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Financial Regulators Reveal Impending Restrictions on Incentive Compensation for Bank Officers

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AUTHORED ARTICLE | Spring 2016

Published in the Spring 2016 issue of *The Bankers' Statement*

As the longest awaited sequel in years, financial regulators have finally revealed their revised interagency proposal to restrict incentive-based compensation arrangements for executives at financial institutions. In 2010, the Dodd-Frank Act obligated six agencies, including the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Officer of the Comptroller of the Currency, the Securities and Exchange Commission, the National Credit Union Administration and the Federal Housing Finance Agency, to establish rules prohibiting incentive-based compensation arrangements that would encourage inappropriate risk-taking. Dodd-Frank also prescribed certain disclosure, recordkeeping and governance obligations for the incentive-based compensation programs maintained by the covered institutions.

After issuing an initial proposal in 2011, the regulators took the next five years to re-design their proposal in response to public comments and the recent developments in executive compensation. The newest proposal targets its restrictions on incentive-based compensation at the largest institutions and expands the scope of covered employees. On April 21, 2016, the National Credit Union Administration was the first agency to approve the new proposed rules. Approval from the five remaining agencies will likely follow in future weeks. All financial institutions, even those not subject to the proposed rules, will want to watch these new developments closely as they will likely shape the future of incentive-based compensation in the industry.

Application of the Proposed Rules

The new proposal imposes three “tiers” of requirements based on a covered institution’s asset size. While institutions with less than \$1 billion in assets are exempt for now, those with \$1 billion or more are divided into the following levels—

- Level 1 – \$250 billion or more in assets

- Level 2 – \$50 billion to \$250 billion in assets
- Level 3 – \$1 billion to \$50 billion in assets

Level 1 institutions will experience the most onerous restrictions with the burden diminishing at each level.

In addition to covering compensation for senior executive officers, the revised proposal also covers the compensation of “significant risk-takers,” or those individuals whose incentive-based compensation constitutes at least one-third of their compensation and who (a) are among the top 5% (Level 1) or 2% (Level 2) highest compensated employees or (b) have the authority to commit or expose over 0.5% of their institution’s capital.

Proposal Highlights

Prohibiting Compensation That Encourages “Inappropriate Risk”

Applicable to all covered institutions, the proposal implements the requirements of Dodd-Frank by prohibiting incentive-based compensation arrangements that encourage “inappropriate risk” by providing excessive compensation or that could lead to material financial loss for the institution. Compensation will be deemed “excessive” if amounts paid are unreasonable or disproportionate to the value of services performed by the recipient. Even if not excessive, the rule considers incentive-based compensation to encourage inappropriate risks unless the arrangement strikes an appropriate balance between risk and reward, is compatible with effective risk management and controls, and is supported by effective governance. These requirements generally mandate that the institution adopt financial and non-financial performance measures, consider the current and future risks taken in achieving performance, require board oversight of incentive-based compensation arrangements, and tailor such arrangements appropriately to the institution and the covered person’s role.

Recordkeeping and Disclosure

The new proposal also requires all covered institutions to document annually the structure of incentive-based compensation arrangements and maintain these records for at least seven years. The level of detail for the required records increases for Level 1 and 2 institutions. While the previous proposal would have required annual reporting to the appropriate financial regulator, the new proposal only obligates the covered institutions to disclose these records upon request.

Deferral, Downward Adjustment and Forfeiture, and Clawback Requirements

To appropriately balance risk and reward, the new proposal requires incentive-based compensation arrangements at Level 1 and 2 institutions to contain provisions addressing deferral of payments, potential downward adjustment and forfeiture, and clawback requirements.

Deferral—Applicable to all covered employees, deferral rules provide that 40, 50, or 60 percent of incentive-based compensation awarded to covered persons must be deferred for a specified number of years, depending on the institution’s level, the covered employee’s classification, and the type of compensation (i. e., long-term or short-term incentive plans).

Downward Adjustment and Forfeiture—Downward adjustment provisions would require reduction in the amount of all incentive-based compensation yet to be awarded to a covered person for the current performance period. Forfeiture, on the other hand, would reduce the amount of deferred incentive-based compensation already awarded to a covered person that has yet to vest. Level 1 and 2 institutions must consider forfeiture or downward adjustment in the event of the covered person’s poor performance, such as significant deviation from risk policies and procedures resulting in poor financial performance, inappropriate risk-taking, material risk management failures, and non-compliance with legal standards.

Clawback—Clawback provisions would allow the institution to recover vested incentive-based compensation from a current or former employee for up to seven years if such employee engages in misconduct that results in significant financial or reputational harm to the institution, commits fraud, or intentionally misrepresents information used to determine such compensation.

Concluding Thoughts

As the remaining regulators approve their various versions of the new proposal, financial institutions will want to take note of any modifications made by their appropriate regulator. While the new proposal avoids imposing burdensome requirements on small institutions, mid-sized and large financial institutions may need to significantly modify their compensation structures going forward. Covered financial institutions will want to learn how to adapt their compensation packages to these new rules while still attracting and retaining knowledgeable, experienced executives. The compliance date for the proposed rule, if adopted, would not be until the first calendar quarter beginning 540 days after a final rule is published. Although this period provides some time to consider how to strike an appropriate balance, financial institutions should begin contemplating this new future of executive compensation.