

# 2011 Enterprise Risk Management Symposium

## Managing Risks in Incentive Compensation Plans

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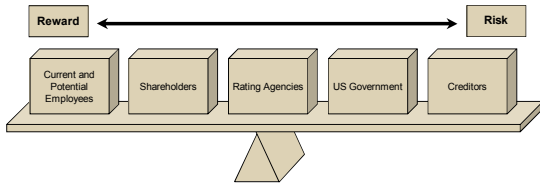
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### Overview

Compensation is a particularly critical topic for employees, employers, rating agencies, the US government, creditors, and shareholders.

- Typically, attention has been focused on the role of compensation in attracting and retaining.
- However, recent market events have shifted the focus to risks that may be inherent in incentive compensation arrangements.
- Any change to an employee's compensation affects one of the most important and personal aspects of a person's employment.



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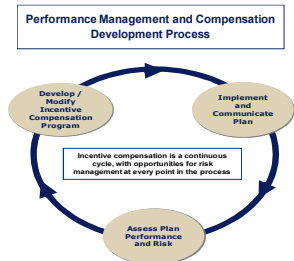
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### Overview (cont.)

- To address these challenges, there are several practical short-term and long-term approaches that companies can use within the Performance Management and Compensation Development Process.



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Main Stakeholders in Compensation

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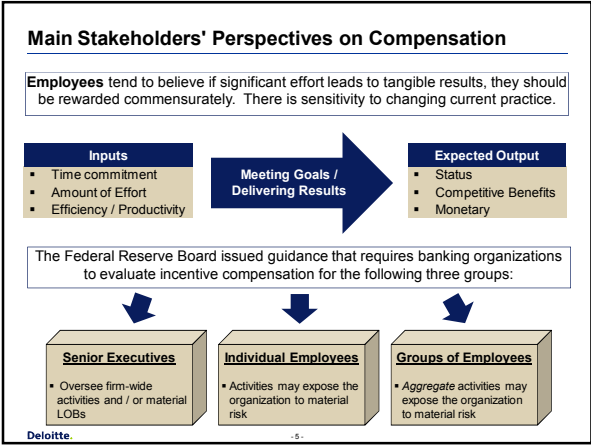
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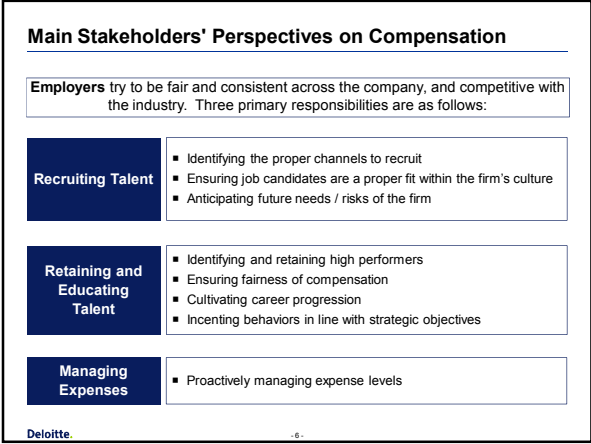
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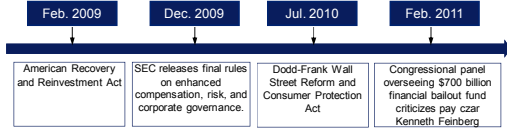
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### Main Stakeholders' Perspectives on Compensation

The US Government has responded to a perceived disconnect between performance and pay in the general public by enacting several reforms.



One **shareholder** goal is to align senior management behavior with their own goals and objectives, thereby mitigating the "agency problem". Other considerations are:

- Increased disclosure requirements can enable investors to evaluate if there is a proper reward and risk tradeoff.
- If compensation practices are viewed negatively or to be unethical by the public, there is a potential for a significant drop off in company intrinsic value and goodwill.

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### Short Term Steps

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### Develop / Modify Incentive Compensation Program

The initial step in this process is to address short-term components of an incentive compensation plan to supplement an already established fixed compensation program.

Component	Detailed Steps
Setting Tone from the Top	<ul style="list-style-type: none"> <li>▪ Senior management needs to communicate the company's desired approach to risk verbally <b>and</b> through its' actions</li> <li>▪ Changes in management's outlook or strategy need to permeate through its risk policy</li> </ul>
Incorporation of Risk Mitigators	<ul style="list-style-type: none"> <li>▪ There are three main types of risk mitigators that can be embedded in incentive compensation plans to address risk:               <ol style="list-style-type: none"> <li>1. Clawback feature</li> <li>2. Retention feature</li> <li>3. Deferral feature</li> </ol> </li> </ul>

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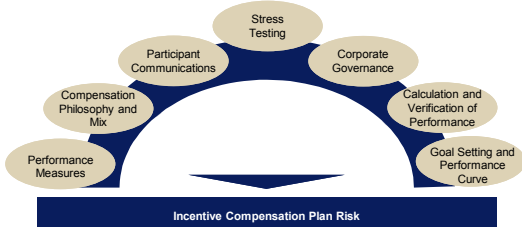
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### Assess Plan Performance and Risk

Some companies have successfully utilized methods to **qualitatively** assess how they are managing compensation risk. One such method is a "Risk Review".

In a "Risk Review", one or more of the following seven categories of risk management activities are evaluated on how effectively they are mitigating compensation risks.



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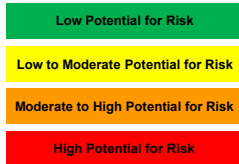
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### Assess Plan Performance and Risk (cont.)

Based upon the assessment of the seven areas in the prior slide, each is given a rating per the color scorecard below.



- Qualitative assessments, such as a "Risk Review", are intended to help identify areas of potential risk and opportunity which can be discussed with the Board and Compensation Committee.
- These discussions can ensure the company has a sufficient understanding of their risk management strategies around compensation.
- This type of assessment is typically performed for the *Senior Executive* and *Individual Employee* groups.

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### Long Term Steps

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## Develop / Modify Incentive Compensation Program



The longer term action items described in this section build upon the strategies employed in the short-term.

- Review Prior Year's Program**
  - The beginning of the cycle is the company's main opportunity to re-review the performance management system and make necessary changes.
- Include All Relevant Parties**
  - The HR department should review important elements of the performance management system with Finance, Internal Audit, and other key internal stakeholder groups.
- Implement Robust Risk-Adjusted Metrics**
  - Currently used metrics may not address the desired risk and return trade-offs.
  - More complicated risk-adjusted metrics can help companies better align incentive compensation with shareholders' views.
    - Examples include RAROC, Embedded Value, Economic Capital

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## Communicate and Implement Plan



Properly setting the stage and achieving buy-in from the workforce is a pre-requisite to a successful plan implementation.

- Communicating the key facts of a compensation plan change is the bare minimum required by senior management.
- Senior management should communicate the change in *philosophy and policy* to a risk-reward based view of compensation.
- Through varied communication techniques to all three employee groups, each should have an understanding of how the risk-reward trade-off applies to them.



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## Assess Plan Performance and Risk



There has not been as much progress in developing **quantitative** assessments, as there has been in qualitative assessments.

**Stress testing** can be an effective means of quantifying the risks inherent in incentive compensation and can provide several benefits.

### Types of Stress Tests

- Vary Employee Behaviors**
  - Given the current compensation plan, vary the assumptions behind employee behaviors and the forecasted economic conditions.
- Test Impact of Other Risk Events**
  - Keeping all other items constant, test a series of risk events that are not typically associated with compensation.
- Test Compensation Components**
  - Adjust the compensation plan components (e.g., claw back provision, length of payout, etc) to test their payouts under the various scenarios.

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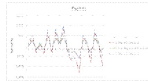
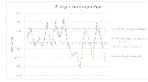
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### Assess Plan Performance and Risk (cont.)



Stress testing can be performed using a variety of tools, ranging from simple spreadsheets to complex financial projection systems.

- System / Program
  - The complexity of the tool should depend on the sophistication of the:
    - Compensation plan
    - Risk scenarios
    - Drivers of the company's financial performance
- Scenarios and Assumptions
  - These should be agreed upon by key internal stakeholder groups.
- Parties Involved
  - This should involve at a minimum the HR department, Executive Risk Committee, and the Chief Risk Officer.
  - The actual execution of the stress testing may be handled by another area (such as Finance).



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