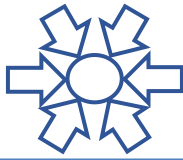

Financial Services Management

Compensation Clawbacks

Cite
S. 1045, Failed Bank Executives Clawback Act

Recommended Distribution:
Human Relations, Policy, Legal, Government Relations

Websites:
https://www.congress.gov/118/bills/s1045/BILLS-118s1045is.pdf

Impact Assessment

- It would be more likely that compensation will be demanded of insiders at covered firms, increasing incentive alignment but also making it more difficult to attract quality senior management and directors who might rescue a troubled bank.
- Controlling shareholders other than parent BHCs and S&LHCs are also at risk for their direct and indirect compensation. This would increase loss and create a still stronger disincentive for nonbanking organizations and individuals to invest in troubled IDIs.
- Only large banks are covered with regard to IDI insolvency or resolution, perhaps allowing smaller-bank insiders who failed to avert failure or even helped to precipitate it to retain prior compensation.
- Clawbacks are required even if an IDI is found to be insolvent without the need for FDIC resolution.
- DIF costs in the wake of bank failures could be somewhat or even meaningfully reduced based on how much compensation is received in claw-back actions.

Overview

Sen. Warren (D-MA) has introduced a revised version of legislation to ensure that both the FDIC and other federal banking agencies can demand that executive and others governing failed banks refund direct and indirect compensation to the federal government. As with Sen. Warren's prior bill to do so,[1] this bill is bipartisan, now also containing compromise language on several points from the prior bill to increase the odds of enactment. For example, the bill would apply only to those at failed banks with assets over $10 billion, making it more difficult to claw back compensation at smaller banks regardless of the level of compensation or nature of the actions of covered persons. Unlike the prior bill, this measure only puts compensation over the past three years at risk rather than capturing all compensation ever received in any form. The bill also does not include language that would have held investors in a parent company liable for

[1] See **COMPENSATION35**, *Financial Services Management*, April 12, 2023.

©2023. Federal Financial Analytics, Inc.

resolution costs. However, clawbacks could occur for insured-depository institution (IDI) insiders even if the FDIC does not resolve an insolvent bank.

Impact

The FDIC's clearest clawback authority in the event of resolutions is implemented by the law's orderly liquidation authority (OLA).[2] In these systemic 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 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. Current law also gives the FDIC discretion to claim covered compensation; this bill mandates that it or another federal banking agency do so.

Although this bill differs substantively from the prior Warren measure, it continues to have numerous drafting errors that complicate an analysis of its impact. For example, "insolvency" precipitating clawback is not defined. The bill requires clawback in resolution or an FDIC receivership, as well as when an IDI is "insolvent." Why this is distinguished from a resolution is not made clear and would appear to allow not only the FDIC, but also the Fed or OCC to act not only in the absence of resolution as long as insolvency is identified and/or to claim more compensation than the FDIC saw fit to do. It is possible that the "insolvency" language is designed to cover instances such as Silvergate's voluntary liquidation, but it could also cover instances in which an insolvent institution is acquired in a pre-resolution or receivership transaction.

Any such claims could still be only for the past three years and at IDIs with assets over $10 billion, with funds also required to go to the Deposit Insurance Fund, not another agency's coffers.

Although the measure is clearly designed like others in this arena to enhance incentive alignment between bank insiders and safety and soundness, the mandatory nature of the claims for insolvency, resolution, or receivership could make it more difficult for troubled banks to attract qualified management, directors, and controlling shareholders due to the potential for compensation capture if rescue efforts do not succeed. This might precipitate early resolution and thus reduce DIF costs, but it could also lead to otherwise-avoidable failures.

What's Next

S.1045 was introduced on June 1 by Sen. Warren with Sens. Hawley (R-MO), Cortez-Masto (D-NV), Braun (R-IN), and Warner (D-VA) as co-sponsors, most of whom are members of the Senate Banking Committee. Chairman Brown (D-OH) is not among them but is likely soon to convene the panel to approve the measure which then stands a good chance of passage in the Senate. Odds in

2 See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

©2023. Federal Financial Analytics, Inc.

the House are less clear, but the consensus nature of this measure combined with ongoing compensation revelations suggest it stands a strong chance of enactment unless controversial provisions are added along the way.

Analysis

Key provisions in the bill are as follows:

- Covered entities are those with over $10 billion in assets that cost the FDIC more than a minimal amount or otherwise have a serious adverse effect on the agency.
- Covered compensation includes salaries, bonuses, other forms of incentive or equity-based compensation, profits earned from buying or selling securities (presumably only those of the failed banking organization), and any wards granted over the three years prior to failure.
- Covered parties would be those who cause more than a minimal loss or otherwise have a "significant adverse effect" on an IDI, including directors, officers, or controlling stockholders (other than a BHC or S&LHC), agents, other parties with ownership interests, and anyone who participates in the IDI's conduct designated by a federal banking agency.
- Clawbacks would be required in the case of insolvency, resolution, or FDIC receivership. Clawbacks are also possible in the event of an OLA receivership. OLA resolutions to declare a conservatorship or bridge bank, but the drafting would not allow clawbacks in such cases even though these would occur in any form of FDIC resolution or even, as noted, in its absence if the IDI is insolvent. It is unclear if the insolvency trigger for compensation capture only applies in the event of FDIC loss or adverse impact.
- Retrieved compensation would go into the Deposit Insurance Fund.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com

© 2023 Federal Financial Analytics, Inc. All rights reserved.