BANKING & FINANCE

Incentive Compensation and Proposed Rules

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In the aftermath of the financial crisis, incentive compensation arrangements in the financial industry were closely examined. These practices are an important element in attracting and retaining staff and in helping build high performance organizations. Appropriately structured arrangements align the interests of employees with those of the employer and benefit both parties. Inappropriate arrangements can lead to a disconnect between employee and firm success, such as when employees take ill-considered long-term risks in order to gain short-term rewards. The employee and the firm may show immediate profit, but the risk can come back to haunt the firm's performance.

Evidence suggests that incentive compensation practices in the financial services industry did encourage inappropriate risk-taking, which contributed to the financial crisis. The balance between risk and reward for employees and the firms they worked for was misaligned.

In order to address this issue, the Board began a horizontal study of incentive compensation practices at the largest institutions in 2009. Interagency guidance was issued in June 2010. The guidance was based on three principles:

- incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk;
- these arrangements should be compatible with effective controls and risk management; and
- these arrangements should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

Dodd-Frank requirements

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act passed. Section 956 requires the agencies to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at financial institutions with $1 billion or more in total assets. The rules must prohibit all covered institutions from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk-taking by providing covered persons with excessive compensation, fees, or benefits or that could lead to material financial loss to the covered institution.

Proposed rules

The agencies first proposed a Dodd-Frank Incentive Compensation rule in April 2011; the proposed rule was based on the

interagency guidance released in 2010. Since then, incentive-based compensation practices have evolved, and the agencies have gained additional supervisory experience. In May 2016, a revised proposal that includes new, more specific and more stringent requirements, especially for the largest institutions, was released for comment. The proposed rule would apply to financial institutions with total assets of $1 billion or more (covered institutions). All covered institutions would be subject to general prohibitions on incentive-based compensation arrangements that could encourage inappropriate risk-taking by providing excessive compensation or that could lead to a material financial loss.

Requirements

The requirements are tailored based on assets, and covered institutions would be divided into three categories:

- Level 1: institutions with assets of $250 billion and above;
- Level 2: institutions with assets of $50 billion to $250 billion; and
- Level 3: institutions with assets of $1 billion to $50 billion.

Smaller covered institutions with assets between $1 and $50 billion (Level 3) would be required to maintain records documenting their incentive-based compensation arrangements and to ensure that those arrangements:

- appropriately balance risk and financial rewards,
- are compatible with effective risk management and controls, and
- are supported by effective governance.

Covered institutions with $50 billion or more in consolidated assets (Level 1 and Level 2) would be subject to mandatory deferral, forfeiture, and claw-back requirements. The mandatory deferral requirements for Level 1 covered institutions would be higher than for Level 2 covered institutions. Level 1 and Level 2 covered institutions would also be subject to more detailed and rigorous requirements for incentive-based compensation arrangements, risk management frameworks, governance, policies and procedures, and recordkeeping and disclosure requirements.

Definitions

Covered persons are defined as:

- executive officers, employees, directors and principal shareholders who receive incentive-based compensation, including the chief executive officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head of a major business line or control function.

Significant risk-takers are defined as:

- nonsenior executive officers among the top 5 percent (for organizations with more than $250 billion in consolidated assets) or top 2 percent (for organizations with between $50 and $250 billion in consolidated assets) of the most highly compensated covered persons in the entire consolidated organization, or
- an individual with authority to commit or expose 0.5 percent or more of the capital of a covered institution.

To prevent evasion of the proposed rule, individuals who have the authority to commit or expose 0.5 percent or more a covered institution's capital would be significant risk-takers even if they were employed by an affiliate of the covered institution, regardless of whether that affiliate was itself a covered institution (for example, an affiliate with less than $1 billion in consolidated assets). Agencies could designate additional individuals as significant risk-takers because of their ability to expose a covered institution to risks that could lead to material financial loss in relation to the covered institution's size, capital, or overall risk tolerance. Covered institutions could also designate additional individuals as significant risk-takers.

Excessive

Compensation, fees, and benefits will be considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into consideration all relevant factors, including:

- the combined value of all compensation, fees, or benefits;
- the compensation history of the covered person and other individuals with comparable expertise at the covered institution;
- the financial condition of the covered institution;
- compensation practices at comparable institutions;
- for postemployment benefits, the projected total cost and benefit to the covered institution; and
- any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered institution.

The comment period ended in July. The agencies are considering the comments received.

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