

Insider

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Debt Ceiling Legislation Could Affect Benefit Programs

By Precious Abraham and Ann Marie Breheny

After intense negotiations with Congress in July, President Obama signed the Budget Control Act on August 2. The legislation increased the debt ceiling by up to \$2.4 trillion and charged a newly created congressional Joint Select Committee on Deficit Reduction — also called the super committee — with finding \$1.5 trillion in savings. While the act has no immediate implications for employer-provided benefit programs, the committee is likely to look at existing deficit reduction and revenue-raising proposals for potential savings.

About the super committee

The super committee is a bipartisan group of 12 senators and representatives — six Republicans and six Democrats (see *Figure 1*).

The committee will operate under a tight timeline. House and Senate committees that want to submit recommendations to the super committee must do so by October 14, and the committee must vote on the recommendations by November 23. If the super committee approves legislation — by a simple majority vote — the House and Senate must vote on it by December 23. Congress may not amend or filibuster any legislation approved by the super committee.

A failure to reduce the deficit by at least \$1.2 trillion by January 15, 2012, would trigger automatic spending reductions. The cuts would spare Social Security, Medicaid and certain programs for low-income

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Figure 1. Members of Joint Select Committee on Deficit Reduction

	Republicans	Democrats
Senators	<p>Senator Jon Kyl (R-Ariz.) is Senate minority whip and serves on the Finance Committee.</p> <p>Senator Rob Portman (R-Ohio) is former director of the Office of Management and Budget. During his House tenure, he was active in retirement security issues and co-sponsored important retirement security bills.</p> <p>Senator Pat Toomey (R-Pa.) serves on the Budget Committee.</p>	<p>Senator Max Baucus (D-Mont.) chairs the Finance Committee. He is often active in legislation that affects employer-sponsored health, retirement and compensation programs. He has a strong interest in comprehensive tax reform and served on the National Commission on Fiscal Responsibility and Reform.</p> <p>Senator John Kerry (D-Mass.) serves on the Finance Committee.</p> <p>Senator Patty Murray (D-Wash.) co-chairs the super committee. She serves on the Health, Education, Labor and Pensions Committee.</p>
Representatives	<p>Representative David Camp (R-Mich.) chairs the Ways and Means Committee. He served on the National Commission on Fiscal Responsibility and Reform.</p> <p>Representative Jeb Hensarling (R-Texas) co-chairs the super committee. He chairs the House Republican Conference and served on the National Commission on Fiscal Responsibility and Reform.</p> <p>Representative Fred Upton (R-Mich.) chairs the Energy and Commerce Committee.</p>	<p>Representative Xavier Becerra (D-Calif.) is a Ways and Means Committee member and served on the National Commission on Fiscal Responsibility and Reform.</p> <p>Representative James Clyburn (D-S.C.) serves as assistant Democratic leader and is an Appropriations Committee member.</p> <p>Representative Chris Van Hollen (D-Md.) serves as ranking member of the Budget Committee.</p>

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populations, and any reductions to Medicare spending would affect provider payments rather than benefits.

The first committee meeting was held on September 8 and focused primarily on organization and procedural rules. The rules include requirements to make the Congressional Budget Office's revenue estimates available to all members at least 48 hours before the final vote and to include, if practical, a statement in the final report on the proposals' possible effects on employment, economic growth and American competitiveness. The committee will maintain a publicly available website. The first public hearing, "The History and Drivers of Our Nation's Debt and Its Threats," was held on September 13.

Possible health care proposals

Health care costs are a significant driver of the budget — and the budget deficit. So the super committee might look to Medicare, Medicaid and other health care programs for potential savings. Issues that could come under discussion include:

- **Medicare payments.** The super committee may target provider payment levels and revise the Medicare secondary payer (MSP) rules. One provision that receives periodic attention on Capitol Hill would extend the MSP period for end-stage renal disease beyond its current 30 months; previous proposals (and unconfirmed reports) have suggested from 42 to 60 months.
- **Sustainable growth rate (SGR).** Although a revenue loser rather than a revenue raiser, super committee members may try to use a deficit reduction package as a vehicle for addressing the SGR, which governs Medicare's physician reimbursement rates. Every year, the SGR is supposed to reduce provider payments but Congress votes to delay the cuts. Many deficit reduction reports recommend long-term or permanent SGR reform. Current reimbursement levels expire on December 31, and the continued SGR delays have grown increasingly expensive. The super committee's proposal could offer revenue raisers to help offset the cost of another SGR fix.

Possible retirement proposals

Lawmakers remain concerned about the Pension Benefit Guaranty Corporation (PBGC) deficit and the perceived risk of a taxpayer bailout. So higher PBGC premiums — an element of key deficit reduction reports and proposals — are expected to be on the table. Other recommendations include authorizing the PBGC board to set premiums and basing premiums on the risks posed by the plan sponsor's financial status or its investment portfolio.

The premium hikes would likely be imposed on both flat-rate and variable-rate premiums and thus would affect all defined benefit plans. Towers Watson continues to work with trade organizations, including the ERISA Industry Committee and the American Benefits Council, to lobby against these proposals. The super committee's tight deadlines, however, will limit opportunities for input and advocacy from the business community.

Several deficit reduction reports have also proposed to cap retirement savings account contributions at the lesser of \$20,000 or 20% of compensation. While some on Capitol Hill have expressed concern that such restrictions could harm lower-income workers, the proposal could receive some attention or other proposals to reduce contribution limits could emerge.

Tax reform and significant changes to Medicare benefits unlikely

Given the super committee's aggressive timeline, consensus on fundamental changes to Medicare or the tax code seems unlikely. Broader changes to

Medicare — such as increasing the eligibility age or restructuring the cost-sharing requirements — are expected to come under discussion, but support from Democrats would be more likely in a package with both Medicare reforms and revenue increases. President Obama and some other Democrats have indicated a willingness to enact Medicare reforms — as long as the reforms are accompanied by tax increases, which Republican committee members strongly oppose.

The super committee is expected to look at tax expenditures, such as the tax exclusion for employer-sponsored health coverage. Although some policymakers are hoping for the committee to eliminate or reform tax expenditures, others would rather see them addressed as part of broader tax reform legislation. Given the short time frame and strong disagreement about tax reform, the super committee's proposal is unlikely to call for broad or fundamental changes. But lawmakers will probably make the tax exclusion for health insurance part of their tax reform discussions into 2012 and beyond.

Super committee may consider additional changes to health care reform

Committee members and lawmakers who oppose the health care reform law may try to scale back its reach. While large-scale changes seem unlikely, some reform provisions could come under discussion. However, a few recently targeted provisions — such as repealing the Community Living Assistance Services and Supports Act or eliminating the Independent Payment Advisory Board — would likely score as revenue losers.

Revenue raisers could include further changes to the subsidy repayment provisions or the way the law counts Social Security benefits for purposes of determining eligibility for tax credits or Medicaid. Congress has already amended the subsidy repayment provisions once to offset the SGR fix and again to offset the costs of repealing the Form 1099 filing requirements earlier this legislative session.

Compensation and other proposals remain in play

The super committee is likely to look to revenue-raising legislation that has been proposed or introduced over the past several years, which could include:

- **Tax treatment of carried interest.** Proposals to change the tax treatment of carried interest served as revenue raisers in several bills during the 2009–2010 legislative term. At issue is

whether carried interest represents performance-based compensation for services — and thus should be taxed as ordinary income — or whether it represents a capital return taxed at the capital gains rate. Earlier proposals to tax all or a significant portion of carried interest as ordinary income were estimated to raise more than \$13 billion over 10 years but were derailed by the complexity of the issues and political opposition.

- **Tax treatment of stock options.** A long-standing proposal from Senator Carl Levin (D-Mich.) would limit the corporate deduction for stock options to the amount treated as an expense against corporate earnings, and companies would have to take the deduction during the period when the expense was recognized. The proposal would subject stock options to the \$1 million compensation limit under tax code section 162(m), and stock options would no longer be considered as performance-based compensation — even if the options hinged on a performance-based vesting condition. The provision has never gained much traction and its chances are uncertain — but it would raise an estimated \$25 billion over 10 years.
- **Corporate-owned life insurance (COLI).** President Obama's budget proposal for fiscal 2012 would keep a company from taking an interest deduction up to the amount of the unborrowed cash value of the COLI policy except where the insured was a 20% owner of the business. The proposal would raise more than \$7 billion over 10 years.
- **Worker misclassification.** The Internal Revenue Service says that misclassifying employees as independent contractors contributes to the tax gap — the amount taxpayers should pay but don't. Various legislative proposals would step up penalties, increase recordkeeping requirements, require Department of Labor audits on employee classification and direct the Department of the Treasury to issue guidance. Worker misclassification has been under discussion for years, and the proposals are estimated to raise more than \$7 billion over 10 years.
- **Commuter benefits.** A proposal by Senator Tom Coburn (R-Okla.) would eliminate the tax expenditure for qualified parking and transportation benefits. In addition, the deficit reduction debate — and competition for revenue offsets — could make it difficult for Congress to extend a current provision under which the monthly limit for transit benefits is the same as that for parking benefits. According to "Back in Black," Senator Coburn's deficit reduction proposal, eliminating commuter benefits could save more than \$51.6 billion over 10 years.

"Higher PBGC premiums are expected to be on the table."

Funding Obligations for Single-Employer DB Plans After Recent Stock Market and Interest Rate Declines

By Gaobo Pang and Mark Warshawsky

Capital markets were volatile and stock market returns were negative in August 2011. These trends were attributable to the confluence of sluggish economic growth, high unemployment, renewed concern about sovereign debt and budget deficits, and the downgrading of U.S. government credit by Standard & Poor's. The equity market tumble reduced asset values in defined benefit (DB) pension plans, and the drop in bond yields increased plan liabilities.

Continuing our series of analyses, this brief article projects through 2014 the regulatory funded status and minimum required contributions for single-employer DB plans, in the aggregate, reflecting capital market conditions and outlooks as of August 31, 2011.¹ The projected average DB plan funded ratio deteriorates, and aggregate funding obligations increase significantly from our projections as of January 1, 2011, overwhelming the funding improvement offered by the 2010 legislative relief.

“On a regulatory basis, the average funded status is now projected to be 76.0% for plan year 2012 — a 3.4 percentage point drop from the earlier projection.”

Updates in data and assumptions

This analysis updates the funding projections with equity and bond market conditions as of August 31, 2011. We assume these market conditions will remain unchanged through 2011. For pension liability valuations, we use the smoothed segment rates and the composite corporate bond rate (CCBR) published by the Internal Revenue Service (IRS). Looking forward, we use July 2011 projections of high-quality bond yields and subtract 35 basis points to project the end-of-2011 segment rates and CCBR. This subtraction reflects the average drop in yields on high-quality long-term corporate bonds in August relative to the levels in July (while daily changes in yield rates could be up or down).

Figure A-1 lists the financial and economic assumptions (see Appendix).² Relative to the beginning-of-2011 assumptions (April 2011 *Insider*), these updated 2011 market conditions are 12.2 percentage points lower for equity returns, 8.3 percentage points higher for bond returns, and 28–34 basis points lower for the CCBR, second segment rate and third segment rate. Equity returns over 2012–2014 are slightly higher, by 0.25–0.38 percentage points, and the bond return for 2012 is 4.2 percentage points lower than the beginning-of-2011 assumptions.³ Other model assumptions are largely identical to those in the April 2011 *Insider* article, including the provisions of the funding relief under the 2010 Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act (Relief Act).

Results: Impact of worsening market conditions

The results appear in Figure 1. On a regulatory basis, the average funded status is now projected to be 76.0% for plan year 2012 — a 3.4 percentage point drop from the earlier projection. The minimum required plan contributions are \$20.2 billion higher, in aggregate. Projected funded ratios are 1.2

Figure 1. Measured funded status and required minimum contributions

Plan year	Updated projections		Difference from earlier projections	
	Funded status (%)	Minimum contribution (\$b)	Funded status (%)	Minimum contribution (\$b)
2008	95.3	77.9*	–	–
2009	94.6	92.1*	–	–
2010	88.8	88.6	–	–
2011	77.4	155.3	–	–
2012	76.0	190.7	–3.4	20.2
2013	85.3	150.4	–1.2	3.1
2014	88.0	145.1	–2.6	9.4

*Estimates of actual contributions based on Form 5500 and financial statement data. Note: The earlier 1/1/2011 projections were published in the April 2011 *Insider*. Source: Towers Watson.

¹ “Funding Obligations for Single-Employer DB Pension Plans: Updated Projections for 2011–2014” in the April 2011 *Insider* describes the model and assumptions. The series of prior studies on the DB plan funding obligations and relief efforts appears in the January, April, June, October and November 2009 and March and July 2010 issues of *Insider*, available at www.towerswatson.com/research/insider.

² Note that the 2011 conditions reflect the market turbulence in August while the 2012–2014 conditions are based on pre-crash July projections. This implicitly assumes the turbulence is transitory and does not alter the medium-term economic outlooks.

³ Assuming a recovery of the 35 basis points in yields, we lower the expected bond return by 4.2 percentage points, given the average duration of 12 years, from the TWIS projection down to 0.2% for 2012.

percentage points lower for 2013 and 2.6 percentage points lower for 2014, which will necessitate \$3.1 billion and \$9.4 billion more in plan contributions, respectively, compared with the earlier projections.

Putting the numbers in perspective, we previously projected that the Relief Act would reduce minimum required contributions by \$1.1 billion to \$7.7 billion a year — a total of \$16.3 billion over 2010–2013. The new projections in Figure 1 indicate that — assuming the markets fail to improve in 2011 — DB plan sponsors will confront much larger funding obligations in 2012, wiping out the benefits of any relief.

Appendix

Depending on the plan sponsor's election, pension assets are measured at fair market value or smoothed value. The latter is computed as the average value of three year-end market values in the model. It includes expected future investment earnings (at no more than a specified interest rate, the third segment rate) and is constrained by the legal requirement that such smoothed value fall between 90% and 110% of market value. Pension liabilities are valued using either the spot bond yield curve (in actuality, a one-month average, approximated by the CCBR in the model) or the smoothed segment rates (in the model, the second segment rate). These rates are published by the IRS.

DOL to Re-Propose Regulation on Fiduciary Definition

By Precious Abraham and Ann Marie Breheny

Congress has been discussing regulations to expand the definition of “plan fiduciary,” as proposed by the Department of Labor (DOL). The new definition would consider more paid providers of investment advice to retirement plans or plan participants as fiduciaries. According to the DOL, the existing 35-year-old definition does not reflect today's retirement practices.

Plan sponsors, service providers and lawmakers protested that the proposed definition was overly broad and would interfere with plan investment decisions, limit investment education, and increase costs for plan sponsors and participants.

Figure A-1. Economic and financial assumptions at calendar year end (%)

	2008	2009	2010	2011	2012	2013	2014
Equity return	-38.70	25.46	14.75	-3.51	8.89	8.47	8.38
Bond return	8.44	1.92	10.16	12.63	0.20	4.63	4.69
CCBR	7.90	5.88	5.60	4.58	5.13	5.28	5.39
2nd segment rate	6.38	6.67	5.90	4.95	5.46	5.58	5.67
3rd segment rate	6.68	6.77	6.45	5.32	5.79	5.87	5.95

Source: Towers Watson.

Certain economic and financial assumptions are made, as in Figure A-1:

1. For 2011–2014, CCBRs are approximated by 10-year high-quality corporate bond yields, second segment rates by the average of 10-year and 20-year high-quality corporate bond yields, and third segment rates by 20-year high-quality corporate bond yields. These yields are projected by Towers Watson Investment Services Inc. (TWIS) based on July 2011 assumptions. This analysis subtracts 35 basis points from these projections for 2011, as discussed in the text.
2. Historical equity and bond returns are based on Russell 3000 equity and Barclays Capital long government/credit bond indexes, respectively, as of August 31, 2011. Annual equity and bond returns for 2012–2014 are the July 2011 TWIS projections. This analysis assumes a loss for the 2012 bond return owing to the interest rate movement, as discussed in footnote 3.

“Assuming the markets fail to improve in 2011, DB plan sponsors will confront much larger funding obligations in 2012, wiping out the benefits of any relief.”

Lawmakers question proposed regulations at House and Senate hearings

The DOL's proposed regulations were the focus of a July 26 hearing held by the House Education and the Workforce Committee's Subcommittee on Health, Employment, Labor and Pensions. Assistant Secretary of Labor Phyllis Borzi of the Employee Benefits Security Administration testified about the proposed regulation, feedback the DOL has received and the department's plans for moving forward with a final regulation. In addition to raising concerns about how the new definition would affect plan sponsors, participants and service providers, some lawmakers questioned the need to update the definition at all and suggested the agency is moving too quickly.

In her testimony, Assistant Secretary Borzi noted that most workers now hold their retirement funds in

“Some lawmakers questioned the need to update the definition at all and suggested the agency is moving too quickly.”

401(k) plans and individual retirement accounts (IRAs), and choose investments from a greater variety and complexity of options, so participants must rely more heavily on professional investment advisors. Borzi testified that the current rule is outdated and frequently enables advisors to avoid responsibility for giving poor advice. She said increased opportunities for self-dealing, less transparent fee arrangements and the narrowness of the current regulation have harmed both plans and plan participants. Borzi also stated that the proposed regulation would address problems but would not limit access to investment education.

Plan sponsors and some lawmakers are worried that the interplay between the proposed regulations and standards being developed by other government agencies under the Dodd-Frank Wall Street Reform and Consumer Protection Act could restrict a retirement plan's ability to invest in swaps — an investment option often used to mitigate risks. Plan sponsors have pushed for alignment of these rules to prevent such conflicts. In response to these concerns, Assistant Secretary Borzi told the subcommittee the DOL would continue working with the other agencies — the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Treasury Department and Internal Revenue Service (IRS) — to avoid conflicting standards.

Subcommittee members are also concerned that the new regulation will increase litigation and will have potential implications for employee stock ownership plans and IRAs. Some subcommittee members pushed for the agency to re-propose the regulation. A second panel of witnesses generally voiced the same concerns raised by plan sponsors and service providers, with several also urging the DOL to re-propose the regulations.

The Senate's Health, Education, Labor and Pensions (HELP) Committee also briefly discussed the regulation on July 26, although lawmakers had taken the opportunity to ask questions about the proposed regulation when Labor Secretary Hilda Solis appeared at another hearing. For example, Senator Richard Blumenthal (D-Conn.) expressed the same concerns others have raised about the rule's potential effects on investment advice and financial education.

“The agency said its decision was partly ‘a response to requests from the public, including members of Congress, that the agency allow an opportunity for more input on the rule.’”

Letters to DOL

In addition to the hearings, several groups of lawmakers have written the DOL. In a May 10, 2011, letter, the New Democrat Coalition said the proposed rule would limit access to investment education and information, which “would result in worse investment decisions by participants and would, in turn, increase the costs of investment products, services, and advice that are absolutely critical parts of a sound investment strategy for consumers.” The letter was addressed to Labor Secretary Solis, CFTC Chair Gary Gensler and SEC Chair Mary Schapiro, and urged the regulators to work in consultation and coordination to “avoid duplicative or contradictory guidelines governing investment in U.S. markets.” Finally, it urged the DOL to re-propose the regulation so the public could suggest modifications.

Separately, House Education and the Workforce Committee Chair John Kline (R-Minn.), House Ways and Means Committee Chair Dave Camp (R-Mich.), Senate HELP Committee ranking member Mike Enzi (R-Wyo.) and Senate Finance Committee ranking member Orrin Hatch (R-Utah) wrote to Secretary Solis, Treasury Secretary Tim Geithner and IRS Commissioner Douglas Shulman about the proposed regulation. They stated their belief “that the proposal, in its current form, is unworkable as it creates too many unanswered questions as to who is and who is not a fiduciary” and raises “significant questions as to what will be considered financial literacy and education and what will be considered investment advice.” The letter also expressed concern about the “apparent lack” of cooperation between the DOL and the “other federal regulators who oversee products and services sold to retirement plans and participants.”

The DOL's response

On September 19, the DOL announced its intention to re-propose the rule on the definition of a fiduciary. According to the DOL, “the re-proposal is designed to inform judgments, ensure an open exchange of views and protect consumers while avoiding unjustified costs and burdens.” The agency said its decision was partly “a response to requests from the public, including members of Congress, that the agency allow an opportunity for more input on the rule.” The new proposed rule is expected in early 2012.

Managing Compensation Plans at Financial Institutions — Potential Implications of the Draft Rules

By Christopher Fabro and Steve Seelig

Several agencies recently issued draft rules on compensation plans and risk under the Dodd-Frank Wall Street Reform and Consumer Protection Act. These include the Federal Deposit Insurance Corporation for insured institutions, the Securities and Exchange Commission for investment advisors and broker-dealers, and the National Credit Union Association for credit unions.¹

Under the proposed rules, all but the largest of these financial institutions would continue to have considerable flexibility in designing their compensation programs — a marked departure from regulations imposed by many non-U.S. regulators. The rules would regulate larger institutions — generally, those with more than \$50 billion in assets — more tightly, subjecting certain executives and risk takers to mandatory deferral rules. For many non-executive roles, however, the current draft rules stop short of the more stringent actions taken by non-U.S. regulators.

Perhaps most surprising in these proposals is the presumption that being paid “excessive compensation” necessarily leads to inappropriate and excessive risk-taking. Not only would financial institutions have to prohibit incentive compensation that could cause material financial losses — consistent with the *Interagency Guidance on Sound Incentive Compensation Policies* published in 2010 — they could not pay any “excessive compensation.”

Financial institutions would have to submit detailed reports about their compensation programs, which the regulating agencies would review for compliance. Each agency is expected to provide an approval process. However, agencies might reserve their right to review compensation program operations to determine whether the design is curtailing risk taking, which could essentially put institutions’ pay programs under continuous audit. The draft regulations are silent about enforcement authority.

The proposed regulations would require covered institutions to perform four major tasks (see *Figure 1*).

The following discussion describes how these tasks would interact, who would perform them and issues for institutions to consider.

Task 1: Establish that the institution has prohibited excessive compensation.

Proposed rule: “A covered financial institution must not establish or maintain *any types* of incentive-based compensation arrangements, or any feature of any such arrangements, that encourage *inappropriate risks* by the covered financial institution by providing a *covered person with excessive compensation* [emphasis added].”

Under this rule, management would have to take the following steps annually:

Step 1. Compile a complete list of employees, directors and principal shareholders.

The starting point is every employee, director and principal shareholder. Principal shareholders are those who directly or indirectly own, control or have the power to vote 10 percent or more of any class of voting securities of the institution.

Step 2. Determine who among this group receives variable incentive compensation.

Institutions could eliminate rank-and-file employees who received no variable compensation as an

“Perhaps most surprising in these proposals is the presumption that being paid ‘excessive compensation’ necessarily leads to inappropriate and excessive risk-taking.”

Figure 1. Compliance tasks, responsibility and frequency

Task	Responsibility	Frequency
1. Establish that the institution has prohibited excessive compensation.	Management	Annual
2. Establish that the institution has prohibited incentive compensation that could cause a material financial loss.	Management	Annual
3. Institute policies and procedures reasonably designed to ensure compliance with the regulations.	Board	Ongoing
4. Submit a report to regulators so they can assess whether the incentive compensation structure meets the regulations.	Management	Annual

Source: Towers Watson.

¹ The Office of the Comptroller of the Currency (Treasury Department), the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision (Treasury) and the Federal Housing Finance Agency have issued substantially similar regulations.

incentive for performance. However, given that most non-exempt workers are eligible for a corporate incentive plan, most employees would likely remain on the list.

Step 3. Of this group, determine whether any compensation arrangement pays amounts that are unreasonable or disproportionate to the services performed.

A benchmarking challenge. Each institution would have to figure out how to apply the “unreasonable or disproportionate” test. Under the tax code, where the concept of “reasonableness” applies to “disqualified employees” at nonprofits, institutions can quickly identify employees whose compensation differs significantly from peers through market and internal comparisons. For example, if the employee’s compensation is below the 50th percentile, then as long as services are comparable to the market median, the compensation passes the initial test of reasonableness and proportionality.

Under the proposed rules, however, “compensation” includes cash and non-cash benefits. While there are reliable standards for assessing base salary, and short-term and long-term incentives for most employee groups, comparing non-cash benefits to the market might require more data sources. And while databases tracking competitive non-cash benefits exist, most institutions will need to use new processes to combine all relevant data sources.

As to shrinking the pool of “covered” employees to those in a position to take inappropriate risks, it appears that receiving excessive compensation, by definition, encourages inappropriate risks. This section of the proposed rule does not appear to differentiate between employees who are empowered to take “inappropriate risks that could lead to a material financial loss” and other employees.

Factors to consider

The proposed rule identifies at least six steps to follow in determining whether compensation is “unreasonable or disproportionate to the services performed by the person.” Companies would have to document how they applied this standard in a report for regulators.

1. Determine the combined value of all cash and non-cash benefits provided for the current year and prior years — consider the projected total cost and benefit to the institution for postemployment benefits.
2. Categorize all covered individuals by expertise.
3. Identify comparable institutions based on asset size, geographic location, the complexity of the

institution’s operations and assets, and any other relevant factors.

4. Determine the extent to which the institution’s compensation practices are in line with those at comparable institutions.
5. Consider whether compensation is appropriate based on the institution’s financial condition.
6. Determine whether the individual is linked to any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse.
7. Examine any other factors the corporation determines to be relevant.

Comment: *Factor 6 appears to be more of a regulatory review standard that could be applied by compliance, risk management or the supervisory agency.*

Step 4. Provide data and analysis to the board or an appropriate committee to assess whether the overall design and performance of incentive compensation conforms to the regulations.

Management would have to include data and analysis regarding the “excessive compensation prohibition,” along with a tandem report regarding the “material financial loss prohibition,” in an annual report to the board (or its committee). Boards of large financial institutions would have additional responsibilities in reviewing and approving the report.

Comment: *Institutions would need to decide whether to submit the same report to both the board and regulators (minus disclosures about any specific person’s pay, see Task 4 below). Other issues include deciding whether to have the board sign the report, given the potential expansion of fiduciary responsibility.*

Task 2: Establish that the institution has prohibited incentive compensation that could cause a material financial loss.

Proposed rule: “A covered financial institution *must not establish or maintain* any types of incentive-based compensation arrangements, or any feature of any such arrangements, that encourage *inappropriate risks* by the covered financial institution, by providing incentive-based compensation to covered persons, *either individually or as part of a group* of persons who are subject to the same or similar incentive-based compensation arrangements, that *could lead to material financial loss* to the covered financial institution [emphasis added].”

The definition of a “covered employee” is based largely on the *Interagency Guidance on Sound Incentive Compensation Policies*. Under this rule, management would have to take the following steps annually:

“Each institution would have to figure out how to apply the ‘unreasonable or disproportionate’ test.”

Step 1: Compile a complete list of all employees, directors and principal shareholders of the covered financial institution.

Same as Task 1, Step 1.

Step 2: Of this group, determine who — either individually or as part of a group — is subject to the same or similar incentive-based compensation arrangements that could lead to material financial loss.

This rule follows the definition in the sound compensation policies regulations. Institutions would need to decide how stringent to be in determining covered employees. While each institution would define material financial loss differently, all should be prepared to share their threshold with the board and their regulator. For example, if a group of loan originators does not make enough loans to materially affect the bank, does this mean the group is not “covered”?

To define this threshold, an institution could perform an internal “stress test” of the volume of losses that would affect the bank significantly, defined in terms of profit reduction, impact on the bank’s capital ratios or market cap loss. To ensure it was not aiming too high, an institution could choose a lower threshold than what might trigger a “material loss” under the stress test. For example, if a loss of \$400 million in loan defaults is material based on a stress test, the bank could use \$200 million as a “bright line” to trigger an internal audit of the plans. This “materiality” test should provide a broad enough definition to flag individuals or groups whose pay programs should be reviewed.

Institutions would have to consider all elements of incentive compensation, including those for lower-level covered employees. In particular, institutions would have to track and review any long-term incentive programs, spot awards or referral programs.

Step 3: Determine that these individuals’ or groups’ incentive compensation programs accomplish the following factors —

1. Balance risk and financial rewards, such as by deferring payments, risk-adjusting awards, reducing sensitivity to short-term performance or extending performance periods.
2. Are compatible with effective controls and risk management.
3. Are supported by strong corporate governance, including active and effective oversight by the institution’s board of directors or board committee.

Comment: Factor 1 suggests that at least one of those examples should be part of the incentive compensation design unless the institution makes a strong case otherwise. It does not appear that having in place effective controls and risk management under Factor 2 could substitute for these plan designs, as the three factors listed are part of an “and” test.

Institutions may assume that Factor 3 is met by requiring that management provide a report to the board or board committee.

Step 4: For institutions with \$50 billion or more in total consolidated assets, deferral is required for executive officers.

The deferral requirements would apply to all executive officers and have two parts:

1. At least 50% of annual incentive-based compensation must be deferred over at least three years to be paid no faster than on a pro rata basis.
2. The deferral amount must be adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period.

Determining executive officers² and designing the compensation deferral elements and timing appear to fall to management. It also appears the adjustment could take place during the deferral period, so institutions would have to define, in advance, exactly when actual losses or aspects of performance would be realized.³ Institutions may not be able to set a formulaic deferral period for all officers — certain officers would have longer deferral periods than others.

Step 5: For institutions with \$50 billion or more in total consolidated assets, identify employees that present particular loss exposure as part of appropriately balancing risks and rewards.

Under this requirement, the analysis would be performed by management and endorsed by the board (or a committee). Institutions would need to identify who had the expertise to make the risk and compensation determinations — such as the compensation committee alone or the compensation and audit committees together.

Conceptually, the requirements are similar to the deferral requirements for executive officers: Determine who ought to be covered by the rule, design the pay program to reflect the magnitude and time horizon of the risks created, make sure the design helps mitigate these risks, and approve the compensation plan.

“While each institution would define material financial loss differently, all should be prepared to share their threshold with the board and their regulator.”

² An executive officer of a covered financial institution is someone holding the title or — without regard to title, salary or compensation — performing the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer or head of a major business line.

³ Section 409A of the Internal Revenue Code has strict rules that require deferral payment schedules be set before services are rendered.

To identify employees presenting particular loss exposure, the board or board committee would have to:

1. Identify covered individuals (e.g., traders) who could expose the institution to substantial losses given the institution's size, capital or overall risk tolerance.
2. Determine that the compensation arrangement — including the way compensation is paid — effectively balances the employee's financial rewards with the range and duration of risks linked to his or her activities. Institutions would have to use appropriate methods to ensure risk sensitivity, such as deferring payments, risk-adjusting awards, reducing sensitivity to short-term performance or extending performance periods.
3. Evaluate the overall effectiveness of the methods used to discourage inappropriate risk taking, considering whether the methods ensure that payments offset the full range of applicable risks and are sensitive to all potential risks, including those that may be difficult to predict, measure or model.
4. Approve and document the incentive compensation for these people.

Comment: *Imposition of these requirements on board members clearly expands their responsibilities for pay programs beyond those of named executive officers and/or Section 16 officers.*

Step 6: Provide data and analysis to the board or an appropriate committee to assess whether the overall design and performance of incentive compensation are consistent with the regulations.

Same as Task 1, Step 4.

Task 3: Institute policies and procedures reasonably designed to ensure compliance with the regulations.

Proposed rule: "Any incentive-based compensation arrangement, or any feature of any such arrangement, [must be] *adopted pursuant to policies and procedures developed and maintained by each covered financial institution and approved by its board of directors, or a committee thereof, reasonably designed to ensure and monitor compliance with the requirements [of this regulation] commensurate with the size and complexity of the organization, as well as the scope and nature of its use of incentive-based compensation [emphasis added].*"

To meet this requirement, institutions would have to "codify" the way they undertake risk management and compensation programs but would not have to discuss how they manage risk.

The policies and procedures must, at a minimum:

1. Be consistent with the reporting requirements.
2. Ensure that risk management, risk oversight and internal control personnel have an appropriate role in designing incentive compensation arrangements and assessing their effectiveness in restraining inappropriate risk-taking.

Comment: *It is significant that the rules do not assign Requirement 2 to non-compensation professionals, although they must sign off on the design developed by the HR/compensation function.*

3. Have a process to independently monitor incentive compensation awards and payments, risks taken and actual risk outcomes to determine whether amounts are reduced to reflect adverse risk outcomes or high levels of risk taken.

Comment: *Not only would institutions have to anticipate and adjust the period over which compensation remains sensitive to risk outcomes, they would also have to review the data for accuracy. This rule suggests that plan designs must anticipate how to reduce pay for those who undertake institutional risk, but stops short of mandating that pay is subject to adjustment over the risk period.*

4. Permit the board or a board committee to assess whether the overall design and performance of the institution's incentive compensation meets the regulations.

Comment: *This rule clarifies that the board or board committee must oversee the pay-setting process but not on a daily or individual level. Thus, for example, the board or committee would not need to ensure that an employee's compensation was deferred over an appropriate period but would need to ensure that the proper employees were making that determination.*

5. Document the processes for establishing, implementing, modifying and monitoring incentive compensation.

Comment: *Similar to Requirement 3 above, the implication is that pay programs must include a feature to permit modification of incentive compensation previously promised or paid for those taking institutional risks, although "modifying" may reference the design of future pay programs.*

"Institutions would have to 'codify' the way they undertake risk management and compensation programs."

6. Where deferral is used, determine that time frames and adjustments are appropriate.
7. Have in place a corporate governance framework that permits board or board committee oversight, including the approval of incentive compensation to executive officers.

Comment: *This final requirement is essentially written into most compensation committee charters and should not impose any new requirements for most companies.*

Task 4: Annually, management must submit a report to regulators so they can assess whether the incentive compensation structure meets the regulations.

Proposed rule: “A covered financial institution must submit a report annually to, and in the format directed by, the [applicable agency], that describes the structure of its incentive-based compensation arrangements for covered persons and *that is sufficient to allow an assessment* of whether the compensation structure or features of those arrangements provide or are likely to provide those persons with excessive compensation, fees, or benefits or could lead to material financial loss to the covered financial institution [emphasis added].”

The requirements for the annual report would be essentially identical to those for management’s report to the board or board committee responsible for overseeing Tasks 1 and 2 above, with one important difference. While management’s reports to boards are likely to specify compensation structures and payments to executives or those posing significant risks to the institution, institutions need not report actual compensation of individuals to the agency.

Comment: *The enforcement question raised earlier resurfaces here. Even though the annual report need not spell out compensation for covered individuals, an agency that was concerned about whether an institution had met a compensation prohibition might ask for individual compensation information.*

Minimum standards. Whichever format the regulator mandates, the information submitted would have to include the following:

1. A clear narrative description of the components of the incentive compensation arrangements and the people paid under them
2. A succinct description of the policies and procedures governing incentive compensation
3. For institutions with assets of \$50 billion or more, a succinct description of incentive compensation policies and procedures for executive officers and others who could expose the institution to substantial losses
4. Material changes made to incentive compensation arrangements, policies or procedures since the last report
5. The reasons the incentive compensation structure discourages inappropriate risks by ensuring that covered individuals or groups are neither excessively compensated nor paid incentive-based compensation that could lead to a material financial loss

The volume and detail of information provided by a covered financial institution should reflect its size and complexity as well as the scope and nature of its incentive-based compensation arrangements.

Summary

Based on the draft regulations, the implications for financial institutions are significant. Defining a “covered” employee — not to mention defining “excessive compensation” and which employees should be reviewed every year — calls for a very complex set of analytics for the board of directors to review.

Moreover, while the material financial loss prohibition might be more straightforward, it is not clear how institutions would go about refining their own definitions of “materiality” and its influence on “covered employees.” This could have unintended consequences, as different financial institutions would have different perspectives, leading to different compensation structures and levels for those performing the same job at competitor institutions. The resulting inconsistencies could make recruiting and retention harder for institutions that require their employees to defer their compensation or subject more of it to claw-back risk.

“Different financial institutions would have different perspectives, leading to different compensation structures and levels for those performing the same job at competitor institutions.”

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