



Designing and Measuring the Effectiveness of Compensation
Incentive Programs – Assessing Incentive Plan Risk

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The Perceived Role of Pay in the Great Recession

- Certain commentators, shareholders, and governance groups have charged that flawed compensation design was key to the recession
- Criticisms have included:
 - Compensation plans encouraged too much risk-taking and didn't penalize sufficiently for "bad bets"
 - Too much of total pay was delivered annually in cash, with employees bearing no long-term downside risk
 - Clawbacks didn't exist to recover payments if financial results were misstated or inaccurate
 - Equity awards vested over too short of a time period
 - Many incentive plans were based on revenue, not earnings, and paid for sales regardless of profitability
 - In certain industries, compensation plans were not aligned appropriately with the business cycle
- Merited or not, many of the regulations, legislation, and company-initiated changes were spawned from these charges

Executive Pay Interventions Were Trending Up, But...

- In general, involvement by outside parties in executive pay has increased over time:
 - Stock market rule changes added shareholder rights
 - Activist shareholders have assumed a more forceful role in the process
- Government involvement in executive compensation has typically been indirect . . .
 - Tax law limits on executive pay have existed for many years (e.g., IRC §280G, IRC §162(m), IRC § 409A)
 - SEC disclosure requirements were expanded (2007 proxy disclosure rules, 2007 8-K disclosures, 2010 proxy disclosure rules)
 - IRS Form 990 requirements have been expanded
- ...Until 2008 and 2009

...Now We Have a Tidal Wave of Legislation and Principles...

- SEC expanded disclosure rules for executive pay
- FDIC proposal to charge higher insurance premiums to banks with “risky” pay practices
- American Recovery and Reinvestment Act
 - Created pay restrictions on government aid recipients
 - Created the Pay Master role
- US Treasury principles
- US House of Representatives legislation (Frank)
- Financial Services Authority (UK) principles
- Financial Stability Board (G20) principles
- Conference Board report
- Australia Prudential Regulation Authority (APRA) principles
- Numerous academic studies, etc.

The New Reality Is That The Compensation Design Process Will Explicitly Take “Risk” Into Account

- Acceptable risk taking is a necessary and important part of well-designed compensation programs
- Companies need to take action to:
 - Strengthen the effectiveness of their pay programs by:
 - Defining “risks” based on their unique circumstances
 - Assessing their pay programs to determine what is acceptable and the most appropriate design
 - Disclose, if appropriate, in their proxy filing
 - Enterprise-wide compensation policies and practices relating to risk management practices and risk-taking incentives to the extent that risks arising from these policies and practices are reasonably likely to have a material adverse effect on the company
 - Fortunately, “reasonably likely” is not the reality for most companies
 - Disclosure is not required if this is not applicable to the company; however, companies may decide to state specifically they have reviewed and determined that this is not applicable
- A framework for thinking about different types of “risks” is presented on the next page followed by an approach for conducting a comprehensive risk assessment

What the SEC Disclosure Rules Say About Risk

- If any pay programs create risks that are reasonably likely to have a material adverse effect on the company, then the company must discuss:
 - Its “policies and practices of compensating its employees, including non-executive officers, as they relate to risk management practices and risk taking incentives”
- "Reasonably likely" is same standard used in MD&A so should be some familiarity as to its meaning
- Disclosure is part of the proxy, not the CD&A, so the responsibility to conduct the analysis falls with the company, not the Board or compensation committee
- Companies not required to disclose under this regulatory standard will still need to consider if a discussion of the connection between pay and risk is warranted in its description of the risk oversight function
- Compensation committees will need to determine the extent to which they focus on the connection between pay and risk-taking as they make their pay setting decisions

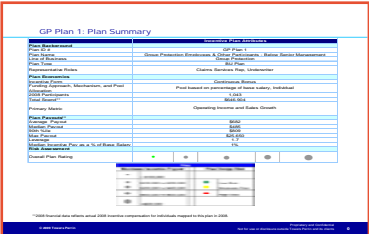
There Are Various Categories That Should Be Considered As Companies Think About Their Unique “Risks”



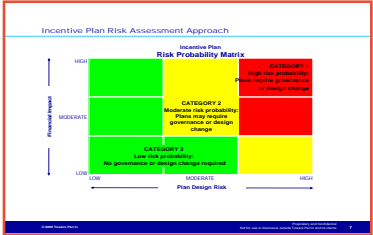
Now we will walk through a risk assessment methodology...

Risk Assessment Methodology Process Overview

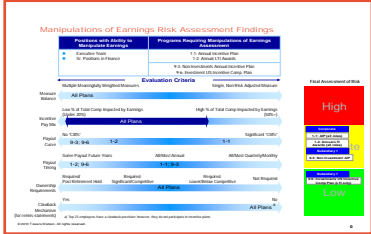
1. Conduct Plan Inventory



2. Evaluate Plan Design and Governance Risk



3. Assess Potential for Manipulation of Earnings



4. Provide Recommended Action

Risk Assessment Conclusions and 2010 Plan Year Considerations

Conclusions

- XYZ Corp. must maintain strong governance and mitigation factors, particularly for plans identified as having high financial impact and high plan design risk
 - Subsidiary 1:
 - 7-1: Incentive Plan for Managers
 - 7-1: Incentive Plan for Wholesalers

Considerations

- For Incentive Plan for Managers, consider increasing the discretionary bonus target to minimize the impact of override commissions
- In addition, consider eliminating override commission from 1st dollar by establishing a minimum performance level (e.g., 70% to goal) to better align incentive spend to attainment to plan

Incentive Plan: Operational Risk Assessment & Financial Impact

Operational Risk

Financial Impact	Philosophy/Mix	Plan Design	Governance and Administration
<ul style="list-style-type: none"> • While risk is inherent in all businesses, the key issue is management against appropriate risk standards • In evaluating the financial impact of risk, consider: <ul style="list-style-type: none"> • Potential monetary impact on business • Probability of occurrence 	<ul style="list-style-type: none"> • Risk inherent in compensation program philosophy and compensation mix • Sample key issues/concerns <ul style="list-style-type: none"> • Does pay philosophy have point of view on risk management? • Is pay mix heavily skewed toward fixed vs. variable pay? • Within variable compensation, is pay appropriately mixed? 	<ul style="list-style-type: none"> • Risk inherent in compensation program design and mechanics • Sample key issues/concerns <ul style="list-style-type: none"> • Do incentive plans create an opportunity for excessive payouts? • Are incentive performance metrics and plan mechanics aligned with business strategy? • Are there clawback/holdback mechanisms? 	<ul style="list-style-type: none"> • Risk inherent in the oversight and administration of plans across the business • Sample key issues/concerns: <ul style="list-style-type: none"> • Does the compensation governance have a clear mandate, ongoing monitoring and oversight? • Do performance targets reflect the appropriate levels of stretch/achievability? • Is there a process for reporting and responding to risk concerns?

Incentive pay by design drives behavior; some behavior creates risk for the enterprise

Operational Assessment: Plan Design Detailed Evaluation Criteria

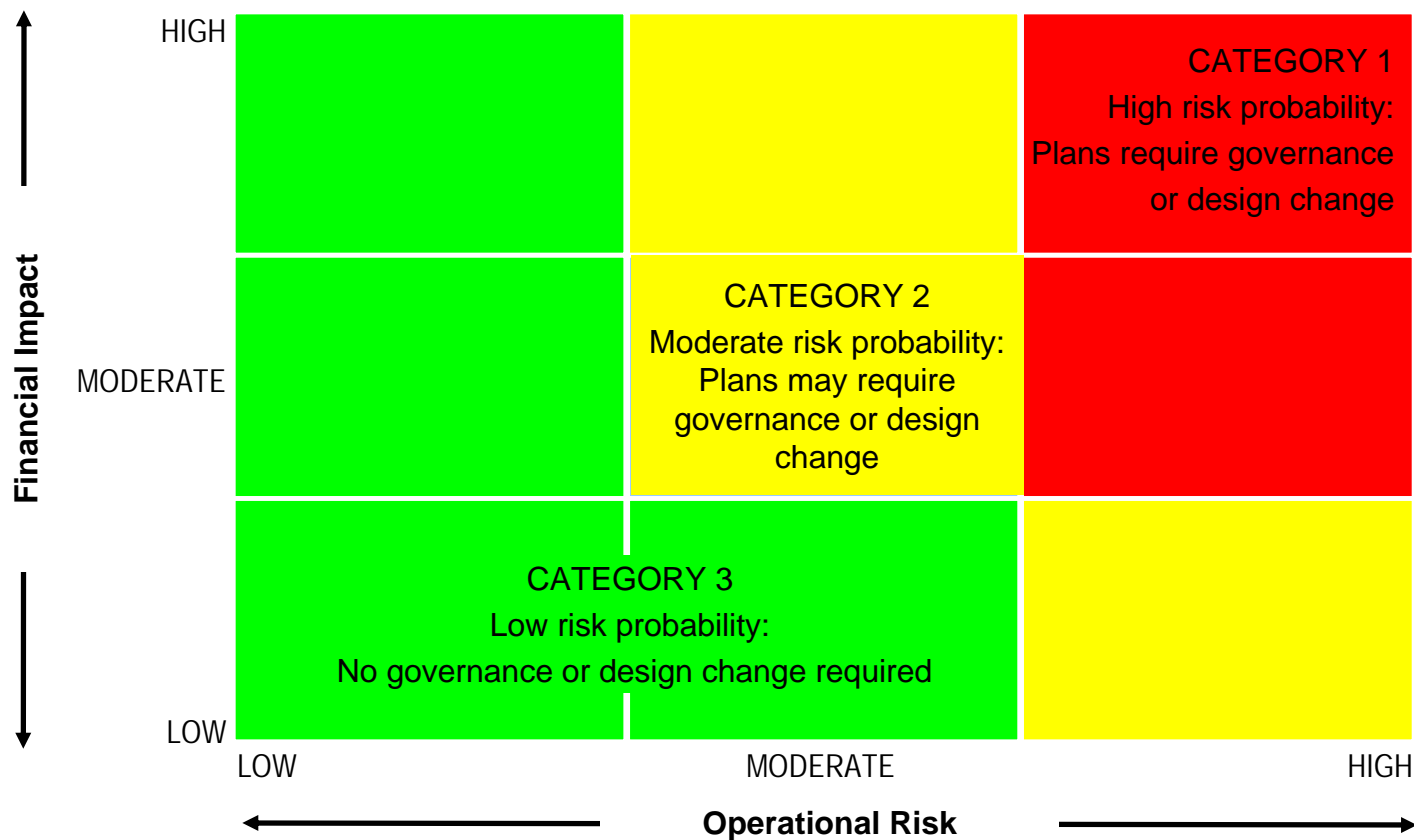
Evaluation Criteria		Risk Assessment Standards								
Incentive Pay Opportunity										
Maximum Payout	●	<\$100,000	●	\$100,000 - \$200,000	●	\$200,000 - \$400,000	●	\$400,000 - \$600,000	●	\$600,000+
Incentive Plan Metrics										
Primary Metric	●	Risk-adjusted measure (i.e. RAROC, economic profit) ensures quality results	●	Top-line measure (i.e. volume, revenue)						
Level of Balance (with measure description)	●	Multiple, meaningfully weighted performance measures with at least one that reflects risk	●	All or most incentive based upon a single non-risk adjusted measure						
Corporate Alignment Metric	●	Yes	●	No						
Line of Business/Division	●	Yes	●	No						
Incentive										
Upside Incentive										
Capex										
Funding										
Funding										
Funding										
Incentive										

Operational Assessment: Plan Governance Evaluation Criteria

- Independence
 - Is there independent oversight of the plan?
- Design Process
 - Is a clear pay philosophy set relative to market and internal guiding principles?
- Approval
 - Is there formal corporate approval and an approval authority “checklist” by function?
- Exceptions, Disputes and Adjustments
 - Is this process clear, well understood, documented and executed consistently?
- Accurate and Timely Payouts
 - Is data tracking accurate and timely?
 - Is performance communicated on an ongoing basis during the performance period?
- Plan Monitoring and Oversight
 - Is there a “scorecard” for assessing plan performance during the performance period?
 - Are periodic reviews conducted with a cross-functional team to inform future design?

Plan Design And Governance Risk Assessment: Each Plan is Reviewed Consistently and Assigned to One of the Nine Probability Matrix Boxes







**Incentive Plan
Risk Probability Matrix**









Towers Watson's Perspective on Risk Management and Pay

There are no prescriptive ways to structure a pay program so that it does not encourage excessive risk-taking. The specific design of the program depends on the business model, risk issues, job duties, governance system, expected returns, and the values of the organization and its employees.

Potential Red Flags

-  Salaries that do not cover living expenses
-  High short-term cash opportunity for employees who can harm business long term
-  Steep incentive curves and uncapped payouts
-  Totally formulaic awards and unrealistic goals
-  Payout timing not aligned with risk tail
-  Performance metrics that do not reflect sustainability

Potential Mitigating Features

-  High levels of stock ownership
-  Cash bonus paid in stock or malus clause
-  Goal setting in line with reasonable expectations
-  Deferrals in line with risk tail
-  Performance metrics that reflect quality of earnings
-  Strong governance and/or ERM system

In Light Of The Crisis And Public Pressure, Some Companies Are Making Changes To Address The Risk Issue

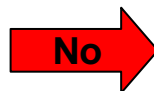
- Implementation of clawback provisions
 - Allows recoupment of awards under certain conditions
 - Mitigates risk of manipulating short-term results
- Shift from revenues to earnings as an incentive driver
 - Mitigates risk of maximizing sales without profits
- For financial institutions, use of cost of capital/capital adequacy to determine annual incentive pool
 - Ensures that income statement does not take precedence over stability
- Forced deferral of a portion of annual incentive and increased focus on performance over the longer term
 - Part of incentive paid in stock or cash that vests over a multi-year period
 - Greater prevalence of three-year performance plans
 - Subject to forfeiture (bad actors, resignation)
 - Mitigates behavioral risk and myopic focus on short-term results

In Light Of The Crisis and Public Pressure, Some Companies Are Making Changes (cont'd)

- Retention ratios
 - Requires percentage of equity awards to executives be held for a period of time or until retirement/termination
 - Mitigates risk of focusing on ST gain at the expense of LT shareholder value
- Governance changes
 - Increased independent oversight of compensation, both in approving plan design and plan payouts
- Greater use of discretion and judgment
 - Taking into account not just results but how they were achieved; aimed at behavioral risk and compliance risk
- Comprehensive audits of pay and risk across the organization
 - Includes all incentive plans and tests for operational risk and financial impact
- The challenge for companies is to balance the pressures of the current environment with the need to attract, retain, and motivate top talent

What to do for the 2010 Proxy

1. For 2009, did your company undertake a review of the connection between pay and risk?

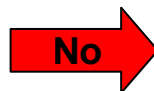


Discuss the following alternatives with outside counsel:

1. Undertake a judgmental, retrospective review, to determine if any disclosure is required *OR*
2. State affirmatively you have not done a review, and promise to do so for 2010 *OR*
3. Remain silent for the current proxy

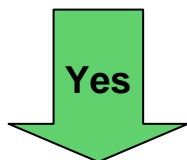


2. Did any of the pay programs create risks that are reasonably likely to have a material adverse effect on the company?



No disclosure is required but may be considered:

1. Disclosure of the process undertaken to render this conclusion
2. Discussion of how pay design does not promote inappropriate risk taking
3. Pay/risk discussion as part of overall company risk management and oversight
4. CD&A disclosure on connection between pay and risk for NEOs



Disclosure is required and must include a discussion of issues outlined in the SEC regulations (e.g., design philosophy, clawbacks) and other appropriate issues.

Recap and Potential Next Steps

- Determine with SEC counsel what your approach should be for the **2010 proxy**
- **Create a working group** including client risk officer/ finance, general counsel, and HR that can advise the compensation committee about how it should proceed
- Understand the **company risk profile** compared to that for peers and/or the industry
- **Develop a process** by which current compensation design can be assessed from the perspective of whether it promotes excessive risk taking
- **Determine if disclosure is required** for the proxy year or **if disclosure of the process** is otherwise in the company's interest
- Consider the extent to which the company's assessment of compensation and risk should be **presented to the compensation committee** to help influence their pay decisions
- Adjust current compensation architecture to help **reduce risk-taking**, if necessary
- In future years, review whether **impact of the risks** have been in line with the company risk profile. If not, consider how pay programs might be adjusted

Questions & Answers