Statement by Vice Chairman Travis Hill on Notice of Proposed Rulemaking on Incentive-based Compensation Arrangements

May 6, 2024

I agree with the general principle that compensation can play an important role in a bank's culture and risk-taking, and I generally support reasonable efforts to reduce incentives to "swing for the fences" and take short-term risks. At the same time, compensation agreements play a crucial role in recruiting and retaining qualified staff, and are at the core of a well-functioning market economy.

In 2010, the banking agencies issued guidance ("2010 Guidance") that adopted a principles-based approach to "help ensure that incentive compensation policies … do not encourage imprudent risk-taking."[1] Notably, the 2010 Guidance asserted that a principles-based approach "is the most effective way to address incentive compensation practices, given the differences in the size and complexity of banking organizations covered by the guidance and the complexity, diversity, and range of use of incentive compensation arrangements by those organizations."[2] The guidance established expectations that incentive compensation would "balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks" and provided different options that banks can use to "make compensation more sensitive to risk."[3] Overall, implementation of the 2010 Guidance, along with other supervisory engagements around that time, contributed to meaningful change in incentive compensation practices across the industry,[4] and the incentive compensation

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[1] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. 36,395 (June 25, 2010).

[2] *Id*. at 36,399.

[3] *Id.* at 36,407-36,408. These options included risk adjustment of awards; deferral of compensation; longer performance periods; and reduced sensitivity to short-term performance.

[4] *See, e.g.,* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, National Credit Union Administration, Federal Housing Finance Agency, Securities and Exchange Commission, Notice of Proposed Rulemaking: Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670, 37,675 (June 10, 2016) ("The institutions subject to the [2009-10] Horizontal Review [conducted by the Federal Reserve, in cooperation with the OCC and FDIC] have made progress in developing practices that would incorporate the principles of the 2010 [Guidance] into their risk management systems, including through better recognition of risk in incentive-based compensation decision-making and improved practices to balance risk and reward. Many of those changes became evident in the actual compensation arrangements of the institutions as the review progressed."); *Compensation in the Financial Services Industry—Government Perspectives: Hearing Before the H. Comm. on Fin. Servs.*, 111 Cong. 48-49 (2010) (Statement of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System) ("On the positive side, many firms, spurred by supervisors, shareholders, and others, are reexamining their incentive compensation practices and analyzing, in ways they did not before, the potential links between compensation and risk-taking behavior. … For example, most [large, complex banking organizations] have implemented measures that are designed to make the incentive compensation of senior executives more sensitive to risk, most commonly by increasing the share of executives' incentive compensation that is deferred and the share that is paid in equity or equity-linked instruments. A number of firms also have expanded or plan to expand the situations under which the incentive compensation of employees can be 'clawed back' to

arrangements that were cited by some as a factor in the 2008 financial crisis[5] are far less common today.[6]

In contrast to the principles-based approach set forth by the 2010 Guidance, this proposed rule would establish a highly prescriptive set of requirements for incentive-based compensation arrangements. For example, the proposal would require that all incentive-based compensation arrangements of senior executive officers and "significant risk-takers" at covered institutions with $50 billion or more in total assets contain deferral, forfeiture, downward adjustment, and clawback provisions.[7] In my view, the proposal is too broad and too blunt,[8] would impose highly subjective triggers for forfeitures and downward adjustments,[9] and would incentivize shifting a greater portion of compensation into base salary and out of incentive-based compensation.[10] In addition, the extraordinarily long lookback period, which would allow recovery for seven years after compensation vests[11] — or up to 12 years after the compensation is awarded — seems like overkill.[12]

Finally, Section 956 of the Dodd-Frank Act, which the proposed rule would implement, requires the relevant agencies to "***jointly*** prescribe regulations or guidelines" prohibiting certain

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include measures specifically related to risk. In addition, risk-management functions at many firms now have a greater role in the design of incentive compensation arrangements and in the evaluation of employee performance for compensation purposes, and at many firms the board of directors is becoming more actively engaged in overseeing compensation structures for non-executive employees.").

[5] *See, e.g.,* Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011), p. 63-64, 279, 291.

[6] *See, e.g.*, Vittoria Cerasi, Sebastian M. Deininger, Leonardo Gambacorta, and Tommaso Oliviero, "How post-crisis regulation has affected bank CEO compensation," *Journal of International Money and Finance* (Feb. 11, 2020) ("We find CEO compensation policies have significantly changed after the implementation of the [Financial Stability Board's *Principles and Standards for Sound Compensation*]. In particular, CEO variable compensation has become significantly more negatively correlated to short-term profitability and risk . . .").

[7] *See* Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, National Credit Union Administration, Federal Housing Finance Agency, Notice of Proposed Rulemaking: Incentive-Based Compensation Arrangements ("2024 proposal"), § __.7.

[8] For example, the mandatory four year deferral period would apply equally to employees ranging from the chief executive officer to the head of human resources.

[9] For example, the events triggering forfeiture and downward adjustment review would include, among other things, "inappropriate risk taking, regardless of the impact on financial performance." *See* 2024 proposal, *supra* note 7, at § __.7(b)(2)(ii).

[10] This has occurred in other jurisdictions. *See, e.g.*, Eir Nolsøe and Michael Bow, "Goldman Sachs scraps bonus cap for senior London bankers," *The Daily Telegraph* (May 2, 2024) ("Rather than curb rewards, the [EU's] bonus cap pushed up base salaries. Banks increased pay to ensure they could compete internationally for talent.").

[11] *See* 2024 proposal, *supra* note 7 at § __.7(a)(1)(ii); § __.7(c).

[12] *See, e.g.,* Meridian Compensation Partners, LLC, Comment Letter on 2016 Notice of Proposed Rulemaking on Incentive-Based Compensation Agreements (July 22, 2016) (describing how the "lengthy deferral and clawback periods (effectively up to 12 years) could hinder financial institutions' ability to attract and retain talent, or may require a compensation premium to do so.").

incentive-based compensation arrangements.[13] It is extremely odd to issue this proposal without all the relevant agencies participating. Should commenters invest time and resources to respond to this proposal, or wait until all the relevant agencies are in agreement?

I do not support the proposal, but I appreciate all the work from staff over the past fourteen years (and counting).

[13] 12 U.S.C. § 5641(b) (emphasis added).