Bank Incentive Compensation:
Regulations on the Way?

By David Hirsch

Bank regulators are exploring ways to change how banks use incentive compensation to motivate their executives and other employees. Their actions reflect the perception, proven or not, that excesses in pay practices at a limited number of large institutions contributed significantly to the recent financial crisis.

The concern is that poorly designed incentive compensation programs can encourage banks to take on excessive risk at their institutions, with attendant financial and reputation damage. The Federal Reserve Board recently issued a proposed supervisory guidance relating to incentive compensation policies for bank employees.[1] Ostensibly opening the proposed guidance to public comment, the Federal Reserve commenced two supervisory initiatives intended to instigate the banking industry into developing and implementing sound incentive compensation practices. Similarly, the Federal Deposit Insurance Corporation (FDIC) issued a proposed rule that would decrease the risk-based assessment rates which banks would pay to the Federal Deposit Insurance fund if the bank's incentive compensation programs meet certain criteria.[2]

The first Federal Reserve initiative involves review of the incentive compensation practices at 28 large, complex banking organizations (LCBOs). Each LCBO is expected to provide documentation to the Federal Reserve describing the bank's current incentive compensation arrangements and its plans for improving these practices. The Federal Reserve will help tailor a unique incentive compensation plan appropriate for each LCBO. The lessons learned from this experience may

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result in guidance not only for LCBOs, but also for the rest of the industry.

The second Federal Reserve initiative involves reviewing the incentive compensation arrangements at non-LCBO banks during the Federal Reserve's regular risk-focused examination process. Smaller banks, which likely use incentive compensation in a more limited manner, may implement less extensive policies than LCBOs, but the Federal Reserve will take enforcement action against banks whose incentive compensation arrangements pose a risk to bank safety and soundness. This initiative applies only to those banks that are member banks of the Federal Reserve.

The Federal Reserve's proposed guidance identifies three principles of safe and sound incentive compensation arrangements: providing incentives that do not encourage excessive risk-taking beyond the bank's ability to identify and manage risk; compatibility with effective controls and risk management; and strong corporate governance.

The first principle relates to three general groups – executives, individual employees who can generate significant risk (certain traders), and employee groups who, in the aggregate, can generate significant risk (loan officers). Incentive compensation arrangements for these employees should balance risk and financial results. Amounts paid to an employee should take risk into account. The Federal Reserve wants to see lower incentive compensation for employees who generate larger risks for the organization, all else being equal. The proposed guidance suggests that "actual payments vary based on risks or risk outcomes."[3]

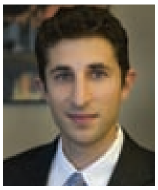
The proposed guidance offers four methods for managing risk in incentive compensation arrangements:

- Adjusting incentive compensation based on the risk the employee's activities pose to the bank;
- Deferring payment beyond the end of the performance period, and adjusting payments for actual losses or risk realizations;
- Extending performance periods; and
- Reducing the rate at which incentive compensation awards increase due to higher levels of performance.

The second and third principles involve ensuring that a bank's incentive compensation structure is compatible with and reinforced by the firm's risk management processes and corporate governance. Doing so involves the board (or a compensation committee) conducting documented, regular internal reviews to ensure that the processes for achieving balanced incentive compensation arrangements are being followed. For banks that are public companies, this process will be similar to the one recently mandated through SEC proxy disclosure rules (and similar, although less intensive, than the rule applying to institutions that accepted TARP/CPP funding). Risk-management personnel should play a role in designing incentive compensation arrangements. Incentive compensation for such risk-management employees should be based on the achievement of risk-adjusted performance or adherence to internal controls, rather than on the financial performance of certain business units.

The FDIC's proposed rule seeks to provide an incentive for banks to design incentive compensation systems that align employee performance with the long-term interests of the bank and its stakeholders. Banks featuring such systems will face lower risk-based assessment rates. Since this is a zero sum game, the implications for those banks that don't do this successfully will be higher premiums comparatively. While the FDIC's notice seeks comment on a range of techniques to lower incentive compensation risk, it suggests that restricted, non-discounted company stock which becomes available and vests over a multiple-year period and is subject to look-back mechanisms (such as claw-backs) would suffice, if the program is administered by a board committee of independent directors.

While these proposed rules are only the initial steps to direct regulation of incentive compensation arrangements at banks, they signal that bank regulators view incentive compensation as a significant source of bank and systemic risk. Although guidance has not been issued by the OCC or OTS to date, one can expect that they will weigh in with their expectations as well. Whatever form the final guidelines take, they will have to be considered by bank boards of directors, compensation committees and those who are involved with setting and explaining incentive compensation practices. Implementing the principles of these proposals will ensure that banks minimize the chance of regulator intervention or enforcement and will mitigate adverse deposit insurance premiums determinations. ◆



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Footnotes:
1 Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55,227 (proposed Oct. 27, 2009).
2 Incorporating Employee Compensation Criteria into the Risk Assessment System, 75 Fed. Reg. 2,823 (proposed Jan. 19, 2010).
3 Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. at 55,233