Managing Risks in Incentive Compensation Plans

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Incentive compensation is a particularly critical issue for job seekers, employees, employers and shareholders. Attention has typically focused on the role of incentive compensation in attracting and retaining employees along with incenting behaviors in line with strategic objectives. However, recent market events have shifted the focus to risks that may be inherent in incentive compensation arrangements. These risks may be particularly difficult to identify and manage and, as such, companies should consider implementing robust risk management processes for proper alignment of incentive compensation with both strategic objectives and company risk appetite.

With increased attention being focused on this area of risk from regulatory bodies and various stakeholders, life insurance companies should also consider developing strategies to address regulatory requirements and compensation plan risks in the short and long term. In particular, companies may need to develop techniques and approaches to allow them to:

- Better align current incentives in compensation programs with the risk profile and appetite.
- Design internal controls to appropriately mitigate excessive risk taking.
- Maintain an appropriate level of incentives to attract and retain necessary talent.
- Meet increasing demands for disclosure, analysis and documentation from external regulators and stakeholders.

To address these challenges, there are several practical short-term and long-term strategies that life insurance companies can use to strengthen their risk management of incentive compensation across the performance management and compensation development cycle.

Performance Management and Compensation Development Cycle

Incentive compensation plan design should be viewed as a cyclical process that incorporates periodic assessment of the plan and revises the plan to keep it aligned with external conditions and company strategy. There are three major steps within this process that should be undertaken every fiscal year.

1. **Develop/modify incentive compensation program.** The initial step in this process is to create both short-term and long-term components of an incentive compensation plan to supplement an already established fixed compensation program. This risk management-oriented approach seeks to achieve a proper balance between risk and reward by establishing a well-designed incentive compensation plan and balancing fixed and at-risk pay.

2. **Communicate and implement plan.** Whether viewed positively or negatively, any change to an employee's compensation affects one of the most important and personal aspects of a person's employment. In order for the compensation plan to work as intended, plan participants should

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understand through proper communication and implementation what they are being incented to do.

3. **Assess plan performance and risk.** This step includes both qualitative and quantitative methods to assess plan performance against the intended design and behaviors. Any deviations from what is expected should be properly communicated to key stakeholders. Key drivers of plan deviations must be understood so that they can be properly addressed through plan modifications. Many companies use *qualitative* assessments of compensation plans. However, *quantitative* assessments, such as stress testing, can be critical in helping companies understand trade-offs between risk and reward embedded in the compensation plans.

Short-Term Strategies

Given the fact that most compensation plans are administered on an annual cycle, it might take a company several years to fully embed effective risk management into the incentive compensation program. However, within the first year, there are several practical next steps that companies can undertake across the components of the compensation cycle to begin to strengthen their risk management practices.

- **Develop/modify incentive compensation program.** Setting the tone from the top is relevant here at the onset of the cycle. As an initial step, any changes in management's outlook or strategy for the organization may necessitate a revision in a company's risk policy. Within this context, it is important for a company to perform a fresh, holistic review of its compensation risks within an enterprise risk management (ERM) framework and consider whether design features mitigate or exacerbate risk. Key design components can help companies mitigate risks in the compensation plan. Claw back, retention and deferral features are three examples of useful risk mitigators that can be embedded within plans.

  Within the incentive compensation formulas themselves, metrics can be selected to appropriately balance risk/reward and better align compensation with the company's strategic objectives and risk appetite. Commonly used metrics include earnings per share, stock price appreciation plus dividends, return on equity, revenue growth, and cash flows. There is no hard and fast rule in assessing the correct number and complexity of the metrics used in the incentive compensation payout structure; therefore, each company must assess the appropriateness of the metrics based on its own circumstances.

- **Communicate and implement plan.** The nature and degree of changes to a compensation plan may necessitate a commensurate need for transparent and consistent communication and change management across the organization. A key step in this process is establishing a climate that is receptive to change by providing tools and illustrative examples to enhance transparency for employees. Employees should be engaged in formal discussion that addresses not only the facts of the compensation plan, but also the philosophy underlying the compensation plan and how the plan fits with the overall company strategy and objectives. Finally, it may be helpful to create an ongoing forum for employee's questions or concerns that may arise throughout the year.

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- **Assess plan performance and risk.** Some companies have successfully used methods to qualitatively assess compensation risk. One such method is a "risk review" wherein key features of the compensation plan are inventoried, risk mitigators and aggravators are identified, and a risk assessment is performed by assigning a score to each plan feature. These steps are intended to help identify areas of potential risk and opportunity that can be discussed with management and/or the compensation committee. Another method to employ is the continual tracking of key risk indicators (KRIs), such as the allocation of total compensation between fixed compensation and variable payouts. These KRIs can provide a timely and periodic view of the plan's risk/reward balance.

Long-Term Strategies

Many of the longer-term action items build on the strategies employed in the short-term over the course of the compensation cycle. As lessons are learned and the concept of balancing risk and return is ingrained into the company's culture, significant strides can be made in managing compensation risk.

- **Develop/modify incentive compensation program.** Information gleaned from the review of metrics and any qualitative or quantitative analyses performed in the prior year can be leveraged in redesigning the plan. Prior assessments may identify that metrics currently used in plans do not adequately reflect the risk and return trade-offs desired by the company, nor incent the right behaviors. In the longer term, a well balanced set of robust risk-adjusted metrics can be implemented to better align employee incentives with strategic objectives and risk appetite, while helping to meet recruiting and retention needs.

- **Communicate and implement plan.** Properly setting the stage and achieving buy-in from the workforce can be important to plan implementation. A more significant change in a plan can require a commensurately significant effort around communication and change management. Over time, the company can continue to build and reinforce a culture and philosophy of a risk-reward based view of compensation through consistent communication.

- **Assess plan performance and risk.** While qualitative assessments can be a good first step in identifying risks in a plan, eventually quantitative methods should be used to more fully understand the impacts of those risks. Stress testing can be an effective means of quantification for incentive compensation risks. Companies may apply stress testing to gain a better understanding of how the plan behaves under a range of employee actions, economic and non-economic scenarios and payout structures with the intent of answering the following questions:
  - How does the compensation formula respond across a range of employee behaviors and economic assumptions?
  - How does the compensation formula respond if various other (non-compensation) risk events occur, such as operational, strategic, and market risk events?
  - How do various compensation plan components (e.g., claw back provision or length of payout) impact payouts under various scenarios?

  To help ensure appropriate governance, stress testing results should be communicated to the compensation and risk committees along with the chief HR officer and other key stakeholders.

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Conclusion

By setting tone from the top and devoting appropriate resources, effort and thought leadership to the key issues in the compensation cycle, a company can enhance its balance of the rewards and risks inherent in an incentive compensation system. Due to the complexity of the metrics and strategies to effectively assess plan performance, it may take several iterations of the plan cycle for companies to fully embed these risk management principles. However, by steadily enhancing risk management processes, companies can make progress today by addressing short-term recommendations while laying the foundation to implement longer-term solutions in the future.

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