



SOCIETY OF ACTUARIES

**ERM Symposium
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**5A: Integrating ERM and Incentive
Compensation**

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2010 Enterprise Risk Management Symposium Integrating ERM and Incentive Compensation

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Overview

- Over the past twelve months, there has been an extraordinary amount of focus on the relationship between risk and incentive compensation.
- The Securities and Exchange Commission ("SEC") released final rules on December 16, 2009 with respect to enhanced compensation, risk, and corporate governance disclosures.
 - The rules require companies to discuss "features of a company's compensation policies and practices that have the potential to incentivize its employees to create risks that are reasonably likely to have a material adverse effect on the company".
 - Companies would be required to review all incentive compensation arrangements, not just executive incentive plans.
 - Disclosure is only required if companies determine that their incentive plans are "risky".
 - However, in a February 5, 2010 speech, the assistant director of the SEC's Division of Corporation Finance, Larry Spiegel, suggested that even if a company determines that their incentive plans are not risky and disclosure is not required, "it would be helpful to provide a description of [the] process" undertaken by the company with respect to risk reviews.
- The European Union Solvency II Directive addresses companies' approach to risk management.
 - While compensation is not specifically addressed in the guidance, we believe that reviewing the company's incentive compensation arrangements for excessive risk would be part of effective risk management.
- To assist companies in determining if their compensation programs potentially incentivize risky behaviors, we have developed (i) a methodology for conducting risk assessment and (ii) a risk assessment tool.



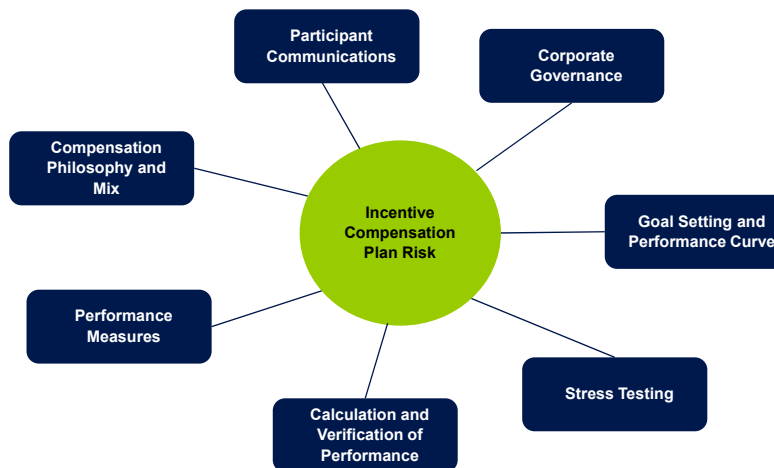
Conducting a Risk Review – Overview

- In order to determine if the company's incentive compensation arrangements are not "excessively risky", the company will need to conduct a risk review.
- Below we have outlined a general approach for conducting a risk review:

Phase	Detailed Steps
Information Collection	<ul style="list-style-type: none"> • Inventory the incentive compensation arrangements • Identify key features of the plans (e.g., participation, performance measures, performance and payout curves, potential incentive dollars, performance period) • Understand the Company's key strategic objectives and long-term business plan
Identification of Key Risks	<ul style="list-style-type: none"> • Identify potential <u>risk mitigators</u> • Identify potential <u>risk aggravators</u>
Conduct the Risk Assessment	<ul style="list-style-type: none"> • Interview key members of Human Resources, Internal Audit, Operations, and Finance to understand the policies, practices, and controls in place to minimize behaviors that encourage risk • Analyze and "score" each incentive compensation arrangement using Deloitte Consulting's risk evaluation tool (which is based on the risk mitigators and aggravators). See the following page for the areas that will be "scored" • Identify areas of potential risk and modification
Presentation to Management and/or Compensation Committee	<ul style="list-style-type: none"> • Discuss the following with Management and/or Compensation Committee: <ul style="list-style-type: none"> ○ Risk review process ○ Conclusions reached in risk assessment ○ Areas where "controls" are strong ○ Areas where "controls" need strengthening ○ Suggested approaches to making modifications
Additional Items	<ul style="list-style-type: none"> • Re-align the compensation programs to appropriately balance risk and add controls • Develop supporting materials regarding the process and proxy disclosure (if needed or requested by SEC)

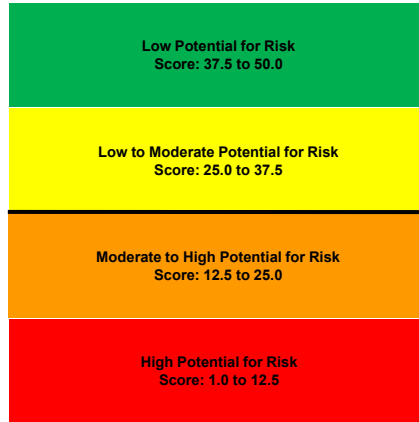
Conducting a Risk Review – Overview

- "Risks" in incentive compensation arrangements can be commonly found in one or more of the following areas:



Conducting a Risk Review – Overview

- For each of the seven areas of evaluation, we would “score” the incentive compensation arrangement based on a scale of 1 to 5.
 - A score of “1” would represent “high potential for risk” and a score of “5” would represent “low potential for risk”.
- Each evaluation area would then be weighted based on our experience in developing appropriately balanced incentive compensation arrangements. The scores would be aggregated and evaluated using the following scale (based on 50 total points):



Conducting a Risk Review – Common Risk Mitigators and Aggravators

- For each of the areas where risks can commonly be found, we have identified the most prevalent risk mitigators and aggravators.

Compensation Philosophy and Mix	
Common Risk Mitigators	Common Risk Aggravators
<ul style="list-style-type: none"> Company has a stated compensation philosophy. 	<ul style="list-style-type: none"> Company does not have a stated compensation philosophy.
<ul style="list-style-type: none"> The Company consistently considers and follows the compensation philosophy. There are few, if any, exceptions to the philosophy. 	<ul style="list-style-type: none"> The Company does not consider the compensation philosophy when making pay decisions or the compensation philosophy is not followed.
<ul style="list-style-type: none"> Compensation is balanced between base salary, short-term incentives, and long-term incentive (“LTI”) compensation. A majority of LTI compensation is at-risk. 	<ul style="list-style-type: none"> Short-term and/or LTI compensation is over-weighted. LTI compensation is heavily weighted on fixed compensation.
<ul style="list-style-type: none"> The mix of (i) short-term to LTI compensation and (ii) fixed to at-risk compensation is tailored to each individual depending on their role, responsibility, and line-of-sight. 	<ul style="list-style-type: none"> The mix of (i) short-term to LTI compensation and (ii) fixed to at-risk compensation is the same for all employees.

Conducting a Risk Review – Common Risk Mitigators and Aggravators

Performance Measures	
Common Risk Mitigators	Common Risk Aggravators
<ul style="list-style-type: none"> Performance metrics incent participants to drive the Company's performance in key strategic areas. Metrics are measurable and quantifiable. 	<ul style="list-style-type: none"> Performance metrics do not support the Company's business or strategic objectives, and/or are difficult to measure.
<ul style="list-style-type: none"> Performance measures are balanced between key short-term objectives and long-term strategic goals. 	<ul style="list-style-type: none"> Performance measures are overly focused on the Company's short-term performance.
<ul style="list-style-type: none"> All participants are measured, in part, on corporate performance. Business unit and individual performance is also measured. Participants have line-of-sight. 	<ul style="list-style-type: none"> Participants do not have corporate performance goals. Performance goals do not provide an appropriate line-of-sight for participants.
<ul style="list-style-type: none"> Metrics are generally consistent with those used by other similarly-sized insurance organizations and/or the metrics used by analysts to evaluate performance. Goals are specifically designed to drive performance at corporate, business unit, and individual levels. 	<ul style="list-style-type: none"> Metrics are not consistent with those of other similarly-sized insurance organizations. Goals are not unique to each Business Unit or individual.
<ul style="list-style-type: none"> Metrics are based on profit, quality of earnings, and return to the Company and shareholders. 	<ul style="list-style-type: none"> Metrics are based on "top-line" growth and do not consider quality of earnings or shareholder return.
<ul style="list-style-type: none"> Performance measures are generally consistent year-over-year. Changes are only implemented to reinforce the Company's strategic objectives or in response to a change in the Company's business. 	<ul style="list-style-type: none"> Performance measures change annually and few are kept year-over-year.
<ul style="list-style-type: none"> Short- and long-term incentive plans are based on different goals and there is little overlap. 	<ul style="list-style-type: none"> Goals for short- and long-term incentive plans overlap.
<ul style="list-style-type: none"> The length of the performance period correlates with the desired period of measurement. 	<ul style="list-style-type: none"> Performance period length is inconsistent with goal measurement period.

Conducting a Risk Review – Common Risk Mitigators and Aggravators

Goal Setting and Performance Curve	
Common Risk Mitigators	Common Risk Aggravators
<ul style="list-style-type: none"> Goals are tied to the Company's budgeted financial results and are well vetted throughout the organization. Goals are tested against historical results and projected peer company performance. 	<ul style="list-style-type: none"> There is little discipline in the goal setting process and/or goals are not tied to budgeted financial results. Goals are not tested for difficulty.
<ul style="list-style-type: none"> Goals are set and approved at the beginning of (or before) the performance period, when performance is largely unknown. Goals are not modified during the year. 	<ul style="list-style-type: none"> Goals are set and approved after several months of the performance period have elapsed and performance is largely known. Goals are changed during the middle of the performance period.
<ul style="list-style-type: none"> The threshold goal will be attained 80% of the time, the target goal will be attained 50% of the time, and the maximum goal will be attained 10% to 20% of the time. 	<ul style="list-style-type: none"> The probability of attaining the threshold, target, and maximum goals is significantly harder or easier to attain than the performance curve described in risk mitigators.
<ul style="list-style-type: none"> The "payout curve" reflects the difficulty of achieving the goals. The payout curve is (generally) "flat" between threshold and maximum. Threshold and maximum payouts are consistent with competitive practice. 	<ul style="list-style-type: none"> The payout curve does not reflect the difficulty of achieving the goals. The payout curve is significantly steeper between threshold and target and/or target and maximum. Threshold and maximum payouts diverge from competitive practice.
<ul style="list-style-type: none"> Payouts are capped. 	<ul style="list-style-type: none"> Payouts are not capped.
<ul style="list-style-type: none"> A minimum level of corporate performance is established in order for participants to earn an award ("on/off switch"). 	<ul style="list-style-type: none"> There is not a minimum level of corporate performance required for participants to earn an award.
<ul style="list-style-type: none"> If the Company uses relative performance, the peer group is comprised of insurance organizations that are similar in terms of size, location, and/or specialty. The peer group rarely changes. 	<ul style="list-style-type: none"> If the Company uses relative performance, the peer group does not reflect competitor organizations, changes frequently, and is comprised of historically poor performers.

Conducting a Risk Review – Common Risk Mitigators and Aggravators

Calculation and Verification of Performance	
Common Risk Mitigators	Common Risk Aggravators
<ul style="list-style-type: none"> Performance is calculated by members of Finance and verified by Internal Audit. The Compensation Committee or Board approves performance and plan funding. 	<ul style="list-style-type: none"> Internal Audit does not verify results. The Compensation Committee or Board has a small role in reviewing performance or plan funding.
<ul style="list-style-type: none"> There is a consistent methodology in place for calculating performance. If exceptions or adjustments to the calculation are contemplated, they are also based on a consistent methodology and using full disclosure. The Compensation Committee approves all such actions. 	<ul style="list-style-type: none"> Performance is calculated in an inconsistent manner each year. There is no "standard approach" for addressing exceptions or adjustments to the calculations. Such adjustments are not required to be approved by the Compensation Committee.
<ul style="list-style-type: none"> The Company has adopted a clawback in the event of a material misstatement of earnings. 	<ul style="list-style-type: none"> The Company has not adopted a clawback provision, or the provision is very narrow.
<ul style="list-style-type: none"> A portion of the incentive plan award is deferred. The deferred portion is at-risk based on future performance. 	<ul style="list-style-type: none"> The Company does not require the deferral of any portion of the award.

Stress Testing	
Common Risk Mitigators	Common Risk Aggravators
<ul style="list-style-type: none"> The Company "stress tests" the incentive plan award payouts for all possible performance scenarios before and after implementation. Performance scenarios range from "normal" to "catastrophic". 	<ul style="list-style-type: none"> No stress testing, or limited scenario stress testing, of the incentive plan award payouts is performed.
<ul style="list-style-type: none"> Results of stress test are discussed with the Compensation Committee or Board. 	<ul style="list-style-type: none"> Results of stress test are not discussed with the Compensation Committee or Board.
<ul style="list-style-type: none"> The plan is appropriately amended to reflect the results of the stress testing. 	<ul style="list-style-type: none"> The plan is not amended to reflect the results of the stress testing.

Conducting a Risk Review – Common Risk Mitigators and Aggravators

Participant Communications	
Common Risk Mitigators	Common Risk Aggravators
<ul style="list-style-type: none"> Participant communications are clear and concise regarding performance metrics and goals, award opportunities, and how to attain the goal without exposing the Company to excessive risk. 	<ul style="list-style-type: none"> Participants communications do not provide much detail on the incentive plan. Participants have little understanding of what they are being incented on or how to achieve the goal without introducing excessive risk.
<ul style="list-style-type: none"> The Company has a policy in place regarding excessive risk-taking. Management clearly communicates the consequences of excessively risky behavior. 	<ul style="list-style-type: none"> Management does not address the consequences of risky behavior.
<ul style="list-style-type: none"> A confidential whistle-blower policy is in place regarding the manipulation of performance results. 	<ul style="list-style-type: none"> No whistle-blower policies are in place or they are not confidential.

Corporate Governance	
Common Risk Mitigators	Common Risk Aggravators
<ul style="list-style-type: none"> A Compensation Committee is in place that has oversight for the Company's compensation programs. Committee members fully understand the Company's compensation programs and impact of regulatory requirements on pay. 	<ul style="list-style-type: none"> No Compensation Committee is in place or the Committee members are not well-versed in compensation-related issues. Executive pay decisions are not fully discussed with the Committee.
<ul style="list-style-type: none"> The Company has (and adheres to) stock ownership guidelines and/or stock retention requirements. Such policies are consistent with competitive practice. 	<ul style="list-style-type: none"> The Company does not have (or follow) stock ownership guidelines and/or stock retention requirements. Such policies diverge from competitive practice.
<ul style="list-style-type: none"> All decisions that may introduce additional risk are fully vetted with the Board and Compensation Committee. 	<ul style="list-style-type: none"> "Risky decisions" are not discussed with the Board or Compensation Committee.

Example Risk Review

- To illustrate how Deloitte Consulting's risk assessment tool and methodology is applied, we have prepared a sample risk review of an annual incentive plan for top executives.

ABC Insurance Co. – Top Executives	
Description of Annual Incentive Plan	
<ul style="list-style-type: none"> The Company's stated compensation philosophy for executives is to provide 30% of total pay in base salary, 20% in annual incentives, and 50% in LTI. LTI is provided equally in time-vested restricted stock and performance shares. The annual incentive plan is based on performance for the time period of January 1, 2010 to December 31, 2010. Goals are reviewed with the Compensation Committee in late January and approved at the February meeting. Each executive has corporate goals (75% opportunity) and individual goals (25% of opportunity). Corporate goals are tied to the approved budget. No executives have divisional goals, even though two of the top executives have divisional responsibilities. The goals are provided below: <ul style="list-style-type: none"> Earnings per share (60% of corporate goal weighting) Sales growth (30% of corporate goal weighting) Return on equity (10% of corporate goal weighting) Each executive has up to five individual strategic goals that are weighted equally and based on non-financial goals. The goals are set so that threshold performance is achievable 95% of the time, target is achievable 60% of the time, and maximum is attainable 5% of the time. The Company does not have a corporate "on/off switch". Threshold, target, and maximum performance results in an award payout of 70%, 100%, and 200% of target, respectively. The Compensation Committee may adjust performance results to adjust for unusual items, but no formal policy is in place. The Committee has used their discretion in each of the past three years. Once the performance period is complete, results are calculated by Finance and discussed with the Compensation Committee. Awards are then approved at the next Committee meeting. Internal Audit does not review the calculations. No award deferral has been implemented. A clawback is in place for executive officers that applies in the event of a material misstatement. There is a three-year sunset provision on the clawback. The incentive plan has not been, and will not be, stress tested. 	

Example Risk Review

ABC Insurance Co. – Top Executives		
Evaluation Criteria	"Unweighted Score" (Maximum of 5.0)	Rationale for Score
Compensation Philosophy and Mix	4.7	<ul style="list-style-type: none"> The Company has a stated compensation philosophy in place. The Compensation Committee considers this philosophy when making pay decisions. The mix of compensation for top executives is well-balanced, with base salary representing 30% of compensation, annual incentives representing 20% of total compensation, and LTI compensation representing 50% of total compensation. The heavy weighting on LTI compensation discourages participants from gaming the short-term goals, as it could negatively impact the value of their LTI awards. Approximately 45% of total compensation is at-risk (20% in annual bonus and 25% in performance shares). Ideally, a greater percentage of compensation should be at-risk.
Performance Measures	3.5	<ul style="list-style-type: none"> The plan contains corporate and individual goals, providing the participants with excellent line-of-sight. However, divisional executives should have divisional goals to provide them with better line-of-sight. The plan is over-weighted on EPS results. However, EPS results and revenue growth balance each other to a degree (i.e., "top line" and "bottom line" goals). Goals are tied to stated financial results. The 10% weighting of return on equity most likely does not incent participants to focus on this measure. Equally, it most likely does not encourage participants to "game" the measure. The use of additional return or "credit quality" goals and decreasing the weighting of EPS would better balance the plan and reduce gaming possibilities. Individual goals support the Company's strategic objectives and serve as a balance to the Company's financial objectives.

Scoring Scale

1 = Low Risk

3 = Moderate Risk

5 = High Risk

Example Risk Review

ABC Insurance Co. – Top Executives		
Evaluation Criteria	“Unweighted Score” (Maximum of 5.0)	Rationale for Score
Goal Setting and Performance Curve	3.1	<ul style="list-style-type: none"> Goals are directly tied to the Company’s budget. Goals are reviewed and approved by the Board of Directors. The performance curve appears to induce risks, as the goals at and below target are easy to achieve and result in relatively high payouts. Above target, the goals are very difficult to achieve. The link between pay and performance should be adjusted. The “cap” or maximum of 200% of target serves as a risk mitigator. The Company does not have a threshold level of corporate performance in order for participants to qualify for an incentive plan award. As a result, participants could focus on “maxing” one measure to ensure a payout at the expense of other measures. However, the balance of the performance measures and cap discourages gaming.
Calculation and Verification of Performance Results	3.2	<ul style="list-style-type: none"> Performance is not reviewed by Internal Audit. As only Finance prepares the performance calculations, there is an opportunity for additional gaming. Gaming is mitigated by the Compensation Committee’s involvement over a two-meeting period, thus providing an opportunity to review and question performance. Adjustments may be made to the bonus plan performance results based on the Compensation Committee’s discretion. As there is no pre-set methodology for making adjustments to performance results, participants may be incented to game the results. A clawback is in place to further mitigate risk. Awards are not deferred and/or subject to future performance, which creates risk, as participants may not focus on long-term results.

Scoring Scale
Deloitte

1 = Low Risk

3 = Moderate Risk

5 = High Risk

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Example Risk Review

ABC Insurance Co. – Top Executives		
Evaluation Criteria	“Unweighted Score” (Maximum of 5.0)	Rationale for Score
Stress Testing	1.5	<ul style="list-style-type: none"> The Company does not stress-test the payouts under the annual incentive plan. Consequently, the Company and Compensation Committee do not understand the impact on incentive awards and how employees may respond to potentially significant macro- or company-specific scenarios.
Participant Communications	4.5	<ul style="list-style-type: none"> Executives are provided with a detailed summary of their incentive plan goals, the performance curve for the goals, and their award opportunities (annual and long-term). The Board and CEO clearly communicate that taking on excessive risk is unacceptable. Any decisions that may be considered “excessively risky” must be discussed with the CEO and Board. The Company provides quarterly updates that track year-to-date performance compared to the goals, allowing participants to understand the level of performance required to meet and exceed targeted goals. However, the updates may incent participants to attempt to “game” a goal if they know they are close to the goal, but fall a little below the necessary level of performance.
Corporate Governance	4.8	<ul style="list-style-type: none"> The Company has a Compensation Committee that has oversight for the executive compensation program (i.e., pay levels and practices). All pay decisions for the executives are approved by the Committee. All proposed actions that may introduce the Company to additional risk are discussed with and approved by the Compensation Committee after they are fully vetted. The Company has stock ownership guidelines, but they are inconsistent with competitive practice and may encourage executives to become risk-averse.

Scoring Scale
Deloitte

1 = Low Risk

3 = Moderate Risk

5 = High Risk

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Example Risk Review

Scoring

- We have summarized the scoring for the Annual Incentive Plan for Top Executives below. The maximum score is 50.



Scoring Scale (Each Evaluation Criteria)


1 = Low Risk

3 = Moderate Risk

5 = High Risk

Stress Testing

Potential Benefits of Stress Testing

Companies have made progress in qualitative assessment of compensation risk. Stress testing can be an effective means of quantitative assessment of the risks inherent in incentive compensation.

Stress testing incentive compensation can provide several insights and benefit opportunities:

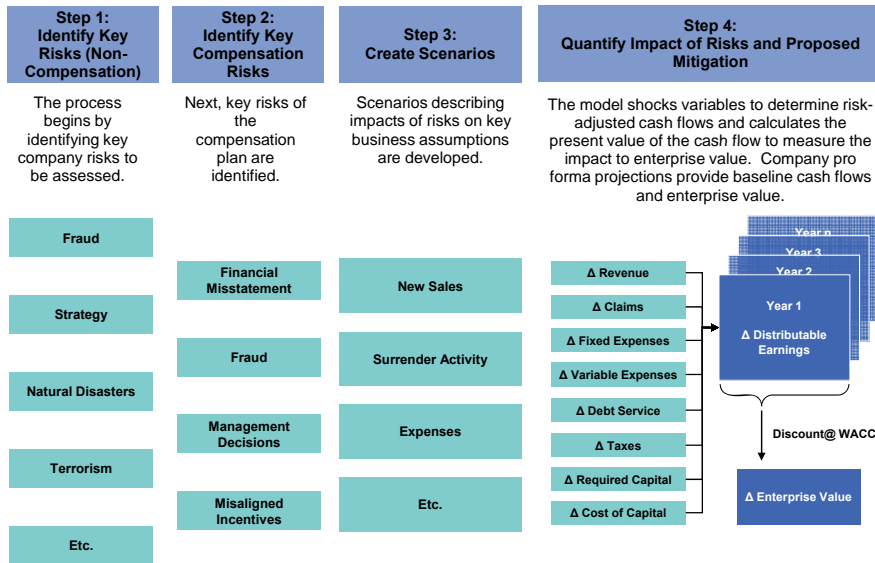
1. Confirm that incentive compensation is working as intended or identifies areas where it is not
2. Align employee incentives with the company's risk appetite
3. Provide data to support required disclosures
4. Generate detailed information to educate Board about compensation
5. Allow management to prepare for compensation impacts of potential future risk events
6. Provide information to educate employees about potential impacts to their compensation under a range of situations
7. Enhance the company's ERM practices and enables a holistic view of risk across the organization

Approaches to Stress Testing

Stress testing may be used to assess a plan in different ways:

<u>Approach</u>	<u>Key Components</u>
1. Test compensation formula with range of employee behavior and economic assumptions	<ul style="list-style-type: none">▪ Make assumptions about risk-taking behaviors of employees▪ Assess whether the plan responds appropriately under range of scenarios▪ Key stakeholder: Board / shareholders
2. Test compensation formula under specific risk scenarios	<ul style="list-style-type: none">▪ Risk scenarios should be consistent with what is used for other types of risk analysis▪ Determine impact on compensation should specific scenario arise▪ Key stakeholder: Chief Risk Officer
3. Quantify impact of various components of compensation plan design (e.g., clawback provision, length of payout, etc.)	<ul style="list-style-type: none">▪ Make assumptions about how compensation plan design will impact employee behavior▪ Use model to quantify likely incentive compensation outcomes resulting from plan design choices▪ Key stakeholder: Chief HR Officer

Stress Testing Process



Model Development

- Models should include the following:
 - Standard projections of insurance cash flows, income statement components and balance sheet components
 - Components required to calculate incentive compensation
 - Key drivers of corporate financials and compensation
 - Flexibility to incorporate model shocks based on key drivers
 - Key outputs / measurements to be evaluated
- Specific level of detail depends upon the drivers of business profitability and compensation
- Spreadsheets or actuarial projections can be used to perform stress testing :

Spreadsheet	<ul style="list-style-type: none"> Easy to modify to add and change compensation plan features Greater flexibility to model mitigation activities Requires building out complex insurance cash flow functionality May not be able to accommodate a large number of scenarios
Actuarial Projection Software	<ul style="list-style-type: none"> Usually has existing robust functionality for insurance cash flows May not incorporate all required components to model compensation May be difficult to modify for modeling mitigation strategies
Hybrid (Software + Spreadsheet)	<ul style="list-style-type: none"> May be possible to take outputs from an existing projection model and layer in compensation formulas in a spreadsheet Lacks the iterative impact of compensation payments feeding back into company financials

Scenario Creation

Creating appropriate scenarios for both non-compensation and compensation risks is a critical component of scenario testing.

- Determine critical risk areas for which scenarios should be created
- Collect scenarios currently used in the enterprise for other purposes for cross-referencing
- Identify key business activities to understand what areas of company activities may be impacted by risk
- Create specific scenarios to describe the risk events under consideration
- Conduct interviews with internal subject matter experts to understand and quantify the key impacts on business activities that would result from specific risks occurring
- Cross-reference scenarios against other existing scenarios in the organization for consistency

Creating robust scenarios on compensation risk may be challenging due to the sensitive nature of compensation and the implications around management behaviors engendered in the risk scenarios.

Scenario Creation: Failures Modes and Effects Analysis (FMEA)

Failure Modes and Effects Analysis is a process of expert elicitation used to gain information about specific risks that might occur and translate qualitative information about risks into quantitative information. This can be a very useful approach to scenario creation.

Description

- Method adapted from the manufacturing industry
- Failures modes are defined as any errors or defects in a process, design or item; Effects Analysis is the study of consequences of failures
- In insurance, failures can be viewed as risk events that might impact a company's operations
- Process uses expert elicitation to identify the potential failure modes and drill into the likely effects

Benefits

- Expert elicitation process allows company personnel to break down large seemingly incomprehensible risk scenarios into specific quantifiable impacts
- The process is particularly useful for dealing with strategic and operational risk scenarios
- Can be used to prioritize potential risks based on their severity, expected frequency and likelihood of detection

Presentation of Results

Before finalizing the stress testing model, it is important to consider what metrics should be used to measure results and how results should be reported. Considerations in the selection of metrics and presentation of results include:

- Balance of corporate profitability metrics and incentive compensation measures
- Alignment with corporate strategy and existing performance measurement frameworks
- Alignment with other risk measures used in the organization
- Audience for results (e.g., CEO, Board, CHRO, CRO)

Potential Profitability Measures	Potential Compensation Measures
Income	Amount of compensation paid
Enterprise Value	Value of non-cash compensation
Revenue	Deferred compensation accrued
Required Capital or RAROC	Present value of deferred compensation
Cash Flow	

Modeling Mitigation Strategies

A final step in stress testing compensation risk is to evaluate the impact of mitigation activities. Mitigation activities to model may include:

- Changes to thresholds or formulas for compensation payments
- Changes in structure of compensation plans
 - Clawback periods
 - Deferral of payment
 - Different compensation metrics that balance risk and reward
- Other non-compensation mitigation strategies (e.g., imposing caps on production levels)

Key Issues in Modeling Mitigation Strategies

- Consider how behaviors will change in the wake of changes to compensation plans / formulas
- Model the follow-on effects of compensation changes on recruiting and retention; changes may make compensation less competitive / attractive
- Model the follow-on effects of non-compensation mitigation strategies on profitability drivers
- Consider whether new risks will arise post-mitigation

Case Study

Case Study Model

- Excel-based model using Deloitte's IntEvaR™ calculation platform:
 - Simple projection of a single business unit selling only UL including 10 years of new business production
 - Full statutory projection model with income statements and balance sheets for 20 years
 - Uses distributable earnings to the corporate line as the key measure of profitability
 - Existing stress testing model for ERM extended to encompass compensation risks
 - Compensation formula for pool of executives defined as:
 - Additional 2% of base salary for every percentage point by which premium grows in excess of a threshold
 - Threshold set at 5%
 - Premium-related compensation capped at 50% of salary
- PLUS:
- Additional 2% of base salary for every percentage point by which distributable earnings exceed a defined threshold
 - Threshold starts at \$2 million and grows every year by a defined percentage
 - Earnings-related compensation capped at 25% of salary

Mitigation strategies might focus on changing structure of compensation, numerical inputs (e.g., 2%), comparison thresholds and caps.

Case Study Scenarios

Scenario	Description	Impacts to Drivers
Non-Compensation Risks		
1. Pandemic	2-year progression of Stage 5 Avian flu pandemic	<ul style="list-style-type: none"> Decrease in production and lapses in years 1 and 2 Increase in mortality rate in years 1 and 2 Increase in fixed expense in years 1 and 2
2. Baby Boomer Retiring	Challenges in retention and recruiting to replace retiring Baby Boomer	<ul style="list-style-type: none"> Decrease in production in years 3 and 4 Increase in fixed expense in years 3 and 4
3. Breach of Data	Employee circumvents security measures and erases key data	<ul style="list-style-type: none"> Decrease in production in year 1 Increase in lapse rate in year 1 Increase in fixed expense in year 1
4. Natural Disaster	Corporate headquarters are destroyed during working hours by a natural disaster	<ul style="list-style-type: none"> Increase in fixed expense in years 1 and 2 Increase in mortality rate in year 1 Decrease in production in year 1
5. Public Scandal	National media reports on perceived market conduct abuses by the company	<ul style="list-style-type: none"> Decrease in production in years 1 and 2 Increase in fixed expense in year 1 Increase in lapse rate in year 1
Compensation Risks		
1. Relaxed Underwriting	Underwriting standards are relaxed to boost near-term premium income, resulting in higher production and claims	<ul style="list-style-type: none"> Increase in production levels in year 1 Increase in mortality rate on new business in subsequent years
2. Production Slowdown	Production levels are capped in order to release capital and enhance distributable earnings in the near-term	<ul style="list-style-type: none"> Decrease in production in years 1 through 10
3. Expense Reduction	Aggressive lay-offs are used to severely cut expenses and improve earnings, leading to poor service and a need to backfill with contractors	<ul style="list-style-type: none"> Decrease in expenses in year 1; increase in year 2 Increase in lapse rates in years 2 and 3 Decreases in production in years 2 and 3

Case Study Output

Scenario	Year 1 Distributable Earnings	Enterprise Value	Year 1 Bonus Compensation	PV of Compensation
Baseline	\$2.0M	\$283.0M	\$94K	\$6.8M
Non-Compensation Risks				
1. Pandemic	\$(0.1)M	\$244.9M	\$0K	\$4.8M
2. Baby Boomer Retiring	\$2.0M	\$249.1M	\$94K	\$2.7M
3. Breach of Data	\$(2.7)M	\$275.1M	\$0K	\$4.4M
4. Natural Disaster	\$(43.2)M	\$219.6M	\$0K	\$1.8M
5. Public Scandal	\$3.0M	\$279.6M	\$1,000K	\$7.0M
Compensation Risks				
1. Relaxed Underwriting	\$(1.9)M	\$255.8M	\$1,580K	\$3.9M
2. Production Slowdown	\$5.9M	\$231.2M	\$1,000K	\$4.0M
3. Expense Reduction	\$2.7M	\$261.6M	\$1,021K	\$8.3M

Key Take-Aways

- The sensitivity of discussions around management actions and compensation may make it difficult to develop scenarios
- Model used must be able to incorporate all necessary drivers and have sufficient flexibility for both compensation and non-compensation risk scenarios
- Selection of risk scenarios is highly dependent upon the way the company “keeps score” – both for employees / executives and for itself
- Proposed compensation changes and mitigation strategies should be thoroughly tested across various scenarios before implementation to avoid unintended consequences
- Changes to compensation and implementation of mitigation strategies will lead to a new set of risk scenarios to be tested
- Selection of compensation metrics may drive the type and level of risk to which a company is exposed; leading practices for metrics include:
 - Metrics that are aligned with the time-horizon of the business
 - Metrics that are consistent with the company’s strategic objectives and performance measurement
 - Risk-adjusted metrics (RAROC, embedded value, economic capital) or a combination of risk and reward metrics

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