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New York DFS Issues Guidance on Monitoring Incentive Compensation Arrangements

State-Regulated Banking Institutions Advised to Ensure that Incentive Compensation Tied to Employee Performance Indicators Is Subject to Effective Risk Management, Oversight and Control

BACKGROUND

On October 11, the New York Department of Financial Services (the "NYDFS") issued guidance, announced in a press release by Governor Andrew Cuomo, emphasizing that its regulated banking institutions must ensure that any incentive compensation arrangements tied to employee performance indicators are subject to effective risk management, oversight and control.

The NYDFS release provided that the guidance was prompted by the recent joint enforcement actions by the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau and the Los Angeles City Attorney's Office against Wells Fargo Bank for unsafe or unsound sales practices, including the unauthorized opening of deposit or credit card accounts. According to the NYDFS, the action against Wells Fargo demonstrates that misaligned incentive compensation, coupled with a lack of effective oversight and internal risk controls, may harm customers and adversely affect a banking institution's safety and soundness.

DISCUSSION

The NYDFS guidance advises that regulated banking institutions develop incentive compensation arrangements that do not provide incentives to employees to engage in unacceptable conduct. In the case where incentive compensation is tied to indications of employee performance, such as number of accounts opened, the banking institution must ensure that such arrangements are subject to effective risk management, oversight and control. Banking institutions are advised to provide particular attention "to controls around cross selling or referral bonus arrangements as such arrangements have inherent risks, including the possibility of conflicts of interest and inexperienced or unlicensed personnel selling, or supervising the sale of, affiliates' products." In addition, such arrangements should follow certain minimum principles:

- Balance Between Risk and Rewards: Banking institutions must balance risk and financial results such that employees are not encouraged to expose their organization to undue risk;
- Effective Controls and Risk Management: Incentive compensation arrangements must be supported by risk management processes and internal controls; and
- Effective Corporate Governance: Incentive compensation arrangements must be supported by robust corporate governance practices, including effective oversight by the board of directors.

The NYDFS guidance indicates that the NYDFS will include review of incentive compensation arrangements as part of its regular risk-focused examinations, "including the review of processes in place in identifying and deterring misconduct, participation of frontline business units, effective risk management and internal audit, and effective oversight of the board of directors," and that misaligned arrangements will be acted upon by the NYDFS. Banking institutions are expected to maintain records of the structure and approval process and oversight of incentive compensation arrangements.

A copy of the NYDFS guidance is available here: http://www.dfs.ny.gov/legal/industry/il161011.pdf

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