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New Rules for Incentive-Based Compensation

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In April, the OCC, Fed, FDIC, FHFA, NCUA, and SEC issued a proposed rule implementing Section 956 of the Dodd-Frank Act which sets restrictions on incentive-based compensation for banks. The goal of the new rule is to curb short term incentives and excessive risk.

The most onerous restrictions on incentive-based compensation apply to covered institutions with over $50 billion in consolidated assets. However, smaller institutions will still need to maintain, document, and enforce incentive-based compensation plans which reduce the risk of material financial loss to the institution.

Covered Institutions

The proposed rule would apply to covered institutions (including depository institutions, holding companies, and subsidiaries) that have incentive-based compensation plans and are in one of three levels:

- Level 1 ($250 billion in consolidated assets);
- Level 2 ($50 to $250 billion in consolidated assets and all Federal Home Loan Banks above $1 billion); and
- Level 3 ($1 to $50 billion in consolidated assets).

Under the rule, all covered institutions are prohibited from establishing or maintaining incentive-based compensation arrangements that encourage inappropriate risk by providing covered persons (executive officers, employees, directors, or principal shareholders) excessive compensation, fees, or benefits that could lead to material financial loss to the covered institution. Compensation is excessive if it is unreasonable or disproportionate to the value of the services performed by a covered person taking into account all relevant factors including the following:

- The combined value of all compensation, fees, or benefits provided to the covered person;
- 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 covered institutions, based upon such factors as asset size, geographic location, and the complexity of the covered institution's operations and assets;

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- For post-employment 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.

Incentive-based compensation policies could encourage inappropriate risks which could lead to material financial loss unless the policies (1) contain a balance of risk and reward; (2) are compatible with risk management and controls; and (3) are supported by effective governance. Such policies should not be closely tied to short term revenue or profit goals without adjustments for long term risks associated with achieving those goals. In an effort to make incentive-based compensation policies sensitive to risk, covered institutions may want to include in their policies deferral of payment of compensation, longer performance periods, and adjustments based on risky behavior, compliance deficiencies, or actual losses. Policies may also include non-financial measures of performance such as whether the covered person has followed or promoted sound risk management practices or provided leadership throughout their tenure.

Covered institutions will need to have effective management and control in place to make sure that the incentive-based compensation policies are effectively implemented and enforced without undue influence by covered persons. This would include maintaining strong and continued oversight by the board of directors of the covered institution. The board would need to (1) conduct oversight of the incentive-based compensation program; (2) approve incentive-based compensation arrangements for senior executive officers, including the amounts of all awards and payouts under such arrangements; and (3) approve any material exceptions or adjustments to incentive-based compensation policies or arrangements for senior executive officers. The board must ensure that senior management is held accountable for effectively implementing and monitoring the incentive-based compensation policies.

Covered financial institutions must also create and maintain annual records documenting the structure of incentives. The records must be held for seven years and demonstrate compliance of the rule. At a minimum, the records must have all incentive-based compensation plans, a list of who is subject to each plan, and a description of how the institution's incentive-based compensation program is compatible with effective risk management and controls. The proposed rule does not, however, require an institution to report the actual amount of compensation or other benefits an individual covered person receives. Institutions are not required to provide annual reports regarding their policies, but must make them available upon request. When a request is made, the institution should request confidential treatment from the requesting agency.

Level 1 and 2 Institutions

Level 1 and Level 2 institutions have additional rules including additional reporting and governance requirements, mandatory deferral of bonuses, restrictions on incentive plans, and downward adjustments, forfeitures or claw backs of incentives. However, regulators of Level 3 institutions that hold consolidated assets of $10 billion or more may apply the same rules regarding Level 1 and 2 institutions, if such Level 3 institutions operate with a high level of complexity, or have compensation arrangements which are consistent with Level 1 and Level 2 institutions.

Conclusion

While the focus and burden of the new incentive-based compensation rules are directed at Level 1 and Level 2 institutions, Level 3 institutions will still need to ensure that they have developed incentive-based compensation policies that are tailored to the size and complexity of the institution and account for the different risks posed by different covered persons. Further, their board of directors will need to closely monitor management to ensure that the institution's incentive-based compensation policies are being enforced and documented.