Industry update:
Incentive-based compensation arrangements
Re-proposed under Section 956 of the Dodd-Frank Act
Industry update on incentive-based compensation

Incentive-based compensation (IC) has been a focus of the global and US regulatory community since the financial crisis. As such, legislators and regulators have taken actions to address inappropriate incentive compensation programs that encouraged excessive risk-taking and contributed to the crisis. Consequently, US regulators are preparing rules to ensure that performance-based incentive compensation does not encourage inappropriate risk-taking and that firms are able to claw back compensation for past misbehaviors. The regulators asked for feedback, and this paper is being issued to provide an update on the industry commentary activity as it relates to the interagency Notice of Proposed Rulemaking (NPR) on incentive-based compensation.

In the US, Section 956 of the July 2010 Dodd-Frank Act (Act) required the Securities and Exchange Commission (SEC), the Federal Reserve (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Housing Finance Agency (FHFA) and the National Credit Union Agency (NCUA) – the “agencies” – to jointly write rules or guidelines covering IC arrangements that prohibit any types of incentive compensation arrangements that encourage inappropriate risk-taking. In 2010, the Final Guidance on Sound Incentive Compensation Policies was jointly released by the FRB, OCC, FDIC and Office of Thrift Supervision (OTS); the guidance applied to banking institutions and focused on tying rewards to longer-term performance to deter excessive risk-taking and to preserve the overall safety and soundness of the institution. In April 2011, the federal agencies published guidelines for a proposed IC rule and received industry comments, but this 2011 version of the proposed rule was never finalized.

Between 2011 and 2016, the agencies studied incentive compensation and risk management practices within the industry under the Final Guidance on Sound Incentive Compensation Policies. Many of the lessons learned by the agencies are reflected in the 2016 NPR, which was published by the agencies between April 21 and May 16, 2016. The 2016 NPR’s requirements expand significantly beyond the April 2011 principles-based federal banking agencies’ IC NPR (see the section “What’s changed since the 2011 NPR?” later in this paper).

Comments on the 2016 NPR were due July 22, 2016, and the preamble of the proposed rule suggests that a final rule may be issued as soon as the fourth quarter of 2016.

In recent conversations with its clients – banking institutions that are covered under the original guidance and firms that are proposed to be covered under the 2016 NPR – EY has found that organizations are evaluating the current NPR and conducting initial assessments to identify policy and process changes necessary to comply with the proposed rule. Many organizations recognize the changes could be significant and are considering modifying their incentive compensation programs prior to the effective date of the final rule. Further, some are proactively developing a transition plan to manage the impact of mandatory deferral requirements and reduce employee turnover due to the potential impact on compensation under the proposed rule.

Many firms responded to the NPR, as did industry and consumer groups, with a mix of comments in favor and against elements of the proposed rule. EY has reviewed the comment letters submitted in connection with the 2016 NPR. Beyond criticisms about the quality of cost-benefit analysis undertaken in preparing the NPR and the abbreviated length of the comment period, EY identified five key themes in the industry comment letters:

- Board of directors’ discretion could be significantly constrained by the proposed rule
- The industry strongly prefers principles-based, rather than rules-based, requirements
- Broad-based disagreement exists about the proposed definition of Significant Risk Taker (SRT)
- There is serious concern about the length of the proposed deferral and clawback periods
- Questions and concerns exist about the applicability of the 2016 NPR beyond large banks

Each theme is discussed briefly below.

Board of directors’ discretion could be significantly constrained by the proposed rule

The 2016 NPR states the role of the board of directors, and/or the compensation committee for Level 1 and 2 covered institutions, would continue to oversee the incentive compensation program, approve plans for senior officials and approve material exceptions for senior officials.

However, several commenters were concerned with what they perceived as a shift in oversight from boards of directors to the regulatory agencies over whether IC arrangements are within the institution’s risk appetite and do not encourage inappropriate risk-taking.

The commenters pointed out that an institution may make a business decision to pay materially more than comparable institutions in order to attract and retain talent, and that these business decisions should not result in the compensation being deemed “excessive.” Commenters suggest that the board of an institution should be responsible for determining how its IC program is administered so that each institution can tailor its practices for its strategy, size, scale, complexity and risk appetite. The 2016 NPR could limit the board’s discretion in this regard.
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Questions to consider:

• What changes are needed to the talent management processes to provide for the development, recruitment and succession planning for the Chief Executive Officer, Chief Audit Executive and Chief Risk Officer(s) and their direct reports?

• To what extent has the organization involved the board of directors in educating and planning for the required changes to the current IC program, including potential governance changes?

• How has management assessed the potential impact of the rule to its governance, people, talent management, operational processes and technologies, and what were the key conclusions (e.g., significant organizational or financial impacts)? What will need to be done to manage the impact?

The industry strongly prefers principles-based, rather than rules-based, requirements

The 2016 NPR prescribes a number of key areas, including tiering of firms by asset size, defining Senior Executive Officers (SEOs), defining and establishing tests for SRTs, providing expectations for functional departments and determining deferral and clawback time.

Many commenters argued that the agencies should use a principles-based approach in order to enable institutions to interpret and apply the rule according to their institution's business model, organizational structure and specific operational factors.

Many in the industry stated that, in its current form, the proposed rule is overly prescriptive regarding key areas such as defining SEO, designating SRTs and prescribing the tenor and duration of deferrals. Some commenters also highlighted what they perceive to be the potential unintended consequence of motivating talented employees to leave their institutions for less regulated organizations or industries, thereby starving firms of necessary key talent.

Questions to consider:

• Has management begun discussing 2016 NPR requirements and proposed actions with their respective regulators?

• How will the organization compete for talent under the new rules on incentive-based compensation?

• What would be the organizational impact and interplay between the 2016 NPR and other rules affecting IC such as the HR Retention Plan requirement to be submitted with the organization's annual resolution plan?

Disagreement about the definition of Significant Risk Taker

Another key element of the 2016 NPR is the specific definition of an SRT. Individuals would be designated as SRTs if they receive incentive compensation that is at least one-third of their total compensation and satisfies the relative compensation (top 5% or 2% of highest compensated persons at Level 1 and Level 2 institutions, respectively) or exposure test (able to expose 0.5% of the capital of the covered institution). While the concept of SRTs was included in the 2010 guidance, it is now further defined.

Implementation challenges

Financial institutions of varying sizes may have different challenges in implementing the 2016 NPR rules, depending on whether they were subject to prior guidance. Some common implementation challenges may include:

• Developing a detailed project plan to implement rule requirements by the implementation date

• Identifying what could be considered “excessive compensation” in accordance with the 2016 NPR

• Creating a pay mix that would be suitable to regulators that would not promote excessive risk-taking behavior

• Carefully considering the compensation mix in the year before the effective date and understanding how employees will be impacted by the transition to mandatory deferral requirements in the first few years of the proposal

• Formulating a talent management program to develop, attract and retain appropriate talent consistent with rule requirements

• Explaining why an employee is not considered an SRT and/or why an employee is able to change SRT designation year over year

• Recognizing the potential income statement accounting changes from impacts due to changes in compensation practices

• Hiring employees with Human Resources skill sets and expertise within the risk function

• Informing the board of directors and its committees about the rule so that they can oversee not only the rule’s implementation, but also other regulations, business-as-usual activities, strategic outlooks and transformational changes

• Retaining top talent by creating compensation policies and procedures that are adverse to policies by rival institutions or industries not under the same requirements
A number of comment letters focused on the SRT definition in the 2016 NPR. Some commenters suggested the proposed definition is overly broad and would capture employees who have neither the ability nor incentive to create material risk. The commenters argued that covered institutions, rather than federal agencies, are in the best position to determine which of their employees are SRTs and proposed revising the rule to give the covered institutions the option to include a rationale for why employees that meet the definition under the “exposure test” should not be considered to be SRTs due to limited ability to expose the institution to risk or material financial loss.

However, not everyone felt the SRT definition was too broad; some, including many individual consumers and consumer interest groups, felt the definition did not go far enough. While these commenters expressed general support for the proposed rule, they felt the proposed SRT definition would exclude individuals they felt should be covered, such as some non-SEOs, with the ability to put significant amounts of capital at risk at impacted institutions. Commenters highlighted, for example, that potential SRTs would avoid automatic designation if their incentive-based compensation is less than one-third of their total compensation, or if both their total compensation is below a sliding percentile among non-SEOs and they do not hold the authority to commit at least 0.5% of the capital of the covered institution. Based on these scenarios, the commenters proposed that the definition of SRT be expanded.

Questions to consider:
- What employees are covered, potentially covered and not covered by the rule?
- How will the institution determine who among the covered employee population will be designated as SRTs?
- How does the institution plan to demonstrate and document how its incentive plans are risk-balanced for covered employees?
- What risk metrics will be used to determine which employees can expose 0.5% of the firm's capital?
- How does the identification of SRTs align with a firm's risk governance concepts, in particular the “three lines of defense”?

There is serious concern about the proposed deferral and clawback periods

Institutions having more than $50 billion in consolidated assets would be required to include deferral and clawback periods within their incentive compensation plans in order to recover compensation upon the occurrence of certain risk events.

Many commenters provided input both in support of and opposed to the compensation deferral and clawback portions of the 2016 NPR. Some felt that the deferral and clawback requirements are exceedingly burdensome and unnecessarily complex and should be simplified. They point out that the NPR lacks any analysis or discussion of not only why the proposed percentages of compensation to be deferred are the most appropriate to balance risk and reward, but also how those percentages were derived.

Commenters also felt that the proposed 7-year clawback period is excessive and imposes burdensome record-keeping requirements. Those commenters noted that a 7-year period is longer than the average business cycle and that mandating clawback from the vesting date means that, in practice, compensation could be subject to clawback for up to 11 years due to the mandatory deferral period of up to 4 years plus the 7-year clawback period after the vesting date. These aspects could create unnecessary uncertainty in an institution's compensation plans and, coupled with other aspects of the proposed rule (e.g., forfeiture), could place the institution at a competitive disadvantage to entities not covered by the 2016 NPR in recruiting and retaining talent.

However, the critique was not all one-sided. Some commenters felt that, as currently proposed, a four-year deferral period for Level 1 SEOs’ and SRTs’ qualifying incentive-based compensation would be too short and would not do enough to defer activity that exposes the institution to inappropriate amounts of risk. The commenters cited examples of compensation practices prior to the financial crisis that were, in their opinion, excessive, and may not have been materially different had the proposed rule been in place at that time.
Questions to consider:

- What would be the impact to existing or planned compensation plans, given the proposed deferral and clawback rules?
- Are the firm’s record-keeping processes and mechanisms sufficient to meet the proposed rule, inclusive of risk metrics and data?
- Do the current systems and tools produce the required data and/or risk metrics, or will the firm be required to enhance its systems?
- What are the accounting implications of compliance with the proposed rule’s deferral and risk-based forfeiture requirements?

Questions and concerns exist about the applicability of the 2016 NPR beyond large banks

Various types of financial institutions beyond large banks expressed concerns about the applicability of the NPR to them. Of note:

- **Insurance companies.** At a fundamental level, insurance savings and loan holding companies (SLHCs) felt that Congress never intended for the relevant proposing agencies to apply Section 956 to insurance companies and that regulators lack the authority to do so, as this authority is possessed by the state commissioners or superintendents of insurance.

  These commenters felt that the rule was developed based on the agencies’ experience regulating large, systemically risky banking institutions; however, the rule does not include any discussion of the appropriateness or impact of applying the rule to insurance companies. Also, commenters noted that the proposed rule would apply to only 12 insurance companies, thus putting those institutions at a competitive disadvantage in recruiting and retaining talented executives and potentially weakening the overall risk management capability.

- **Federal Home Loan Banks (FHLBs).** Given that FHLBs have cooperative ownership structures and tend to have conservative risk profiles, the organizations do not believe they should be a covered as part the final rule. However, if they are subject to the final rule, they believe they should be subject to the rules of Level 3 institutions, without the possibility of being deemed a Level 2 institution, due to their size, complexity and existing oversight from the FHFA regarding compensation.

- **Credit unions.** Some commenters argued that credit unions are substantially different from larger banks and other financial services firms. They asserted that compensation structures do not promote inappropriate risk-taking and do not present a systemic risk to the US financial system. Commenters argued that the proposed rule places an excessive compliance burden on credit unions. While some credit unions and credit union leagues support the spirit and intention of the proposed rule, they expressed a view that that the NCUA should not participate in the joint proposal.

Questions to consider:

- What is your firm’s approach to comply with the proposed rule should it be enacted as currently written?

What’s next?

The final rule could be published as soon as the end of the year. Compliance with the final rule is proposed to be required no later than the beginning of the institution’s first calendar quarter that begins 540 days after a final rule is published in the Federal Register. However, the rule is not applicable to a performance period that began prior to the effective date. As an example, if the rule is published in December 2016, the compliance date would begin in June 2018 and would not be effective until the beginning of the next performance period, which, for some organizations, may be January 2019. The rule would not apply to any IC plan with a performance period that begins before the compliance date.

Organizations should understand the potential impact on governance structures, people, processes and technology if the final rule is similar to the proposed rule. Even if changes are made, the rule will likely still be more rigorous than the 2010 guidance and the original 2011 NPR. In EY’s experience, organizations that are more proactive often have better outcomes and results that are in alignment with strategic goals and objectives.

Institutions that proactively focused on the 2010 guidance have had greater success in making the necessary changes in a way that minimizes the impact to the organization’s ability to maintain competitive incentive compensation programs. This includes involving individuals from all three lines of defense to strategically restructure compensation programs, identify technology needs and develop detailed implementation plans in advance of the deadline.
What’s changed since the 2011 NPR?

While the 2016 NPR has many similarities to the 2011 NPR, financial institutions will be impacted to varying degrees, even those that were subject to regulation under the 2010 Interagency Final Guidance on Sound Incentive Compensation Policies.

Key updates to the 2011 guidance are:

- Determination of SRTs based on a more prescriptive methodology
- Mandatory deferral provisions for qualifying incentive compensation awards
- Prohibition of hedging incentive compensation awards by covered persons
- Determination of “excessive compensation” practices for covered persons

Affected business functions:

The 2016 NPR, in its current form, would have a wide-ranging impact on a variety of functions within the organization. In addition to affecting human resources departments, the NPR would require an increased involvement by risk management and internal audit in planning, forming, assessing and monitoring the incentive compensation framework for the institution. The NPR would also significantly increase the scope of employees that may be considered SRTs. Furthermore, the NPR would enhance the expectation on each firm’s governance structures (e.g., formal compensation committee and joint board committee meetings), processes (e.g., independent review of compensation framework by internal audit or risk) and technology (e.g., updated record-keeping systems and readily available data on risk events).

Linking culture and performance

Banks recognize the incentives challenge goes beyond the structure and magnitude of pay, as shown in A set of blueprints for success, the seventh annual global bank risk management survey by EY and the International Institute of Finance. The survey – which covers 67 banks from 26 countries – clearly shows that banks are starting to embed ethics and control issues more broadly into employee performance and pay decisions.

The survey highlights that banks have:

- Broadened the degree to which performance management metrics been introduced across the firms that produce a closer link to risk culture and behaviors, or risk controls. Previously, these linkages were more narrowly targeted at business heads. (See Chart 1)

- Revised performance metrics for business-line heads to better incentivize them to drive risk-compliant behaviors and to reinforce accountability, especially for non-financial risks. In fact, 82% of respondents made such revisions in the last two years, including 30% in the past year.

- Increased the degree to which bonuses are automatically reduced for employees who breached controls: this year, 55% had some type of automatic reduction in pay or bonus pools, up from 50% last year. Now, 29% have an automatic link between control breaches and bonuses, up from 17% in last year’s survey. Last year, more firms limited such deductions to significant control breaches.

Overall, this points to a strong recognition that incentives influence risk culture and behaviors. Over half (53%) of the surveyed banks believe that aligning compensation with risk-adjusted performance metrics is an important element of strengthening risk culture.

Chart 1: Degree to which performance metrics are linked to risk culture
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