NEW YORK STATE
DEPARTMENT *of*
FINANCIAL SERVICES

Andrew M. Cuomo
Governor

Maria T. Vullo
Superintendent

TO: Chief Executive Officers of NYS Chartered Banking Institutions; Managers of NYS Licensed Branches & Agencies of Foreign Banking Organizations

FROM: Maria T. Vullo, Superintendent of Financial Services

RE: Guidance on Incentive Compensation Arrangements

DATE: October 11, 2016

In light of the recent joint enforcement action 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, the New York State Department of Financial Services (the "Department") is issuing this guidance to its regulated banking institutions to emphasize that incentive compensation arrangements must be devised, if at all, so that employees are not provided incentives to engage in unacceptable practices or conduct.

The Wells Fargo action highlights the fact that misaligned incentive compensation arrangements, inappropriate sales practices, lack of formalized governance and effective oversight of sales practices, and the failure of internal control functions to identify risks and shortcomings at a bank may lead to disastrous outcomes for consumers, and for the bank from a safety and soundness and reputational risk perspective.

When broad organizational strategies and goals at a bank, such as maximizing profits by increasing the number of product relationships per customer, factor into individual performance through key performance indicators, coupled with incentive compensation arrangements tied to such performance indicators, without effective risk management, oversight governance and control, employees are tempted to resort to gaming these key performance indicators for personal advantage to the detriment of consumers.

Inappropriate sales practices, driven by misaligned incentive compensation arrangements, and enabled by weak risk management and controls, undermine the basic trust that underlie the relationship between a bank and its customers, adversely impact safety and soundness, and harm consumers. In fact, flawed compensation practices in the financial industry were one of the factors that contributed to the financial crisis that began in 2007.

Incentive compensation arrangements that encourage or foster inappropriate corporate practices or bad behavior should have no place in our banking system.

Accordingly, the Department advises all regulated banking institutions that no incentive compensation may be tied to employee performance indicators, such as the number of accounts opened, or the number of products sold per customer, without effective risk management, oversight and control.

In addition, incentive compensation arrangements at our banking institutions must, at a minimum, meet the following principles[1]:

- **Balance Between Risks and Rewards:** Appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks;
- **Effective Controls and Risk Management:** A banking institution's risk management processes and internal controls must reinforce and support the development and maintenance of any incentive compensation arrangements: and
- **Effective Corporate Governance:** Incentive compensation arrangements must be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

Particular attention should be given 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.

Misaligned incentive compensation arrangements and unacceptable corporate or individual conduct that result in consumer harm or other unsafe and unsound practices will be acted upon by the Department. The Department will conduct supervisory review of incentive compensation arrangements during the Department's regular risk focused examination process, 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. Banking institutions are expected to maintain records that document the structure and approval process of their incentive compensation arrangements, as well as the related risk management and oversight of such arrangements, for the Department's examination.

For further information, please contact your relationship manager or point of contact at the Department.

[1] Based on the Interagency Guidance on Sound Incentive Compensation Policies issued in 2010 jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.