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*Expert Analysis*

# Compensation risk analysis: The bank director's role

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The federal banking regulatory agencies have acknowledged that incentive compensation practices in the financial industry contributed to the financial crisis. Current regulatory developments have made incentive compensation a hot-button topic for bank directors, who are struggling to understand and adopt compensation programs that do not encourage inappropriate risk-taking and thereby threaten institutional safety and soundness.

## BANK EXECUTIVES RESPOND MEANINGFULLY TO INCENTIVE COMPENSATION

Recent research suggests that bank executives assume or avoid risk in response to compensation incentives in their contracts.

A recent report published by the Federal Reserve Bank of Kansas City analyzing the risk-taking activities of banks based on the features of CEO pay[1] concluded that "risk-seeking bank management shifts away from traditional portfolio lending and toward less traditional investment and off-balance sheet activities, *i.e.*, activities that are more reliant on non-interest income and the systematic risk associated with it."

The report found that "banking executives respond in economically meaningful ways to the incentives present in their compensation contracts."

The significance of incentive pay for financial executives is not merely academic. The compensation of bankers has claimed the attention of the public, the media and policymakers, both in the United States and Europe.

In July the European Parliament adopted rules limiting banker bonuses to a percentage of salary, deferring bonus payouts, and making some portion of bonuses contingent and subject to recall if a troubled bank requires rescue.[2]

The American approach, on the other hand, has been defined by guidelines rather than rules. While the guidelines do not define excessive compensation, some

of the largest U.S. banks have publicly committed to reducing or reviewing executive pay packages. Focused scrutiny on bankers' pay may have paved the path for a permanent government role in compensation practices in financial institutions.

This article discusses federal banking agencies' recent attempts to address imbalances between incentive pay and risk-taking[3] that could compromise institutional safety and soundness.

## FDIC PROPOSAL TO INCORPORATE COMPENSATION INTO RISK-BASED ASSESSMENTS

In January the Federal Deposit Insurance Corp. floated the idea of factoring compensation criteria into an insured institution's risk-based assessments. FDIC Financial Institution Letter FIL-l-2010 announced that the agency is considering adjusting banks' deposit insurance rates to adequately compensate the deposit insurance fund for perceived excess risk-taking.[4]

In its background statement, the FDIC cited statistics indicating that in one-third of the material loss reviews issued in 2009, employee compensation practices were a contributing factor to the failed institution's losses. (Material loss reviews are studies performed by the federal banking agencies on the causes of the failure of FDIC-insured banks where the losses to the deposit insurance fund exceed the greater of $25 million or 2 percent of the institution's assets.)

While claiming it "does not seek to impose a ceiling on ... compensation" where stock awards are involved, the FDIC has suggested the use of restricted, non-discounted stock and multi-year vesting periods for significant stock awards. The FDIC also seems to favor subjecting stock awards to "clawbacks" to account for the outcome of risks assumed in earlier years.

Finally, the FDIC's proposed rulemaking encourages compensation programs administered by a compensation committee of the board of directors composed of independent directors with input from independent compensation professionals.

In its letter, the FDIC sought public comment on these questions:

- Should the FDIC's risk-based assessment system reward firms whose compensation programs present lower risk or penalize institutions with programs that present higher risks?
- How many basis points would an adjustment to the institution's initial risk-based assessment rate need to be for the FDIC to have an effective influence on compensation practices?
- Which employees should be subject to the compensation criteria that would be used to adjust the FDIC's risk-based assessment rates?

The public comment period ended Feb. 18. The responses were blunt on both sides of the issue.[5]

Both supporters of restrictions on bank executive pay and opponents weighed in, with more than 15,000 comments received.

The American Bankers Association strongly opposed the proposal, calling it "ill-advised," "out of step" and "unworkable."


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The Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce objected, stating "the proposed rulemaking is neither well thought-out nor timely" and that "in identifying the issues emerging from the financial crisis, the FDIC did not list executive compensation."

On the other hand, the California Public Employees Retirement System, generally known as CalPERS, and other investors supported the FDIC's exploration of the issue.

As of Aug. 12, the FDIC had taken no further action on the proposal. In light of publication of joint agency guidance on incentive compensation in June (discussed below), the FDIC's risk-based assessment proposal may be dormant for now.

## BANKING AGENCIES GUIDANCE ON SOUND INCENTIVE COMPENSATION POLICIES

The Federal Reserve Board issued proposed guidance on incentive compensation in October 2009 and, jointly with the FDIC, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, issued its final "Guidance on Sound Incentive Compensation Policies" June 25.[6]

The guidance has three key principles:

- Employee compensation incentives should appropriately balance risk and reward.
- Compensation incentives should be compatible with effective controls and risk management.
- Compensation incentives should be supported by strong corporate governance with oversight by the corporation's board of directors.

The guidance does not address or define when or how incentive compensation will be considered excessive.

### *Large banks vs. small banks*

Large banks are the focus of the guidance for two reasons: They are more frequent and intensive users of incentive compensation, and ineffective approaches to incentive compensation at large banks can have ripple effects throughout the financial system.

The supervisory agencies expect that small banks, believed to use incentive compensation less frequently, will have less extensive, less formal and less detailed plans for incentive compensation.

The guidance says large banks should monitor industry, academic and regulatory developments involving executive compensation, a requirement not identified for smaller banks. Large banks are encouraged, not required, to have experience and expertise in risk management and compensation represented on their boards, while smaller banks are encouraged to educate their directors on the issues through training or rely on advice from outside lawyers and consultants.

In fact, throughout the guidance, the standards for compensation-related review are higher for large banks than small banks.

Regardless of a bank's size, however, the supervisory agencies will be including findings concerning incentive compensation in their examination reports and have stated

***A report found that "banking executives respond in economically meaningful ways to the incentives present in their compensation contracts."***

their intention to take enforcement action against institutions whose incentive compensation encourages imprudent risk-taking.

### *Employees covered by joint agencies' guidance*

The guidance spells out the type of risk designed to be balanced through appropriate compensation policies and is not limited to financial risk. Imprudent risk-taking can include credit risk, market risk, liquidity risk, operational risk, legal and compliance risk, and reputational risk. This laundry list of risks suggests that employees throughout an institution, and not just senior management, may be subject to the incentive pay risk-balancing test.

Indeed, the guidance applies to "covered employees," which include senior management, plus others in the bank with the ability to expose the bank to material amounts of risk. Groups of employees in the aggregate may be in a position to expose an institution to material amounts of risk, in which case they are covered as well.

For example, a group of loan officers may fall in this category. Tellers and bookkeepers are listed as types of employees who are not likely to be able to expose the bank to a material amount of risk, but there is no blanket exemption in the guidance for them or any other specific occupational category.

### *Governing principles of the guidance*

The guidance is based on three principles. The first of these, that incentive compensation should balance risk and rewards so as not to encourage imprudent risk-taking, is to be achieved by four methods:

- Risk adjustment of rewards.
- Deferral of payment of the incentive compensation.
- Longer performance periods for accumulating the benefits of the risk-based compensation.
- Reduced institutional sensitivity to short-term performance.

The second principle is that a bank's risk management processes and internal controls should support balanced incentive compensation arrangements.

There are three illustrative methods for achieving compliance with this principle:

- Risk management personnel should have input on compensation.
- Compensation for risk managers and internal control personnel should be sufficient to hire and retain able staff, whose own compensation should not be based on the performance of business units they review.
- When performance standards are not met, compensation should be reduced. This third mechanism basically means that incentive compensation should not be "one-way"; allowing bonuses and awards for good performance should go hand-in-hand with compensation consequences for performance failures.

The final principle of the guidance, and the one most directly pertinent to bank directors, is that incentive compensation programs should be supported by strong corporate governance and active oversight by the board of directors.



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Again, the guidance suggests means for implementation:

- The board of directors should get data and analysis from management to assess the bank's incentive compensation program.
- The board should have, or have access to, expertise in risk management and compensation practices.
- The board should directly approve compensation arrangements for senior executives.
- The board should approve and document any exceptions from the incentive compensation program.

The board's role is especially important because the guidance indicates that all organizations that employ incentive compensation to a significant degree should have a compensation committee reporting to the full board. It is predictable that larger banks with incentive pay programs will be examined for compliance with this element.

### *Mixed signals*

The guidance straddles the fence. Ultimately, the agencies say, banks have "considerable flexibility" in structuring their incentive compensation arrangements. The guidance does not mandate or prohibit particular types of incentive compensation. The agencies seem aware that there may be countervailing consequences to some compensation "fixes."

***The significance of incentive pay for financial executives is not merely academic.***

For example, restrictions on golden parachutes may be less effective if departing executives can negotiate golden handshakes when they move on.

Reading between the lines of the guidance, incentives to promote employee retention are subtly discouraged when they apply to senior management but subtly favored in the context of risk management and internal control staff.

The guidance implies that bank shareholders have a dual, and somewhat incompatible, role to play in reducing the risks taken by incentivized management.

On one hand, it notes that "shareholders of a banking organization may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness."[7]

But on the other hand, banks are encouraged to share information on their incentive compensation arrangements with their shareholders "to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements to encourage employees to take imprudent risks."[8]

## CONCLUSION

The fallout from the worldwide financial crisis raised the bar for officers and directors of banks with incentive pay arrangements. Federal banking agencies have officially added "compensation risk assessment" to the duties of bank directors.

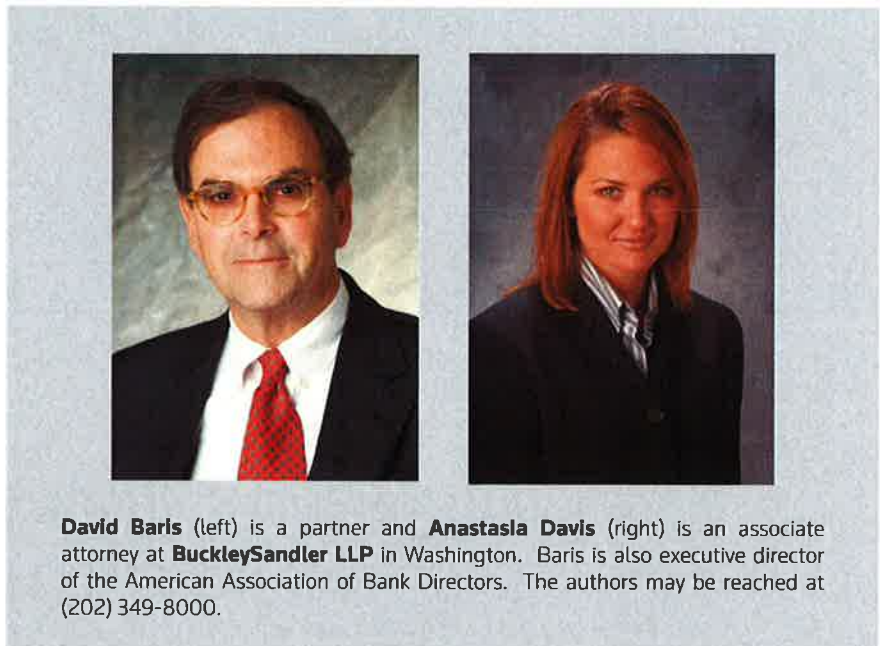
Caution suggests further educating board members on current compensation practices, establishing and permanently monitoring policies and procedures governing compensation arrangements, creating compensation committees that report directly

to the board, using various tests to analyze and refine compensation programs, and possibly involving shareholders in compensation matters.

The challenge facing bank boards and their compensation committees is how to structure incentive compensation with a view that promotes an appropriate level of risk for that institution.

## NOTES

1. "Executive Compensation and Business Policy Choices at U.S. Commercial Banks," by Robert DeYoung (University of Kansas, KU School of Business), Emma Y. Peng and Meng Yam (Fordham University, Graduate School of Business Administration), Presented at FDIC-JFSR Bank Research Conference, September 17, 2009, published by the Federal Reserve Bank of Kansas City, RWP 10-02, January 2010.
2. *See* Press Release, European Parliament, European Parliament ushers in a new era for bankers' bonuses (July 7, 2010), *available at* http://www.europarl.europa.eu/news/expert/infopress_page/042-77908-186-07-28-907-20100706IPR77907-05-07-2010-2010-false/default_en.htm.
3. The Dec. 16, 2009, proxy disclosure rules of the Securities and Exchange Commission requiring disclosure of compensation incentives likely to create or increase company risk are not considered in this article. Moreover, this article does not address Section 956 of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires financial institutions with more than $1 billion in assets to disclose incentive arrangements to their federal regulators and requires federal regulators to adopt regulations or guidelines that prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions.
4. 75 Fed. Reg. 2823 (Jan. 19, 2010).
5. View comments at http://www.fdic.gov/regulations/laws/federal/2010/10comAD56.html.
6. 75 Fed. Reg. 36395 (June 25, 2010).
7. 75 Fed. Reg. 36395, 36405 (June 25, 2010).
8. 75 Fed. Reg. 36395, 36402 (June 25, 2010). Section 951 of the Dodd-Frank Financial Reform Act requires public companies subject to the proxy rules to request, at least once every three years, a shareholder vote on executive compensation.



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