Some ERM Perspectives on Incentive Compensation

By Alfred O. Weller

The title of this Call for Essays is "Incentive Compensation – The Critical Blind Spot in ERM Today." The central question is what should enterprise risk managers do to manage the critical blind spot "incentive compensation". The management goal was clearly encapsulated by William Shakespeare in 1605. In Macbeth Act 5 Scene 1, Lady Macbeth speaks the famous line "Out, damn'd spot! out, I say!"

Successfully achieving this goal may involve any and all of the following perspectives and considerations.

1. **Identifying Incentive Compensation** – Incentive compensation is created anytime there is a new economic deal (e.g., sale or contract), or a change in economic circumstances. Incentive compensation is commonly described more narrowly as a change to an underlying employment agreement to "incent" the employee to a new level and/or type of performance by rewarding such performance with increased income. In practice, for the following reasons, incentives arise in a much broader variety of circumstances. Sound management and, in particular, sound enterprise risk management requires awareness and recognition of these possibilities as a whole.

2. **Employee Diversity** – If every employee had the same background, came from the same economic circumstances and was motivated by incentives in the same way, places of employment would be incredibly dull and uninteresting. Such uniformity might even be a significant risk in itself. Employee diversity means that an incentive program that works well with one group of employees might be totally inappropriate to a second group. To use a decades old example, free Yankee tickets to a group from the Bronx probably would not incent a group from Brooklyn.

3. **Economic Motivation** – General motivations for economic activity can be classified many ways. For simplicity, one set of general motivations is:
   - Love – economic activity is undertaken to provide something for free to a loved one;
   - Fear – economic activity is undertaken to provide something for free to a person threatening physical harm;
   - Mutual benefit – economic activity is undertaken for mutual benefit as when economic goods are bartered.

   Any single set of economic incentives is unlikely to have the same impact on individuals in each group.

4. **Time Horizons** – Incentives are often tied to yearly intervals in keeping with annual financial reporting. But what happens when employee goals span different time periods? For example, do actuarial examination raises (commonly classified as a form of incentive compensation) have any impact on performance or even pass rates for groups of actuarial students focused on professional recognition as qualified actuaries able to design and manage actuarial projects? Or in a pension plan tied to average earnings before retirement, is a one year incentive to reduce overtime likely to overcome a multiyear incentive of higher pensions attributable to increased overtime?

5. **Levels of Communication** – Communication always occurs on multiple levels often with not every participant's attention focused on the same level. In today's age, e-mail on a phone appears different from e-mail on a computer appears different from printed copy. Some folks focus on main message and fill in detail; others on details and build to main message. Position in a firm can affect focus. There may be levels of meaning. In such cases, problems can result on levels not contemplated by the originator of the communication. To give one not uncommon enough example, introduction of a new incentive compensation program can be viewed as a reduction in salary with little

Some ERM Perspectives on Incentive Compensation *by Alfred O. Weller*

chance of attaining incentives – in other words as an incentive to look for employment elsewhere.

6. **Incentive Compensation in relation to Overall Earnings** –In a bygone era when card games occurred by candlelight, sometimes it was appropriate to ask whether the game was worth the candle? In many business negotiations a change of 10% to 15% is needed before an offer is considered. When incentive compensation programs spread across many salary levels, testing whether the game is worth the candle to all participants is important.

7. **Measurements Used in Determining Incentive Compensation** – According to Goodhart's law, when a measure becomes a target, it ceases to be a good measure. Goodhart was a British bank regulator but his comments apply as well to incentive compensation. For example, incentive targets can become self-fulfilling prophecies, when coding of premiums for incentive credit is out of phase with coding for policy effective date.

8. **Balancing Management Objectives** – Short-term management objectives (e.g., increased sales) can conflict with long-term management objectives (e.g., strong customer relationships and marketplace image). Management needs to design short-term incentives to also contribute to long-term goals.

9. **Legal and Environmental Constraints** – Law, regulation, and even accounting and tax requirements can impose constraints on incentive compensation programs. Less obvious are constraints imposed by the business environment. For example, a claims management firm that billed for services as a percentage of incurred losses could take a hit to income by incenting rapid claim settlement at below historical average claim severities.

10. **Assessing success** – An incentive compensation program succeeds when desired performance improves, the improved performance contributes more to success than administration of the program costs, and employees recognize that their compensation is related to the overall success. This is far different than claiming accurate measurement of the contribution of each employee in the firm. Incentive compensation is not laser surgery and generally not suited to such precise evaluation. If Joyce Kilmer had worked in a human relations department, he might have written:

    Incentive programs are designed by fools like me,
    But only God can make a tree.

In summary, unique best incentive compensation programs do not generally exist, but effective ones do. Review of the above considerations enhances the chances of effective, practical design and implementation of incentive compensation programs. Lastly, the list also serves as a checklist affording an expedient test of incentive compensation program features.

Some readers will have noticed that, unless you count the year 1605, there are no formulas, equations, data or statistics in the preceding paragraphs - a six sigma moment in actuarial literature if you will. The basics of sound enterprise risk management do not always require mathematical analysis. To this end, we close with a quote from William Bradford on the role of risk management in the founding of Plymouth Plantation.

In regard to the question of risk in crossing the Atlantic and founding Plymouth Plantation Bradford wrote: *"It was answered, that all great and honorable actions are accompanied with great difficulties and must be enterprised and overcome with answerable courages. It was granted the dangers were great, but not desperate. The difficulties were many, but not invincible. For though there were many of them*

Some ERM Perspectives on Incentive Compensation *by Alfred O. Weller*

likely, yet they were not certain. It might be sundry of the things feared might never befall; others by provident care and the use of good means might in great measure be prevented; and all of them through the help of God, by fortitude and patience, might either be borne or overcome."

Thus, Plymouth Plantation claims to have succeeded in part because of enterprise risk management. The example might even apply to the current Call insofar as survival is a mighty powerful form of incentive compensation. The point of this example is that a key step in overcoming the incentive compensation blind spot is understanding people in the enterprise and doing basic risk management analysis similar to what the Pilgrims did shortly after Macbeth was written. Hopefully the above list and examples help.

Alfred O. Weller, FCAS, FCA, MAAA, is an Actuarial Consultant at Weller Associates in Upper Montclair, NJ. He can be contacted at *alweller@verizon.net.*