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Lessons From Wells Fargo: Forfeiture and Clawback Policies

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The Wells Fargo & Co. sales incentive fraud scandal has further increased the scrutiny on banking industry compensation practices. Since 2010, banks have followed the Interagency Guidance on Sound Incentive Compensation Policies and reviewed their incentive plans to ensure they do not motivate inappropriate risk taking. However, incentive compensation in the retail business lines was often perceived as inconsequential and unlikely to pose significant risk to the organization.

All that changed in 2016 when Wells Fargo was fined $185 million to settle accusations that employees opened more than 2 million fraudulent accounts over several years without customer knowledge or approval, in order to meet internal sales goals. The CEO resigned under pressure and he and the former head of retail banking lost pay to forfeitures and clawbacks.

These terms have been used interchangeably with initial media stories reporting Wells Fargo "clawed back" compensation, when in fact, it was a forfeiture. What is the difference between a clawback and a forfeiture? How and why should banks consider these policies?

Clawback policies provide companies with the opportunity to seek repayment of incentives if it is later learned that there was a restatement of earnings or misconduct. While clawbacks are an important and expected governance feature of executive compensation programs, it can be challenging for companies to seek repayment of awards that have already been paid.

Forfeiture provisions, on the other hand, provide companies with the ability to cancel outstanding incentives that have been deferred or remain unvested. Forfeiture provisions are easier to execute, as the company has not yet paid out the incentive awards or released the shares to the recipient. The Wells Fargo situation highlighted forfeiture provisions as a more practical tool for ensuring incentives can be reduced if necessary after the initial award value has been determined.

Companies crafting forfeiture and clawback policies should carefully consider what triggers will be included, including but not limited to:

Inaccurate financials: Policies commonly provide for forfeitures and/or clawbacks when it is later determined that the financial results that were the basis of incentive payouts need to be restated. The Sarbanes-Oxley Act and the Dodd-Frank Act both require clawback but they focus on material financial restatements. (Regulators have not finalized the Dodd-Frank Act's clawback rule so it has not formally gone into effect.) Many policies also cover incorrect calculations that do not lead to a restatement. Companies must also consider whether to require fault on behalf of the employee before triggering a potential forfeiture or clawback.

Misconduct: Companies are increasingly including misconduct as a potential trigger for recoupment. Misconduct can be defined in a number of ways, including violation of company risk policies, fraud, negligence or inadequate consideration of risk. Policies should also consider a provision covering failure to supervise that leads to improper risk behavior. Misconduct may also include violation of restrictive covenants, such as non-compete provisions. Policies may establish that the misconduct must have resulted in material harm to the company to trigger a potential forfeiture or clawback. The Wells Fargo case highlighted the importance of considering reputational harm in addition to financial harm for such provisions.

Material downturn in performance: Some policies also include a material downturn in financial performance as a trigger, which suggests risks were not properly evaluated. These provisions occur primarily in forfeiture provisions among larger banks and may be defined as negative earnings or capital levels falling below regulatory requirements.

Although the Dodd-Frank Act requires regulators to implement clawback regulations, those regulations have not yet been finalized. Absent final regulations, the industrywide best practice is to provide that the occurrence of certain triggers will lead to a review. However, the compensation committee typically retains discretion to determine whether a forfeiture or clawback is appropriate and, if so, the amount.

While all companies hope that clawback and forfeitures will never be needed, they are becoming expected governance practices that help discourage excessive and inappropriate risk. They are tools no bank wants to use, but having sufficient policies to recoup pay in the event of significant risk event is an expectation of regulators and shareholders.

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