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Banker Pay Proposal Includes Incentive Pay Deferral
Arielle Bikard

Banks and other financial institutions may be in for a bumpy ride in coming months, thanks to a proposed rule on incentive compensation that would impose new structural and compliance burdens on how executives get paid. Other business sectors should take notice too, since the rule could set a compensation standard.

The Federal Deposit Insurance Corp. issued its proposed rule, required by the Dodd-Frank Act, last month. It would set longer time horizons on incentive-based compensation and require a review of compensation practices for employees who expose financial firms to substantial risk.

The rule aims to prevent "excessive compensation" at covered institutions, including banks, bank holding companies, broker-dealers, credit unions, investment advisers, Fannie Mae, and Freddie Mac. Institutions with under $1 billion in assets would be exempt under the proposed rule, while those with $50 billion or more in assets-in other words, those likely to be deemed "systemically important" to the financial sector-would face more restrictions.

Those larger entities would need to defer at least half of the incentive-based compensation going to their top executives over a period of at least three years. The deferred payments would also be subject to a "meaningful look-back review" of actual results. In addition, the board of directors would need to identify other employees who might have the ability to expose institutions to substantial losses and to examine the incentive-based compensation structures for those individuals, too. Compliance with the requirements would need to be presented in annual reports, although the proposal is unclear on whether that assertion would be "filed" (with legal liability attached) or "furnished" (not attached).

While the proposal is largely consistent with the Interagency Guidance on Sound Incentive Compensation Policies that the FDIC and several other agencies adopted last June, some parts, such as the mandatory deferral period, are new. Since mandatory deferrals aren't a universal practice within large financial institutions, many organizations will have to overhaul the structure of their compensation programs to meet the requirements.

The deferral period is intended to align the incentive programs with the long-term interests of the organization, says Mindy West, chief of policy and program development at the FDIC's Division of Supervision and Consumer Protection. "Rather than having incentives for the 'quick hit'-which we saw some evidence of in the last crisis-this takes the longer view on formulating the incentive compensation systems," she says.

West says that a deferral period seems like the right way to go, considering that European counterparts already have specified deferral periods. Calls for unified, cross-border approaches to running the global financial system are now standard fare.

http://media.complianceweek.com/images/2011/02/25/mullany-mary_148181_148182.gif Still, others worry about the downsides of a mandatory pay deferral. "You want some certainty if you are an executive officer that if you're getting an incentive award and you perform in compliance with the performance goals that are set, that you'll actually get paid the reward," says Mary Mullany, a partner at law firm Ballard Spahr.

Larger banks might also have trouble recruiting people who might suddenly be subject to the pay deferral, compared to smaller banks where it wouldn't apply, Mullany says. "That's an opportunity for the $45 billion [companies] and below potentially to benefit from being an institution that has a little less federal scrutiny," she says.

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-Mary J. Mullany, Partner, Ballard Spahr

The rule's new reporting requirements could also cause tracking issues and become an administrative burden, says Deborah Lifshey, managing director at Pearl Meyer & Partners, a compensation consulting firm. "Boards and committees will have to dig deep to see which executives can cause material harm. There will also need to be three separate groups of individuals monitored, all for different reasons - Executive Officers, those individuals who could cause 'material financial loss' and those individuals at larger institutions who could expose the organization to substantial loss in relationship to the firm's size." she says.

Lifshey also says the proposal has some ambiguity that ought to be addressed during the comment period. For example, she says, "There might also be some questions for the rule about deferrals, because some people are wondering whether that applies to equity or does it also apply to cash."

http://media.complianceweek.com/images/2011/02/25/lifshey-deborah_148173_148174.gif Any final new regulation could also have unintended consequences in the firm's compensation structure, Lifshey adds. "Anything that's not incentive-based will fall outside of these rules," she says. "It's possible that financial institutions, especially those smaller in size, will say try to avoid the burden of compliance by placing an emphasis on fixed compensation.' In other words, financial institutions might be so worried about whether or not the regulators will approve incentive pay, that they would put a greater emphasis on salary or salary stock."

FDIC PROPOSAL

The following summary and highlights are from the FDIC's "Interagency Notice of Proposed Rulemaking: Incentive-Based Compensation Arrangements":

The FDIC Board of Directors has approved the attached Notice of Proposed Rulemaking (NPR) implementing section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which applies only to financial institutions with total consolidated assets of $1 billion or more. This NPR seeks to strengthen the incentive compensation practices at covered institutions by better aligning employee rewards with longer-term institutional objectives. The NPR will be published in the Federal Register for a 45-day comment period following approval by all of the other agencies involved in this rulemaking: the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, National Credit Union Administration, U.S. Securities and Exchange Commission, and Federal Housing Finance Agency (the Agencies).

Highlights:

Covered financial institutions are those regulated by the Agencies with total consolidated assets of at least $1 billion. For these institutions, the NPR:

prohibits incentive-based compensation arrangements that encourage inappropriate risks by providing covered persons with "excessive" compensation; prohibits incentive-based compensation arrangements that encourage inappropriate risk taking by providing covered persons with compensation that "could lead to a material financial loss" to an institution; requires disclosures that will enable the appropriate federal regulator to determine compliance with the rule; and requires the institution to maintain policies and procedures to ensure compliance with these requirements and prohibitions commensurate with the size and complexity of the organization and the scope of its use of incentive compensation.

For covered institutions with at least $50 billion in total consolidated assets, the NPR also requires:

For "executive officers" (as defined in the NPR), deferral of at least 50 percent of incentive-based compensation for a minimum of three years. Deferred payments must be adjusted to reflect actual losses or other measures of performance that become known during the deferral period. For other covered persons that individually have authority to expose an institution to substantial risk, the board of directors must identify such employees; evaluate and document the incentive-based compensation methods used to balance risk and financial rewards; and approve incentive compensation arrangements

after appropriately considering other available methods for balancing risk and financial rewards.

Source:FDIC Notice: Proposed Rulemaking for Incentive-Based Comp.

Any move toward more fixed pay could then have a snowball effect: When companies benchmark their compensation against their rivals, they could end up raising everyone's salary across the board, says Lawrence Cunningham, a law professor at George Washington University Law School. "Companies might say, 'He's getting $10 million and I'm only getting $9 million-well, I'm getting $10 million now!' And the other guy gets $11 million and we keep moving up."

The 'To-Do' List

http://media.complianceweek.com/images/2011/02/25/cunningham-lawrence_148169_148170.gif On a practical level, compliance officers will want to roll up their sleeves in coming weeks and comb through the rule proposal. "Since the proposal speaks to a somewhat expert audience, compliance personnel will need to be sure that they have internal experts on compensation packages who know about the technology of measuring risk, to make sure that the paybacks didn't create operation risks or systemic risks," Cunningham says.

Mechanically, the most difficult part of the proposal to implement will be the issue of excessive compensation for the covered employees. Companies will first have to identify those who could subject the organization to excessive risk, and then benchmark their pay, says Steven Seelig, executive compensation counsel at consulting firm Towers Watson. "There's going to be a lot of work to be done in understanding whether or not that individual internally has compensation that's above the median. So it's going to be a big compliance exercise."

"The touchstone of this is going to be trying to figure out who within your organization are the risk takers-that's going to end up being the most difficult task for financial institutions," Seelig says. It could even push companies to define risk-takers more narrowly to avoid the compliance burden, he says. "That's going to be a point of tension, whereas before it was not, because the compliance requirements weren't as onerous."

The rule itself has a somewhat onerous approval process. The Securities Exchange Commission, the Federal Housing Finance Agency, and four other members of the Federal Financial Institutions Examination Council will independently need to approve the proposal before it will be jointly sent to the Federal Register and go out for its 45-day comment period. The rule is still two to three weeks away from being written in the Federal Register, according to FDIC's West.

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