



The power of incentives

Kate Angell and Geoffrey Strickland discuss the challenges with insurance companies' incentive arrangements.

There is no doubt that people respond to incentives, whether it is a sale in a shop attempting to influence people to purchase a particular item, or encouragement to travel out-of-peak hours by offering reduced train fares. Few people would disagree that the best way to get people to act in a certain way is to reward them for doing so.

Incentive pay arrangements, and their influence on the way employees act, have recently come under the spotlight and are under significant pressure from a variety of sources – a difficult economic environment, highly volatile financial markets, continued criticism from pay watchdogs and new legislative initiatives.

From its initial focus on the banking sector last year, the spotlight is now moving to all firms regulated by the Financial Services Authority (FSA), including the insurance industry. The FSA sent a 'Dear CEO' letter on this topic in October last year, and in a CEIOPS Issues Paper issued in November last year the issue was referred to in relation to the control environment of insurers – "... remuneration policies should be structured to avoid potential incentives for unauthorised or unwanted risk taking". More recently, at the end of February 2009, the FSA published a draft code of practice on remuneration policies relevant to all FSA regulated firms, with consultation

and further proposals from the FSA on this topic to follow. The principles specified in the code of practice published by the FSA are set out in Figure 1 overleaf. Indeed, some people believe that the power of management incentives is in some ways greater than the regulatory framework, and unless acknowledged and addressed, could result in the Solvency II framework being less effective than it could, or should, be.

The focus is not on what is, or is not, an appropriate level of reward for an individual, but more specifically on how the pay arrangements are structured to encourage the right behaviour. And, it is not just about executive pay arrangements – the impact of the structure of pay arrangements is an issue for staff across all levels within organisations.

The concept of establishing pay arrangements to encourage the right behaviour is simple. The difficulty begins when it comes to designing incentives that motivate employees to act in the desired way, while also being acceptable to all the parties involved (including the employees themselves, the employer, shareholders, the regulator, rating agencies and industry bodies). The FSA's focus is to ensure that firms follow remuneration policies which are aligned with sound risk management systems and controls and with the firm's stated risk appetite, and which do not expose the firm to excessive risk. In addition to this, individual firms will want to ensure that their remuneration



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policies are also aligned with the company's stated strategy and, for listed companies, with the interests of shareholders. Conflicting with these is the tendency for discretionary incentives to become a fixed, or expected component of an individual's remuneration package, particularly in industries where there is a shortage of skilled talent.

So what features does a good incentive arrangement possess? The main three components of a typical package are a salary, an annual bonus and a long-term incentive plan. Annual bonuses are typically referred to as 'short-term' incentives, and have a performance period of 12 months or less. 'Long-term' incentive plans typically relate to a performance period of more than 12 months, with three years being the most common timescale.

It is useful for employers (and, indeed, employees) to consider all of the incentive components together to form a 'total reward' view, which should also include the value of pension and risk benefits and so on. This can allow more robust comparisons with peer companies.



Figure 1 | Principles from the FSA's draft code of practice

General principle	
	Firms must ensure that their remuneration policies are consistent with effective risk management.
Specific principles	
Governance	Boards and relevant remuneration committees should exercise independent judgement and demonstrate that their decisions are consistent with the firm's financial situation and future prospects. Their members should have the skills and experience to reach an independent judgement on the suitability of the remuneration policies, including the implications for risk and risk management.
	The procedures for setting compensation within the firm should be clear and documented, and they should include measures to avoid conflicts of interest. Risk and compliance functions (in consultation with the firm's HR function as may be deemed appropriate) should have significant input into setting compensation for business areas.
	Compensation for staff in the risk and compliance functions should be determined independently of the business areas. They should have different performance metrics, with greater emphasis on the achievement of their own objectives.
Measurement of performance for the calculation of bonuses	Assessments of financial performance to calculate bonus pools should be principally based on profits. The bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required.
	Firms should not assess performance solely on the results of the current financial year.
	Non-financial performance metrics, including adherence to effective risk management and compliance with regulations, should form a significant part of the performance assessment process.
Measurement of performance for long-term incentive plans	The measurement of performance for long-term incentive plans, including those based on the performance of shares, should also be risk-adjusted.
Composition of remuneration	The fixed component of remuneration should be a sufficiently high proportion of total remuneration to allow the company to operate a fully flexible bonus policy.
	The major part of any bonus which is a significant proportion of the fixed component should be deferred, with a minimum vesting period.
	It is highly desirable that the deferred element of variable compensation should be linked to the future performance of the division or business unit as a whole.

Starting with the salary, this should be good but not too excessive, or in the FSA's original words, "large enough to meet the essential financial commitments of the employee". In the FSA's latest guidelines, this has changed subtly to "a sufficiently high proportion of total remuneration to allow the company to operate a fully flexible bonus policy". In other words, companies should be able to award small, or nil bonuses without feeling that this impacts unduly on an employee's basic living standard.

Other variable elements of the pay arrangement should provide the opportunity for individuals to earn significant rewards for superior performance. This links with the argument that discretionary incentives should only be used to reward exceptional performance, and that they should not be paid merely to encourage the right behaviours – behaviours which it is reasonable for the employer to expect from employees without being additionally rewarded.

For the annual bonus element, it is often appropriate to establish an arrangement whereby the maximum amount payable is capped at a certain percentage of salary. This prevents employees receiving 'windfalls' in excessively profitable years. In its February 2009 guidance, the FSA also suggested that not less than two-thirds of larger bonuses should be deferred and that payment of the deferred element should be linked to future performance.

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The long-term incentive part of any arrangement is typically made in the form of company equity, helping to encourage equity ownership of the company and strengthening the alignment of the shareholders' and employees' economic interests. One difficulty here can be ensuring that the employee appreciates the value of such equity arrangements, particularly when a number of different hurdles need to be achieved in order for the equity to be awarded. Too many complicating factors can result in the employee placing little, or no value on such awards.

For the discretionary elements of an incentive pay arrangement, it is important to be able to measure an employee's performance against the strategy of the company and the interests of the FSA. Part of any discretionary element may therefore be linked to non-financial targets, such as adherence to risk management procedures (although the argument remains as to whether such adherence should be rewarded or expected). The remainder may depend on financial performance, but this area gives rise to a multitude of issues that need to be considered and addressed when designing appropriate pay arrangements. Some of these issues are:

- Different lines of business are naturally more volatile than others, and require different levels of capital to support them. Consider, for example, the different features of a motor book and a property cat book.

- The final results for some lines of business are not known with a reasonable level of confidence for some years after the business was written. Should adjustments be made if significant reserve deteriorations are experienced on a particular book of business?
- The performance of an individual book of business may be protected through the purchase of low level reinsurance, which may not make economic sense when considering the company in totality.
- Depending on the line of business and the position of the underwriting cycle, in some cases it may be most sensible for an underwriter to severely limit the amount of business being written.

Summary

Good incentive arrangements will reward the right behaviours which align with the company's strategic goals – it just does not make sense to expect a certain strategic outcome while rewarding different behaviours. A more sophisticated approach to designing incentive pay arrangements for insurance companies is long overdue and, if carefully designed, should both motivate high calibre individuals and benefit the organisations with whose performance they are entrusted.

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