



Pay check

New proposed regulations for incentive pay
at financial institutions



Incentive-based compensation in the financial services industry (FSI) has been a hot-button issue for regulators and the general public for the past several years. Although regulations governing compensation aren't a new component of the overall regulatory framework, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directed six regulatory agencies to jointly issue rules addressing pay packages in a new manner. Those rules are now nearing their final form.

Institutions covered by the new rules will face a variety of compliance requirements, ranging from short-term concerns such as incentive plan redesign and covered employee identification to longer-term requirements surrounding governance. Less explicit in the new proposed regulations, but central to the ability to comply, is the question of culture—the internal characteristics that influence risk behavior.

The public comment period on the agencies' new proposed rule to govern incentive-based compensation ended on July 22, 2016. As of July 26, there were more than 40 comment letters submitted by covered institutions, trade associations, and other stakeholders, many of which raised significant concerns with various aspects of the proposal.¹

How we got here—and what has changed along the way

The six agencies that are required to formulate incentive compensation regulations under Section 956 of the Dodd-Frank Act proposed an original set of rules in 2011. The intent behind the rules, then as now, is to prevent compensation arrangements from encouraging “inappropriate risks” that either provide an individual with excessive compensation or could lead to “material financial loss.”

Their mission under the Dodd-Frank Act was twofold: to force institutions to disclose all incentive-based compensation arrangements to regulators, and to prohibit arrangements that could encourage risky behavior or expose companies to financial loss.

Agencies charged with new rulemaking

- Federal Reserve Board (FRB)
- Federal Deposit Insurance Corporation (FDIC)
- Office of the Comptroller of the Currency (OCC)
- Securities and Exchange Commission (SEC)
- Federal Housing Finance Agency (FHFA)
- National Credit Union Administration (NCUA)

The original version was largely principles-based and left areas of substance open to interpretation. Many banks took action then—developing procedures to identify covered employees, balancing risk-taking incentives, and revising risk-management controls and corporate governance.

However, these discrete policies and procedures are only part of the necessary approach to balance risk and reward and prohibit inappropriate risk-taking behaviors. Culture is an indispensable means to not only drive compliance with rules on compensation, but also to drive behaviors that are beneficial to the enterprise. As Federal Reserve Bank of New York President Bill Dudley said, “One way in which incentives can be shaped is through the structure of compensation,” and “a proper compensation system can be an important tool for enhancing culture.”²

In April and May 2016, the six controlling agencies “re-proposed” a new version³ of the compensation rules, which are more prescriptive than the principles-based rules proposed in 2011. These changes reflect the experience and insights gained by regulators over the last five years of working with financial institutions. Once finalized, the new rules would be effective 18 months after publication.

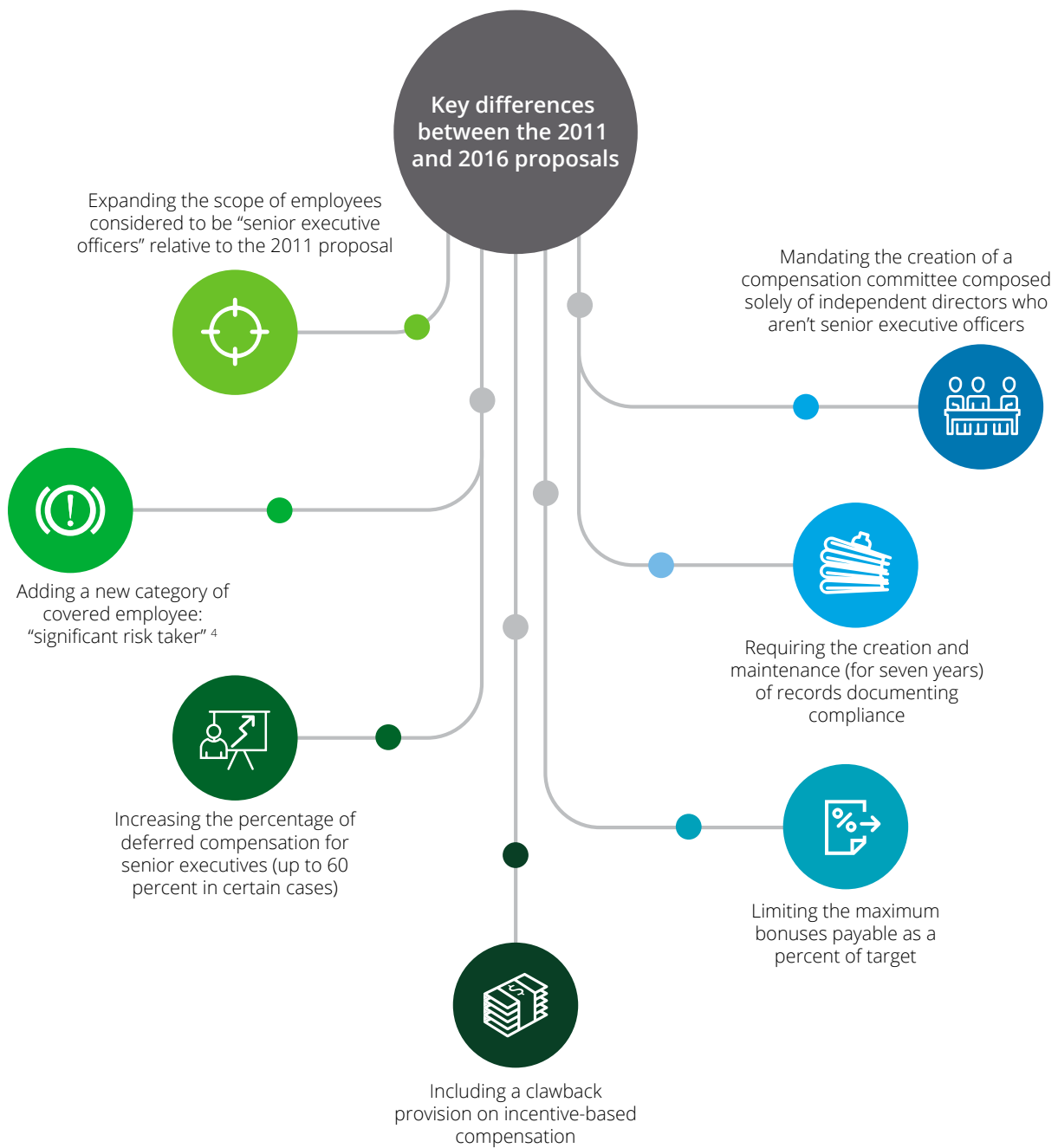
The new proposed rules apply different requirements to institutions based on their total consolidated assets.

New incentive compensation rules apply by asset size

Level 1	Covered institutions with \$250 billion or more in total consolidated assets
Level 2	Covered institutions with \$50 billion to \$250 billion in total consolidated assets
Level 3	Covered institutions with \$1 billion to \$50 billion in total consolidated assets

The larger the enterprise, the more rigorous the requirements. If one covered institution is the subsidiary of another, it would be subject to the same requirements and defined at the same level as the parent institution, even if the subsidiary is smaller than the parent. Financial institutions with less than \$1 billion in total consolidated assets are exempt from the rule.

The 2016 proposal is more stringent than the 2011 proposal in most respects. It expands upon the earlier guidance in significant ways, including:



Which institutions will have to comply?

There are, in effect, two lists of covered institutions, although both groups will be subject to the same requirements and the same asset thresholds. The first comes directly from Section 956 of the Dodd-Frank Act. The second list includes institutions the regulatory agencies have jointly proposed to treat as subject to the rules.

Institution types mandatorily covered by legislation



- National banks, state member banks, and federal savings associations
- Bank holding companies (BHCs) and savings and loan holding companies (SLHCs)
- SEC-registered broker-dealers
- Credit unions
- Investment advisers (registered and unregistered)
- Fannie Mae
- Freddie Mac

Additional institution types covered by agencies' proposed rule



- US operations of foreign banking organizations (FBOs) that are treated as BHCs
- Edge and Agreement corporations
- State-licensed and uninsured branches and agencies of FBOs
- State-chartered non-depository trust companies that are members of the Federal Reserve System
- Federal Home Loan Banks



How should covered institutions respond to the new requirements?

Deloitte's analysis of the proposed regulations and the organizations that will have to comply with them suggests covered institutions should address the requirements in three phases: short-, medium-, and long-term.

Short-term actions

Identify covered employees. Most covered institutions already have procedures in place to identify covered employees based on the 2011 rules, and they will need to review and potentially expand them to meet the new standards. For example, Level 1 and 2 organizations must identify "significant risk takers."

Who are "covered persons" under the new rule?

According to the re-proposed rule:



"... a covered person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions at a covered institution for any period of time in the relevant performance period: president, chief executive officer (CEO), executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head of a major business line or control function."



"... an individual in a covered institution with at least \$50 billion in assets who is not a senior executive officer but was among the top 5 percent (for organizations with more than \$250 billion in consolidated assets) or top 2 percent (for organizations with between \$50 and \$250 billion in consolidated assets) of most highly compensated covered persons in the entire consolidated organization or had authority to commit or expose 0.5 percent or more of the capital of a covered institution."

Review and assess incentive plan design and deferral requirements.

Covered institutions will need to review and potentially amend existing incentive plans to comply with the proposed directives. Throughout this review process, it's important for organizations to consider that incentive arrangements align with a company's business strategy and balance motivating employees with the company's stated risk appetite and risk control framework.

Deferrals

The proposed rules define what percentage of incentive-based compensation should be deferred and the required deferral period (e.g., three years or four years after the award is earned). While some institutions may already require incentive compensation deferrals, others may need to adopt new provisions to ensure their plans meet the new requirements and comply with Internal Revenue Code Section 409A.⁵ Additionally, considering the impact of any changes on termination provisions (death, disability, retirement, etc.) will be important.

Caps

The proposed rules limit the amount of incentive compensation that can be awarded as a percent of target for Level 1 and 2 institutions (i.e., 125 percent of the target incentive for senior executive officers and 150 percent for significant risk takers). Level 1 and 2 organizations have to amend their annual and long-term incentive plans. In our experience, similar incentive caps implemented by European banks in response to legislation have resulted in significant increases to base salaries, and a similar response is considered likely here in the US. In addition, we expect to see the target and/or threshold level of payout increased in order to maintain competitive compensation programs. Covered institutions should review and reassess

performance curves (i.e., threshold, target, and maximum performance goals and corresponding payout levels) to ensure the incentive compensation structure is well-designed and there is an appropriate relationship between the level of company financial and/or non-financial performance achieved and the corresponding incentive plan payout to plan participants.

Forfeiture and adjustments

Under the new proposals, Level 1 and Level 2 institutions would be required to make subject to forfeiture all unvested incentive-based compensation of a senior executive officer or significant risk taker. They would also be required to make subject to downward adjustment all incentive-based compensation not yet awarded if the following outcomes occur:

- Poor financial performance attributable to a significant deviation from the institution's risk parameters
- Inappropriate risk taking
- Material risk-management or control failures

In light of these requirements, organizations should assess whether their existing policies and procedures for adjusting incentive deferrals are compliant with the proposed rules. A breach of risk management protocol or a shortfall in capital holdings may trigger the need for adjustments in incentive payouts.

Revise existing clawback policy.

Most companies covered by these new requirements will already have broad clawback policies in place. In some instances, however, complying with the new rules may require updates to those policies—for example, the need for a seven-year recovery period (most clawback policies have a three-year look-back provision).

Why culture and conduct matter: Alignment of risk and reward

The proposed rules require covered institutions to define and implement incentive payout adjustments based on the occurrence of certain conduct failures. These might include compliance breaches, mis-selling, information security breaches, and confidentiality violations.

Institutions can use adjustments in incentive payouts to correct risk management or control failures. But in order for an effective compensation program to be administered, the support of a strong governance system and risk safeguarded culture is imperative. When responsible parties at all levels in an organization have internalized the reasons not to behave with excessive risk, there is less need for direct "carrots and sticks."

Indeed, the November 2015 Financial Stability Board progress report on the implementation of its Principles for Sound Compensation Practices concluded in part: "While the [Compensation Monitoring Contract Group's] work has revealed that supervisors believe the tools are in place to address conduct issues through compensation mechanisms, the effective use of such mechanisms by firms—and therefore their influence on potential misconduct—is unclear." Where rules fall short, culture can make up the difference.

Source: "Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards," Financial Stability Board, November 10, 2015, available at <http://www.fsb.org/wp-content/uploads/FSB-Fourth-progress-report-on-compensation-practices.pdf>.

Review and update governance documentation procedures. Existing documentation processes are likely robust in most institutions, but many will need to update them to reflect the new requirements, especially the need to maintain records for seven years. This will require an evaluation of current internal control processes that aid in:

- Inventorying incentive arrangements
- Maintaining an appropriate balance of risk and reward
- Monitoring ongoing incentive-based compensation arrangements
- Training sessions that are used to educate employees on the requirements posed by the rules

Review compensation committee oversight and independence. Under existing stock exchange listing rules, a publicly traded company must maintain a compensation committee composed solely of independent, non-employee directors. For most covered institutions, the proposed rule isn't likely to have an impact of existing committee membership, but institutions should review their committees' charters to include the latest requirements.

Medium-term actions

Solidify scrutiny of the rewards program. Once the necessary short-term review is complete, the company can turn its attention to building more sustainable, competitive compensation programs. These include the need to examine how the new rules stand to affect certain executives' compensation programs and what alternative reward arrangements they may need to remain competitive in the marketplace. Any changes to the incentive program should align with broader business objectives. They should also

take into consideration any changes made in other programs, such as retirement benefits. Decisions like these go beyond hard and fast rules. They involve alignment with the overall rewards philosophy as much as they do with the perceived value and competitiveness of the program.

Review performance management.

Given the importance of culture, this will be an appropriate time to review the way performance management contributes to managing risk in the organization. Does the current performance management system support the ability to align risk and individual performance? Do covered employees have risk-related objectives included in their performance management goals? And if an employee receives a bad risk rating, does the organization have an adequate corrective action process in place? If performance issues aren't properly addressed, employees may be unaware of performance deficiencies—and unable to correct them.

Strong cultures have two common elements: a high level of agreement about what is valued, and a high level of intensity with regard to those values.

An institution's culture and training programs enable leaders to address these problems. After-the-fact adjustments to pay can provide "rough justice" for a risk violation, but a clear, single vision of expected standards can prevent one, and performance management programs should promote these standards. As an institution readies its three lines of defense—the business units, the chief risk officer and compliance teams, and the audit function—to carry out these new mandates, the overlay of culture over bright-line rules is invaluable.

Review control function employees.

The new proposed rule would capture employees in the control functions (finance, human resources, legal, and risk) who weren't previously subject to these requirements. The company should balance incentive compensation for these individuals to support both short-term growth and the long-term financial health of the company. For the sake of control function independence, it's also leading practice to fund bonus pools for the control functions independently from the business unit plans they oversee.

Long-term actions

Build in ongoing review and governance.

Beyond the immediate implications of the re-proposed rules, it's important for companies to have the structures and oversight procedures they will need to promote continued compliance. One way to achieve this is to form a management committee made up of senior control function employees who conduct regular reviews of all policies and procedures to maintain compliance with incentive compensation rules and internal guidelines. This management committee should provide a full report to a joint meeting of the compensation and risk management committees at least annually.

Over-emphasis on value creation can inadvertently incentivize employees to take inappropriate risks in pursuit of personal financial reward, while an overly risk-averse plan can limit incentives to drive company value.

Culture as the root of compliance

The most significant determinant of behavior in organizations isn't rules but culture—the value, beliefs, attitudes, and actions that the people in an organization share. Compensation both reflects and drives these attributes: As a participant at Deloitte's 2015 Cross-Industry Compliance Leadership Summit said, "Show me a compensation system, and I'll show you a value system." Regulators agree, and bodies such as the Financial Industry Regulatory Authority and the OCC have made culture a priority in examinations.

One reason culture is vital is that it can inform subjective decisions in ways that rules can't. Financial institutions should take measured risks and reward people

for taking them effectively. But they should also avoid undue levels of risk and make certain they don't compensate people in ways that tempt such behavior. This doesn't mean that incentive compensation has become imprecise or "squishy" with the injection of culture—quite the reverse. Culture, applied to a regulated environment, emerges as something distinct and measurable. And like any input into business outcomes, it must be measured to be controlled.

How can an enterprise exert control over its culture? Some sources say the impetus must come from the top down. Other voices emphasize the role of the middle—because front-line managers

can lead by direct example in ways senior leaders may not. This is a false choice. Culture is the responsibility of everyone at every level, either to define it, to spread it, or to live it. But the effort should be deliberate. Every organization should have a team leading the charge of culture, and programs such as training, while an internal communication strategy should be developed to spread the message.



What happens next?

With the six mandated regulatory agencies in basic agreement about the shape of the new system, covered institutions should closely monitor the agencies' process as they work to finalize the rule. The recommendations in this document outline many of the considerations and short-, medium-, and long-term steps that institutions should consider taking in anticipation of this timeline.

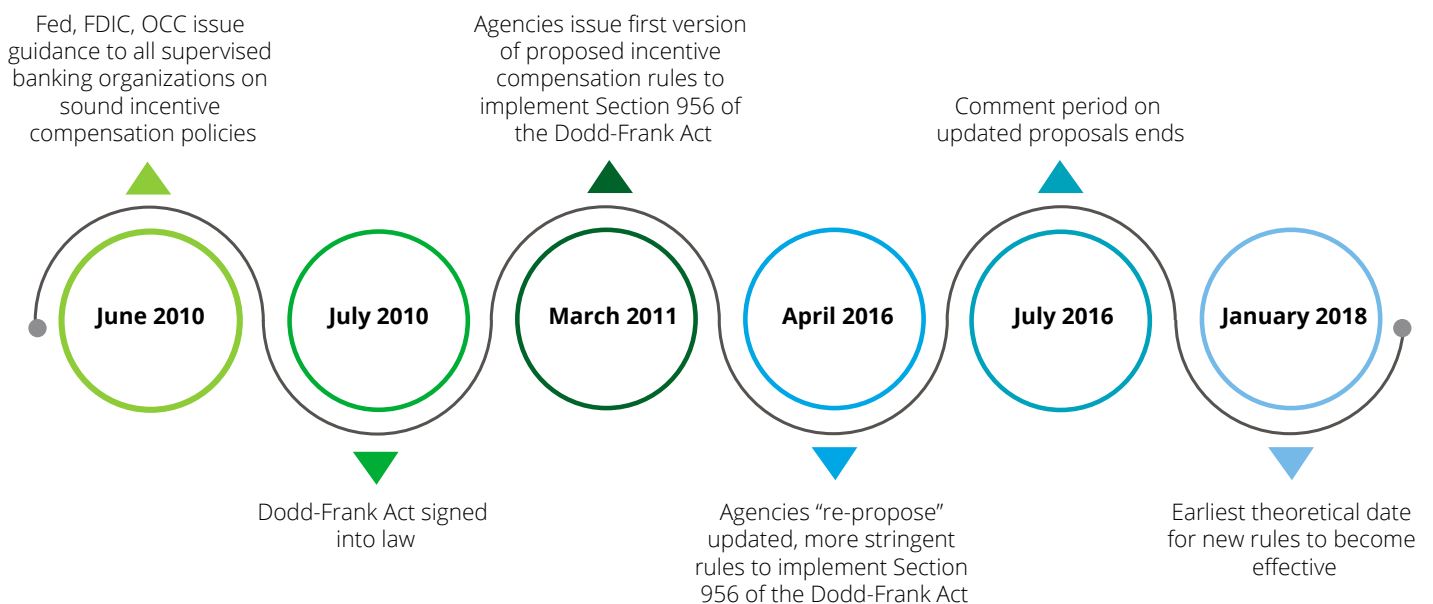
There are many process, technology, and cultural steps that can't be defined until the rules become final. But that doesn't mean the intervening period should be given over entirely to watchful waiting.

In particular, it's advisable for each institution to verify which set of rules apply, which personnel under the proposed rules would qualify as "covered individuals," and what adjustments need to be made to the existing incentive programs.

The new rules on incentive compensation are the long-delayed, operative culmination of a legislative and regulatory impulse that has its roots in a years-old debate. Their arrival is a surprise to no one—but the details of their implementation still require careful scrutiny.

The overall course of the proposed rules is as follows:

Incentive compensation regulations: Rulemaking timeline



Endnotes

- ¹ Comments on Proposed Rule: Incentive-based Compensation Arrangements, Securities and Exchange Commission, Release No. 34-77776; File No. S7-07-16, available at <https://www.sec.gov/comments/s7-07-16/s70716.htm>.
- ² William C. Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, "Enhancing Financial Stability by Improving Culture in the Financial Services Industry," (October 20, 2014), available at <https://www.newyorkfed.org/newsevents/speeches/2014/dud141020a>.
- ³ Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Federal Housing Finance Agency, Securities and Exchange Commission, "Incentive-Based Compensation Arrangements," 81 Fed. Reg. 37670, (June 10, 2016), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-06-10/pdf/2016-11788.pdf>.
- ⁴ Significant risk taker is defined as any covered person at Level 1 and Level 2 institutions who received at least one-third of total compensation as incentive-based compensation, and who meets the relative compensation test and exposure test. The relative compensation test includes the top 5 percent of highest compensated persons in the entire consolidated organization, including affiliated covered institutions, for Level 1 institutions, and among the top 2 percent of highest compensated persons in the entire consolidated organization, including affiliated covered institutions, for Level 2 institutions. The exposure test includes having authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution.
- ⁵ Internal Revenue Code Section 409A generally provides that amounts deferred under a "nonqualified deferred compensation plan" are included in income when deferred or, if later, when the amounts are no longer subject to a substantial risk of forfeiture, unless the nonqualified deferred compensation plan complies with the requirements related to timing of elections, distributions and funding.

Contacts

Elia Alonso

Principal | Deloitte Advisory
Deloitte & Touche LLP
elalonso@deloitte.com

Keith Darcy

Independent Senior Advisor to
Deloitte & Touche LLP
kdarcy@deloitte.com

Robert Dicks

Principal
Deloitte Consulting LLP
rdicks@deloitte.com

Michael Kesner

Principal
Deloitte Consulting LLP
mkesner@deloitte.com

Maureen Mohlenkamp

Principal | Deloitte Advisory
Deloitte & Touche LLP
mmohlenkamp@deloitte.com

Chris Spoth

Executive Director
Deloitte Center for
Regulatory Strategy
Deloitte & Touche LLP
cspotth@deloitte.com

The Center wishes to thank the following Deloitte professionals for their insights, support, and contributions to the report:

Ian Dawson, manager, Deloitte Consulting LLP

Zach Dressander, senior marketing specialist, Deloitte Center for Regulatory Strategy, Deloitte Services LP

Lara Hamilton, Deloitte Advisory senior manager, Deloitte Center for Regulatory Strategy, Deloitte & Touche LLP

Jennifer Kwech, senior manager, Deloitte Consulting LLP

Alex LePore, Deloitte Advisory senior consultant, Deloitte & Touche LLP

Yana Swain, Deloitte Advisory manager, Deloitte & Touche LLP

Tara Tays, senior manager, Deloitte Consulting LLP

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