

Corporate Governance

A Risk-Sensitized Executive Pay Governance Process — Part One

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The deterioration of the global economy has occurred with breathtaking speed and unprecedented breadth. As events unfold, one common view has emerged: the crisis is predominantly a failure in human decision-making, influenced by two fundamental pay and performance-related factors:

- A growing number of players, blinded by self-interest and the prospect of increasing rewards, threw caution to the winds for the sake of short-term gains; and
- Corporate managers accepted the status quo in making business decisions, misunderstanding the “global” consequences of critically important strategic decisions and actions.

Clearly, a new understanding of risk is at the core of the discipline organizations need to survive. Increasingly, Compensation Committees will have to become more knowledgeable about the fundamentals of behavioral finance and the biases that can lead management down paths that are not in the best interests of their companies or their shareholders.

This *InsightOut* is the first of a two-part analysis of Compensation Committees and Corporate Governance and the links between a global view of risk and a workable framework for a risk-sensitized executive pay governance process.

Part One:

- Briefly summarizes recent legislative developments associated with executive pay.
- Explores the indications that more rigorous executive compensation risk oversight is coming to all companies.
- Proposes a methodology for aligning pay for performance and avoiding pay for failure.
- Poses questions that highlight how this methodology may be applicable in specific situations.

Part Two will explore ways, specifically those available to the Compensation Committee, to improve the alignment of executive pay practices with shareholder interests.

THE GENERAL PERCEPTION OF EXECUTIVE COMPENSATION

The perception is growing that compensation design can lead executives to take excessive and inappropriate risks. Incentive devices can reflect a “naive” acceptance of a number of biases and flaws, including:

- An insufficient balance between “line-of-sight” pay and performance measures and the alignment of pay with an enterprise’s sustained value creation;
- The failure of reward programs to offset a human preference for tangible, near-term results over more ambiguous longer-term objectives; and
- An overemphasis on precedents and competitive practices, yielding big payouts to executives while shareholders’ equity drops in value.

If executive compensation supports faulty decision-making, shareholders and their advocates will clamor for “claw-backs” or other punitive treatment of executive pay and severance. Bailout provisions and other regulatory/legislative initiatives are incorporating this ethic, as are proactive recommendations by shareholders and their advisory groups.

The Federal government’s attempts to fix executive pay at financial institutions are broadly summarized in the sidebar, *Executive Compensation on the Legislative Front*, on page 2.

Executive Compensation on the Legislative Front

Legislation	Coverage	Key Provisions
Emergency Economic Stabilization Act's (the Act) Troubled Asset Relief Program (TARP) October 3, 2008	Senior executive officers (SEOs) of financial institutions that sell troubled assets to the Treasury must have met appropriate standards for executive compensation and corporate governance ¹	<ul style="list-style-type: none"> ▪ Incentive arrangements must avoid causing SEOs to take "unnecessary and excessive risks" that would threaten the value of the financial institution ▪ Claw-back requirements if incentive compensation is paid based on materially inaccurate statements of earnings, gains, or other criteria ▪ Golden parachutes to SEOs are prohibited ▪ No corporate tax deductions for SEO compensation in excess of \$500,000
Treasury Department Guidelines February 4, 2009 ²	Senior executives of financial institutions receiving bailout assistance generally on a prospective basis (not including the approximately 360 companies that had already entered into TARP under its Capital Purchase Program)	<ul style="list-style-type: none"> ▪ Caps total annual compensation at \$500,000 other than compensation relating to restricted stock or "similar long-term incentive arrangements" (subject to certain vesting and cash-out restrictions) ▪ Includes more restrictive golden parachute provisions ▪ Expands "unnecessary and excessive" risk certification requirement ▪ Shareholder "say-on-pay" requirements (primarily geared toward companies in need of exceptional assistance)
American Recovery and Reinvestment Act (Stimulus Act) February 17, 2009	Virtually all TARP companies — supersedes original TARP provisions and Treasury Department's guidelines Generally applies to anywhere from one to 25 executives depending upon the level of the company's TARP funding ³	<ul style="list-style-type: none"> ▪ Prohibits paying or accruing any bonus, retention award, or incentive compensation with the exception of long-term restricted stock (additional restrictions apply to vesting and amount) ▪ Expands golden parachute and claw-back provisions (including potential "retroactive" claw-backs) ▪ Expands upon requirement for an annual nonbinding shareholder "say-on-pay" vote ▪ Adds restrictions on perquisites

See *Other Developments* on page 3.

¹ For further details, see Buck's October 20, 2008 FYI, Executive Compensation under the Emergency Economic Stabilization Act of 2008. http://www.buckconsultants.com/buckconsultants/Portals/0/Documents/PUBLICATIONS/Newsletters/FYI/2008/FYI_10_20_08b.pdf

² Although these guidelines were superseded by the Stimulus Act and never went into effect, they provide insight into Treasury Department's original thinking on the direction of executive pay for entities entering into a program under TARP.

³ See Buck's March 2, 2009 FYI, Stimulus Act's New Restrictions on Executive Compensation. http://www.buckconsultants.com/buckconsultants/Portals/0/Documents/PUBLICATIONS/Newsletters/FYI/2009/FYI_03_02_09.pdf

Other Developments

The Stimulus Act's prohibitions on bonuses, etc., described on page 2, did NOT apply if a bonus payment was paid pursuant to a written employment contract executed on or before February 11, 2009. This became known as the "AIG Provision" because it was added to avoid lawsuits by AIG employees who had been provided with "retention" bonuses.

After the backlash from the \$165 million AIG paid in bonuses in March 2009, Congress attempted to recoup bonus payments that had been made to TARP company employees:

H.R. 1586 passed the House on March 19, 2009. It applied a 90 percent tax rate on bonuses paid after December 31, 2008 by the 12 companies that had received at least \$5 billion in TARP funds.

S. 651, the Compensation Fairness Act of 2009, passed the Senate shortly thereafter. It applied an excise tax of 35 percent each on the employer and the employee with respect to bonuses paid after December 31, 2008 by companies that received \$100 million or more of TARP funds.

In addition:

S. 651 also imposes a \$1 million annual limit on deferred compensation for employees of companies with TARP funds greater than \$100 million.

H.R. 1664 seeks to prohibit any bonus or "other supplemental payment" that is not directly based on performance-based measures to executives of any company with TARP funds other than certain small banks. The Bill calls for the Treasury Department to set standards for performance and for "unreasonable and excessive" compensation as they relate to executives of these TARP companies.

Longer-Term Implications

It is well understood that both Treasury and Congress have made significant missteps in the enactment and implementation of legislation affecting executive compensation of TARP companies. Nevertheless, the general mood among lawmakers and shareholders is that executive pay at financial institutions needs to be highly regulated. In general, the financial community agrees. Lloyd Blankfein, Goldman Sachs' CEO, stated in a speech in Washington, DC, on April 7th that there is a need for "broad changes to how Wall Street pays employees and is regulated." Further, according to recent survey results commissioned by the Institute of International Finance, responding banks agreed almost unanimously that their compensation packages contributed to the global financial crisis.

Treasury has indicated the need to examine how company-wide compensation strategies at financial institutions — not just those related to top executives — may have encouraged excessive risk-taking that contributed to subsequent market

events. It also sees a need to begin developing model compensation policies and suggests that those policies include the following requirements:

- Compensation Committees of all public financial institutions — not just those receiving government assistance — review and disclose executive and certain other employee compensation arrangements and explain how they promote sound risk management and long-term value creation;
- Top executives at financial institutions hold stock for several years after it has been awarded/vested to encourage a long-term focus on the economic interests of the company; and
- Corporations offer shareholders a non-binding resolution that both the levels of executive compensation and the structure of incentives promote risk management and long-term value creation for the firm and the economy as a whole.

As shareholders seek greater accountability of corporate executives and corporate Boards, Compensation Committees will need to develop “best practices” associated with executive pay programs.

EXECUTIVE COMPENSATION RISK OVERSIGHT: TRENDING TOWARD MAINSTREAM COMPANIES

The underlying principles applicable to the executive compensation provisions of TARP companies could ultimately apply to a broader “main street” population of public companies. In fact, as the following bullets indicate, there is growing sentiment that at least certain elements of TARP be applied to corporations that are not involved in TARP.

- The shareholder advisory firm, RiskMetrics Group (RMG), has provided a set of principles to serve as informal guidelines in establishing pay practices. One of its principles emphasizes that compensation programs should be designed to support companies’ long-term strategic goals. According to RMG, requiring senior executives to hold company stock until they retire can encourage a long-term focus on company performance.
- RMG is also aligning its policies on compensation-related shareholder proposals to TARP provisions. For example, shareholder proposals on “claw-backs” of incentive pay, which RMG previously did not support if a company had instituted a corresponding policy, may now receive support if that company policy does not meet the TARP standards that RMG describes as a “best practice.”
- In October 2008, the SEC staff had discussed “broader implications” of TARP requirements and asked the compensation community to consider this question: “Would it be prudent for Compensation Committees, when

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establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target — with risk, in this case, being viewed in the context of the enterprise as a whole?” Citing inadequate risk oversight and a broken link between pay and performance, The Conference Board, a New York-based research organization, issued a December 2008 report identifying “pressure points” corporate Boards should discuss to improve risk management and the design of executive pay programs.

- During an April 6, 2009 speech in Washington, the SEC’s Chairman outlined a broad reform agenda that includes proxy access and more disclosure on director qualifications, board leadership, and compensation risks. According to the Chairman, the SEC will propose several alternatives in May to allow shareholders to nominate director candidates to appear on management proxy statements. The Chairman indicated that proxy access is a direct response to the governance and risk-oversight failures illustrated by the global financial crisis. “Proxy access is all about making boards more accountable for the risks undertaken by the companies they manage,” she said.
- It also is expected that 2009 will see a bumper crop of “say-on-pay” proposals (to date there have been 143 proposed advisory votes on executive pay matters). A number of these address alignment of senior executives’ incentive arrangements with long-term share performance, including “hold-till-retirement” (HTR) policies for stock-based incentives.

ALIGNMENT OF PAY FOR PERFORMANCE AND AVOIDANCE OF PAY FOR FAILURE

Recent economic turmoil followed a period in which senior corporate executives attained unprecedented wealth. Not surprisingly, “pay for performance” versus “pay for failure” concepts have been at the forefront of virtually any discussion involving executive pay. In order to meet basic standards of corporate governance, corporate Boards and their Compensation Committees need to assess:

- The adequacy of peer group selection in determining appropriate levels of pay to avoid the “ratcheting up” effect ;

- The size of the executives' pay packages relative to the company's peers — both in total and on an element-by-element basis;
- The rationale of pay mix — fixed vs. variable; short-term vs. long-term;
- The relative size of equity-based awards in light of substantially reduced share values — i.e., reflecting the increased stress that a "restoration" or "status quo" approach would place on key measurements that will affect shareholder perception, namely: overhang, run rate, and dilution of total stock holdings;
- Levels of fringe benefits (e.g., auto and aircraft usage) paid to executives;
- Potential severance pay amounts and the events that would trigger such payments; and
- The adequacy and transparency of the compensation discussion and analysis (CD&A) section of annual proxy filings, particularly in relation to the determination of performance goals and the measurement of attainment of such goals.

Taking this assessment a step further, Compensation Committees will also need to consider how each item above can influence senior management's behavior. They will have to develop a complete understanding of the linkage between performance goals, executive behavior, risk management, and shareholder value.

QUESTIONS FOR COMPENSATION COMMITTEES

Aside from assessing the levels of pay, the pay mix, and the elements of short-term and long-term pay-for-performance criteria that will determine payouts to executives, Compensation Committees will need to go several steps further in order to ensure compliance with corporate governance requirements. Several key questions they need to raise include:

- Is the Committee knowledgeable enough to identify the risks executives may consider taking in order to meet established performance targets?
- How can the Committee ensure that all inappropriate risks have been identified? What safeguards are in place in case

of negative circumstances (e.g., financial restatement, poor business decisions, etc.) due to an unidentified risk?

- Once risks are identified, how can the Committee assess whether or not taking them is in the best interests of the company and its shareholders?
- In developing performance goals for executives, does the Committee clearly understand the linkages between these goals, executive behavior, risk management, and shareholder value?
- Is there a scorecard that tracks executives' performance: (i) relative to worst, expected, or better-than-expected results, (ii) to various categories of risk, or (iii) to the effect of their decision-making on the financial statements and on shareholder value?
- Are there mechanisms in place for adjusting performance criteria within a performance cycle and, if so, is there an acceptable rationale for making adjustments?
- Is it time to reconsider the amount and composition of severance packages and the circumstances under which they are payable?

CONCLUSION TO PART ONE

Executive pay should be refocused on risk-sensitive initiatives and their related performance metrics. To that end, incentives should be designed around near-term, mid-term and longer-term company value-creating programs. The fact that the planning environment is cloudy puts a premium on anticipating contingent business scenarios and planning optimum responses to each target, best, and worst case scenario.

When establishing targets and creating incentives, Compensation Committees must not only discuss how difficult

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it is to achieve the targets but also consider the risky behaviors executives might utilize to earn payments. If executive pay is repositioned in this context, it is more likely to align with desired performance.

Part Two will propose a program that integrates Executive Pay, Risk Management, and Corporate Governance and outlines how Compensation Committees could achieve this integration.

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