RB 27a rescinded 04/18/01. Incorporated into Thrift Activities 310

Handbook: **Thrift Activities** — **Section: 140**
Subject: **Oversight by the Board of Directors** — **RB 27a**

March 5, 1993

Executive Compensation

RESCINDED

Summary: This Bulletin provides guidance to regulatory personnel for review of compensation provisions and clarifies OTS policy regarding unsafe and unsound practices relating to executive compensation and employment contracts contained in 12 CFR §§ 563.39 and 563.161. This Bulletin further clarifies a number of issues that arose in connection with Regulatory Bulletin (RB) 27 and re-emphasizes OTS policy to defer to healthy thrifts' boards of directors in compensation matters. RB 27, dated November 8, 1991, is rescinded with the issuance of this Bulletin.

For Further Information Contact: Your Regional Office or the Policy Division of the Office of Thrift Supervision.

Regulatory Bulletin 27a

The Director of the Office of Thrift Supervision (OTS) has authority under § 4(a)(1) of the Home Owners' Loan Act (HOLA) to provide for the safe and sound operation of savings associations. Section 8(b)(6) of the Federal Deposit Insurance Act authorizes each regulatory agency to take actions to limit the terms of, or to prohibit an insured depository institution from entering into or making payments under, any contracts between an insured depository institution and an institution-affiliated party that constitute an unsafe or unsound banking practice.

General Policy

The OTS will ordinarily give healthy institutions deference concerning compensation levels and compensation arrangements for their directors and senior executive officers. All MACRO factors, not just capital, will be considered in the review of employment contracts and other compensation arrangements.

As a general rule, the OTS will defer to the savings association's board of directors concerning executive compensation arrangements, provided the following conditions are met:

- The savings association is not a problem association,
- The compensation arrangements do not present significant safety or soundness concerns that could lead to material financial loss or damage to the association, and
- Members of the board complied with their fiduciary duties in connection with approving the compensation arrangement.

The OTS requires the board of directors of each association to annually review all employment contracts and compensation arrangements for senior executive officers and directors and to document their justification and approval in the board minutes. Directors who have a personal interest in the compensation arrangements should not participate in the deliberations on or vote on the arrangements. Employment contracts may only be renewed or extended upon explicit review and approval by the board of directors.

Prior Approval Requirement

All problem associations should submit employment contracts for senior executive officers and directors to the Regional Director for prior review. The Regional Director may extend this requirement to other employees of the savings association as well. Compensation at problem institutions requires regulatory scrutiny on a case-by-case basis in order to balance a problem institution's need to lower operating expenses against the need to provide a higher than normal level of compensation to attract or retain qualified management.

Definitions

"Compensation" includes any payment of money or provision of any other thing of value in consideration of employment, including, without limitation, base salary, commissions, bonuses, pension and profit-sharing plans, severance payments, retirement, director or committee fees, fringe benefits, payment of expense items without accountability or business purpose or that do not meet the IRS requirements for deductibility by the association. The grant or exercise of stock options will not ordinarily be considered compensation unless they are so material in amount or conditioned upon factors that result in incentives that cause supervisory concerns.

A "senior executive officer" includes any individual who exercises significant influence over, or participates in major policymaking decisions of, a savings association without regard to title, salary, or compensation. The term includes but is not limited to the president, chief executive officer, chief operating officer, chief financial officer, chief lending officer, chief investment officer, general counsel, or their functional equivalents.

A “director” is any individual who is a member of the board of directors of the association or of any subsidiary of the association.

An “employment contract” is any agreement, intended to be legally enforceable, that materially affects the terms and conditions of a person’s employment.

A “problem” association is defined as an association that: (1) has a composite MACRO rating of 4 or 5; (2) is undercapitalized under prompt corrective action standards; (3) is subject to a capital directive or a cease and desist order, a consent order, or a formal written agreement, relating to the safety and soundness or financial viability of the savings association, unless otherwise informed in writing by the OTS; or (4) has been notified in writing by the OTS that it has been designated a problem association or an association in troubled condition.

Existing Contracts

The OTS will review, comment, and take appropriate action to correct existing employment contracts that are deemed to be unsafe or unsound.

The OTS will not generally require changes to pre-existing contracts in healthy institutions. Contract provisions, however, that raise significant safety and soundness concerns will be subject to examination comment or formal enforcement actions until the contract is terminated or modified. The OTS may, on safety and soundness grounds, insist that the board replace unacceptable managers and use its best efforts to renegotiate employment contracts that are excessively burdensome on the institution.

Unsafe or Unsound Practices

The following guidelines are illustrative, not exhaustive, examples of compensation provisions considered unsafe or unsound. Other compensation provisions may also be objectionable depending on individual circumstances. These guidelines are based on safety and soundness concerns that are especially important for problem associations. Regulators must use judgment in the application of the guidelines, taking into account the condition of the institution, the reason for the provision and the materiality of the provision.

Regulators should review compensation provisions in problem associations under these guidelines (1) during examinations, (2) in conjunction with applications that contain compensation arrangements, and (3) when employment contracts and compensation payments are submitted for review by problem associations.

- Compensation arrangements that provide incentives contrary to the safe and sound operation of the association. For example, compensation based primarily on short-term operating results may encourage unreasonable risk-taking to achieve short-term profits. Compensation tied to current operating results should be closely monitored by the board of directors.

- Compensation arrangements that provide for compensation that significantly exceeds compensation paid to persons with similar responsibilities and duties in other insured institutions of similar size, in similar locations, and under similar circumstances, including health and profitability.

- Contracts that contain automatic renewals or extensions of the contract without providing explicit review and approval by the board of directors.

- Contracts that provide for an excessive term. As a general matter, a one-year term is not objectionable; a term exceeding three years is generally objectionable.

- Total compensation paid out upon the departure of an employee, regardless of the reason, that exceeds three times the employee’s average annual compensation.[1] Total compensation must include payments for the remaining contract term, if applicable, as well as any severance payments. Average annual compensation should be based on the most recent five taxable years.

- Contracts that do not adequately reflect or define the duties and responsibilities of the employee.

- Compensation programs (including deferred compensation/retirement/insurance) for independent directors that are not commensurate with their duties, or that jeopardize their independence, such as vesting requirements that would require an independent director to forfeit previously accrued amounts if they did not serve for a minimum number of years.

- Contracts that are collateralized or otherwise guaranteed by the savings association, unless the contract terms provide that the contract is unenforceable if the association becomes a problem

1. In the case of termination for cause, however, no payments should be made.

association or unless the contract is approved by the Regional Director. Guarantees provided solely by the holding company are permissible.

- Contracts that provide for employer reimbursement of costs incurred by employees seeking to enforce employment contract terms in the absence of legal judgment or settlement.

- Change-in-control provisions that provide for immediate vesting, particularly for problem institutions.

- Generally, any contract that requires payment upon the voluntary resignation of the employee will be examined carefully to determine whether it is unsafe and unsound.

RB 27a does not apply to employment contracts or other compensation arrangements between a holding company and a holding company executive. Employment contracts between a holding company and a thrift executive are not covered unless such contract or arrangement is likely to adversely affect the financial or managerial condition of the association. If applicable, separate contracts should be maintained between a thrift executive and the association and the thrift executive and the holding company.

The following "golden parachute" provision should be included in new and renewed employment contracts: "Any payments made to the employee pursuant to this agreement, or otherwise, are subject to and conditioned upon their compliance with 12 USC § 1828(k) and any regulations promulgated thereunder."

John F. Robinson

— John F. Robinson
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