

Regulatory Alert

Regulatory Insights for Financial Services

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Incentive-based Compensation: Interagency Proposed Rule

KPMG Insights:

- **14 Years in the Making:** Interagency proposal aims to curb “excessive risk-taking” at certain financial institutions with assets of \$1 billion or more by regulating incentive-based compensation, as mandated in the 2010 Dodd-Frank Act.
- **Balancing Compensation with Risk:** Would introduce requirements for risk-adjusted awards, mandatory deferrals, and forfeiture and clawback provisions.
- **Feedback and Comments:** Expect sharp feedback across divergent voices during the comment period.

Six federal financial regulators (Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC), National Credit Union Administration (NCUA), and Federal Housing Finance Agency (FHFA)) are required, by Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, to jointly propose regulations or guidelines that would prohibit any types of incentive-based compensation arrangements that “encourage inappropriate risks by a covered financial institution with assets of \$1 billion or more:

1. by providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or
2. that could lead to material financial loss to the covered financial institution.”

Pursuant to this requirement, the six agencies issued joint proposed rules in 2011 and again in 2016.

Three of the agencies are now [proposing](#) a new rulemaking that re-proposes the 2016 regulatory text, while also adding certain questions and alternative regulatory provisions based on supervisory experience, changes in industry practices, and other developments since the 2016 release.

Overview of the Proposed Rule. The proposed rule is intended to align incentive-based compensation with the long-term interests and safety and soundness of covered institutions by making compensation arrangements more sensitive to risk through proposed prohibitions and requirements. The proposal uses a tiered approach based on asset size categories, where covered institutions within the two largest asset size categories 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. The table below outlines key aspects of the proposed rule.

Proposal	Description
<p>Definitions, Scope, and Applicability</p>	<ul style="list-style-type: none"> — “Covered institutions” are defined in Section 956 and would be categorized by total consolidated asset size into Level 1 (≥\$250 billion), Level 2 (≥\$50 billion and < \$250 billion), or Level 3 (≥\$1 billion and <\$50 billion), with subsidiary institutions subject to the same requirements as their parent institutions. — “Covered persons” would be defined in the proposal and would include executive officers, employees, directors, or principal shareholders receiving incentive-based compensation at a covered institution. <ul style="list-style-type: none"> – “Senior executive officers” would be defined as a covered person who holds the title or performs the function of one or more of the following positions for any period of time in the relevant performance period: President, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head of a major business line or control function. – “Significant risk-takers” would be defined under one of two potential tests: <ul style="list-style-type: none"> • As covered persons who are among the top 5 percent (for Level 1 covered institutions), or top 2 percent (for Level 2 covered institutions), of highest compensated covered persons (excluding senior executive officers) in the entire consolidated organization, including affiliated covered institutions (the “relative compensation test”). • As a covered person who has the authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution (the “exposure test”).
<p>General Prohibition on Risk-Encouraging Compensation Arrangements</p>	<p>The proposal would generally prohibit incentive-based compensation arrangements at covered institutions that could encourage “inappropriate risks” by providing “excessive compensation” relative to the value of the services performed by executives or other employees. Incentive-based compensation arrangements would be required to appropriately balance risk and financial rewards by:</p> <ul style="list-style-type: none"> — Including financial and non-financial measures of performance. — Allowing non-financial measures of performance to override financial measures of performance, when appropriate. — Being subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.
<p>Deferral of Payments</p>	<p>For Level 1 and 2 institutions, the proposal would require incentive-based compensation arrangements to be subject to temporary deferral of a portion (40-60 percent, depending on institution size) of compensation. Deferral periods could range from one to four years depending on the type of incentive-based compensation arrangement, the size of the covered institution, and whether the covered person is a senior executive officer or a significant risk-taker.</p>
<p>Forfeiture and Downward Adjustments</p>	<p>For Level 1 and 2 institutions, the proposal would require consideration of forfeiture or downward adjustment of incentive-based compensation for senior executive officers and significant risk-takers if any of the following adverse outcomes occur:</p> <ul style="list-style-type: none"> — Poor financial performance due to deviation from risk guidelines. — Inappropriate risk taking. — Material risk management or control failures. — Statutory, regulatory, or supervisory non-compliance that resulted in enforcement or legal action by agencies or financial restatement.

	<ul style="list-style-type: none"> — Other poor performance or misconduct.
Clawback Provisions	<p>For Level 1 and 2 institutions, the proposal would require inclusion of clawback provisions in the incentive-based compensation arrangements for senior executive officers and significant risk-takers to allow the institution to recover incentive-based compensation for a minimum of seven (7) years. If an institution determines that a current or former senior executive officer or significant risk-taker engaged in any of the following, it would be required to consider clawing back compensation:</p> <ul style="list-style-type: none"> — Misconduct that resulted in significant financial or reputational harm to the institution. — Fraud. — Intentional misrepresentation of information used to determine the incentive-based compensation.
Other Prohibitions	<p>The following additional prohibitions would apply to Level 1 and 2 institutions:</p> <ul style="list-style-type: none"> — Options. If incentive-based compensation is in the form of options, the amount of options used to meet the minimum required deferred compensation could not exceed 15 percent of the total incentive-based compensation awarded for the performance period. — Hedging. Would prohibit purchasing hedging instruments for covered persons that offset any decrease in the value of incentive-based compensation arrangements. — Maximum incentive-based compensation opportunity (leverage). Would prohibit awarding incentive-based compensation to a senior executive officer in excess of 125 percent of the target amount for that incentive-based compensation. For a significant risk-taker the limit would be 150 percent. — Relative performance measures. Would prohibit use of performance measures based solely on industry peer performance comparisons. — Volume-driven pay. Would prohibit providing incentive-based compensation to a covered person based solely on transaction revenue or volume without regard to transaction quality or compliance with sound risk management.
Sound Governance and Risk Management Controls	<ul style="list-style-type: none"> — For Level 1 and 2 institutions, the proposal would require establishment of: — Risk management frameworks for incentive-based compensation programs that are independent of any lines of business, include an independent compliance program, and are commensurate with the size and complexity of operations. — A compensation committee (composed solely of directors who are not senior executive officers) that would obtain input (and independent written assessments) from the institution’s risk and audit committees, and risk management function, on the effectiveness of risk measures and adjustments around incentive-based compensation arrangements.
Recordkeeping and Disclosure Requirements	<p>For all covered institutions, the proposal would require creation and maintenance of records for seven (7) years documenting the structure of incentive-based compensation arrangements and compliance with the rule. Similarly, it would require disclosure of these records to the supervising agency upon request.</p>

Alternative Provisions. Based on supervisory experience, changes in industry practices, and other developments, the agencies are considering a number

of alternative regulatory provisions, including those outlined in the table below:

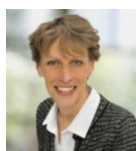
Alternative Provision	Description
Compliance Date	Reducing the timeline for complying with the rule from 540 days to 365 days after a final rule is published.
Two-tiered Asset Thresholds	Establishing a two-level structure rather than a three-level structure, where the general prohibitions and requirements would apply to all covered institutions, and the proposed additional prohibitions and requirements would apply to covered institutions with average consolidated assets of \$50 billion or more.
“Significant risk-taker” Definition	Replacing the two tests (i.e., relative compensation test and exposure test), with requiring covered institutions to identify significant risk-takers and submit a notice of its identification methodology to its primary Federal regulator.
Setting Performance Measures and Targets	Requiring performance measures and targets to be established before the beginning of the performance period.
Options	Modifying the proposed limit on options from 15 percent to no more than 10 percent of the amount of total incentive-based compensation awarded for that performance period.
Forfeiture and Downward Adjustment	Limiting the discretion of Level 1 or 2 institutions to seek to recover incentive-based compensation by requiring (rather than requiring consideration of) forfeiture and downward adjustment of incentive-based compensation for the adverse outcomes.
Clawback	Requiring Level 1 or 2 institutions to claw back (rather than consider clawing back) any vested (i.e. paid) incentive-based compensation. This alternative would provide an exception to recovery if the institution can document that clawback is impracticable or an equivalent amount of incentive-based compensation has been impacted through forfeiture or downward adjustment.
Hedging	Prohibiting Level 1 and 2 institutions from designing incentive-based compensation arrangements that allow a covered person to purchase a hedging instrument or similar instrument to offset any decrease in the value of the covered person’s incentive-based compensation. This would include requiring covered institutions to have contracts with employees that ban personal hedging.
Volume-driven incentive-based compensation	Expanding the prohibition to cover all incentive-based compensation based on transaction revenue or volume, rather than limiting the provision to incentive-based compensation based solely on transaction revenue or volume.
Risk Management and Controls Requirements	Adding a requirement for Level 1 and 2 institutions to include (within the risk management framework) consideration of a risk management and controls assessment from the independent risk and control functions in setting incentive-based compensation for senior executive officers and significant risk-takers.

Comment Period. Once the proposed rule is adopted by all six agencies, it will be published in the Federal Register with a comment period of sixty (60) days following the date of publication. Until then, each adopting agency indicates that it will make the proposal available on its website and will accept feedback and comments on both the re-proposed 2016 regulatory text as well as the newly proposed alternative regulatory provisions.

Note: The NCUA is expected to act on the proposed rulemaking “in the near future”, and the SEC previously included the Section 956 proposed rulemaking in its Fall 2023 regulatory agenda (see KPMG’s Regulatory Alert, [here](#)).

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