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Americas FS Regulatory CoE

Linking Compensation, Conduct, and Culture: Incentive-Based Compensation Arrangements – Interagency Notice of Proposed Rulemaking

Six federal regulatory agencies (Agencies) recently issued a joint proposed rule to prohibit incentive-based compensation arrangements that would encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss.
The issuance is a re-proposal of a joint proposed rule released by the Agencies in 2011. It includes some modifications to reflect the Agencies' supervisory experiences and industry developments in the intervening five years. In general, the re-proposed rule would impose a tiered-approach based on asset size and apply increasingly more strict and prescriptive requirements to a larger group of individuals as the asset size of the covered institution increases.

Compensation arrangements that did not effectively consider risk management or risk governance and focused too heavily on revenue generation were widely thought to be a contributor to the 2007–2008 financial crisis. To address this concern, the Agencies jointly issued guidance on sound incentive compensation policies and conducted numerous examinations on the compensation practices at supervised entities. In addition, Congress prohibited certain incentive-based compensation arrangements in Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Agencies' proposed rule is intended to implement those provisions. The Agencies note that "incentive-based compensation practices and the design of incentive-based compensation arrangements at banking organizations have improved significantly" and that many plans, especially in larger organizations, now provide for deferred compensation and risk adjustments. A final rule will provide more detail and specificity regarding supervisory expectations for incentive-based compensation arrangements. Supervisors conduct numerous examinations of banks regarding these issues. Banks that violate the final rule could be subject to fines and penalties.

Covered Institutions. Consistent with the 2011 proposal, the re-proposed rule would define covered institutions (including depository institutions, broker-dealers, investment advisers, credit unions, and other financial institutions under the supervision of the Agencies) as firms with average total consolidated assets of $1 billion or more that offer incentive-based compensation. It would establish general qualitative requirements applicable to all covered institutions including:

— prohibitions on incentive-based compensation arrangements that could encourage inappropriate risk-taking by providing excessive compensation or that could lead to a material financial loss;
— requirements for performance measures that appropriately balance risk and reward;
— requirements for board of director oversight of incentive-based compensation arrangements; and
— requirements to document the structure of incentive-based compensation arrangements, demonstrate compliance with the proposed rule, and maintain records.

In addition, larger covered institutions (distinguished as institutions with total assets of $50 billion or more (Level 2) and institutions with total assets of $250 billion or more (Level 1)) would be subject to increasingly more strict and prescriptive requirements related to the structure of their incentive-based compensation arrangements, including incentive award limits, deferral requirements, downward adjustments and forfeitures, and clawbacks.

Covered Persons. The current proposal would expand the definition of a "covered person" in two ways:

— *Senior executive officers:* The new proposal would expand the list of senior executive officers to include five more types of executives: *chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head of a major business line or control function.* Consistent with the 2011 proposal, senior executive officers would still include persons in the positions of: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer and chief risk officer.
— *Significant risk-takers:* The current proposal adds a newly defined category of persons separate from senior executive officers that would be covered by the rule. "Significant risk takers" would be defined as persons whose compensation is at least one-third incentive-based and who meet one of two tests: (i) their compensation is among the highest amounts of compensation paid to covered persons in the consolidated organization (top 5 percent for Level 1, and 2 percent for Level 2) or, (ii) they are authorized to commit or expose 0.5 percent or more of the net worth or total capital of the consolidated organization.

In general, the rule would apply to any executive officer, employee, director, or principal shareholder (holding a ten percent or more voting share of any class of securities) at a covered institution. For Level 1 and Level 2 institutions, senior executive officers and significant risk-takers would be subject to specific restrictions as outlined in the rule, including deferral requirements, downward adjustment and forfeiture reviews, and clawbacks.

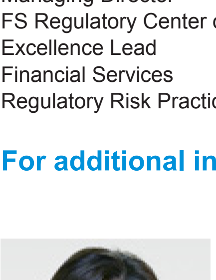
Compensation. The proposed rule would define "incentive-based compensation" as any variable compensation, fees, or benefits that serve as an incentive or reward for performance, whether paid in cash, an equity-like instrument, or any other thing of value. Previously proposed requirements regarding compensation clawbacks, deferred compensation, and deferred vesting remain in the rule.

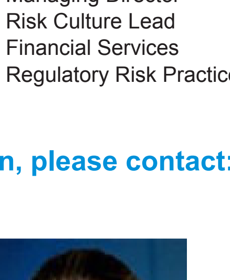
Comments on the proposed rule will be accepted through July 22, 2016 by all of the issuing Agencies, which include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Securities and Exchange Commission, and the Federal Housing Finance Agency.

Compensation, Conduct, and Culture. An organization's compensation and incentive framework, along with the associated rewards and punishments, can greatly influence the conduct of its management and staff. It serves as an integral component of the organization's efforts to maintain a strong ethical culture. Deferred compensation, deferred vesting, and the risk of clawbacks, as proposed in the Agencies' rule, can play a useful role in aligning the personal goals of senior leadership and material risk-takers with the risk-culture and the long-term financial results of their organization.

KPMG believes that a core component of brand reputation and strength consists of having a strong culture that promotes and reinforces "doing the right thing" at every level of the organization. Compensation practices at regulated financial institutions can support implementation of such a culture. The current compensation re-proposal illustrates that U.S. financial regulators continue to press financial firms for improvements in remuneration practices. The re-proposal provides firms with another opportunity to evaluate their existing efforts in the context of evolving regulatory standards.

KPMG has developed a framework to assist firms with evaluating their existing cultures, measuring the system of values and behaviors that shape their risk decisions, and, if needed, developing a plan to improve their overall culture and the conduct of their employees. The framework is outlined in the attached paper, *Approaching the Crossroads of Conduct and Culture: Improving Culture in the Financial Services Industry*.





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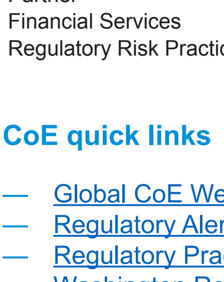

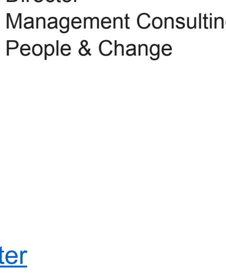

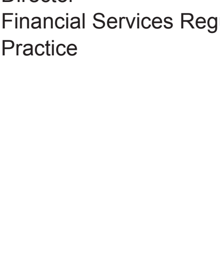

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