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Proposed Regulations on Incentive-Based Compensation Provide Guidance for All Financial Institutions

by Heather Archer

On February 7, 2011, federal banking and securities regulators published a notice of proposed rulemaking that sets forth standards on incentive compensation, as well as annual reporting requirements. While the proposal ostensibly applies only to "covered financial institutions," meaning those institutions with $1 billion or more in assets, the standards will be helpful for financial institutions of all sizes. Moreover, this "guidance" can be expected to trickle down to smaller community banks as examiners seek to apply the Interagency Guidance on Sound Incentive Compensation Policies ("Guidance") issued in June 2010.

The proposal echoes principles of the Guidance, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and compensation related safety and soundness standards of the Federal Deposit Insurance Act. Unlike those other pronouncements, however, the proposal puts much more meat on the bones as to what is expected.

Since the release of the Guidance and the Dodd-Frank Act, financial institutions have struggled with regulatory expectations regarding, and disclosure of, their incentive-based compensation programs, along with the governance mechanisms designed to provide that incentive-based compensation does not subject the institution to unnecessary risk or material financial loss. Regulators have begun paying more attention to overall compensation, as well as incentive-based compensation in recent regulatory examinations, administrative actions and in the context of pending regulatory applications. The proposed regulations apply the principles of the Guidance and the Dodd-Frank Act by three primary means: prohibitions of excessive compensation to "covered" persons or groups of covered persons, adoption of incentive-based compensation policies and procedures, and reporting requirements.

Prohibition of Excessive Compensation

The proposed regulations prohibit financial institutions from establishing incentive-based compensation arrangements that expose the institution to inappropriate risk through excessive compensation to covered persons or encouraging such covered persons to take inappropriate risk that may result

in a material financial loss to the institution. Key definitions include:

- **Covered person**: any executive officer, employee, director or principal shareholder of a covered financial institution. The definition applies to any employees of an institution, and it is specifically intended to apply when a group of covered persons, such as loan officers, could collectively cause a material financial loss to the institution.
- **Covered financial institution ("CFI")**: national banks, state member banks, state nonmember banks, bank holding companies, savings associations, credit unions, broker-dealers, and other institutions with assets of $1 billion or more, which asset size is generally determined based on the average of the institution's four most recent Call Reports or bank holding company financial statements.
- **Incentive-based compensation**: any variable compensation that serves as an incentive for performance, regardless of the form of payments (e.g. cash, stock options, other property), but not including salary or payments tied solely to continued employment or that do not vary based on performance metrics (e.g. contributions to a 401(k) plan).

There are two distinct elements for consideration: (1) "excessive compensation"[1] and (2) encouraging risks that would cause a material financial loss. Compensation is considered excessive when amounts paid are unreasonable or disproportionate to the amount, nature, quality, and scope of services performed by the covered person. Types of information the regulatory agencies will consider in making this assessment include:

1. The combined value of all cash and non-cash benefits provided to the covered person;
2. The compensation history of the covered person and other individuals with comparable expertise at the CFI;
3. The financial condition of the CFI;
4. Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets;
5. For post-employment benefits, the projected total cost and benefit to the CFI;
6. Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the CFI; and
7. Any other factors the regulatory agencies determine to be relevant.

In determining whether incentive-based compensation could lead to a material financial loss, regulators intend to rely on the standards previously established in the Guidance, including balancing potential risks with financial reward and whether the institution has effective controls and strong corporate governance. The risk assessment is required to occur over an extended time horizon so that the long-term effect of actions that may not otherwise cause immediate returns can be analyzed. The proposal suggests four methods to make compensation more sensitive to risk, which are among others the CFI could develop internally:

1. Risk adjustment of awards, typically based on managerial judgment with appropriate oversight;
2. Deferral of payment (for a period that is sufficiently long to allow the risks to be realized);
3. Longer performance periods; and
4. Reduced sensitivity to short-term performance.

Similar to other recent programs and legislation, the proposal emphasizes that internal controls and corporate governance are essential in monitoring risks related to incentive compensation. These standards again apply to all financial institutions. Internal controls are expected at every stage of the incentive compensation process, from initial design through determining whether performance goals were achieved in light of the noted risks. Boards of directors and compensation committees must establish the goals of the incentive-based compensation program, as well as provide oversight once such programs are established.

Additional rules apply to larger CFIs, which are defined to have assets of $50 billion or more. These rules include a required deferral of 50% of incentive-based compensation

[1] Vague terms such as excessive compensation call to mind Justice Potter Stewart's oft quoted statement regarding pornography: "I know it when I see it."

for at least three years.[2] Again, we have seen regulators apply similar standards to institutions of less than $1 billion in size under the Guidance, so the board and compensation committees of smaller institutions should consider whether the regulators would find deferral appropriate in the context of their compensation arrangements.

Establish and Maintain Compensation Policies and Procedures

As an integral part of the institution of internal controls and effective governance over incentive-based compensation programs discussed above, the proposal requires that CFIs adopt and implement policies and procedures to promote compliance and accountability with the CFI's incentive-based compensation programs. Policies and procedures will be reviewed based on the size and complexity of the CFI and its incentive-based compensation programs. The policies and procedures should focus on those covered persons that could cause the most loss to the CFI. Oversight of the CFI's policies and procedures require monitoring by a group or person independent of the covered person, meaning that the group tasked with oversight has a separate reporting line to senior management from the covered person creating the risk or the oversight is vested in the compensation committee.

Documentation sufficient to allow the CFI's federal regulator to review compliance with the proposed rules will also be required. Such documentation would include:

1. A copy of the CFI's incentive-based compensation arrangement(s) or plan(s);
2. The names and titles of individuals covered by such arrangement(s) or plan(s);
3. A record of the incentive-based compensation awarded under the arrangement(s) or plan(s); and
4. Records reflecting the persons or units involved in the approval and ongoing monitoring of the arrangement(s) or plan(s).

At the very least, we recommend that all institutions note that they have considered the Guidance, and that such documentation reflects an assessment of risk and performance by the compensation committee when the institution awards incentive-based compensation. The compensation committee minutes should also note the reasonableness of the compensation in light of the value of an employee's services. If there are concerns, a peer-group study may provide support. The compensation committee minutes should identify the internal controls that will effectively monitor performance when risks are associated with grants of incentive-based compensation. Certain institutions may consider going further and adopting a formal policy of the board or compensation committee setting forth the parameters of granting incentive-based compensation.

Reporting Requirements

Annual reports are required of CFIs within 90 days of the institution's fiscal year end. The required report is supplemental to the CFI's current regulatory reporting requirements and is limited to addressing regulatory concerns related to incentive compensation, all of which information should be afforded confidential treatment. The report must include:

1. Clear narrative description of the components of the CFI's incentive-based compensation arrangements applicable to covered persons and specifying the types of covered persons to which they apply;
2. Succinct description of the CFI's policies and procedures governing its incentive-based compensation arrangements;
3. Succinct description of any specific incentive compensation policies and procedures that apply to those individuals with the ability to expose the institution to possible losses;
4. Any material changes to the CFI's incentive-based compensation arrangements and policies and procedures made since the CFI's last report was submitted; and
5. Specific reasons the CFI believes the structure of its incentive-based compensation plan does not provide covered persons with incentives to engage in behavior that is likely to cause the CFI to suffer a material financial loss and does not provide covered persons with excessive compensation.

[2] The *Wall Street Journal* and others have implied that a three year deferral period would be satisfactory. The actual time frame, however, will need to be considered on a case-by-case basis. Compensation committees should evaluate the foregoing factors to determine the appropriate time frame.

The proposed regulations will be effective six months after publication of the final rule. In light of the difficulty in modifying compensation plans, we urge institutions to reconsider their existing programs consistent with the Guidance and the proposed regulations. The proposal makes it clear that it serves to supplement existing rules and guidance of each agency, including the Securities and Exchange Commission. The agencies also specifically requested comments on certain aspects of the proposal.

Conclusion

Although the proposed regulations apply only to institutions with $1 billion in assets or greater, every financial institution should consider applying the proposed standards in varying degrees to assist in compliance with the Guidance. The initial step is for the board or compensation committee to consider whether any of the institution's incentive-based compensation is excessive or encourages risks that could result in a material financial loss. Documentation of the relevant considerations will be necessary evidence of compliance with the Guidance, and the proposal sets forth considerations that may be appropriate for your institution depending on the type of incentive-based compensation arrangements that are currently in place or are being considered in the future.

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