Focus on Incentive Pay Practices: A Message from the Regulators

by Michel Vanesse | August 8, 2016

Incentive pay is an important part of compensation packages. It allows employers to reward those employees who perform well (and show those employees who do not that under-performing will have negative consequences). It is a well known fact that incentive pay drives behavior. But what the 2008 financial meltdown may have shown is that poorly calibrated incentives may generate counter-productive, if not dangerous, behaviors. Therefore, all employers should carefully design and document their incentive pay programs to make sure their interests are well protected, and incentive pay is awarded only when appropriate.

This is very clearly the opinion of six agencies that oversee financial institutions, and that have come to the conclusion that the 2008 crisis was caused, at least in part, by dangerous pay practices. The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA), the National Credit Union Association (NCUA), the Board of Directors of the Federal Reserve System (the Federal Reserve) and the Securities and Exchange Commission (SEC) recently released proposed regulations that set forth detailed requirements applicable to incentive compensation programs adopted and maintained by financial institutions.

While these requirements would only apply to covered financial institutions, we believe that they should at least be taken into account by all employers (particularly, publicly held companies), as this new set of rules and principles may very well become "best practices" beyond the financial services industry. Here are some key aspects of the proposed regulations that may give employers some guidance in the design and implementation on their incentive pay programs.

Identifying Risk-Takers

While the proposed regulations generally define covered persons to include any executive officer, employee, director or principal shareholder, the focus primarily is on senior executive officers and significant risk-takers, including the most highly compensated employees and those with authority to expose 0.5% or more of the employer's capital. Proper incentive pay plan design should include steps to identify this population and to create incentives that drive productive behaviors and also protect the employer against excessive risk-taking.

This shows that properly designing incentive programs should include an assessment of the risks that the programs could generate and the employees whose behaviors could lead to excessive risk-taking. Selecting a typical matrix with targets and levels of pay is only one aspect of proper plan design.

Comprehensive Approach to Plan Design

The proposed regulations also show that the complete life cycle of a well designed incentive pay program extends well beyond the relevant performance period that is taken into account to calculate incentive awards. The incentive pay program should provide for (1) a deferral period following the performance period, during which a substantial portion of any earned incentive award remains unvested, or subject to a risk of forfeiture, and (2) a clawback period during which an incentive award that previously was earned, vested and paid may have to be paid back by the employee to the employer.

Also, the proposed regulations directly address the selection of parameters and targets for incentive pay, and explicitly identify specific plan designs that are deemed to generate unwanted, risky behaviors and yield excessive compensation. For example, for larger institutions, an incentive pay program will not be deemed to adequately balance risk and reward if the performance measures are based solely on peer group comparisons or on volume without regard to transaction quality or general compliance with applicable risk management principles.

All these requirements give employers good guidance as to the multiple layers of prudent incentive pay design and definitely show that carefully selecting performance criteria and targets for eligible employees is only one of the many steps employers should take before adopting any incentive pay program.

More Robust Plan Operations

Another important aspect of the proposed regulations relates to the implementation of incentive pay programs. The proposed regulations require employers to develop more comprehensive control mechanisms to make sure that incentive pay is awarded only when appropriate under plan terms and in accordance with applicable regulatory requirements, and that forfeiture and clawback provisions are duly enforced by those in charge of plan administration. Regulatory mandates would include administrative procedures to be adopted by employers to create an effective oversight that is independent from the employer's business operations.

This would require the adoption of specific policies and training programs, ongoing monitoring of plan operations and the creation of internal procedures to ensure that the workforce does not engage in excessive risk-taking in violation of applicable policies. Ultimately, the board of directors (or a committee of the board) will be responsible for the adoption of adequate principles and objectives, and for the communication of these principles and objectives to management for purposes of implementation.

Importance of Documentation

As indicated above, adherence to the rules and principles set forth in the proposed regulations should lead to the adoption by employers of new policies and internal processes. Applicable policies and any reporting or monitoring processes that will be put in place should be carefully documented and communicated to employees. Also, to the extent incentive pay programs will include more elaborate features, including potential downward adjustments, deferrals of payments, expanded forfeiture provisions, clawbacks, and detailed administrative provisions to address the implementation and control of these features, the formal documentation to be created for incentive pay programs and awards is likely to become more detailed. The formal plan documents or the award notices will need to include all applicable contractual provisions in order for the employer to be able to effectively implement these features, particularly when they result in a reduction of incentive pay.

Conclusions

While the proposed regulations would only apply to covered financial institutions and, if taken in their totality, could be quite burdensome, they set forth principles that could, at least in part, be used by employers to create a sound and prudent environment for purposes of designing and administering incentive pay programs.

About the Author

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