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Incentive-Based Compensation for the New Banking Environment

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With considerable fanfare, the FDIC has passed and then quickly announced its proposed rules implementing Section 936 of the Dodd-Frank legislation – even before the other regulatory agencies could put their own imprimatur on the jointly developed proposal. Clearly the FDIC wants to make this a branding opportunity. But enough of inside-the-beltway politics.

The proposal takes some interesting approaches to its subject. The aspect that has received the most media attention is the part that applies to the largest banks. For financial institutions with $50 billion or more in consolidated assets, the proposal would require that, for any executive employee who receives incentive-based compensation, at least half of that must be in a form that is paid at least three years after it is earned. The details of who is covered by this rule, and how the deferred portion may be affected by developments during the three-year period, are discussed below. It is a reasonably precise and objective rule.

Receiving less publicity in the immediate aftermath of the announcement is a set of rules, also part of the proposal, that applies to financial institutions as small as $1 billion in consolidated assets. The proposal has sweeping application in that it covers not only commercial banks and thrifts, but also

SEC-registered broker-dealers and investment advisers, government-sponsored entities (Fannie Mae, Freddie Mac, Federal Home Loan Banks) and credit unions.

Although less headline-grabbing, the more broadly applied rules likely present a far greater challenge because they call for a deep understanding of the risk profile of the financial institution and of each part of the financial institution. The financial institution must provide reports to its designated federal regulator about the way its incentive-based compensation programs work, for all of the covered employees. The report must demonstrate how it is that the incentives of each program do not encourage inappropriate risk-taking. The companies are being asked, in effect, to prove a negative.

In explaining how an incentive-based compensation system might be tweaked to reduce its tendency to encourage inappropriate risk-taking, the regulators have identified four types of adjustments:

- Develop a methodology for the managers to determine the risk sensitivity of the person's activities, and provide for an adjustment to the incentive compensation for the individual based on that analysis. The methodology could be quantitative or a judgment call.
- Defer the payment, and provide for adjustment in the amount of incentive compensation, based on how things turn out.
- Use longer performance periods for performance measurement.
- Use a formula for performance measures that underweights short-term performance and overweights longer-term performance.

The goal, says the proposal, is to achieve a better "balance" than existed in the past between the incentive to take risks, so as to achieve rewards for the company, and the incentive to avoid too much risk. What we find striking about this mandate is how relativistic it is. When regulators try to enforce the new regime, how will they be able to recognize the right (or wrong) amount of adjustment in the sensitivity of compensation to risk? The most we can expect is that the duty to explain these relationships in a periodic report to the regulator will sensitize managers to think deeply about the risks in their business models, and the incentives built into their compensation systems.

Besides motivating financial institutions to think about these relationships, though, the outcomes may impact determinations of safety and soundness, if regulators disagree with the institution's own assessment of its risk-reward balance. In this respect, the proposed regulations would give the regulators yet another tool for finding fault. Whether the tool will be used as intended, to curb "unbalanced" risk-taking, or will be applied with hindsight to trap the unlucky, remains to be seen.

Reporting and Plan Adjustments Required For financial institutions under $1 billion in consolidated assets, the new proposal would require no changes. For financial institutions with $1 billion or more in consolidated assets (which the proposal calls "Covered Financial Institutions"), the proposal:

- Prohibits any incentive-based compensation arrangement that encourages executive officers, employees, directors or principal shareholders ("Covered Persons") to expose the institution to inappropriate risks by providing the Covered Persons with excessive compensation;

- Prohibits establishment or maintenance of any incentive-based compensation arrangements for Covered Persons that encourage inappropriate risk-taking by the Covered Financial Institution that could lead to a material financial loss;

- Requires that the board of directors, or a committee of the board, approve all incentive-based compensation arrangements for Covered Persons and maintain documentation of this approval;

- Requires policies and procedures appropriate to the institution's size, complexity, and use of incentive-based compensation, to help ensure compliance with these requirements and prohibitions; and
- Requires annual reporting to federal regulators concerning incentive-based compensation arrangements for Covered Persons, containing both objective information about how the arrangements work and the specific reasons why they do not encourage inappropriate risk-taking.

Additional Plan Adjustments for Larger Institutions In addition to the requirements that apply to all Covered Financial Institutions, for financial institutions with $50 billion or more in consolidated assets, the proposal also:

- Requires deferral of at least 50% of the incentive-based compensation paid to "executive officers" for a period of at least three years;
- Requires that for these "executive officers" the deferred amounts be adjusted for actual losses or other measures or aspects or performance that are realized or become better known during the deferral period; and
- Requires the board of directors, or a committee of the board, to identify those Covered Persons who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance.

Timing and Opportunity for Comment The proposal will have a 45-day comment period after its publication in the *Federal Register*. That publication will not occur until after all of the relevant federal agencies have approved it. Therefore, it may be a while before the comment period begins. Moreover, it is not inconceivable that changes may be made before the other federal agencies act.

After the comment period, the federal agencies will consider the comments and will come up with a final rule. The proposal anticipates that the final rule (whatever it may contain) will become effective six months after publication of the final rule in the *Federal Register*. The informational reports will be due within 90 days of the end of each Covered Financial Institution's fiscal year, after that effective date.

During the comment period, the various federal agencies request comment on many subjects, including the timing for becoming effective. Although the comment period will not even open until publication of the proposed rule in the *Federal Register*, it is not too early to begin thinking about comments that should, in the view of affected companies and individuals, be made.

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