Holistic Risk and Competitive Review of Incentive Plans

By Patrick Connell
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In McLagan's previous Alert, "What Do They Mean by Unreasonable Risk?", we considered the challenge of defining unreasonable risk and who should decide that *after the fact* the risks taken were unreasonable. As a starting point to ensuring that compensation plans are properly constructed to avoid the inducement to take unreasonable risk, while motivating behavior that provides a reasonable return to shareholders, we suggested the following:

- Define the different forms of risk to be managed
- Outline the ways a prudent organization can best manage risk
- Identify observable phenomenon that can indicate a possible disconnect between incentives and prudent risk management
- Describe the characteristics of compensation plans that optimize the risk/ return relationship

NEXT STEP—HOLISTIC FRAMEWORK FOR REVIEWING RISK AND COMPETITIVENESS

In this Alert, we provide a framework to take a more holistic view of incentive plan design that moves beyond performance metrics and award opportunities into considering the overall risk and competitiveness of a firm's compensation program. We continue to assert that risk comes in many forms and represents both upside and downside opportunity. Since banks are in the business of taking risk, risk minimization should **not** be the goal, but, rather, profit maximization at an acceptable risk level, defined within the banks' stated tolerances. We recognize that communication of this goal does not role off the tongue the way "risk minimization" does, but it is an important distinction. To help ensure that a firm's incentive plans support their business objectives (including risk-taking) while attracting, retaining and motivating employees, we recommend that the risk posed and market competitiveness of incentive plans be thoroughly reviewed.

KEY ELEMENTS AND QUESTIONS REGARDING INCENTIVE PLAN DESIGN

In this section, each element of incentive plan design is identified and leading questions are asked to explore the current incentive plan structure. In a full review of incentive plan design, a firm's structure would be compared versus the external market and best practice, including risk management. Risk within one element of incentive plan design may be offset by another element of plan design. A classic example would be high award opportunities being offset by larger deferrals / long-term awards. Another example would be producer plans that measure performance based on net-interest revenue rather than profitability, but offset by stringent underwriting standards and high collateral requirements. This list is not intended to be exhaustive, but rather a framework for firms to review existing incentive plan design and consider enhancements both from a competitive and risk management perspective.

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PHILOSOPHY

- What is the business mandate and risk appetite?
- Peer Group – Size (Assets, Revenues, and Employees), Geographic Proximity, Business Competitors and Labor market Competitors?
- Benchmark jobs – What jobs are most similar? Realistic employment opportunities?
- Market positioning – Follow (25th %tile), Meet (50th %tile) or Lead (75th %tile) Market Compensation?

OBJECTIVES

- Attract – How do you assess, select and on-board the right candidates?
- Retain – How do you keep the right employees? How much turnover is acceptable / encouraged?
- Motivate – What actions / behaviors do you want to encourage or discourage?

ELIGIBILITY (BASED ON)

- Specific business or functional responsibility? Responsibility for risk-taking or management?
- Level in organization – Corporate Title versus Functional; Producer versus Manager? Front-office versus support/infrastructure roles?
- Time in position, promotion / transfer, minimum individual performance, salary threshold, incentive/commission threshold?

TYPE OF PLAN

- Annual – Commission, Target-based, Balanced Score-Card, Managed Accrual, Discretionary?
- Long-term – Deferral, Add-On, Retention or Incentive oriented? Vehicle?

PERFORMANCE MEASURES

- Measured at Firm, Division, Business, Team and / or individual level?
- Quantitative / Objective?
- Qualitative / Subjective?
- Fully captured risk?
- Over what time period?
- Year-over-year? Versus Absolute / Budget? Versus Index / Peers?

FUNDING

- Formula (Top-down) or budgeted (bottom-up)? Variable or fixed percentage?
- At what level does funding take place (e.g., Division, Product/Team)?

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AWARD OPPORTUNITIES

- Weighting at Firm, Division, Business, Team and/or individual level?
- For a given level of production at a given level of risk?
- Competitive with external market?
- Acceptable from an internal equity point of view?
- Over what time period? Does it align with the business/performance cycle?

MIX OF PAY / FIXED VS. VARIABLE

- Salary, annual incentive and long-term incentive as percentage of total compensation?
- Consistent with risk alignment / realization of profits?
- Practical management of cash flow, expense and retention of key individuals?

PLAN ADMINISTRATION

- Who is responsible for overseeing administration of each plan?
- Are the current tracking systems accurate?
- Are payments made on a timely basis?
- Is there an independent audit of all payments?
- Is communication and disclosure transparent to internal and external stakeholders?
- Timing/Vesting of awards?
- Caps on overall incentives, specific transactions or both?
- On/Off Switches and ability to override division/business plans based on aggregate firm performance?
- Termination Provisions – How are incentives treated under various termination scenarios?
- Is their coordination of incentive programs with benefit and severance programs?

ROLE OF RISK MANAGEMENT FUNCTION

- Do you have an independent risk function that sets, reviews, monitors and enforces the risks of each plan?
- To whom does this risk function report?
- Do risk people rotate to and from business management?
- Is there regular firm-wide stress testing and scenario analysis to ensure that the plans will be able to pay out under a wide range of potential scenarios?
- Are risk charges regularly updated?
- Do risk analyses regularly trigger corrective action?

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- Does the risk process include credit, legal, operations, compliance, treasury as well as the business areas?

CONCLUSION

The regulatory scrutiny on risk management creates either an actual or virtual requirement for firms to review incentive plan design. A narrow view would focus on performance measures and award opportunities. A holistic view would focus on all elements of incentive plan design. Old incentive programs are like old houses; they have details and character that have made them useful/desirable over the years evidenced by the fact that they are still here. However, if a regulatory/housing code change requires you to upgrade the electrical, it will come at significant time and expense. You would be best advised to consider if new plumbing and insulation are in order while the walls are opened and the inner workings are exposed. It will only cost you more if you have to open up those same walls in a year or two.

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