INCENTIVE COMPENSATION - NEW RULE

by Steve Brown

Driven by the Dodd Frank Act (DFA), banking regulators yesterday issued a 77 page joint proposal on incentive compensation that every banker should be aware of. While it only applies to banks over $1B in assets (and is most onerous for those above $50B in assets), the

concepts and regulatory focus will certainly trickle down to even the smallest banks in coming quarters.

DFA requires regulators to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at "covered" financial institutions (FI's). Covered FI's are defined as a financial institution with more than $1B in assets (including banks, credit unions, broker-dealers, investment advisers, FNMA, FHLMC and any other institutions Federal regulators determine should be treated as covered).

The new proposal (http://tiny.cc/02j9t) was specifically designed to prohibit incentive-based payment arrangements (or any feature of any such arrangement) at a covered FI that would encourage inappropriate risk-taking through excessive compensation or that could lead to a material financial loss. Covered FI's are required to disclose to regulators the structure of the incentive-based compensation arrangements to allow examiners sufficient information to determine whether the structure provides excessive compensation (including benefits) that could lead to the risk of material loss to the institution.

While not directly applicable to community banks under $1B in assets, the regulators definitively state in this proposal that they believe "flawed incentive compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007." It is pretty clear from this that compensation practices will certainly change throughout the industry, either by direct regulation or to adhere to best practices.

Under the proposal, regulators will adopt standards for determining whether an incentive-based compensation arrangement encourages inappropriate risk-taking; will require deferral of a portion of incentive-based compensation for executive officers; and will require the board of directors to specifically identify those covered persons (other than executive officers) that have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. The rule would require covered FI's to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with these requirements and prohibitions. While community banks don't have to have anything as robust as this group of $1B or larger banks, it is critical to review compensation practices to ensure they align properly with risk controls to ensure undue risks aren't taken (as that would fall under safety and soundness, regardless of size). The proposal also indicates deferred compensation should be sufficiently long to allow for the realization of a substantial portion of the risks from the covered person's activities.

In determining whether payments are "excessive," regulators under the proposal will consider the combined value of all cash and non-cash benefits; the compensation history of the covered person and other individuals with comparable expertise; the financial condition of the FI; comparable compensation practices at comparable institutions (based upon factors such as asset size, geographic location and complexity); and connections between the individual and any fraudulent act or omission, breach of trust fiduciary duty or insider abuse.

Even if this proposal doesn't apply directly to your community bank, expect more regulatory focus on the sorts of controls your bank has governing processes for designing, implementing and monitoring incentive-based compensation arrangements. Regulators expect banks of all sizes to make sure both those in risk management and directors have a strong role in designing incentive based compensation arrangements, monitoring their use and assessing whether they achieve a balance between risk and reward.

BANK NEWS

FDIC Assessment

The deposit insurance assessment was finalized by the FDIC Board and will go into effect starting 2Q. The final rule moves the assessment base from one based on domestic deposits to one based on total assets less tangible equity (tier 1 capital). Because of the larger base, fees decreased to make the structure relatively revenue neutral. That said, the move should reduce insurance costs for banks under $10B and dramatically increase it for CAMELS 3-5 banks over $10B. Banks over $10B will also move to a performance-based set of adjustments.

Brokered CDs

In a related matter, the FDIC is conducting a brokered CD study to better understand the product's role in the crisis and its impact on funding. The study, to be released in July, may also change the brokered deposit adjustment included in the FDIC assessment.

China Rates

As expected, China hiked its short-term bank borrowing rate by 25bp (the 2nd increase this year) to 3% in an attempt to cool inflation.

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