Introduction

Incentive Compensation: The Critical Blind Spot in ERM Today

The Joint Risk Management Section of the Society of Actuaries (SOA), the Casualty Actuarial Society (CAS), and the Canadian Institute of Actuaries (CIA), in collaboration with the International Network of Actuaries in Risk Management ("IN-ARM") sponsored a call for essays on ***"Incentive Compensation-the Critical Blind Spot in ERM Today".*** The call is the fourth in a series of calls on ERM topics related to the financial crisis. In the first call of the series: ***"Risk Management: The Current Financial Crisis, Lessons Learned and Future Implications,"*** published in early 2009, incentive compensation programs were identified as a key factor in the Global Financial Crisis. In this current call incentive compensation has been singled out for examination. It has been argued that the single biggest blind spot in current ERM frameworks is the misalignment of incentive compensation. Compensation practices have been at odds with risk management historically. Most firms are driven by growth not longer term profits; there is high risk and no reward for being the show stopper if things aren't right. To exacerbate the situation, the risk manager is often perceived to be acting outside the structure of the firm.

To address the possible deficiencies in current incentive compensation programs, the call asks respondents to describe a compensation program that would provide appropriate incentives to employees to incorporate rigorous ERM into the management and operation of their companies. Authors were asked to consider the following questions:

- How do you reflect risk in the incentive comp program?
- How do you consider multiple time horizons?
- How do you reward or penalize favorable/unfavorable development for old years?
- How do you reward or penalize the role of actuaries/risk managers?
- How do you reward marketing?
- How do you reward or penalize integrated results?
- How do you discourage self-dealing and conflicts of interest?
- How do you minimize agent-principal risk?
- How do you deal with incentive compensation plans at competitors that do not adjust for risk?

This e-book contains 13 topical essays that express the opinions and thoughts of a number of authors on the subject. An essay is understood herein to essentially represent a short non-fiction form of writing expressing the often subjective opinion of the author. It should be understood that the thoughts and insights shared herein are not necessarily those of the Society of Actuaries, the Casualty Actuarial Society, the Canadian Institute of Actuaries, or corresponding employers of the essayists.

After review and deliberation by a dedicated group of volunteer experts, the Joint Risk Management Section Awarded prizes to:

- **1st prize:** *Management is Needed* – Not Incentive Compensation, by David Ingram
- **2nd prize:** *Incentive Compensation/Risk Management - Integrating Incentive Alignment and Risk Mitigation,* by Towers Watson (Rick Beal, Alex Weisgerber, Claudia Poster and Esther Becker)
- **3rd prize (tie):** *Incentive Compensation and the ERM Person/ Actuary,* by Charles Bryan
- *Some ERM Perspectives on Incentive Compensation,* by Al Weller

Of the essays published here, a few respondents have hands on experiencing with incentive compensation programs (Ingram, Bryan, and Fleming).

Some of the themes in the essays were:

- Management matters, Ingram states it as follows: "Management must manage. An incentive comp formula will not be sufficient."
- The governance of the incentive compensation program is important. For instance Beale et al suggest the establishment of a governance framework to ensure balance.
- The measure(s) used to determine incentive compensation must be monitored for unintended consequences. As stated by Weller "According to Goodhart's law, when a measure becomes a target, it ceases to be a good measure.
- Time frames matter, i.e., longer time frames are better. In particular, when short time frames are used there is a risk that compensation will be provided before the "true" outcomes of management activities are known.
- Goals other than risk management will be part of the incentive compensation program. Per Ingram, "while risk managers want Risk to be featured in incentive comp programs, it is not necessarily the most important thing for most companies in most years."
- Incentives flowing from governments and regulators are important influences on corporate managements also. In Rudolph's words "The government had become a prisoner of the bureaucracy, which itself suffered (and continues to suffer) from regulatory capture. This is when special interest groups, such as investment bankers, effectively take over a regulatory agency through a combination of lobbying, infiltration and bureaucratic job security. Incentives at governmental agencies need to protect the public."

A variety of approaches to incentive compensation were offered including:

- Use of risk adjusted performance metrics (Beal, et.al.)
- Special caps to guard against unintended windfalls (Beal, et.al.)
- Compensation based on various financial measures, where the time frames are selected to provide some protection against payouts that occur before the real outcomes are known (Bryan)
- Claw back and deferral features (Pohle)
- Option provisions (Huh)

- No incentive compensation, at least as incentive compensation is currently implemented. Flemming cites a number of studies that question the value of incentive compensation. "Studies among general industry companies dispute whether top executive pay in fact reflects company performance, and in one study of 271 CEOs, no significant statistical relationship was found between total CEO pay and total shareholder return." Flemming also points to a PWC study that "found that Complex (incentive) plans are a motivation killer."

There were a number of literary references in the essays. Lalani cites the well-known book about extreme events, *The Black Swan, The Impact of the Highly Improbable,* Nassim Taleb. Barry cites *The Signal and the Noise* by Nate Silver, a book that has a quite a following among quantitative types, and Weller quotes Shakespeare.

The 13 essays give us much to ponder on the topic of incentive compensation. However, as numerous of the authors pointed out, there does not appear to be one "right" approach to incentive compensation that will prevent managements from being reckless and incent employees to practice good risk management. No matter how well thought out an incentive compensation program is, it needs to be implemented carefully, and will not, by itself result in managements that manage well.