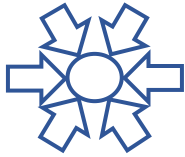

Financial Services Management

Executive-Compensation Clawbacks

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Impact Assessment

- Clawbacks would punish irresponsible governance as well as reduce moral hazard and FDIC resolution costs.
- However, they may also make it more difficult for troubled financial companies to attract qualified new management, independent directors, and/or major shareholders.
- The bill would apparently allow the FDIC to clawback compensation at solvent IDIs not in resolution if it thinks this warranted by poor management or governance practices.
- A new source-of-strength requirement for creditors and shareholders of parent holding companies would also reduce FDIC resolution costs for all IDIs regardless of whether the parent company is a bank holding company now liable to the FRB for pre-resolution support.
- However, ex post, unlimited liability could also dry up funding and shareholder equity when a banking company is under stress, accelerating or even causing failure.

Overview

Executive compensation incentives have proved among the most important reform priorities in the wake of recent bank failures.[1] In addition to efforts to complete long-delayed regulations mandated by the Dodd-Frank Act,[2] bipartisan Members are pressing different approaches to clawing back compensation from failed-bank executives who appear to have profited handsomely despite allowing or even encouraging untenable risks. One major, recent measure would not only grant the FDIC express clawback authority in the wake of non-systemic resolutions, but also expand clawbacks to a wide range of persons affiliated with the failed bank and to holding-company investors. However, much in this bill is

[1] See *Client Report* **REFORM220**, April 11, 2023.

[2] See **COMPENSATION33**, *Financial Services Management*, July 28, 2010.

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only sketchily drafted. However, given its high-profile sponsors, it is a precursor of the issues to come as more carefully designed legislative proposals advance.

Impact

In addition to Dodd-Frank Act provisions mandating incentive-compensation reform, the law also give the FDIC clawback authority in the event of systemic resolutions implemented by the law's orderly liquidation authority (OLA).[3] In these cases, the FDIC has the authority to claim compensation paid to a finance company's senior management and directors for the two years prior to seizure and, in case of fraud, for an unlimited period.

However, this power does not apply to FDIC receiverships or other resolution actions taken for failed insured depository institutions (IDIs) even if, as was the case for SVB and Signature, a systemic designation leads the FDIC to cover uninsured depositors. Further, the FDIC does not have the power to clawback compensation at a bank that is not yet either insolvent or in resolution.

This bill attempts to change this construct and does so by giving the FDIC such broad clawback authority that it appears to be able to recoup compensation even at solvent institutions when it thinks this warranted and it is not the IDI's primary federal regulator. FDIC clawbacks would also be mandatory in insolvencies even if there is no FDIC resolution, but the agency appears to have the option to use the formidable powers granted by the bill in any circumstance it thinks warranted.

In any such case, executives would not be the only persons at risk. The bill allows the FDIC to go after an array of "institution-affiliated parties" (see below) found responsible for the IDI's condition and thus reaches to directors, shareholders, and even certain consultants. Although mandatory clawbacks would need to cover five years, other clawbacks could be shorter or perhaps even longer.

As noted, the bill also makes holding-company creditors and shareholders liable for the losses borne by a failed IDI, with this provision apparently intended to cover all of the IDI's losses for at least some unspecified period of time, not just those incurred by the FDIC in resolving the failed bank. Under current law,[4] holding companies have an obligation to serve as a source of strength for subsidiary IDIs, but this is triggered only by Fed orders or, in the case of an industrial loan company (ILC) or similar charter, by the FDIC (with this agency's right to demand such support considerably less clear despite the FDIC's recent rule designee).[5]

Retroactive source-of-strength clawbacks from parent-company investors could ensure both better subsidiary governance and lower FDIC resolution costs, but equity investors would presumably be increasingly wary as an IDI's condition

[3] See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

[4] See **FHC19**, *Financial Services Management*, July 29, 2010.

[5] See **ILC15**, *Financial Services Management*, December 21, 2020.

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worsened. Investors willing to lose their equity stake if a bet on a troubled bank does not pay off may be far less willing to do so if they are liable not only for their shareholdings, but also reimbursement to the FDIC. If funding does not dry up, its cost would surely rise precipitously for similar reasons.

What's Next

This bill was introduced on March 29 by Sens. Warren (D-MA), Cortez-Masto (D-NV), Hawley (R-MO), and Braun (R-IN). Although Senate Banking Chairman Brown (D-OH) is not among them, he has indicated his determination to give the FDIC the express clawback authority for non-systemic resolutions also sought by President Biden.[6] HFSC Chairman McHenry (R-NC) has also made it clear that he wants to go after failed-bank compensation,[7] with pressure to do so sure to grow as SVB and Signature executives and directors are called to testify about their activities prior to bank failure. That said, it is unlikely that he and other Members on both sides of the aisle will be willing to go as far as this bill demands. There has yet to be any Congressional discussion of the bill's provisions with regard to IDI parent companies.

Analysis

Key provisions in this very short measure include:

- All "institution-affiliated parties" found to be responsible for the failed institution's condition would come under the restrictions noted below. Thus, clawbacks could govern not only executives, but also employees, shareholders, directors, and even certain consultants and attorneys.
- The FDIC could claw back salaries, bonuses and other incentive compensation, equity-based compensation, and most other forms of remuneration. Fees for covered third-party persons (e.g., consultants) are not covered even though that appears to be the bill's intent. Clawback is mandatory for all or some compensation at insolvent and/or resolved banks from at least the prior five years sufficient to prevent "unjust enrichment" and reflect the person's culpability.
- OLA's requirement that the FDIC does its best to recoup compensation and otherwise discipline insiders would not be limited to finance companies. The measure intends to do so regardless of the authority under which the FDIC becomes an institution's receiver, but the bill's language does not appear also to do so.
- Clawback proceeds would go to the DIF or Treasury (with the bill not making clear how this would be determined).
- Creditors and shareholders of an IDI's parent are to bear the IDI's losses.
- Clawbacks are to be deposited with the DIF or Treasury, with the bill not making clear how this is to be decided.

[6] See *Client Report* **REFORM217**, March 28, 2023.

[7] See *Client Report* **REFORM218**, March 29, 2023.

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