

Ri\$k Minds 2008

Geneva, 8-12 December 2008

The role of the risk officer in reward

Risk and reward.

Find the right balance.*

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*connectedthinking

PRICEWATERHOUSECOOPERS 

Introduction

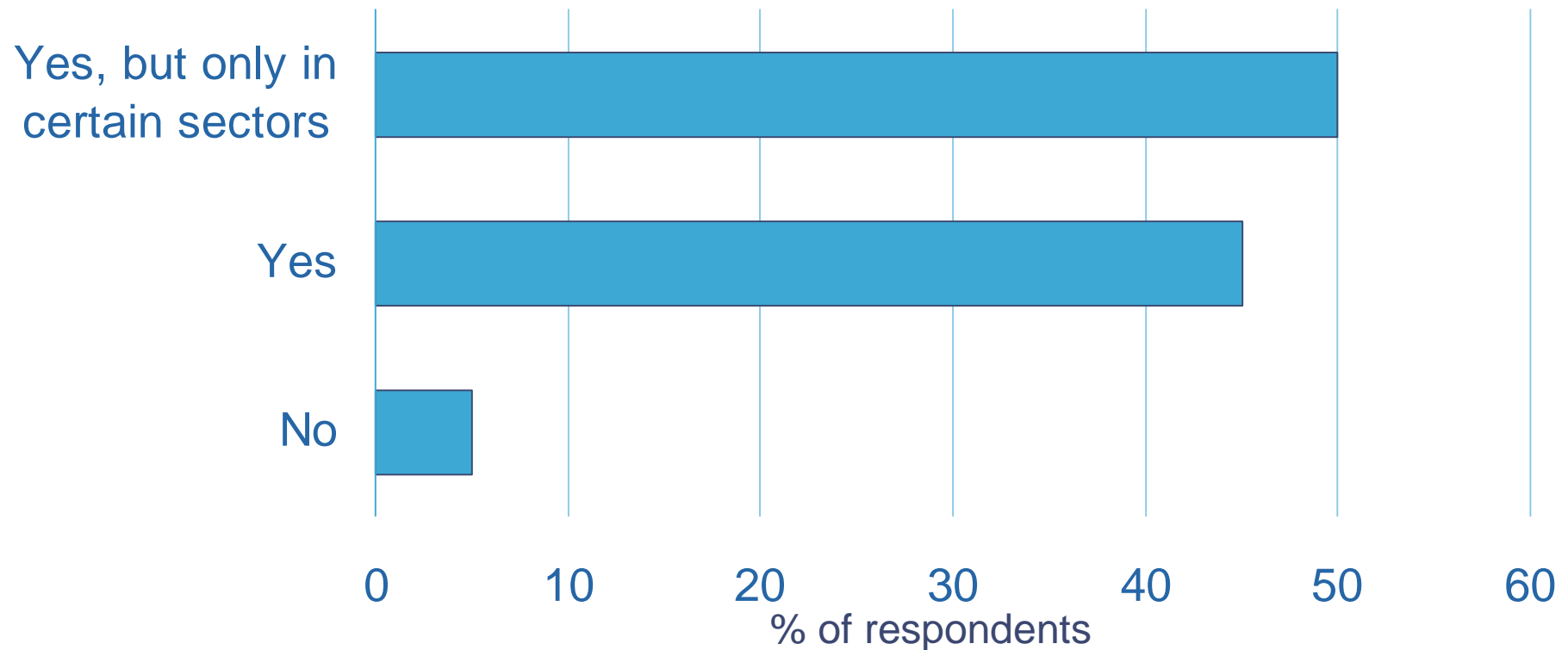
- Unprecedented financial turmoil
 - Government intervention
 - Public anger
 - Regulator interest
-
- Is reward a symptom or cure?
 - What needs to change?
 - What is the role of the risk officer?

What is the real story?

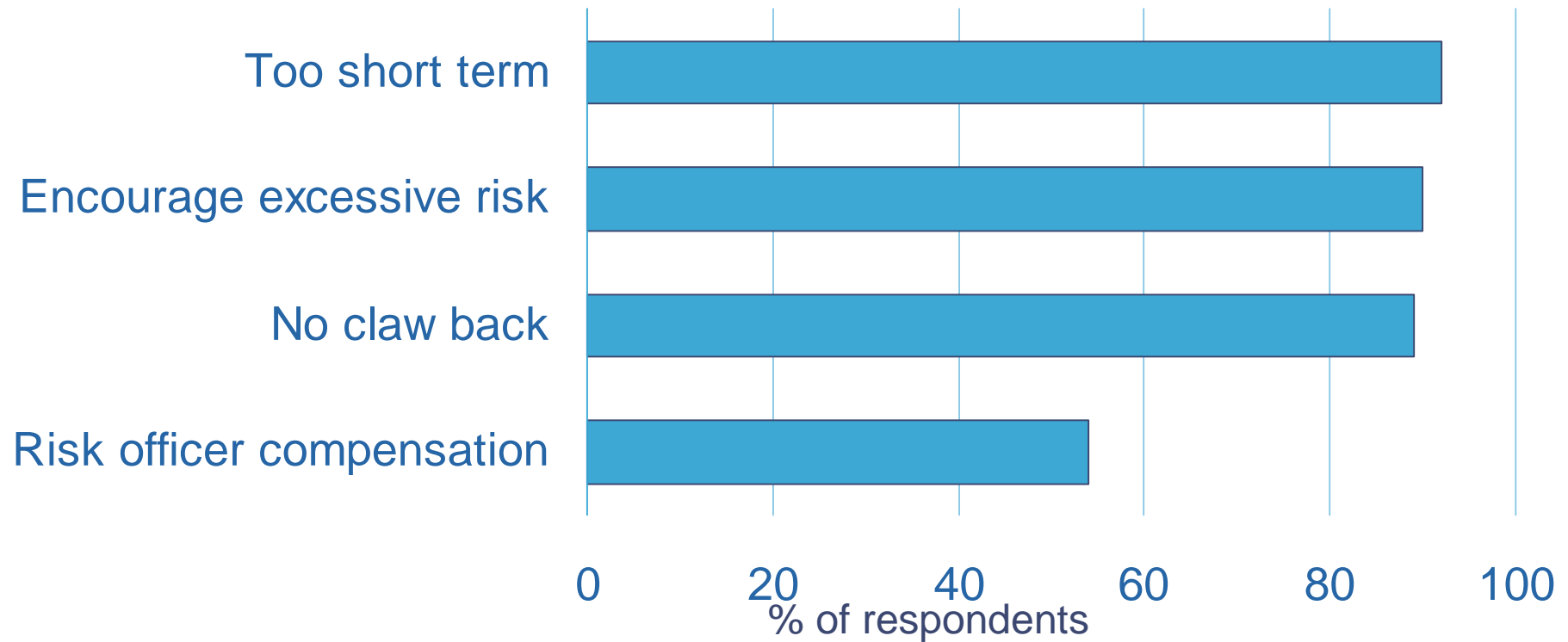
- PricewaterhouseCoopers commissioned the EIU to help with research
- Surveyed 264 senior participants from across financial services industry
- Interviewed prominent industry executives and commentators, including:
 - Andrew Moss - Chief Executive **Aviva Plc**
 - Sir Win Bischoff - Chairman of **Citi**
 - Edward Bonham-Carter - Chief Executive of **Jupiter Asset Management**
 - Michel Tilmant – Chairman of **ING**
 - Jon Peace- Chairman of **Experian**
 - Richard Kearns - CAO **Zurich Financial Services**
 - Paul Lee - Director, **Hermes Equity Ownership Services**
 - Sir Andrew Likierman of the **London Business School**
 - Peter Montagnon- **Association of British Insurers**

Overwhelming consensus that the way in which people are rewarded needs to be changed

Is compensation in financial services in need of reform?



So what do people think are the problems with reward systems...

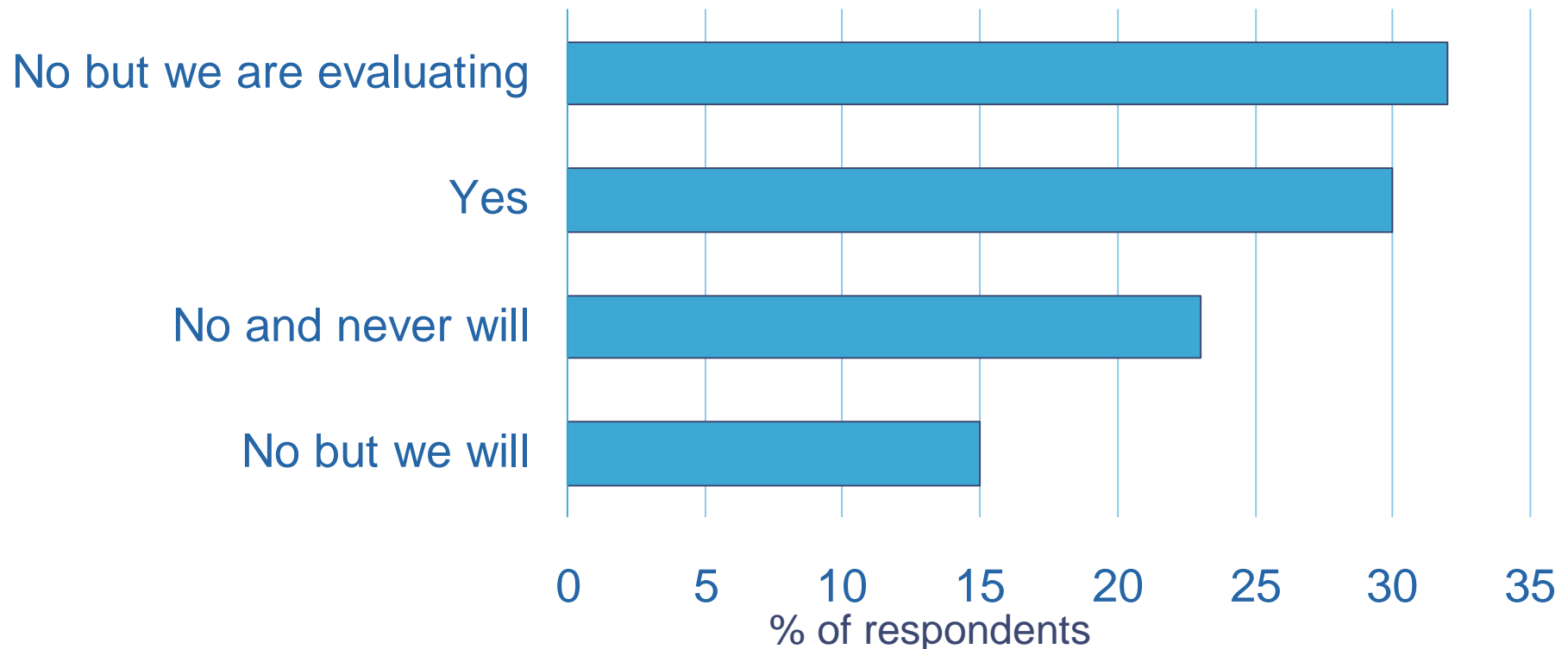


"There is a risk that the remuneration systems are too short-term and that they do incentivise behaviour which is not helpful in terms of maintaining long-term financial stability."

Hector Sants, Chief Executive, FSA

Use of risk-adjusted metric

Do you use a risk-adjusted bonus metric?



“Consideration should be given to ways through which the financial targets [for] compensation ... can be measured on a risk-adjusted basis.”

IIF Committee on Market Best Practices

Financial Services in Perspective

PricewaterhouseCoopers LLP

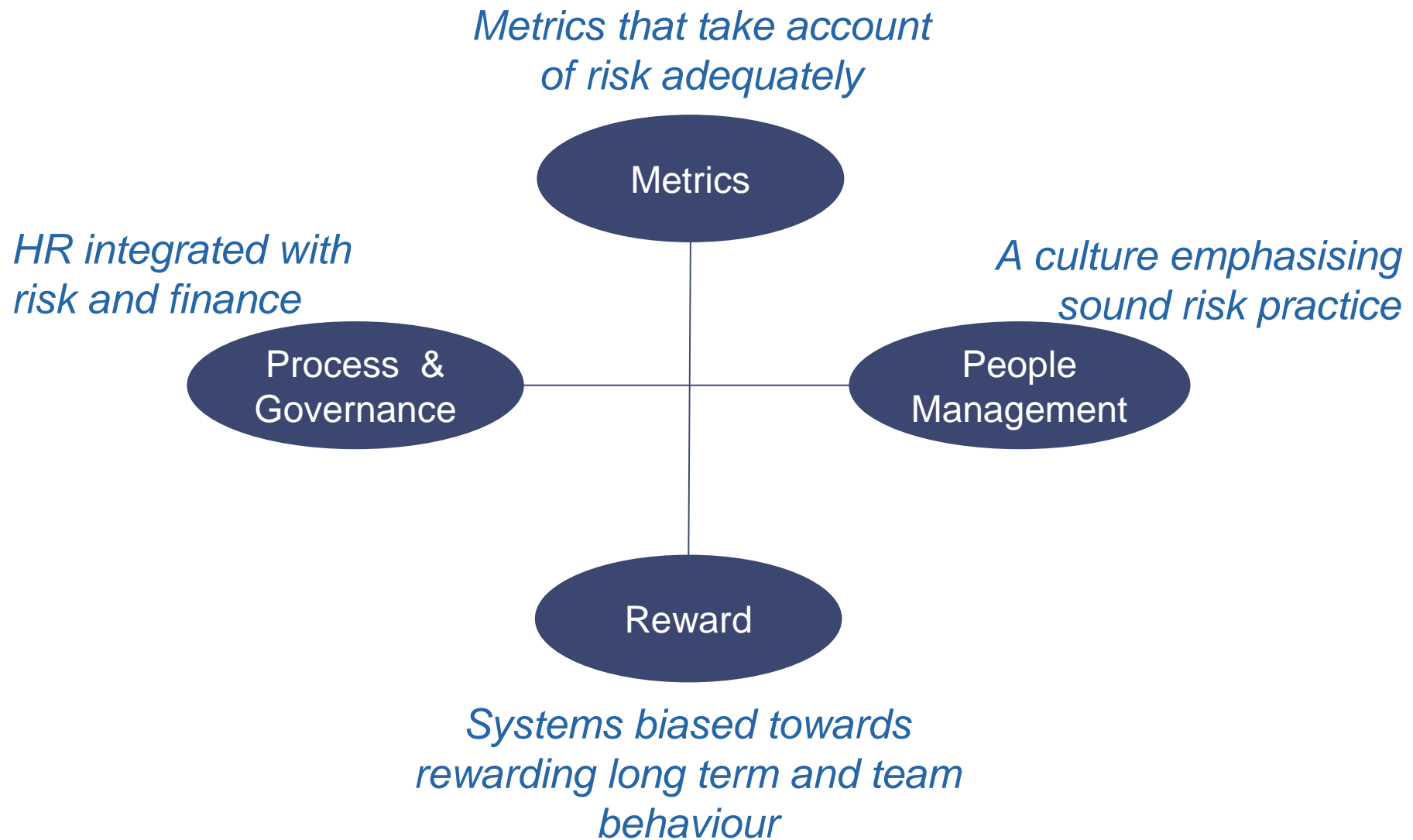
Risk and reward – key issues

Reward was not the cause of the credit crunch...but it added fuel to the fire

We need to see:

- more long-term incentives at board level *shareholders will demand it*
- more focus on group performance to *avoid the risks of “eat what you kill”*
- revamped deferrals *to align reward with business unit value*
- greater use of risk-adjusted measures *to incentivise appropriate risk taking*

But it is not all about reward



Regulatory involvement from the FSA

Principles issued in CEO letter on 13 October

Measurement of performance

- Based on profits
- Risk-adjusted
- Multi-year assessment
- Non-financial measures / behaviours

Composition of remuneration

- Sufficient fixed component
- Mix of cash and shares
- Major proportion of bonus deferred

Deferred compensation

- Significant % deferred
- Multi-year performance assessment
- Legally robust and enforced

Governance

- Remuneration Committee
- Strong role for HR and Risk
- Independence, conflicts of interest
- Separation of back office

Responses required by mid-November for top 20 firms

International developments

- G20 stated in November that: “action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking”
- G20 has tasked Financial Stability Forum to “review compensation practices as they relate to incentives for risk taking and innovation” and report back by end of Q1 2009
- FSA report and Code likely significantly to influence outcome, as they are furthest forward in acting on the issue
- Major regulators likely to follow the FSA’s lead in 2009

Questions for the CRO

- Are your reward structures aligned with the risk appetite of the organisation? Do they encourage risk taking consistent with this appetite?
- Is reward based upon risk adjusted performance measures? Are these consistent with the way the business is run?
- What is your role in the governance process around determination of reward? Do you know how reward is set in practice?

Strong role for risk – what does it mean?

- Opportunity for leadership
- Ensure overall consistency with risk appetite of the firm
- Alignment often occurs because of culture of the organisation
- How do you align reward with risk appetite?
 - Ranges/gearing
 - Risk adjusted performance measures

Risk adjusted performance measures

- Which risk adjusted framework? Economic profit/RORAC/RACE/others?
- How good/comprehensive is the data – is this a performance measure that is embedded in the organisation?
- Desk level allocation is costly and time consuming
- In practice a hybrid with risk-adjusted pool then discretionary allocation
- Three levers to be used - all need to be aligned
 - Risk adjusted profit
 - Pooling/individual performance
 - Deferral mechanisms

Role in governance process

- What are you doing to get actively involved?
- Is process strong at all levels of the organisation? What is the remit of the Compensation Committee?
- Do you really know how the allocation works in practice? Have you checked?
- How are you helping the organisation, particularly HR and Finance, understand the complexity and risk in the business?
- How is the CRO rewarded?

Conclusions

- Regulation of financial services pay is here
- Link between risk and reward is central to this
- Risk officers expected to play a key role
- Are you ready to step up to the challenge?

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