Incentive Compensation/Risk Management - Integrating Incentive Alignment and Risk Mitigation

By Rick Beal, Alex Weisgerber, Claudia Poster and Esther Becker, Towers Watson

Insurance companies' risk management practices came under great scrutiny as a result of the financial crisis. Ensuring that the structure of incentive compensation does not promote unnecessarily risky behavior has been the subject of many recommendations by regulatory agencies, Congressional mandate and commentary from professional organizations. At times, it seems these efforts may be aimed at trying to create (and enforce on the industry) one "perfect" incentive plan.

No single incentive design can fit every circumstance. However, organizations that follow a set of key principles can design effective incentive plans that align with organizational strategy, motivate individual and teams to achieve incremental performance, and incorporate appropriate risk-adjusted design safeguards, if organizations follow a set of principles.

1. First Understand the Risk Context

Before a balanced incentive plan can be designed, the organization must identify its material financial, operational and strategic risks. In short, it must have in place the basics of an Enterprise Risk Management (ERM) framework. Many organizations use historical incident/loss analysis, modeling and other tactics to better understand all of these risk areas.

Identifying employees who have the potential to expose the company to material adverse risk is another essential step. The Federal Reserve definition of material risk takers includes employees (or groups) anywhere in the organization that, through decisions or influence, can expose the organization to material risk. These are the employees whose incentive plans and performance goals should be scrutinized to ensure they do not encourage imprudent risk taking. These employees should receive additional, regular communications on the risk expectations of the enterprise.

While the definition is helpful, a "back of the envelope" approach to identification of material risk takers is not sufficient. Rather, a rigorous analytical approach should focus the organization's intelligence on the full range of business risks and map employees from every function to specific risk taking scenarios. These employees are not always the most senior people in the organization, and their ability to materially impact results may not always be obvious. For example, consider traders and employees who build models that establish and monitor risk parameters for acceptable trades.

Allocating risk capital to employees in critical risk functions and comparing it to a defined materiality threshold (e.g., a specified percentage of profits) can be a useful quantitative approach to identify material risk takers.

Organizational culture is another important factor that shapes the risk environment. Companies that overvalue short-term return run a greater chance of encouraging "rogue" behavior, prompting employees to take inappropriate risks or encouraging managers to turn a blind eye to risk taking. Therefore, it is important for managers to think critically about the tone of the organization's cultural attitude towards risk. An ideal culture balances support for prudent risk taking (e.g., that which supports differentiated performance and innovation) with strategies to discourage excessive risk taking.

2. Apply Risk Balancing/Design Interventions to Minimize Risk

Incentive plans must similarly find a balance between performance focus and risk sensitivity while taking into account business requirements and market practice. Managing these tradeoffs is the crux of traditional plan design. However, in the effort to motivate growth in profitability and shareholder return, risk balancing mechanisms are not always applied. There are a number of design features that should be considered to balance risk and reward, including:

- Risk-adjusted performance metrics in addition to the traditional P&L metrics
- Effective use of discretion as a hedge against windfalls or, conversely, achievement of stretch goals through inappropriate behavior
- Specific quantitative caps/windfall provisions
- Deferrals that match the time period between actions and outcomes
- Provisions to facilitate claw backs and acknowledge performance tails
- Eligibility threshold criteria that limit participation to accountable individuals
- Pay level and design benchmarking to ensure that any rewards are competitive and do not provide outsized results
- Rigorous assessment of quality of goals and outcomes – that is, both how they were achieved and their durability, ensuring that critical investments are not compromised.

3. Establish an Incentive Governance Framework to Ensure Balance

Regardless of its risk profile, an incentive plan requires oversight to ensure it is designed and administered effectively. A thorough review should involve an interdisciplinary perspective from Finance, Legal, Risk Management and senior corporate management and should have Board-level visibility. There are four key elements of a robust incentive compensation governance framework:

- **Structure:** What organizing approach will best support the execution of the governance model?
- **Roles:** What stakeholders are involved in the core processes of incentive design and administration?
- **Decision Authority:** What can each role do or decide for each incentive design and administration practice?
- **Processes & Criteria:** What core processes must the enterprise conduct, and which criteria should be used to assure quality?

For organizations just beginning to consider incentive governance, mapping current practices can give a clear path for identifying weaknesses. Large, complex organizations often find that they have inconsistent, unclear practices, causing the same decisions to be handled differently in different areas of the business. Other organizations find that stakeholders (including, often, the risk team) are not consistently, explicitly included in incentive-related processes. Finally, some organizations' governance efforts are complicated because they do not clearly establish (and hence do not recognize that they have achieved) the desired outcomes of these processes.

Regardless of the governance structure and practices, establishing specific criteria can lead organizations to a deeper understanding of the effectiveness of their incentive design and administration processes. For instance, many organizations find that goal setting is a difficult process to manage and standardize. Incorporating criteria such as "Were common probability of attainment and allocation methods used for formulaic financial goals?" to the review of the goal-setting process can provide an objective basis for judging its outcomes.

4. Monitor Regularly

A thorough analysis can point out where compensation program design features potentially motivate excessive risk taking. The process should be repeatable and include the following elements:

- Cataloging of programs, including all short- and long-term plans and sales incentives, and the potential size of the awards and impacts on the organization

Incentive Compensation … *by Rick Beal, Alex Weisgerber, Claudia Poster and Esther Becker, Towers Watson*

- ERM framework as context with reference to the risk profiles of each business segment and the employees identified as material risk takers
- Identification of factors that mitigate the risks inherent in the plans, allowing for assessment of residual risk.

Regulators increasingly request quantitative "proof" of the degree to which incentives are adjusted for risk taking. Simulation, back testing, and other robust statistical analyses can test correlations among performance, risk and compensation. Analyses should consider differences between top earners' risk profiles and those of other employees; qualitative analysis and assessment of specific risk outcomes; and scenario analysis testing pay sensitivity to risk outcomes.

Addressing the ERM Opportunity

Incentive compensation plan design practices are evolving rapidly. HR, Finance and Risk practitioners are working o better understand inherent and residual business risks as well as inherent and residual (i.e., remaining risk after accounting for governance and business practices which may mitigate risk) risk of incentive plans and to use this information to modify plan design and governance frameworks. Risk takers must have a clear understanding of risk parameters, the importance of compliance and the consequences of non-compliance. In addition, employees should understand what to do if they are pressured to take imprudent risks. By translating the ERM framework into easily understood terms for employees, ERM professionals can provide enormous support to the HR function.

Finally, embracing this work will have the benefit of aligning with the development of insurance companies' Own Risk and Solvency Assessment (ORSA) frameworks. Methods to gauge risk may include both qualitative and quantitative analyses to help portray a clear view of relative risks. However, the ultimate effectiveness of the approaches suggested here depends on communication and implementation throughout the enterprise. The result is achievement of the twin goals of strategically aligned motivation and a balanced culture of risk mitigation.

Rick Beal is Managing Director, West Division Reward, Talent and Communication Line of Business Leader at Towers Watson in San Francisco, CA. He can be contacted at *rick.beal@towerswatson.com.*

Alex Weisgerber is a Senior Consultant at Towers Watson in Chicago, IL. He can be contacted at *alex.weisgerber@towerswatson.com.*

Claudia Poster is Director – Executive Compensation Practice at Towers Watson in New York, NY. She can be contacted at *Claudia.Poster@towerswatson.com.*

Esther Becker is now a Principal at Oliver Wyman in San Francisco, CA. She can be contacted at *esther.becker@oliverwyman.com.*