2011 Federal Reserve Bank of Chicago and DePaul University Risk Conference

Compensation and Risk — Towers Watson Perspectives

April 11, 2011

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TOWERS WATSON

About Towers Watson

- A leading global professional services company that helps organizations improve performance through effective people, risk and financial management
  - 14,000 associates around the world, offering solutions in employee benefits, talent management, rewards, risk and capital management
  - The largest compensation practice in the world
- Towers Watson consultants have worked directly with financial services companies to assess compensation programs, risk profiles and corporate governance at all levels within client organizations
  - We have no agenda to drive certain compensation practices, nor do we have preconceptions on whether certain compensation structures inherently create greater risk taking
  - Our comments and perspectives are shaped by the competitive labor market in which US and International LCBOs, as well as large regional banks, compete for talent

Our assessment of the "current state"

- The financial crisis clearly indentified blindspots in industry thinking about the role of risk in compensation — particularly incentive design
  - Most of our larger financial clients already have made significant progress in addressing critical issues
  - Key modifications:
    - Rebalanced mix of cash and non-cash pay, fixed and variable pay
    - Aligned timing on payouts with risk tail
    - Refined administrative and review processes related to goal setting, performance assessment and pay decisions
    - Heightening governance standards for the "new normal"
    - Defined a strategy for involving risk management in plan design and review
  - Smaller banks and financials may not be as well-positioned against the guiding principles or the proposed FDIC rules
  - For both large and small banks, our experiences confirm the breadth of perspective required to address the issues effectively
    - Addressing compensation and incentives is one part of the solution, not the entire solution

Towers Watson's perspective on risk management and pay

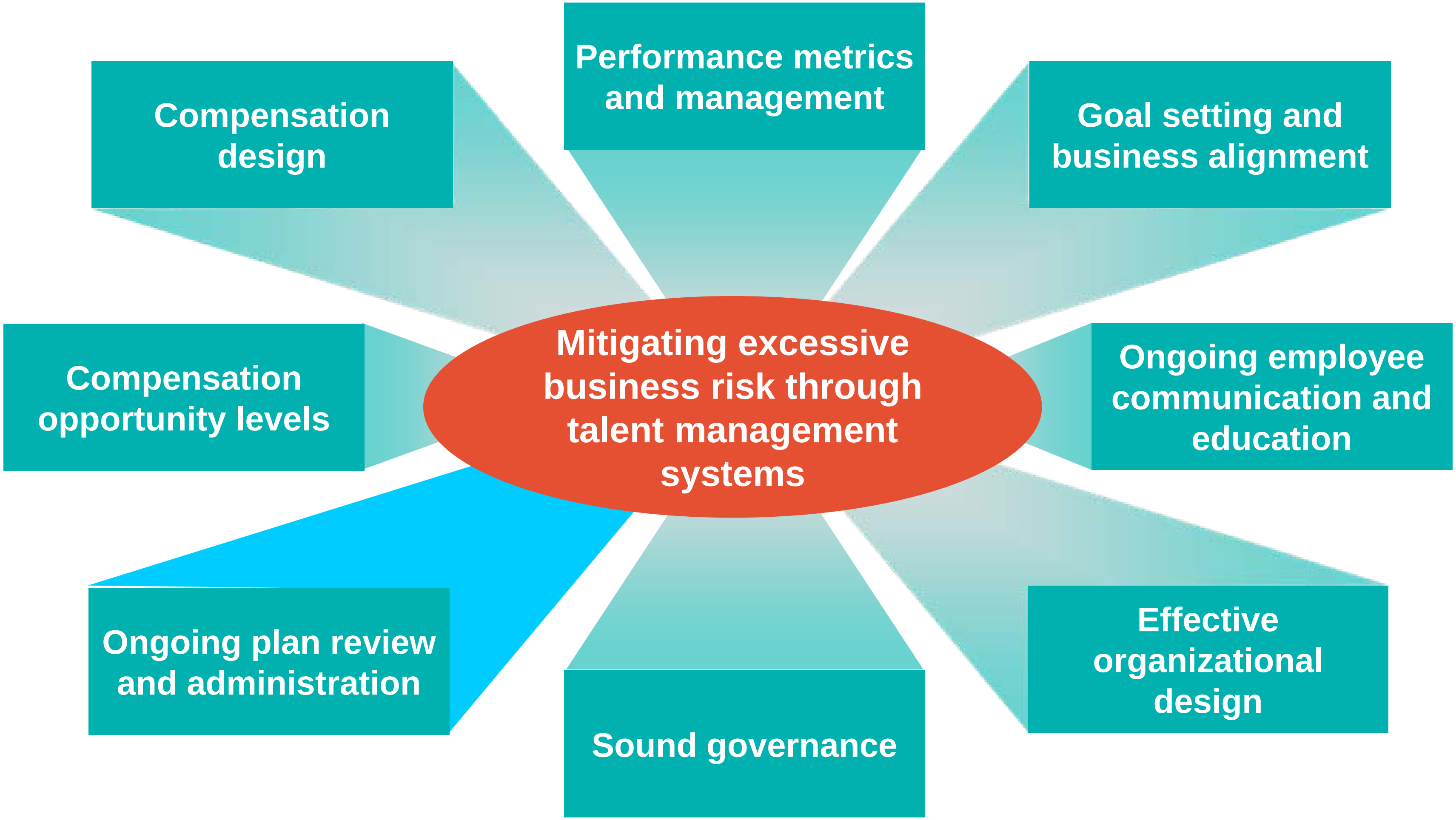
- Risk taking, intrinsic to all businesses and paramount for financial services, should not be eliminated but rather understood, managed, appropriately encouraged and rewarded
- Each company must determine appropriate risk and expected return in each function and line of business
- Effective risk management requires understanding of risks, controls, and governance at corporate and business units embedded in culture and reinforced by the pay system
- Compensation is an integral part of the entire risk management system, but not necessarily always the most significant portion

Towers Watson's perspective on risk management and pay

- The pay component of an effective risk management system is a structure of rewards — not only for senior management but also for employees throughout the organization — that encourages acceptable risk-taking and high performance through optimal pay mix, performance metrics and calibration, and timing
- Incentives should balance the encouragement to take appropriate risk with the temptation to take excessive ones

Towers Watson's perspective on risk management and pay

- Many factors contribute to the ability of financials to support a culture of risk and mitigate potentially excessive business risk through Human Resources systems



Towers Watson's perspective on risk management and pay

There are no prescriptive ways to structure pay programs so they do not encourage excessive risk taking. The most effective program designs reflect the business model, risk issues, governance system, expected returns, and the values of the organization and its employees.

Potential Red Flags

- Salaries that don't cover living expenses
- High short-term cash for employees who can harm business long-term
- Steep incentive curves with no caps
- Formulaic awards
- Unrealistic goals
- Payout timing severely misaligned 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
- Goals = reasonable expectations
- Deferrals in line with risk tail
- Performance metrics that reflect quality of earnings
- Strong governance and/or ERM system
- Highly defined risk management culture

Specific issues related to pay and risk: Balanced, risk taking incentives

- Incentives need to appropriately reflect risk and potential risk outcomes

Observations

- **Discretion:** Qualitative adjustments and discretion are important parts of successful pay programs, side-by-side with quantitative adjustments
- **Line of sight:** Individual performance metrics need to reflect both strong line of sight and alignment to bank-wide performance
- **Fixed vs. variable pay:** The right balance will take into account the flexibility needed to manage business and pay as circumstances change
- **Clawbacks:** Prevalence has increased but views are mixed on appropriate coverage, focus, triggers and effectiveness as a balancing tool

Challenges

- **Goal setting:** Presents continuing challenges in shifting regulatory and capital environments; can historical performance adequately shape realistic future performance expectations that don't require excessive risk taking?
- **Individual risk adjustments:** May defy some current practicalities of measurement
- **First mover vulnerability:** Competitive disadvantages and turnover potential are seen as significant among banks implementing new structures first
- **Cultural challenges:** Differentiated plans by business area depart from past practices and may defeat a "one bank" culture
- **Measuring risk potential and risk tail:** Over-reliance on quantitative (vs. balanced quantitative and qualitative assessment) may inadequately reflect risks

Specific issues related to pay and risk: Effective controls and risk management

- Integrated compensation programs, controls and risk management processes are important parts of effective risk management programs and risk outcomes

Observations	Challenges
▪ **Compensation is a part of good risk management:** A sound compensation program is significant part of good risk management but should not replace it ▪ **Toward a culture of risk management:** Enhancing risk knowledge and reinforcing a risk management culture among employees is as important in effective risk management as some traditional control functions ▪ **Consistent vs. tailored risk management:** Understanding which processes make sense bank-wide, and which need to be tailored to unit-specific risk tolerances is critical ▪ **Separating risk management and control functions**: Separation of risk management and control functions from the business is important but should be balanced with maintaining sufficient connections with the business to effectively monitor it	▪ **Inconsistent methods of incorporating risk into pay**: May create distortions and counterintuitive outcomes (e.g., strict award adjustment using RAROC versus pool adjustment reflecting qualitative and quantitative factors) ▪ **Managing risk through pay alone:** Over-reliance on pay programs to manage risk makes them a “default” risk management system ▪ **Pay may create inappropriate silos:** Overly prescriptive focus and differentiated plans by business may create silos within business that are not appropriate ▪ **Measuring and modeling (ex post and ex ante):** Important, but may present practical challenges and may not yield the results expected

Specific issues related to pay and risk: Strong corporate governance

- Strong governance — including active and effective oversight and disclosure — is important in creating alignment of pay programs

Observations

- **Abating risk requires a stronger corporate mandate:** Historical practice has proven insufficient; most major banks have adapted
- **Communicating differentiated risk tolerances to shareholders and stakeholders:** Important but still evolving
- **The "new normal" in governance:** Presents an enhanced need for governance expertise; identifying experienced resources will be increasingly important
- **Importance of having strong governance culture:** Governance and culture are linked and ongoing processes to ensure continued alignment are important
- **Board involvement** (especially the compensation committee) in pay/risk issues and in dialogue with CRO's is critical

Challenges

- **One-size-fits-all solutions may not make sense:** A singular "best process" is likely sub-optimal; does not reflect unique organizational dynamics, resources and business issues
- **Experience and judgment should not be minimized:** Significant additional process requirements can potentially eclipse the emphasis on sound judgment that is best reflected in a qualitative macro review of results on risk and pay
- **Accelerated education requirements:** many board members must be (re)-educated about risk management issues