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Incentive Compensation And The Erm Person/ Actuary

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I have been in the unusual position of being from an actuarial background and chairing the compensation committee of a publicly held entity. Over the last four years our compensation committee has attempted to achieve several objectives in our compensation approach for the CEO and for the named executive officers that appear in the proxy:

1. Motivate and Compensate that level employee for good performance
2. Retain good people
3. Limit compensation to a reasonable amount
4. Satisfy the requirements of the proxy advisory agencies such as Institutional Shareholder Services (ISS), Glass-Lewis, and others
5. Receive a positive vote on Say-on Pay.
6. Exercise good risk management
7. Other less important objectives

Up until 2013 we had a system for both the short-term plan and the long-term plan based on four metrics: gross written premium, return on equity, combined ratio, and increase in diluted book value per share. These are companywide goals and seem to satisfy goals 1, 2, 3, and 6. However, in 2012 we failed the advisory say-on-pay vote mandated by the Dodd-Frank bill and so we were motivated to speed up the pace of change and more strongly emphasize objectives 4 and 5.

We implemented a new long-term plan whose metrics are Relative Total Shareholder Return, Absolute Operating Return on Equity, and Longevity (to promote retention). So we now have six metrics when considering both our long-term plan and our short-term plan.

The one metric that speaks directly to risk management is the combined ratio. If the combined ratio is controlled every year, then the major risk will not arise from underwriting but instead from investments. Indirectly, we anticipate that the three-year Total Shareholder Return and the three-year Operating Return on Equity will speak to our success in risk management.

So what are the issues that we found we had to consider and how did we incorporate risk management principles into the compensation system? The first issue was whether or not we should use Total Shareholder Return (TSR). Although the proxy advisory agencies are quick to emphasize that they do not mandate any particular metrics, at least one of the agencies uses a numerical score that in part includes a TSR component. Then we come to a secondary question: do the market and the valuation of a stock properly reflect how risky the stock is? After studying this issue, we did not come to a firm conclusion. There are numerous examples of companies who did not seem risky at one point in time because they were able to deliver consistent earnings at roughly the guidance level that, in retrospect, turned out to be extraordinarily risky. On the other hand, the market does seem to penalize those companies that exhibit risk by variation in earnings, often due to net catastrophe risk or lines of business whose combined ratio fluctuates radically. Several large publicly held companies such as Allstate have deliberately reduced their exposure to catastrophe risk because of the perception, or the reality, that the stock price was held down due to this exposure to high risk. We concluded that the best approach was to include TSR as one of many metrics but retain the combined ratio as a metric that directly addresses risk. In addition, in setting the reward levels for the gross written premium, the reward is achievable at the highest level only if the loss ratio is below a specified level.

The second issue was what time frame for incentives should we use? The industry practice seems to use three-years for long-term plans. That seems to be a reasonable compromise between the difficulty of managing and incentivizing over a long time period and the need to use a long time period since risk often shows up only after the book of business becomes somewhat more mature. Certain types of risk such as catastrophes will only show up over a longer time period. Sometimes, a three-year time period is too short.

The third issue was determining if there was any way we could directly include the risk in the compensation system without encouraging behavior that we did not want to encourage or discouraging some level of risk taking. After all, this is insurance. The three sources of risk we thought more deeply about were: risk of inadequate loss reserving; risk of catastrophes and a catastrophic event; the risk of under pricing current business. We concluded these were adequately but imperfectly covered near term by the combined ratio metric and longer term by the operating return on equity metric. Specific coverage of the risks would have to be by committee work emphasizing activities in these three areas, such as determining the probable maximum loss, and assurance that the required activity had taken place.

For inadequate loss reserving, we have three different actuarial reviews of the loss reserves each year. We perform the reserve review using credentialed actuaries that are also employees. We then annually engage a consulting firm to perform an overall review. And our independent auditors perform a review for the Audit Committee.

For the catastrophic risk, we rely on frequent reviews of our reinsurance program and our net retentions. However, this is flawed because there can always be more time spent on this type of review and its accuracy depends upon the diligence of employees. However, we do have strong reinsurance expertise on our Board and that helps us to monitor this risk. Hurricane Sandy showed this was imperfect.

For inadequate pricing, we have had to rely on a strong culture of underwriting caution and an ability to move capital quickly from one line to another line. Moving capital also has an effect on the distribution system. We also use the combined ratio as one of our four metrics in the short-term plan and we set a maximum above which there is no incentive pay for that portion of the plan. This is imperfect because no one really knows what the price should be for many lines, so we supplement the combined ratio metric with a review of the loss ratios by line and sub line at periodic board meetings to take advantage of the insurance expertise on our Board.

Of course there are numerous other risks that are controlled more through an Internal Audit process or other auditing. We have used Internal Audit to review things like the timeliness of claims reporting in programs business. These items can be appropriate for compensation systems below the CEO and NEO level but they can rapidly proliferate until it is a major effort to keep all the targets straight. We also have investment guidelines that are intended to limit the risk from investment fluctuation.

We are hopeful that the described compensation system draws a balance between achieving business objectives and avoiding unreasonable risks. ■

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