsibilities, wages, and job opportunities. This is the first step in the institution comparing the representation of minorities and women in its workforce with the estimated availability of minorities and women qualified to be employed. The institution must state the percentage of minorities and women it employs in each job group. [41 CFR 60-2.12 and 41 CFR 60-2.13]

    - *Determining Availability* – The purpose of the availability determination is to establish a benchmark against which the demographic composition of the institution's workforce can be compared. The institution must use the most current and discrete statistical information available to determine the percentage of qualified minorities and women in a reasonable recruitment area and among those promotable, transferable, and trainable within the institution. Examples of this information include census data, data from local job service officers, and data from colleges or other training institutions. Management should use this information to determine whether barriers to equal employment opportunity exist within a job group. The institution must not determine availability in a manner that has the effect of excluding women and minorities. [41 CFR 60-2.14]

    - *Comparing Incumbency and Placement Goals* – Placement goals serve as objectives or targets reasonably attainable by means of applying every good faith effort to make all aspects of the entire AAP plan work. The institution must establish a placement goal if the percentage of minorities or women employed in a job group is less than would reasonably be expected based on the availability determination. The need for a placement goal does not constitute a finding or an admission of discrimination. The percentage annual placement goal must be at least equal to the availability figure derived for women or minorities, as appropriate, for that job group. Depending on the disparity, the institution could establish a single goal for all women and minorities or separate goals for each group. In establishing placement goals, the following key principles apply: quotas are expressly forbidden, employment decisions must be nondiscriminatory, and institutions are not required to hire an unqualified person. [41 CFR 60-2.15 and 41 CFR 60-2.16]

- ***Designation of Responsibility:* Was an appropriate individual designated to be accountable for implementing the AAP plan?** Depending on the size of the institution, this may or may not be the individual's sole responsibility. However, the individual must have the authority, resources, and support of (and access to) executive management to ensure effective implementation of the AAP plan. [41 CFR 60-2.17(a)]

- ***Identification of Problem Areas:* Has the institution performed an effective analysis of its employment process to determine whether and where impediments to equal employment opportunity exist?** Management must evaluate its workforce by organizational unit and job group, along with its personnel activity, to determine whether there are problems in minority or female utilization. In addition, the institution must evaluate selection, recruitment, referral, other personnel procedures, and the compensation system to determine whether there are disparities. This analysis provides the information needed to develop action-oriented programs. [41 CFR 60-2.17(b)]

- ***Action-Oriented Programs:* Has the institution developed and executed effective action-oriented programs to correct any problem areas identified and to attain goals and objectives?** For these action-oriented programs to be effective, the institution must ensure they consist of more than following the same procedures that have previously produced inadequate results. Institutions must demonstrate a good faith effort to remove identified barriers, expand employment opportunities, and produce measurable results. Examiners should evaluate this area by reviewing the contents of the program, the extent of adherence to the program, and the institution's good faith effort to make its AAP plan work. [41 CFR 60-2.17(c)]

- ***Audit and Reporting System:* Has the institution implemented an effective audit and reporting system to periodically monitor activity and report results to the board?** Institutions must develop and implement an auditing system that periodically measures effectiveness of the AAP. Additionally, institutions should monitor personnel activity to ensure the AAP plan is carried out. They should also regularly report results and program effectiveness to the board. [41 CFR 60-2.17(d)] In addition, the board should consider at least annual reporting as discussed in the *Providing Business Planning and Strategic Direction* section of The Director's Role. Reports should be sufficient to inform the board of any significant problems, delays, or adjustments needed in implementing strategies and actions. Report content and frequency should be consistent with board policy or process requirements.

Evaluative questions and items to consider when examining an AAP plan under Title 41 Parts 60-300 (veterans) and 60-741 (individuals with disabilities) include:

- ***Availability of the AAP Plan:* Does the institution have an adequate process to ensure its AAP plan is made available to applicants and employees?** Each institution must make its AAP plan, absent the data metrics, available to any applicant or employee for inspection upon request. The institution must post at each establishment the location and hours during which the AAP plan may be obtained. [41 CFR 60-300.41 and 41 CFR 60-741.41]

- ***Invitation to Self-Identify:* Does the institution have an adequate process to ensure protected veterans and persons with disabilities are invited to self-identify?** The institution must invite job applicants, persons who have received job offers, and current employees to self-identify as protected veterans (defined by 41 CFR 60-300.2(q) to include disabled veterans, recently separated veterans, active duty wartime or campaign badge veterans, and Armed Forces service medal veterans) or individuals with disabilities. The institution may not compel an individual to self-identify and must keep the information confidential. [41 CFR 60-300.42 and 41 CFR 60-741.42]

- ***Affirmative Action Policy Prohibition Against Discrimination*: Does the institution adequately prohibit discrimination in employment?** The institution must not discriminate because of physical or mental disability or against protected veterans and must take affirmative action to employ and advance in employment qualified protected veterans and individuals with disabilities. [41 CFR 60-300.43 and 41 CFR 60-741.43]

- ***Affirmative Action Program*: Has the institution developed an AAP plan that contains, at a minimum (but does not need to be limited to), the following elements?**

    - *Policy Statement* – The AAP plan must contain an equal opportunity policy statement that must indicate the support of the top executive (such as the president or CEO) for the AAP plan. The policy statement must include certain specific items, be posted on the institution's bulletin boards, and be made available, accessible, and understandable to applicants and employees with disabilities. [41 CFR 60-300.44(a) and 41 CFR 60-741.44(a)]

    - *Review of Personnel Processes* – The institution must ensure that its personnel processes do not stereotype protected veterans and individuals with disabilities in a way that limits their access to the personnel processes and jobs for which they are qualified. The institution must:

        - Periodically review its personnel processes (e.g., hiring, promotion, training opportunities) to ensure that these requirements are met.
        - Describe its personnel processes review and any necessary modifications.
        - Design procedures that aid in implementing a review of this requirement. [41 CFR 60-300.44(b) and 41 CFR 60-741.44(b)]

    - *Physical and Mental Qualifications* – The institution must provide in its AAP plan, and must adhere to, a schedule for the periodic review of all physical and mental job qualification standards. This is to ensure that any screening out of qualified persons with disabilities and protected veterans is job-related and consistent with business necessity. Documenting this review will ensure the institution critically analyzes its job requirements and proactively eliminates those that are not job-related. [41 CFR 60-300.44(c) and 41 CFR 60-741.44(c)]

    - *Reasonable Accommodation Procedures* – The institution must ensure reasonable accommodations are provided to applicants and employees with disabilities and must take the initiative in approaching employees with known disabilities to begin the reasonable accommodation process. Developing and using written procedures for processing requests for reasonable accommodation is a sound business practice that may help the institution meet its reasonable accommodation obligations. Such procedures help ensure that applicants and employees are informed on how to request a reasonable accommodation and are aware of how requests will be processed by the institution. Appendix B to Part 60-741 provides guidance to institutions that choose to develop written reasonable accommodation procedures. [41 CFR 60-300.44(d) and 41 CFR 60-741.44(d)]

- *Harassment* – The institution must develop and implement procedures to help ensure that its employees are not harassed because of their protected veteran status or disability. [41 CFR 60-300.44(e) and 41 CFR 60-741.44(e)]

- *External Dissemination of Policy, Outreach, and Positive Recruitment* – The institution must undertake appropriate outreach and positive recruitment activities that are reasonably designed to effectively recruit protected veterans and persons with disabilities. The scope of the institution's efforts will depend on all of the circumstances and the extent to which existing employment practices are adequate. The regulations provide illustrative examples of outreach and recruitment activities. The institution must assess the effectiveness of these efforts annually. The institution must also document all activities it undertakes to comply with these requirements and must retain these documents for 3 years. [41 CFR 60-300.44(f) and 41 CFR 60-741.44(f)]

- *Internal Dissemination of Policy* – The institution must develop procedures to internally communicate its affirmative action policy. A strong outreach program will be ineffective without adequate internal support from leadership and other employees. To aid further employee cooperation and participation in the institution's efforts, procedures must foster understanding, acceptance, and support, as well as encourage personnel to take the necessary actions to aid the institution in meeting this obligation. The institution must include the policy in its policy manual/employee handbook or otherwise make it available to all employees; other methods of dissemination are also encouraged. [41 CFR 60-300.44(g) and 41 CFR 60-741.44(g)]

- *Audit and Reporting System* – The institution must implement an effective audit and reporting system to periodically monitor activity and report results to the board. The institution must develop and implement an auditing system that periodically measures the effectiveness of its AAP plan. In addition, the board should consider at least annual reporting as discussed in the *Providing Business Planning and Strategic Direction* section of The Director's Role. Reports should be sufficient to inform the board of any significant problems, delays, or adjustments needed in implementing strategies and actions. Report content and frequency should be consistent with board policy or process requirements. Where the AAP plan is found to be deficient, the institution must take action to bring the program into compliance. [41 CFR 60-300.44(h) and 41 CFR 60-741.44(h)]

- *Responsibility for Implementation* – The institution must assign responsibility for implementing the affirmative action activities to an official whose name should appear on all communications regarding the AAP plan. [41 CFR 60-300.44(i) and 41 CFR 60-741.44(i)]

- *Training* – The institution must train the personnel involved in the recruitment, screening, selection, promotion, disciplinary, and related processes to ensure the commitments in the AAP plan are implemented. [41 CFR 60-300.44(j) and 41 CFR 60-741.44(j)]

- *Data Collection Analysis* – The institution must document and retain for 3 years specified data on applicants and hires. [41 CFR 60-300.44(k) and 41 CFR 60-741.44(k)]

- ***Hiring Benchmark/Utilization Goal*: Does the institution have an appropriate hiring benchmark for protected veterans and utilization goal for hiring individuals with disabilities?** The benchmark and utilization goals are not rigid and inflexible quotas that must be met, nor are they to be considered either a ceiling or a floor for employing particular groups. Quotas are expressly forbidden.

  - *Hiring Benchmark for Protected Veterans* – The institution must establish an annual benchmark for hiring protected veterans. The purpose of the benchmark is to create a quantifiable method by which the institution can measure its progress towards achieving equal employment opportunity for protected veterans. An institution must choose one of the two specified mechanisms for establishing its benchmark annually, document its benchmark as specified, and retain relevant documentation for 3 years. [41 CFR 60-300.45]

  - *Utilization Goal for Hiring Individuals with Disabilities* – The institution must establish a 7 percent utilization goal for individuals with disabilities. The utilization goal must be for each job in the institution's workforce or, if it has fewer than 100 employees, for the institution's entire workforce. The purpose of this goal is to establish a benchmark against which the institution measures the representation of individuals within its workforce. The institution must evaluate its utilization annually and develop and execute action-oriented programs to correct problem areas. [41 CFR 60-741.45]

The Department of Labor provides Sample Affirmative Action Programs that are available for illustrative purposes. These sample programs are resources that institutions may use, but do not represent the only way to comply with the requirements. Each institution's AAP plan should be customized to reflect its organizational structure, policies, practices, programs, and data.

### *4. Audit:*

Determine if the institution conducts an effective audit (scope, reporting, and followup) of human capital management issues.

Guidance:

The internal audit and review program is a key mechanism for ensuring human capital management processes are functioning effectively and in compliance with regulations and policies. The internal auditor or other qualified, independent party should review the adequacy of human capital management to ensure compliance with applicable criteria. The audit risk assessment and scope should address human capital management topics, and audit or review frequency should be commensurate with the complexity of the institution's operations and risk profile. A reliable audit program provides the board reasonable assurance that human capital management is sound and that related reporting is complete and accurate.

Note: This procedure focuses on evaluating the reliability and effectiveness of internal audits and reviews in this topical area. Refer to the *Audit & Review Programs* Examination Manual topic for guidance on examining the overall internal audit and review program.

Evaluative questions and items to consider when examining the audit or review of human capital management include:

- ***Audit Coverage:*** **Is there periodic audit or review coverage of human capital management?** Audit or review coverage and frequency should be appropriate relative to risks, changes in the operating environment, regulatory requirements, and periodic testing needs. Coverage should also be consistent with the institution's risk assessment results and annual audit plan.

- ***Scope and Depth:*** **Are audit or review scope and depth sufficient to conclude on the adequacy and effectiveness of the institution's human resources policies, procedures, documentation, and systems?** The scope and depth of work, including transaction testing, should cover the primary processes and controls within the area being audited or reviewed and be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of coverage should be documented and consistent with the approved audit or review plan and engagement contract (if applicable). Audit or review workpapers should be examined to verify the actual scope and depth of work performed. The workpapers may indicate the scope and depth deviated from what was identified (or implied) in the audit plan. For example, workpapers may indicate the work performed was limited to evaluating the existence of policies and procedures and didn't include reviewing other controls, such as training or reporting, or testing compliance with regulations or institution guidance. If the work deviated materially from the original planned scope, internal audit should notify the board (or Audit Committee, if so delegated) of the reasons for the change. Specific items that should be considered in the audit or review scope include:

    - Policies and procedures for all major human capital management areas (e.g., hiring, orientation, termination, job descriptions, performance evaluations, employee training and development programs, succession planning, affirmative action, employee and board compensation and benefits).

    - Compliance with human capital policies, procedures, FCA Regulations, and other FCA guidance.

    - Monitoring and control processes (e.g., reporting, management oversight, delegated authorities, separation of duties, management information systems).

    - AAP plan (as discussed in the *Affirmative Action Program Plan* procedure guidance, institutions are required to have an internal auditing system that periodically measures the effectiveness of the AAP).

    - Fraud-related threats and vulnerabilities, as well as anti-fraud controls.

- ***Reliability of Results:*** **Did FCA identify any concerns with audit or review reliability?** It is important to understand the scope and depth of the audit or review being examined, as discussed above, when evaluating audit or review reliability. With this understanding, the following are key considerations when evaluating the reliability of audit or review results:

- *FCA Testing* – Evaluate the reliability of internal audit or review work by comparing the results to FCA's examination results in this area. This comparison often includes FCA testing transactions that were covered in the internal audit or review (transactions are often loans or loan applications, but may include other types of transactional activity, as well). In addition to the audit or review report, examiners should request and review the workpapers and hold discussions with the auditor to obtain a more thorough understanding of work completed. This can be especially important if the audit or review report is not sufficiently detailed or FCA's examination work and testing identifies potential concerns. Auditors and reviewers complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant audit evidence when conducting and supporting their work. (IIA Standards 2240, 2300, 2310, and 2320) Workpapers should adequately document the work performed and support the final report. If FCA identifies weaknesses that were not identified in the audit or review, the cause for any discrepancy should be determined.

- *Audit/Review Staffing* – Whether internal or outsourced, auditors and reviewers conducting the work need to be qualified, independent, and objective to ensure reliable results. They should have the right mix of knowledge, skills, and other competencies needed to perform the work. (IIA Standard 2230) Additionally, auditors and reviewers need to be independent of the activities they audit so they can carry out their work freely and objectively. (IIA Standards 1100, 1112, 1120, and 1130) For example, audit and review staff should not be involved in developing and installing procedures, preparing records, operating a system of internal controls, or engaging in any other activity that they would normally review. Examiners should evaluate the staffing on the individual audit or review being examined as part of determining the reliability of results.

- *Institution Review of Work Performed* – The institution should complete an independent review of the workpapers to ensure audit or review objectives and scope were met and the results and conclusions were reliable and supported. (IIA Standard 2340) Examples could include a supervisory review of in-house audit work by the Chief Audit Executive (CAE) or other audit staff, or a review of outsourced work by the CAE or audit coordinator. Examiners should consider whether the institution completed these reviews, and if any concerns were identified, when concluding on audit or review reliability.

- ***Reports:* Does the internal audit or review report sufficiently communicate human capital management review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report:

  - Is the report prepared and communicated in accordance with the institution's guidelines?

  - Is an executive summary or overview included to provide the board with a general conclusion on audit or review results?

  - Is the report accurate, concise, supported, and timely in communicating the audit or review objectives, scope, results, conclusions, and recommendations? (IIA Standards 2330, 2400, 2410, 2420, 2440, and 2450)

- Are conclusions and recommendations realistic and reasonable, with material and higher risk issues clearly identified and prioritized?
- Are conclusions and recommendations supported by convincing evidence and persuasive arguments (condition, criteria, cause, and effect)?
- Do results in the workpapers align with report conclusions?
- Does the report conclude whether the institution adheres to policies, procedures, and applicable laws or regulations, and whether operating processes and internal controls are effective?
- Does the report address potential vulnerabilities to fraud, if applicable?

- ***Corrective Action:*** **Are management responses to audit or review findings in this area reasonable, complete, and timely? Have corrective actions been effective?** Audits and reviews are only effective if corrective action is taken to remedy the weaknesses identified. As such, there should be a reasonable, complete, and timely management response to the audit or review report. Management commitments and agreements or any areas of disagreement should be documented in the report or in a separate memo or tracking system. (IIA Standards 2500 and 2600) If corrective actions are not resolving the issues or concerns in a timely manner, examiners should further investigate the reasons. For example, this could indicate the audit or review did not sufficiently identify the underlying causes or materiality of weaknesses, sufficient resources are not being directed toward corrective actions, or weaknesses exist in the institution's corrective action process, including board oversight of the process.

## Examination Procedures and Guidance

### Performance Management

***1. Job Descriptions:***

Evaluate job descriptions to ensure authority, responsibility, and required technical skills are clearly defined and maintained.

Guidance:

Job descriptions are documents that help identify each job's purpose, where that job fits into the organizational structure, and the job's primary accountabilities, responsibilities, and tasks. They help employees understand their roles, and provide a basis for outlining performance expectations, job training, and performance evaluations. The process of creating job descriptions helps management determine how critical each job is, how the job relates to others, and the characteristics needed by a new employee filling the role. They can also help in establishing compensation programs and levels. Institutions may outsource to gain expertise and help develop job descriptions. Even when these processes are outsourced, the responsibility for effective job descriptions remains with the board and management.

Evaluative questions and items to consider when examining job descriptions include:

- ***Processes and Controls:*** **Are there sufficient processes and controls in place pertaining to job descriptions?** The board should provide general expectations and guidance to management on developing and maintaining job descriptions. The board is also specifically responsible for the CEO and, if applicable, chief audit executive (CAE) job descriptions. Management should develop procedures and processes for reviewing, approving, implementing, changing, and maintaining job descriptions.

- ***Knowledge, Skills, and Abilities (KSAs)*: Do job descriptions sufficiently outline the KSAs required for each position?** Job descriptions should provide details about the technical and educational requirements that may be critical or desired in a position. The work environment may also be described to the extent it may affect job duty performance (e.g., travel requirements, ability to work effectively on a team). There should be a direct link between the KSAs in the job description and the performance standards used in the performance evaluation process.

- ***Roles and Responsibilities*: Do job descriptions adequately reflect the roles and responsibilities of each position?** Job descriptions should typically identify the relationships, roles, and responsibilities within the organization, including supervisory, subordinate, and other working relationships. Enough detail should be provided so job duties are clear, which may include the percentage of time spent performing each job function. Job descriptions may also include a salary grade or range. These items help employees better understand how their duties fit into the overall organizational structure.

- ***Security Roles:* Do job descriptions sufficiently document security roles and responsibilities?** Employees should know, understand, and be held accountable for fulfilling their security responsibilities. Job descriptions should specify any additional security responsibilities beyond the institution's general policies. In addition, job descriptions for security personnel should describe the systems and processes they will protect and the control processes for which they are responsible. For additional information, refer to the following booklets in the Federal Financial Institutions Examination Council's IT Examination Handbook: Information Security and Management.

- ***Maintenance:* Are job descriptions up to date with the current organization structure and duty assignments?** Job descriptions should be revised as needed to stay consistent with current duties. Changes in management structure or other reorganization could result in changes to responsibilities and authorities that should be reflected in updated job descriptions.

### *2. Performance Standards & Evaluations:*

Determine if performance standards and evaluations are effectively used to manage staff performance and accomplish business goals.

Guidance:

Management is responsible for defining the organization's functions and responsibilities and allocating them to individual units and staff. Performance standards and evaluations are tools that help ensure these functions and responsibilities are being performed effectively. Performance standards and evaluations provide a way to hold employees accountable for expected results while also providing input for the organizational planning process. Institutions may outsource to gain expertise and provide performance management systems. Even when these processes are outsourced, the responsibility for effective performance standards and evaluations remains with the board and management.

Evaluative questions and items to consider when examining performance standards and evaluation processes include:

- ***Performance Standards:*** **Does the institution have effective processes and controls for using performance standards?** Institutions should have procedures or processes for developing and using performance standards as part of the human resource management system. This should include ensuring performance standards are consistent with job position requirements and the institution's overall goals and objectives. For example, if a goal is to improve credit quality and credit administration, loan officer performance standards should be consistent with that goal and not strictly based on originating new loans. Performance standards should also address adherence to policies, procedures, and other controls. Ideally, processes and controls should ensure performance standards are objective, measurable, realistic, formally documented, and agreed to by both the supervisor and employee.

- ***Performance Evaluations:*** **Does the performance evaluation process include appropriate elements to help ensure effective employee performance?** Institutions should have procedures or processes that govern the employee performance evaluation process. An effective process would typically include a face-to-face appraisal session at least annually between the supervisor and employee, a documented performance evaluation, and a second-level review of the evaluation. The appraisal session and evaluation should focus on agreed-upon goals and performance standards and the extent to which they were met. Management should explore reasons for deviation from performance standards to identify causes and potential corrective actions. Management should document weak performance and resulting corrective action plans to improve employee performance and support termination decisions, when necessary; however, the general focus of the performance evaluation process should be constructive. Individual performance evaluations should reflect established processes and be a tool for accomplishing the desired performance results. Second-level review of evaluations by a higher-level supervisor or someone from human resources is a sound practice to help ensure evaluations are appropriate and comply with institution policies and procedures. *Note: Individual performance evaluations are confidential, and examiners must ensure that specific information is safeguarded.*

- ***Board Responsibilities – CEO:*** **Does the board effectively administer performance standards and evaluation processes for the CEO?** The board is responsible for establishing CEO performance standards and evaluating the CEO's performance. These processes should help the board ensure the CEO and management are carrying out the institution's mission, goals, and plans. The Director's Role, pages 29-30, provides additional guidance for board consideration.

- ***Board Responsibilities – Chief Audit Executive (CAE):*** **Does the board effectively administer performance standards and evaluation processes for the CAE?** The board is responsible for the CAE's performance standards and evaluation. While management can assist with administrative aspects of this process, the board needs to retain responsibility and control to help ensure audit and review staff independence and objectivity are not susceptible to undue management influence.

- ***Using Performance Standards and Evaluations:*** **Are performance standards and evaluations effectively used in organizational planning and human resource management decisions?** Performance standards and evaluations can provide valuable input into organizational planning and human resource management decisions, such as the following:

- Evaluating organizational structure and how functions and responsibilities are aligned.
- Identifying employee potential as part of the succession planning and internal staffing and development processes.
- Providing feedback and recognition to stimulate performance and improve employee morale.
- Identifying weaknesses to be addressed by training, reassignment, or termination.
- Providing input to managers in determining salary programs and compensation increases.
- Evaluating the effectiveness of human resource management practices in achieving business objectives.

***3. Training & Development:***

Review the adequacy of training and development programs.

Guidance:

The goal of training and development programs is to help employees develop and maintain the skills needed to perform their jobs effectively. These programs are also important for helping employees acquire skills for advancement into other positions. Management should have processes in place to identify training needs, such as needs assessments, individual development planning, and an effective performance evaluation process. Management should also consider using a combination of training types, such as on-the-job developmental assignments, e-learning, in-house training programs, or formal external courses. Regardless of the type, management should ensure the training provided is effective by obtaining feedback from training participants. While training and development activities are incorporated throughout the Examination Manual, this procedure focuses on the overall administration of these programs.

Evaluative questions and items to consider when examining training and development programs include:

- ***Processes and Controls:*** **Are sufficient processes and controls in place for administering effective training and development programs?** The board should provide general expectations and guidance to management on administering and maintaining training and development programs. Management should develop procedures and processes for reviewing, approving, implementing, changing, and maintaining training programs consistent with the board's strategic goals related to human capital management. Management should track the performance of training and development programs in meeting those goals. Processes should also include a mechanism for obtaining trainee reactions and evaluations on the content and usefulness of training experiences.
- ***Pertinent to Job Duties:*** **Is training received by employees pertinent to their jobs?** Effective training conveys relevant and timely information that informs participants and develops skills and behaviors that can be transferred back to the workplace. Training and development programs should involve using development plans to identify training that will

best develop and improve staff skills. Ongoing training should be provided to help employees understand their job duties, the related control structures in place, and their obligation to ensure control requirements are met. Employees should have the opportunity and ability to apply the training knowledge to their job situation. The effectiveness and results of the training should then be determined through on-the-job experience and a performance evaluation.

- ***Improve Job Performance:*** **Do training and development programs sufficiently address job performance enhancements and areas of deficiencies?** Training can enhance job performance and address identified deficiencies. Management should use tools and processes such as performance evaluations and audit results to identify performance deficiencies that may be corrected by training. This may involve employee-specific needs or items that affect a group of staff. As discussed in the FCA Informational Memorandum on Confronting the Increased Risk Environment dated July 2, 2009, institutions may need to focus training on developing the skills needed in an increased risk environment. Regulatory changes are another area that could contribute to the need for timely staff training to ensure compliance with new or revised requirements.
- ***Fill Future Needs:*** **Do training and development programs fulfill the development needs of employees as identified in the human resources plan or forecast?** Management should use the human resource plan or forecast to determine the number of employees and skill level needed to meet the organization's goals. The training needs assessment process should identify the gap between current and needed skills and should be used to determine the training and advancement potential of employees. Management should ensure the human resource plan also sufficiently addresses training needs. Training and development programs should then implement this plan by ensuring employees receive the training and development to fill future organizational needs. By developing and promoting existing employees, the institution may lessen the need to fill future positions through outside recruitment.

## Examination Procedures and Guidance

### Compensation & Benefits

#### *1. Compensation Committee:*

Evaluate the structure, operations, and effectiveness of the Compensation Committee in overseeing compensation programs.

Guidance:

FCA regulations require banks, associations, and the Federal Farm Credit Banks Funding Corporation (Funding Corporation) to establish and maintain compensation committees. As discussed in the *Compensation Committee* subsection of The Director's Role, the committee's purpose is to ensure that compensation policies, procedures, and plans encourage improved or continued performance, while not jeopardizing key business and capital plan goals and objectives. The committee helps to ensure compensation and benefit packages are aligned with prudent risk taking and do not provide excessive benefits that may negatively impact financial performance. Note: A board committee performing the duties of the Compensation Committee, with a charter that satisfies committee requirements, may fill the role of a Compensation Committee even if it is not called a Compensation Committee. Refer to question 58 in the *Compensation Committees* section of FCA's [FAQs About Governance Changes in 2006] for details.

Examiners should review documents such as the committee charter, meeting minutes, policies, and procedures to gain an understanding of the committee's membership, responsibilities, and how it executes its duties. After reviewing these documents, examiners should consider meeting with the committee chair to gain additional insights into committee responsibilities, processes, and engagement.

Evaluative questions and items to consider when examining Compensation Committee structure, operations, and effectiveness include:

- ***Charter and Guidance:* Does the committee charter meet regulatory requirements? Are procedures and other guidance sufficient to carry out committee operations?** A formal charter helps to define the committee's duties and responsibilities. It also serves to remind committee members of their responsibilities and familiarize new committee members with them. FCA Regulation 620.31 requires each bank and association to establish and maintain a Compensation Committee by adopting a written charter describing the committee's composition, authorities, and responsibilities. FCA Regulation 630.6(b)(1) identifies similar requirements for the Funding Corporation. In addition, FCA Bookletter BL-060 provides guidance on committee charters and identifies the expectation for written procedures on committee operations. In addition to items already covered above, the following are items to consider when evaluating the charter, procedures, and other guidance:
  - The charter or other written guidance should address items such as maintaining meeting records, having resources available to perform committee duties, reporting only to the board, providing training, communicating with management and others, and completing a committee self-evaluation.
  - As noted in FCA Bookletter BL-060, the committee needs to review the compensation disclosures in the annual report to shareholders to ensure they comply with regulations and are transparent. The charter or other written guidance should address this and any other responsibilities being delegated by the board, such as engaging and overseeing consultants, approving benefit programs, and engaging in other human resource matters.
  - As a sound business practice, after approving the original charter, the board should review it annually and update it, as warranted.
- ***Membership:* Does committee membership comply with regulatory requirements? Do members have the knowledge and skills to serve on the committee effectively?** FCA Regulation 620.31(a) identifies specific membership criteria for composition and independence (FCA Regulation 630.6(b)(2) for the Funding Corporation). FCA Bookletter BL-060 provides elaborative guidance on these elements. In addition to examining compliance with these requirements, examiners should evaluate whether committee members demonstrate the necessary knowledge and skills to carry out the committee's responsibilities effectively. This includes any additional board-delegated responsibilities.
- ***Effectiveness:* Does the committee carry out its duties effectively and in compliance with its charter, procedures, and regulatory requirements?** A committee could comply with its charter, procedures, and regulatory guidance but not effectively perform its governance

duties and responsibilities on behalf of the board. The following are items to consider when evaluating committee effectiveness:

- The committee questions and challenges management and consultants regarding issues and related recommendations under the committee's purview to ensure appropriate due diligence is completed.

- Committee size can impact effectiveness. The number of committee members should be appropriate for the institution's complexity and risk profile. A committee comprised of the full board may not devote sufficient time to reviewing materials thoroughly. A larger group may also hinder or impair individual members from asking sufficient questions. This could also apply if committee meetings have numerous management and staff in attendance.

- Documentation in board or committee materials should be sufficient to evidence committee engagement and effectiveness. This would include meeting minutes and information reviewed by the committee, such as current staff compensation amounts, market research, or analyses prepared by consultants.

- The committee completes self-evaluations (either separate or as part of the overall board evaluation process) that provide insight into the committee's strengths and weaknesses, developmental needs, and potential changes to membership.

- The committee is provided quality training both for new members and ongoing training for existing members. Training can be from various sources (e.g., consultant, conferences, management) but should be relevant to the committee's needs (e.g., succession planning, compensation and benefit programs).

- The committee undergoes an appropriate level of turnover in membership. A committee with limited turnover could be missing out on new or different perspectives from other board members. However, high turnover could hinder the committee's ability to be effective due to lack of consistency and experience on the committee.

- ***Policy and Plan Review and Approval:* Does the committee review the compensation policies and plans for senior officers and employees? Does it approve the overall compensation program for senior officers?** These committee responsibilities are identified in FCA Regulation 620.31(b) (FCA Regulation 630.6(b)(2) for the Funding Corporation). The regulations also identify specific determinations the committee must make and document in carrying out these responsibilities. To carry out its responsibilities effectively, the committee should stay abreast of significant changes in compensation plan mechanisms, as well as marketplace practices and regulatory developments. The committee should also address any other responsibilities delegated by the board that relate to review and approval of compensation policies and plans. For example, the board would be responsible for establishing specific compensation levels for the CEO and the chief audit executive (if applicable), and could delegate this responsibility to the committee.

- ***Additional Responsibilities:* If the board delegated other responsibilities to the committee, has the committee carried them out effectively?** Examiners should evaluate whether the committee has effectively carried out all other significant board-delegated governance responsibilities. As noted above, additional responsibilities beyond those required by FCA regulations should be outlined in the committee charter or other written guidance.

Refer to FCA's *Compensation Committee* workpaper (see Part 3 of the Examination Manual) for more detailed guidance on examining the committee charter, membership, and activities.

***2. Board Compensation:***

Evaluate board compensation practices and levels for appropriateness and compliance with regulatory guidance.

Guidance:

Institutions should recognize the responsibility, expertise, and time commitment required from board directors through appropriate compensation. Directors are held ultimately responsible for the institution's safety and soundness and public mission role, so it is important that they be compensated for carrying out their fiduciary duties and responsibilities. Appropriate compensation is also critical in helping attract qualified individuals to serve as directors.

Evaluative questions and items to consider when examining board compensation include:

- ***Compensation Methodology:* Is the method for compensating directors appropriate, reasonable, and adequately documented?** The methodology should be based on studies, comparisons to other System or non-System lending institutions, professional opinions, or other means that consider factors such as fiduciary duties and responsibilities, expertise, and meeting attendance. The methodology should be incorporated into a board-approved document, such as a policy or compensation plan.

- ***Compensation Amount:* Are director compensation levels reasonable and sufficient to attract and retain qualified directors?** Compensation should be reasonable relative to the time and other contributions necessary to fulfill a director's fiduciary duties. The following are additional considerations when evaluating director compensation amounts:

    - As a sound business practice, institutions should occasionally complete compensation assessments. Doing so helps ensure the institution attracts the best talent and is appropriately compensating those positions. The compensation assessment should be linked to the self-evaluation process and allow for board input.

    - As noted in question 46 in the *Compensation Disclosures* section of FCA's FAQs About Governance Changes in 2006, directors serving on board committees or as a financial expert may receive a higher compensation level. Nothing in FCA's rules prohibits directors who provide services beyond that of a regular board member from receiving a different level of compensation. This flexibility can be used to help attract specialized expertise or talent needed by a board.

    - While attracting the right people to the board is most important, excessive director compensation should be avoided as it negatively impacts profitability and exposes the institution to reputation risk.

- ***Policy on Travel, Subsistence, and Other Related Expenses:* Are compensation for travel, subsistence, and other related expenses sufficiently addressed in board policy?** Directors (and senior officers) may be reimbursed for reasonable travel, subsistence, and other related expenses. Institutions need to adopt a board policy on these reimbursements in accordance with FCA Regulation 620.6(d)(1), and must make that policy available to shareholders upon request.

- ***Board Policy (Banks Only):* Is the policy on bank director compensation adequate and in compliance with regulations?** Bank boards must adopt a policy on director compensation that complies with FCA Regulation 611.400(d) and (e). FCA Regulation 611.400(a) authorizes banks to pay fair and reasonable compensation to directors for services performed in an official capacity. While there are no regulatory limits, examiners should examine bank director compensation to ensure pay levels do not adversely affect the bank's safety and soundness.

FCA Regulation 620.6(b) requires institutions to disclose information on director compensation arrangements, as well as details on actual compensation amounts, in the annual report to shareholders. These disclosures are examined as part of the *Financial & Shareholder Reporting* Examination Manual topic.

### *3. Employee Compensation:*

Evaluate employee compensation practices and levels for appropriateness and compliance with regulatory guidance.

Guidance:

Institutions will typically have multiple compensation programs. For example, the CEO, management team, other employees, or specific groups of employees may have unique compensation and incentive programs tailored to their specific roles. The purpose of such programs is primarily to incent and reward success, as well as retain outstanding talent.

Some organizations pay higher-than-average salaries to attract the best talent, some pay the going rate for similar positions elsewhere, while others pay somewhat below market to control expenses. The ratio between base salaries and incentive compensation can also vary significantly. There can be merit to any of these approaches based on an institution's workforce quality and needs. However, it is important to also be mindful of the current business environment or potential reputation risk. The board, through the Compensation Committee, should be diligent and prudent in its decisions regarding compensation and benefit programs and related costs, and support compensation decisions with appropriate analysis and documentation. Improperly structured compensation programs can lead to unsafe and unsound practices and impact the institution's ability to carry out its mission successfully. Also, the inability to provide sufficient compensation to attract or retain talented staff may indicate a business model weakness that results in insufficient earnings capacity to support overhead expenses and achieve profitability goals. Institutions may outsource to gain expertise and aide in employee compensation programs. Even when these processes are outsourced, the responsibility for effective employee compensation remains with the board and management.

Note: FCA Regulation 620.6(c) requires disclosure of compensation, retirement, incentive, and performance plan descriptions, as well as compensation amounts, for the CEO and senior officer group in the annual report to shareholders. Compliance with these disclosure requirements is examined as part of the *Financial & Shareholder Reporting* Examination Manual topic, but examiners should consider the reported information when examining these plans as part of completing this *Employee Compensation* procedure.

Evaluative questions and items to consider when examining employee compensation practices and levels include:

- ***Board Direction:* Does the board provide sufficient direction on compensation?** Board direction would typically be in the form of a policy, but could be provided through other means. It should clearly and effectively communicate the board's philosophy and expectations. The board should also ensure that compensation programs are managed in accordance with sound business practices. Generally, sound business practices dictate that compensation programs attract and retain individuals qualified for the responsibilities of each job position, and reward those that meet or exceed performance criteria. FCA's Informational Memorandum on Executive Compensation and Benefits Programs dated February 23, 2009, provides guidance to boards on governance practices in overseeing and monitoring executive compensation programs. Also, the *Compensation Committee* procedure focuses on the board's role in overseeing compensation program policies and plans.

- ***Salary Structure:* Is the process for establishing the salary structure reasonable and appropriate?** The salary structure should reflect the relative value of each position to the institution and be consistent with job descriptions and requirements. The following are some considerations when evaluating the process for establishing the salary structure:

  - Institutions should determine each position's value relative to other positions when identifying salary structure. Institutions can accomplish this in different ways, such as using consulting firms, a personnel committee, or a panel of experts. Any of these approaches may be appropriate if it results in internal equity and any differences in grades or salary ranges being linked to differences in position requirements.

  - When setting salary ranges for each grade level or position, organizations generally use salary surveys to compare their compensation rates to similar positions (benchmark positions) in comparable organizations. Salary surveys may be published on a national, regional, or local basis. The geographical base that best corresponds to the institution's labor market should generally be used. For example, local surveys typically are appropriate for most nonexempt positions, regional surveys for many specialty and professional occupations, and national surveys for senior executive positions. Benchmark comparisons allow institutions to ensure the salary scale for each position is competitively priced in accordance with jobs of comparable responsibility and complexity in other institutions with similar size, functions, and operations.

  - An institution's salary structure may include many or few grade levels, wide or narrow salary ranges, and steep or flat progression between the ranges. There are no set standards, but the structure should result in grades and salary ranges being assigned to positions based on the job's worth. Finally, salary structures should be kept current and adaptable to changing economic and organizational needs.

- When examining individual salary levels, examiners should focus on reasonableness of salary amounts and whether they are sufficiently supported, with an emphasis on CEO and senior management salaries. For banks, Section 5.19(a) of the Act requires examiners to analyze CEO compensation and bank employee salary scales during each examination cycle.

- ***Salary Administration:*** **Is the methodology for determining periodic salary range adjustments appropriate? Is performance a key factor in individual salary adjustments?** Typically, institutions will review salary ranges and levels annually and adjust them as needed. Periodic adjustments to salary ranges should be supported with studies that substantiate the basis for the change. Such studies should demonstrate independence from executive management and be fully supported by current data from the competitive marketplace. Progression of individual staff within the ranges should typically be determined by performance. Institutions should make full use of the salary ranges when identifying staff salary levels. Procedures should document the process for making salary adjustments.

- ***Incentive Compensation Programs:*** **Are incentive programs reasonable and appropriately administered? Do they encourage the performance needed to accomplish institution goals and objectives, while not contributing to excessive or inappropriate risk-taking?** In addition to the base salary structure, institutions may adopt incentive compensation programs to encourage improved or continued performance and the accomplishment of strategic goals and objectives. The nature and design of these programs can vary widely. The following are some considerations when evaluating these programs:

  - Incentive programs should be multi-faceted and linked to the goals and objectives that are important to the institution's long-term success, not just increased volume. These arrangements should provide employees incentives that appropriately balance risks and rewards in a manner that does not encourage imprudent risk taking. Likewise, it is usually not desirable to design a program that rewards employees for achieving a single goal or objective as this may inappropriately de-emphasize other areas that are important for long-term success. For example, incentive compensation for the CEO should be based on the institution's and CEO's aggregate achievements rather than a specific goal or accomplishment. For lending staff, loan volume growth should be balanced with achieving sound credit quality and satisfactory credit administration. For internal audit and review staff, the board or Compensation Committee should address potential independence and objectivity issues when setting incentive compensation criteria that may be influenced by audit and review results. In all cases, it is important that institutions be aware of, and take actions to control, potential conflicts of interest that are created by incentive payments. Note: FCA Regulation 618.8040(b)(6) outlines specific limits on incentive compensation related to insurance sales. See the *Related Services* procedure in the *Mission Compliance* Examination Manual topic for examining compliance with this regulation.

  - Incentive programs should be subject to board and management judgment, with a clearly documented board option to override the existing plan or proposed compensation levels on both an individual and program-wide basis. Circumstances leading to an override may include poor individual performance, conduct issues, weak financial metrics, internal audit concerns, or other well-documented rationale. For example, an individual or group may be entitled to a payment based on institution performance, but one of these other circumstances exist that warrants an override or reduction of that payment. The board should ensure that incentive plan documentation allows for this type of discretion on incentive payments, including whether they are disbursed, to whom, and at what monetary value.

  - Incentive programs should be easily understood yet challenging for the participants. Employees should be able to understand performance expectations and have clear criteria on how payouts are tied to fulfilling those expectations. In addition, the percentage of incentive compensation as compared to base salary levels should be reasonable and consistent with the institution's compensation program philosophy. Note: FCA Financial Institution Rating System (FIRS) ratings should not be used as incentive payout criteria. FCA FIRS ratings are confidential and not to be shared with employees.

  - Since these programs may also increase total compensation expenses, institutions should carefully weigh the cost-benefit of such programs and the potential impact on financial results. Importantly, they should not maximize short-term growth or performance at the expense of long-term growth or performance. Incentive plan funding should be derived from the increased revenue produced by accomplishing goals and objectives. The incentive program should also be dynamic in nature to reflect changes in the institution's internal and external environments.

  - When examining incentive program payouts, examiners should evaluate them for reasonableness and compliance with the institution's incentive program criteria, with an emphasis on CEO and senior management payouts.

- ***Incentive Compensation Controls and Monitoring:*** **Are internal controls sufficient to ensure incentive programs are effectively implemented and performance measurement is accurate? Is monitoring and reporting sufficient?** Institutions should have procedures and other controls governing the design, implementation, monitoring, and reporting of incentive compensation arrangements. This should include sufficient systems and controls, along with periodic audits and reviews, to ensure compliance with policies and procedures, accurate measurement of performance against incentive program criteria, and correct payout calculations. Institutions should monitor the performance of their incentive compensation arrangements and revise them, as needed, if payments do not accomplish desired results or contribute to undue risk exposure. Controls should also be sufficient to avoid potential conflicts of interest, fraud, or other situations where employees may inappropriately influence or misrepresent the criteria or results used in determining incentive payouts.

Refer to the following documents for additional criteria, guidance, and information on evaluating employee compensation programs:

- FCA Regulation 620.31(b) – Identifies higher-level compensation program issues for Compensation Committees to address.

- FCA Bookletter BL-060 – Lists key factors related to compensation programs that Compensation Committees should consider.

- The *Compensation* section of The Director's Role – Lists several guidelines for effective compensation programs.

- Guidance on Sound Incentive Compensation Policies – An interagency statement issued by several federal regulatory agencies that provides guidance on evaluating financial institution incentive compensation programs.

***4. Benefit & Retirement Programs:***

Evaluate the administration and reasonableness of employee benefit programs, including retirement plans.

Guidance:

Employee benefits share many characteristics of salary and incentive programs. Benefits provide supplemental support to employees in the form of programs that promote recruitment, retention, health, well-being, and retirement. Examples of common benefits include:

- Retirement pension and savings plans
- Insurance programs (health, life, short-term and long-term disability)
- Leave (annual, sick, administrative)
- Relocation expenses
- Executive perquisites (memberships, special subscriptions, car or travel allowance)
- Automobiles
- Parking
- Fitness and wellness programs

Institutions may outsource to gain expertise and aide in benefit and retirement programs. Even when these programs are outsourced, the responsibility for effective benefit and retirement programs remains with the board and management.

Note: FCA Regulation 620.6(c) requires disclosure of compensation, retirement, incentive, and performance plan descriptions, as well as compensation amounts, for the CEO and senior officer group in the annual report to shareholders. Compliance with these disclosure requirements is examined as part of the *Financial & Shareholder Reporting* Examination Manual topic, but examiners should consider the reported information when examining these plans as part of completing this *Benefit & Retirement Programs* procedure.

Evaluative questions and items to consider when examining benefit and retirement programs include:

- ***Board Direction:*** **Does the board provide sufficient direction on benefit and retirement programs?** Successful benefit and retirement programs begin with a board policy statement addressing how such programs will be used to attract and retain talent and meet the institution's perceived obligations to employees. This direction would typically be in the form of a board policy, but could be provided through other means. While we have no formal requirements for content, effective direction should clearly and effectively communicate the board's philosophy and expectations. For example, the policy should address obligations to staff concerning areas such as life insurance and survivor benefits, sick leave, short- and long-term disability, vacation, and retirement. The board should look at benefit and retirement programs holistically to ensure they conform to organizational philosophy and objectives, receive adequate consideration before being implemented, avoid gaps or overlaps in coverage, and consider the total costs to the organization. FCA's Informational Memorandum on Executive Compensation and Benefits Programs dated February 23, 2009, provides guidance to boards on governance practices in overseeing and monitoring executive compensation and benefit programs. Also, the *Compensation Committee* procedure focuses on the board's role in overseeing compensation and benefit programs.

- ***Program Administration and Controls:*** **Are employee benefit and retirement programs appropriately administered and controlled?** The institution should have sufficient procedures and guidance on these programs available to staff, and controls to monitor and report program implementation, costs, and effectiveness. This would include periodic audits and reviews to ensure compliance with policies and procedures. The board and management should implement an appropriate control system to manage the risk arising from benefit and retirement plans and monitor the impact to earnings.

- ***Pension Expense:*** **Is the potential impact of pension expense on earnings and reputation risk sufficiently addressed?** Institutions may participate in district-wide pension plans or their own independent plans and will incur expenses to fund the plans. For district-wide plans, each institution incurs pension expense equal to their share of the overall district expense. For independent plans, the institution incurs the entire expense. Such expenses must be sufficient to build and maintain the funded status of the plan at an adequate level. Pension expenses directly impact the institution's net income and return on assets. If funded status is not maintained at an adequate level, the plan could become nonviable, pose reputation risk to the institution, and increase risk to future earnings as larger pension expenses will be necessary to improve funded status. The funded status of pension plans should be monitored to understand potential impact on pension expenses. Monitoring should also include changes in plan governance and asset management strategies, which affect funded status.

- ***Supplemental Executive Retirement Plan (SERP):*** **If the institution has a SERP, do the board and management effectively manage the program?** A SERP is an unqualified pension plan used for certain employees with high salaries (above and beyond what is covered in a qualified plan). The institution should have a policy or other guidance that governs the program, defines who qualifies, and guides the investment strategy to enable the institution to appropriately administer the fund while managing the impact on earnings.

Refer to the following documents for additional criteria, guidance, and information on evaluating employee benefit programs:

- FCA Regulation 620.31(b) – Identifies higher-level compensation program issues for Compensation Committees to address.

- FCA Bookletter BL-060 – Lists key factors related to compensation and benefit programs that Compensation Committees should consider.

- FCA's Informational Memorandum on Executive Compensation and Benefits Programs dated February 23, 2009, informs institutions of the importance of fully quantifying and understanding both the near-term and long-term expenses, financial consequences, and reputation risk associated with the entirety of the executive compensation and benefit program.

The following provides additional guidance that is specific to examining district-wide qualified pension plans:

- ***Defined Benefit Plans:*** **Is the district-wide defined benefit plan appropriately managed? Is the pension obligation adequately funded?** Districts that offer a defined benefit plan should ensure an appropriate investment plan that holds sufficient investments to fund the pension obligation. District committees typically manage the pension fund, with one committee advocating for employees and the other managing the plan assets. The committees receive funding statements from the actuary which define the funded status of the plan as well as any changes in actuarial assumptions. Generally, a funded status of 90 to 100 percent is preferable, but 80 percent or better is acceptable. If the funding status falls below 80 percent, the district should have a plan to achieve fully-funded status. The following are additional considerations:
    - Pension assets are invested in a trust fund and are subject to market fluctuations. Like other investments, the committees managing the district fund should regularly monitor the portfolio for material deterioration and make adjustments as necessary.
    - FCA Bookletter BL-060 states that compensation committees should fully understand key assumptions used to calculate compensation and pension plan obligations, such as assumptions used for present value calculations, as well as the sensitivity of the institution's financial exposure to such assumptions.
- ***Pension Information:*** **Is pension information provided to district institutions accurate, timely, and relevant?** Pension plan governance requires information be distributed timely to participants. Institutions should be notified of any projected changes to their pension expense prior to completing annual report disclosures and business plans to ensure accurate financial statements and disclosures.