Client Update

New York State Department of Financial Services Issues Guidance on Incentive Compensation in the Banking Sector

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The New York State Department of Financial Services (the "Department") issued a guidance memorandum earlier this week[1] requiring regulated New York-chartered banking institutions to align their incentive compensation practices with the general principles laid out in the Interagency Guidance on Sound Incentive Compensation Policies issued in 2010 (the "2010 Interagency Guidance").[2] Specifically, the Department's guidance requires that incentive compensation arrangements, at a minimum, (1) appropriately balance risk and rewards, (2) be compatible with effective controls and risk management, and (3) be supported by effective corporate governance. The Department published this guidance on the heels of the record $100 million fine and other penalties levied against Wells Fargo by federal and other agencies, following a recent investigation of that bank's sales practices and incentive compensation arrangements.

The two-page guidance memorandum notes that flawed compensation practices in the financial industry contributed to the financial crisis that began in 2007. The guidance advises that incentive compensation at regulated institutions should not be tied to employee performance indicators, such as the number of accounts opened, or the number of products sold per customer, without effective risk management, oversight and control. The guidance requires regulated

[1] The guidance memorandum is available at the New York State Department of Financial Services website at http://www.dfs.ny.gov/legal/industry/il161011.pdf.

[2] This Interagency Guidance issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision is available at the website of the U.S. Department of the Treasury, Office of the Comptroller of the Currency, at: https://www.occ.gov/news-issuances/bulletins/2010/bulletin-2010-24.html.

financial institutions to ensure that there are appropriate controls for cross-selling or referral bonus arrangements, in particular, because these arrangements may result in conflicts of interest or the sale (or supervision of the sale) of affiliates' products by inexperienced or unlicensed personnel.

WHICH INSTITUTIONS DOES THE GUIDANCE APPLY TO?

The Department's guidance applies to all New York state-chartered banks, savings banks and bank holding companies, as well as state-chartered credit unions, branches of foreign banks, foreign agencies and representative offices. It applies broadly across regulated banking institutions and its scope is not limited to large banking institutions or banks that meet a certain asset threshold.

HOW DOES THE GUIDANCE COMPARE WITH INCENTIVE COMPENSATION REGULATION BY FEDERAL AGENCIES?

The Department's guidance follows several federal regulatory initiatives intended to limit risky incentive compensation practices at banking institutions. These include the 2010 Interagency Guidance, which provides principles-based guidance for compensation policies, procedures and processes at banking institutions under the agencies' supervision, and, more recently, the proposed rules released in April 2016 under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Proposed Rules under Section 956").

The Department's guidance is expressly derived from the general principles of the 2010 Interagency Guidance and includes high level, directional advice—unlike the lengthy, prescriptive Proposed Rules under Section 956. Both the Department's guidance, and the 2010 Interagency Guidance on which it is based, reflect an expectation that regulated financial institutions should apply the principles in a manner that is tailored to the business, risk profile and other attributes of each individual banking organization (*i.e.*, larger organizations require more systematic and formalized policies, procedures and processes).

Rather than providing new or more detailed requirements, the Department's guidance appears intended to serve as a reminder of the incentive compensation principles that banking institutions generally should have been taking into consideration and implementing since the release of the 2010 Interagency Guidance.

WHAT'S NEXT?

Regulated banking institutions appear to be required to immediately comply with the Department's guidance on incentive compensation arrangements. State banking examiners will review incentive compensation arrangements as part of the Department's regular risk-focused examination process. This will include a review of the processes in place to identify and deter misconduct, as well as a review of risk management, internal audit and board director oversight structures. To the extent banking institutions are not already doing so, they must immediately begin to maintain records for the Department's examination that document (1) the structure and approval process of their incentive compensation arrangements and (2) the related risk management and oversight of such arrangements. Lack of compliance with the guidance may affect exam ratings or lead to other regulatory action.

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Please do not hesitate to contact us with any questions.