

Incentive Compensation

Q1 Compensation Actions
and Longer Term Trends

Towers Watson
April 2010



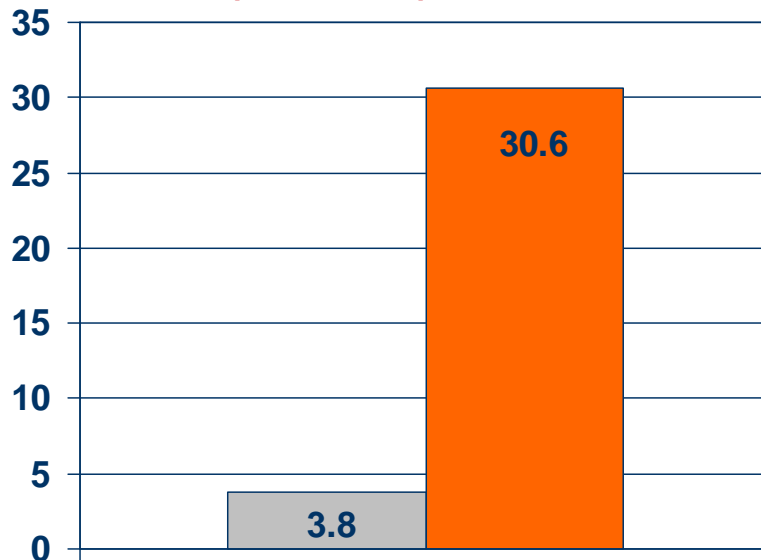
Recovery Has Taken Hold

- 2009 was a significantly better year for the P/C industry (as compared to 2008)
 - Fewer catastrophes
 - Improved investment results
 - Mortgage / financial guaranty markets improved

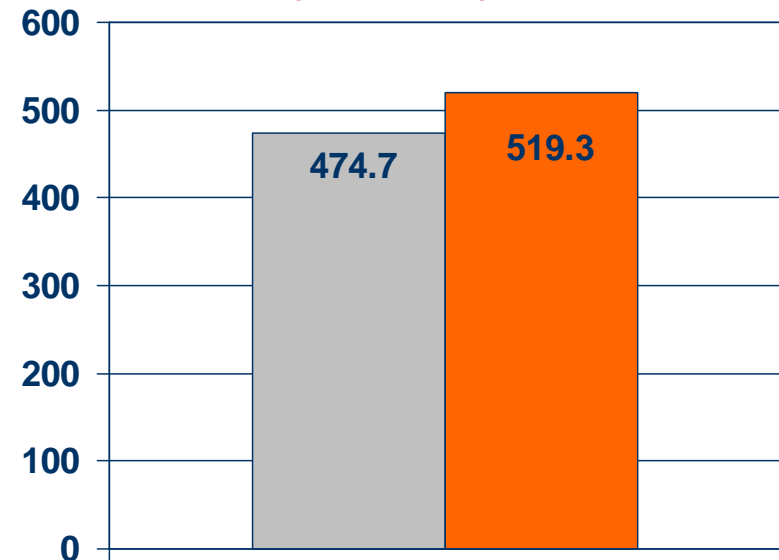
Source: A.M. Best

Financial Results Have Improved

**Net Income
(\$ Billions)**



**Policyholder Surplus
(\$ Billions)**



Source: A.M. Best

Challenges Remain

- Pricing pressure due to weak economy
- Continued financial market volatility
- Regulatory concerns

Source: A.M. Best

Q1 Compensation Actions: Salary

- By now, you probably know that salary raises have resumed, albeit below historical norms

Position	Average Merit Increases Insurance Industry	
	2009 Actual	2010 Projected
Executive	2.2%	2.9%
Manager and Professional	2.5%	2.9%
Nonexempt	2.7%	2.9%

Source: WorldatWork

Q1 Compensation Actions: Bonus

- However, we are just learning about overall trends in actual bonus payouts for FY09

Insurance Industry: Anticipated FY09 bonus payouts compared to FY08 payouts

	25-50% Lower	Less than 25% Lower	About the Same	Higher
Executive	9%	17%	39%	35%
Manager and Professional	17%	12%	38%	33%
Technical / Administrative	13%	17%	39%	31%

Q1 Compensation Actions: Bonus

- Full information on bonus payouts for 2009 will be available when:
 - Large public P/C insurers release proxies
 - Published compensation surveys become available, generally in the third quarter

Longer Term Trends

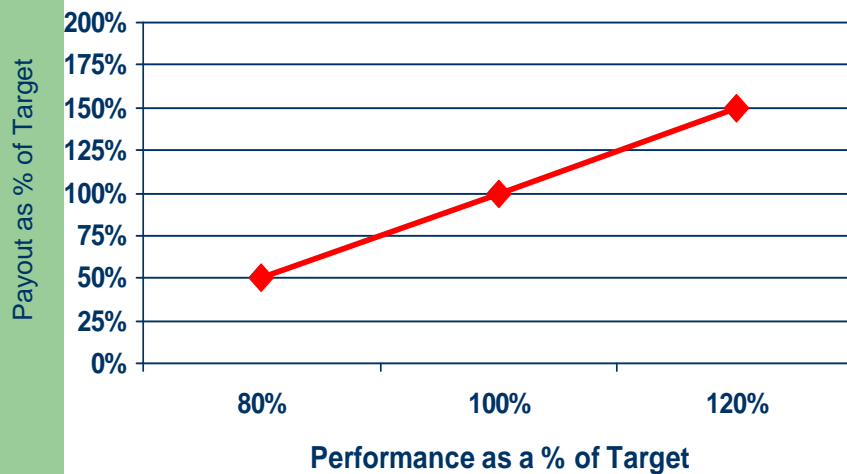
- 2008 and 2009 caused many companies to rethink incentive design longer term
- Three trends may have long-term impact
 - Wider performance ranges
 - Issues with incentives and risk-taking
 - Emphasis on less fixed pay / more variable pay

Wider Performance Ranges

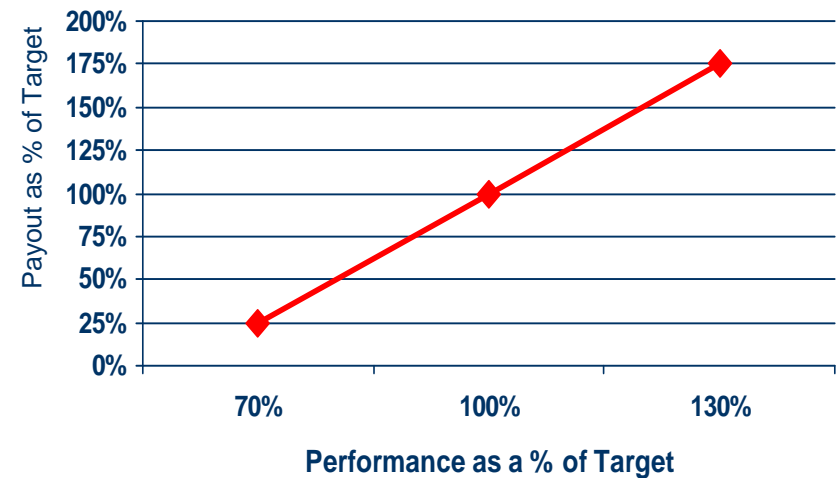
- Many companies are widening the range of performance for which they pay bonuses
 - Just over one-third of insurance companies in Towers Perrin's pulse surveys
- Wider performance ranges provide for:
 - Greater variability in year-to-year results
 - Potential variability within same company but in different business units

Wider Performance Ranges (cont'd)

80/120 Model
Illustrative Performance/Payout Zone



70/130 Model
Illustrative Performance/Payout Zone



Wider Performance Ranges (cont'd)

- Performance ranges have critical motivation and retention implications
 - e.g., being “out of the money” on a plan by Q2 is highly de-motivating
- Wider performance zones can apply to both financial and non-financial metrics

Incentives and Risk

- Public companies now required to disclose any incentive plans “reasonably likely” to lead to material adverse effect on results
- Assessing incentive plans from risk perspective is critical step in design and ongoing plan administration

Incentives and Risk: SEC Rules

Did any compensation programs create risks that are reasonably likely to have a material adverse effect on the company?

No

No disclosure is required, although some disclosure on the compensation/risk question may be considered:

- Process followed to reach this conclusion
- How design discourages inappropriate risk taking
- Compensation/risk discussion as part of overall company risk management and oversight
- Risk related to NEO compensation

Yes

Disclosure is required; address examples and issues outlined in SEC regulations:

- Philosophy and policies relating to compensation and risk
- Consideration of risk in structuring compensation policies or awarding compensation
- Policies designed to address risk such as clawbacks or holding periods
- Policies regarding adjustments based on risk considerations
- Material adjustments made based on risk considerations
- How the company monitors its compensation policies in relation to risk
- Issues within business units, particularly those that have different compensation structures, profitability levels or risk / return profiles

Incentives and Risk: Company Reactions To-Date

Approach	Description
Checklist Approach	<ul style="list-style-type: none">• Evaluate plan designs against “best practice” criteria• No standard list but most feature common elements (e.g., uncapped payouts, cash vs. equity mix)
Integrated Business Risk Review	<ul style="list-style-type: none">• Review plan designs, policies and controls, organization structure, governance and culture• Involves working team, assessment tools, interviews• Purpose potentially broader than just compensation

At a minimum, both approaches require an “inventory” of all incentive plans to evaluate key design elements in risk context

Less Fixed / More Variable Pay

- Fixed compensation costs will continue to grow at lower rates in 2010
 - Lower salary increase budgets
 - More than half of companies are seeking ways to reduce / control benefit costs
 - For now, healthcare cost sharing ratios to stay the same; however future changes could occur

Less Fixed / More Variable Pay

- More emphasis on variable pay requires:
 - Proper mix of financial vs. non-financial measures
 - Effective goal-setting process
 - Robust performance management system
- Also, overall total compensation needs to remain within competitive range to continue meeting attraction / retention objectives

2010 Priority Areas: Goal-Setting

- Right balance of stretch vs. attainability
 - Develop goal-setting philosophy based on probability of goal attainment, e.g.,

Performance Level	Probability / Frequency of Attainment
Maximum	<ul style="list-style-type: none">● 20% probability of attainment● 2 out of 10 years, maximum goal is met
Target	<ul style="list-style-type: none">● 50% probability of attainment● 5 out of 10 years, target goal is met
Threshold	<ul style="list-style-type: none">● 80% probability of attainment● 8 out of 10 years, threshold goal is met

2010 Priority Areas: Goal-Setting

- Consider historical results for additional insights into goal-setting process

Return on Equity	
Period	Result
2001	-1%
2002	4%
2003	9%
2004	10%
2005	15%
2006	18%
2007	16%
2008	6%
2009	9%
2010YTD	14%

Probability of Attainment	
Probability	ROE
10%	16%
20%	15%
30%	14%
40%	12%
50%	10%
60%	9%
70%	8%
80%	6%
90%	4%

Potential Maximum

Potential Target

Potential Threshold

2010 Priority Areas: Incentive Plan Costs and Risks

- Are incentive payouts – company wide – commensurate with results?
- Is proper funding mechanism in place?
 - Is it okay for some employees/departments to receive some level of payout even if company does not attain threshold?
- Are there incentive plans or related processes that could lead to excessive risk?

2010 Priority Areas: Increasing Mix in Variable Pay

- Test percent of overall comp delivered through salary versus incentives
- Test competitiveness
 - Most companies try to keep salaries relatively aligned with market within a +/-15% range

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Compensation Management – 2010

A Look at Incentive Compensation

Compensation Resources[®], Inc.

April 13, 2010

Presented by: Harry J. Schum



Current Hot Topics

- Changing rate of job losses & employment outlook
- Hiring freezes
- Significant competition for any job openings
- Seasoned professionals taking lower paying jobs
- No/low compensation budgets



Current Mindset Issues

- Forecasting another 18-24 months before demand increases
- Balancing current short-range thinking with long-range planning
- Keeping on track with strategic plan



Change in Mindset

- Short-range thinking continues
- The need to “keep a steady course”
- “Hunker Down” mentality
- Expect irrational, ambiguous and impractical regulations



Defining “Best Practices” *

- Methods and techniques that have consistently shown results superior than those achieved with other means, and which are used as benchmarks to strive for.
- *There is, however, no practice that is best for everyone or in every situation, and no best practice remains best for very long as people keep on finding better ways of doing things.*

* www.businessdictionary.com



“Best Practices” Now

- Best practices have changed from the “heydays”
 - Compensation plans, unfortunately, have not
- Timing is right to refresh plans
 - Positioning for future recovery and growth
 - Critical focus on the right performance



What will Best Practices Be?

- Difficulty in predicting market values of pay
- Composition of total compensation package
- Increasing importance of short-term incentives



Overcoming Challenges

- Differentiate pay based on performance
 - Fixed and variable pay elements
- Move away from entitlement
 - Requires strong communication
 - Managers must be properly trained
 - Turnover may result, but could be of poor performers



Basic Objectives of Compensation

- Was
 - Attract, Retain, Motivate
- Now
 - **Focus** – pay for desired performance
 - **Attract** – ability to hire qualified candidates
 - **Retain** – enhance desire to stay
 - **Motivate** – “carrot & stick”



Objectives of Incentives

- Identify expectations
- Focus attention on desired results
- More closely tie pay to work and results
- Reduce or control fixed people costs
- Provide competitive total cash compensation



Entitlement vs. Justification

- Many companies have built a culture of entitlement
- Motivating performance, and tying pay to performance, is a significant factor in driving success



We Still Need Pay for Performance

- Sense of empowerment, pride, job satisfaction, and intrinsic motivation
- See direct influence on rewards
 - Reward employees who can see and drive future growth
- Employees remember how they are treated
 - Treat them poorly, they will leave quickly with the turnaround



Team-Based Incentives

- Reward for collective performance
- Most effective when all group members have some impact on goals
- Rewards can be equal for each member or can be differentiated
- Requires thorough understanding of team dynamics
 - Avoid creating contrasting motivational forces



Gainsharing Plans

- Rewards based on performance of entire organization
- Encourage teamwork and productivity
- Employees share in greater than expected profits
- Focus on quality improvement, labor cost reduction



Gainsharing Structure

- Focus on organization-wide cooperation
- Intended to motivate employees to increase profits through increased productivity
- Open communication with employees increases impact of plan



Gainsharing Indicators

- Award pool generated through:
 - Profit
 - Sales
 - Return on Investments
- Performance measures:
 - Quality improvement
 - Labor-cost reduction



Gainsharing Awards

- Basis for award calculations:
 - Flat amount to all employees
 - Same percentage of base salary
 - Percentage of gains by category
 - Amount or percentage based on individual performance against set goals
- More frequent award payouts increase motivational impact
 - Cause and effect



Gainsharing within the Industry

