Dodd-Frank and the impact on compensation administration
A point of view

Overview

As a result of the "Great Recession" of 2008, the U.S. economy saw the most significant regulatory overhaul since the Great Depression with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Designed to regulate the largest and most complex financial services institutions, Section 956 of the Dodd-Frank Act requires these institutions to demonstrate that covered persons' incentive compensation arrangements are not excessive and do not incent behavior which places the institution at risk. Additionally, these institutions will need to comply with enhanced policies, procedures and disclosure of incentive-based compensation arrangements. This will require organizations to upgrade their technological capabilities in order to collect, monitor and report detailed information about incentive compensation arrangements on as as-needed basis to Federal Regulators. Building out this enterprise-wide monitoring and reporting capability will likely add significant complexity, time and the risk of financial non-compliance penalties for compensation administrators, who already are challenged to control costs, comply with new equity accounting disclosure rules, and retain top talent and producers. Fortunately, existing technology solutions—in many cases already partially deployed as point solutions—are available to help meet these reporting requirements.

The problem is that many institutions may not currently possess the capabilities necessary to report on incentive compensation plans and policies across the enterprise in a synthesized way acceptable to Federal Regulators.

Immediate impacts

In response to this new regulation, financial institutions will need to implement new compensation tools, infrastructure, data architectures and resources to meet the Federal Regulators' monitoring and reporting requirements. In particular, they must identify covered employees, submit annual reports disclosing their respective incentive compensation plans to the appropriate Federal Regulator and describe how risk taking behavior is mitigated through policies and procedures governing these incentive plans.

Financial institutions that adapt most effectively to the regulatory changes could gain a competitive advantage by reducing unnecessary costs, improving productivity and becoming more flexible and efficient in their compensation administration processes.

The end state objective of the Federal Regulators is a transparent, consistent, and documented way of overseeing incentive compensation as it aligns with risk. Failure to comply will result in enforcement action, including the strong possibility of fines, additional capital requirements, and incorporation into the organization's supervisory rating. The problem is that many institutions do not currently possess the capabilities necessary to report on incentive compensation plans and policies across the enterprise in a synthesized way acceptable to Federal Regulators.

Second order effects

In part due to the acquisitive nature of the industry, the business architecture and technology infrastructure is typically composed of disparate systems and processes, which do not easily support obtaining correct and timely compensation data across multiple lines of business. In the past, most financial services organizations have reacted to new regulations, accounting standards and economic challenges separately, and have developed "band-aid" solutions to each set of problems in isolation. In today's business and regulatory environment a more detailed approach is required. First, institutions should consider developing an integrated, enterprise-wide, compensation governance structure to assess current practices, the systems which support them, and performance and risk data against regulatory reporting requirements.

Second, institutions must determine how they will identify covered persons under Section 956, and how they will evaluate the risk for which each covered person is responsible. A covered person associated with a given product portfolio, for example, may not be assigned the entire risk value of that portfolio (e.g. team-managed mutual funds). That is, there may be a difference between the risk value of a given portfolio, and the amount of risk credited to a given covered person.

At the same time, shrinking incentive pools, difficulty in attracting and retaining valuable workers, evolving generational needs and appetite for a flexible, virtual workplace environment are creating the need for innovative compensation arrangements. Therefore, financial institutions are simultaneously faced with the need to unify their compensation reporting capabilities to reinforce and support the development and maintenance of balanced risk-taking incentive compensation arrangements, as well as rethink their employee value proposition and understand how to effectively compensate and leverage people for success.

Lastly, institutions should consider leveraging existing packaged solutions to provide an integrated incentive compensation management platform across the enterprise. Historically focused on Sales Performance Management (SPM), a number of packaged solutions exist today which are designed to be flexible and powerful enough to manage incentive compensation arrangements across large, multi-national institutions with a variety of disparate lines of business. These solutions are in some cases as complex as the businesses they support. However, when implemented properly, these solutions can provide a unified, systematic, and auditable platform for enterprise-wide incentive compensation management, which in turn, can provide institutions with greater visibility into enterprise-wide decision making and global consistency with local flexibility around rewarding specific talent markets and critical workforces.

Existing solutions, new purposes

The business case for these technology packages has usually centered on reducing administrative costs, improving the time-to-market for compensation plan changes, providing greater transparency into compensation plans, and providing detailed sales performance analytics. All of these reasons remain valid, and indeed these solutions are currently deployed to many lines of business at some of the world's largest financial institutions. The reporting requirements under the Dodd-Frank Act will require institutions to take these capabilities to the next level, and have a cross-business unit view into incentive compensation. Failure to have such a capability could easily result in massive administrative costs, providing inaccurate information to Federal Regulators, or simply being unable to demonstrate conclusively to Federal Regulators that the institution is managing risk appropriately.

Concluding thoughts

Dodd-Frank requires sophisticated and far-reaching reporting capabilities in order to meet the requirements of Federal Regulators. These capabilities differ from previous incentive compensation reporting in that they must cross lines of business and link credited risk to compensation. While many of the large financial institutions likely use automated systems for incentive compensation management for a portion of their business today, few have an end-to-end, cross-functional area programs to support capture of relevant data that support monitoring and analysis. Fortunately, a combination of process alignment and existing, tested technology packages can reduce the substantial administrative costs these regulations impose, while adding value by supporting future compensation program requirements more effectively than the fragmented, manual processes commonly used today.

Federal Reserve's Principles

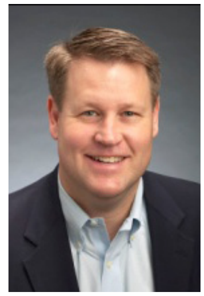
- **Balance Risk and Reward.** Risk and financial awards should be aligned so that individuals are not encouraged to take inappropriate risks which could lead to a material financial loss for the institution.
- **Controls and Risk Management.** Risk management processes, policies, and controls need to govern how incentive compensation plans are designed, implemented, and monitored.
- **Corporate Governance.** The Board of Directors has responsibility to confirm incentive compensation arrangements are appropriately balanced, oversee the development and operation of such arrangements and related process controls, and evaluate if the arrangements are performing as intended.

Contacts

Robert Dicks

Tel: +1 973 602 6160
Mobile: +1 917 721 2843
Fax: +1 212 653 5137
Email: rdicks@deloitte.com
Office: Parsippany, NJ

Rob is a principal in Deloitte Consulting LLP's Sales Effectiveness practice. Rob focuses in the financial services industry, working with firms to achieve their business goals through the use of innovative human capital and sales force effectiveness programs. Rob is frequently called to help clients align compensation strategy and administration with their go to market approach.



Merritt Alberti

Tel: +1 512 226 4420
Mobile: +1 773 255 7678
Fax: +1 866 362 1349
Email: mealberti@deloitte.com
Office: Austin, TX

Merritt is a Director on the Sales Force Effectiveness team. Merritt has 20+ years of sales, marketing, and technology management experience, with the last 15+ years spent in consulting and professional services, helping companies in the areas of sales compensation and sales operations. Most recently, Merritt served at Callidus Software (NASDAQ: CALD) as Senior Vice President, Global Client Services, where led the services team through the company's transition from a traditional license software company to a SaaS company.

Prior to Callidus, Merritt was co-founder and Vice President of Compensation Technologies, a consulting and application hosting organization specializing in the design, implementation and support of incentive compensation management programs. Merritt also spent 5+ years as the director of technology services for The Alexander Group, a boutique consulting organization specializing in sales force effectiveness.