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Behavioral Science For Incentive Compensation Reviews

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Recent attention in Congress on retail incentive compensation, goal-setting and cross-selling of consumer financial products and services is remarkable for its ferocity and its direction at banks and regulators alike. During a Sept. 20, 2016, Senate Committee on Banking, Housing and Urban Affairs hearing, Senator Elizabeth Warren, D-Mass., called out for special attention to “the person in charge of compliance ... the person who is supposed to be responsible to make sure that the bank is following the law.”

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During a Sept. 29, 2016, House Financial Services Committee hearing Congressman Blaine Luetkemeyer, R-Mo., pilloried, “federal regulators who ... failed to stop the ripping off of consumers” and “sat idly by, either oblivious or uncaring,” and then “neglected to fulfill their enforcement obligations after the fact.” He suggested that regulators “ought to be fined, as well” for being “asleep at the switch.”

Incentive compensation is not a new subject for financial services policymakers. According to a 2009 survey of banking organizations conducted by the Institute of International Finance, 98 percent of respondents cited compensation practices as a contributing cause of the financial crisis that began in 2007. Less than a month before the passage of the Dodd-Frank Act, federal bank regulators published “Guidance on Sound Incentive Compensation Policies.” Section 956 of the Dodd-Frank Act itself addresses incentive compensation and requires, among other things, that federal agencies promulgate rules limiting at certain financial institutions incentive-based compensation that, in the regulators’ view, encourages inappropriate risks.

A 2011 proposed rule implementing this statutory requirement generated over 10,000 comments. Perhaps due to divergent views on the subject, there was no formal action on the rulemaking for five years, until the agencies issued a revised proposal in June 2016 — not long before the current incentive compensation controversy hit the headlines. It is safe to say that the subject has been quickly graduated to the regulators’ front burner.

Incentive compensation and goal-setting are commonplace in the employment market, almost ubiquitous for sales functions, and have the potential to provide significant benefits and advantages to institutions. They help to attract skilled employees, promote better performance, express organizational objectives, enhance employee retention, and allow personnel costs to vary with revenue. Properly controlled, they need not be viewed with deep suspicion.

Still, there are numerous indications that there is more regulatory focus to come, and multiple regulators

have undertaken horizontal reviews and will be assessing incentive structures across the industry in the coming months. Accordingly, institutions are well-advised to take a hard look on their own right now.

Prior Guidance

A risk assessment of an institution's model should incorporate at a minimum the formal guidance to date. Any review should cover not only senior executive compensation but also other employees who, either individually or as part of a group, have the ability to expose the organization to significant risk. The existing guidance focuses on ensuring that incentive compensation programs (1) appropriately balance risk and reward; (2) are compatible with effective controls and risk management; and (3) are supported by strong corporate governance.

With respect to the first principle, any risk assessment should ensure that compensation arrangements do not encourage short-term profits or other performance measures at the expense of undue short-term or long-term risk. Regulators may assess whether incentive compensation arrangements contain some component of employee-borne risk associated with their own activities. The risk-reward balance can also be addressed by other program design elements — for example, supplementing numerical sales or product targets with factors such as referrals, customer satisfaction, customer retention or similar factors.

The second principle identified in the guidance, internal controls, requires that there be integration of an institution's compensation arrangements with the overall risk management and internal control framework. Training and auditing are important aspects of the control environment, but adequate compliance management in this regard may require access to internal tracking of incentive payments, risks taken and actual outcomes over a period of time, as well as periodic recalibration of incentive plans based on such data.

The third principle requires that the organization's corporate governance structure play an informed and active role in the organization's incentive compensation arrangements. This includes board review and approval of the key elements of the incentive compensation systems across the organization and periodic board reporting of evaluative reviews of the process.

Behavioral Economics

In assessing an appropriately balanced and strictly monitored and governed incentive compensation program, it may be illuminating to review some lessons from behavioral economics. After all, incentive compensation itself, at bottom, is an application of this field of study.

On Sept. 15, 2015, the Consumer Financial Protection Bureau's well-known reliance on behavioral economics was validated in part by an executive order, which encourages federal agencies to "identify policies, programs and operations where applying behavioral science insights may yield substantial improvements in public welfare, program outcomes and program cost effectiveness." Empirical findings should inform certain aspects of any risk assessment. Among a wide range of findings, (1) where goals are too specific, employees may overlook outcomes unrelated to the goal; (2) goals that are too challenging may lead to inappropriate risk-taking; and (3) goals with improperly short horizons may undermine long-term outcomes.

Behaviors may not always be unethical when they lead to decisions where individuals maximize their own compensation at the expense of their organization in potentially destructive ways. But there are some darker teachings from behavioral economics that remain salient. For example, people naturally are more

prone to “game the system” when they think the risk that they will get caught is low. Moreover, ethical compromises are contagious or, put another way, ethical behavior is more situational and less a function of personal values than we often assume. Watching others misbehave heavily influences behavior. Hence, an incentive compensation control system must not only account for the possibility of outliers manipulating an institution’s reward system — it also must account for the possibility of broader pockets of problems in distinct areas of the organization.

Conducting a Review

There is no one-size-fits-all approach to an internal review and assessment of incentive compensation programs. However, in light of the current regulatory environment, certain factors should be given serious consideration. A risk assessment may mine inactive accounts for potential unauthorized openings, although inactive accounts, without more, may not raise concern. It may also review positive or negative outlier individual employee, branch or even geographical performance to ensure that highly successful employees are not engaging in questionable practices or facing inappropriate pressure and that low-performing employees are being provided with the tools to succeed.

Customer complaints relating to account opening, sales practices and identity theft claims should be the subject of particular focus, along with reports to employee ethics hotlines or similar resources. Institutions may consider implementing follow-up customer communications to confirm new product and a review of those communications and responses.

It is important to ensure that any risk assessment examining these issues is conducted under the attorney-client privilege in order to protect work product from disclosure in the event that it otherwise may be discoverable in civil litigation or a government investigation. However, the attorney-client privilege generally does not provide a basis to withhold documents from banking regulators acting in their supervisory capacity relating to internal reviews, and regulators have more strongly asserted their access to privileged documents in light of the limited safe harbor provision in 12 U.S.C. § 1828(x).

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