

Insights: Alert

Legislation Advances to Hold Senior Executives Accountable When Banks Fail

June 26, 2023

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The Senate Banking, Housing, and Urban Affairs Committee approved legislation on June 21, 2023 with bipartisan support that would provide federal bank regulators with enhanced powers to hold senior executives directly accountable when their bank falls out of regulatory compliance or fails. The “Recovering Executive Compensation From Unaccountable Practices Act” or the RECOUP Act, creates broader authority for regulators to (i) ban “senior executives” (see below) from the industry and (ii) claw back compensation and stock trading profits from senior executives. In addition, the legislation mandates explicit governance standards to promote safety and soundness and responsible bank management.

Expanded Authority to Impose Prohibitions on Bank Executives

The legislation targets a number of deficiencies in risk management and governance practices that were identified by the regulators in the wake of the Silicon Valley Bank, Signature Bank and First Republic Bank failures. The bill expands the removal and prohibition authority of federal banking agencies under 12 USC §1818(e) by specifically authorizing a bank's primary federal regulator to ban covered executives from the industry upon a finding that they failed to “carry out the responsibilities of the senior executive for governance, operations, risk or financial management” of an insured depository institution. In addition, the legislation provide authority for the primary federal regulator to issue a prohibition order if a covered executive is found to have demonstrated gross negligence in the performance of their duties. The RECOUP Act also creates an explicit basis for prohibition where a covered executive is found to have (i) failed to appropriately implement financial, risk, or supervisory reporting or information system or controls or (ii) failed to oversee the operation of the foregoing.

The new prohibition authority under the RECOUP Act is focused on action or inaction by a “senior executive,” which the legislation defines as an individual who has oversight authority for managing the overall governance, operations, risk or finances of a depository institution or a depository institution holding company. The legislation specifically identifies the institution's (or holding company's) president, chief executive officer, chief operating officer, chief financial officer, chief risk officer, chief legal officer, board chair, and any insider board members as senior executives.

The legislation also increases the maximum civil money penalty from \$1 million to \$3 million in the case of “reckless” conduct by a senior executive who engages in unsafe and unsound practices or breaches a fiduciary duty to the institution.

Recoupment of Executive Pay

The RECOUP Act would add a new Section 54 to the Federal Deposit Insurance Act that provides the regulators with broad authority to recoup any form of cash incentive pay or equity compensation received by a senior executive in the 24-month period preceding an institution's failure. The legislation, however, takes the clawback concept one step further by allowing the regulators to recover any profits realized by a senior executive from the sale of securities of the failed institution (or, as applicable, the holding company of the failed institution). Section 54 goes well beyond the regulators' existing authority to regulate bank compensation through safety and soundness guidance and to block payment of compensation to institution-affiliated parties of a troubled institution. There are two limitations on Section 54 authority – (i) the compensation recoupment rules include a “community bank exception” for institutions with a consolidated asset size of \$10 billion or less, and (ii) the rule exempts compensation received by a senior executive who was employed for 12 months or less prior to the institution's failure and whose conduct did not materially contribute to the failure.

New Governance and Accountability Standards

Perhaps the most striking feature of the RECOUP Act is a requirement that depository institutions and, as applicable, their holding companies, with consolidated assets of more than \$10 billion, must adopt governance and accountability standards in their articles of incorporation or bylaws that “promote safety and soundness, responsiveness to supervisory matters, and responsible management.” The legislation specifies the content for the required standards:

- standards applicable to senior executives and board members relating to appropriate risk management, including a requirement of responsiveness to supervisory matters;
- accountability and governance controls that ensure that senior executives and the board are implementing, and ensuring oversight of, reporting and information controls;
- controls to ensure that management does not deviate from sound governance, internal control or risk management; and
- standards that ensure the maintenance of appropriate long-term risk management tailored to long-term economic conditions.

The requirement that corporate governing documents include mandated governance and accountability standards is the most problematic aspect of the RECOUP Act. The standards are relatively vague and, if adopted, would require a significant regulatory project to provide clarity around the implementation of the standards. In addition, a requirement that corporate governing documents include these standards would no doubt create a cottage industry of shareholder litigation seeking to demonstrate that banks are out of compliance with the standards. While the objective of the standards is laudable, the placement of the standards in corporate governing documents may be an ill-considered response to issues that really require more direct supervisory engagement with bank management.

Looking Ahead

The RECOUP Act reflects a measure of agreement among legislators in both parties that some corrective legislation is necessary to address the causes of the recent bank failures. Nevertheless, the fate of the RECOUP Act in its present form remains uncertain. The RECOUP Act must still obtain full Senate approval, and the House Financial Services Committee has yet to take up similar legislation. House Democrats have offered legislation that generally tracks the RECOUP Act and, in some instances, goes beyond the RECOUP Act. For

example, H.R. 4209, offered by Rep. Maxine Waters, D-CA, the Ranking Member of the House Financial Services Committee, would provide the regulators with authority to block stock sales by executives when their bank receives poor regulatory ratings or fails to resolve significant supervisory concerns. At this writing, it is not clear whether a bipartisan consensus will emerge in the House. However, with pressure building around an anticipated legislative response to the recent bank failures, it is possible that legislation will emerge from Congress this year that tracks closely with the objectives, if not the language, of the RECOUP Act.

If you have any questions regarding this alert, please reach out to your Kilpatrick Townsend contact.

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