

Corporate Governance

A Risk-Sensitized Executive Pay Governance Process — Part Two

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As a result of TARP provisions and proactive shareholder advisory groups, executive compensation is coming under intense scrutiny. The focus is two-fold: (1) are pay-for-performance programs really paying for shareholder value created, and (2) are the incentive systems encouraging inappropriate or excessive risk-taking that may threaten rather than create shareholder value?

On the other side of the argument are management's concerns about (1) attracting, motivating, and retaining the right talent to get the job done, and (2) avoiding overly restrictive pay structures (whether required by government mandate or compelled by public perception) that drive executives to other companies that operate in less restrictive environments.

Under such intense scrutiny, the weaknesses of many current executive pay programs are highlighted, especially when executives' pay is overly influenced by company size or by the generous practices of others setting precedents in the marketplace. In such cases, misaligned pay practice is not driven by the company's own value creation strategies and tactics or the company's business circumstances. Rather, executive "insurance and compensation continuity practices",

such as excessive severance, perquisites, golden parachutes, and other benefits — even in the face of company failure — seem to take precedence over a pay-for-performance ethic.

With high-profile adverse public reaction to "self-serving excesses" in executive pay, particularly in TARP-assisted financial institutions, the issue of executive pay has become a lightning rod. While Compensation Committees may have been protective of management's pay interests in the past — and some still are — in today's environment, Compensation Committees tend to exercise more disciplined and careful oversight. In fact, pay practices from 2008 to 2009 have shown restraint and even contraction in the areas of base salary, annual incentives, and long-term incentives, with some companies adjusting the balance among pay components (see *Recent Developments* on page two).

In light of these ongoing changes in perception and practice on the corporate and government side, this *InsightOut*:

- Describes the challenges Compensation Committees must address as they establish a framework for aligning executive pay with shareholder interests.
- Outlines steps that a Compensation Committee should take as part of its executive pay governance process.

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I. CHALLENGES FACING COMPENSATION COMMITTEES

Challenge One: Understanding the Relevant Risks in Context

As indicated in [Part One](#), the TARP bailout program asks companies to proactively address risk in their executive pay programs. This program has broader implications in that proactive proxy advisory groups, if not the Government itself, are implicitly requesting non-TARP companies to look at their executive pay programs in the same way.

The only way to understand risk from its negative side is to see it as a behavioral misalignment and decision-making process that has “global” consequences when risks taken in certain business units have ripple effects in other areas. These consequences eventually spread throughout the enterprise and then to third parties, including alliance partners, vendors, and even customers. For example, when it became clear that bank positions in credit default swaps and structured debt obligations, such as collateralized mortgage obligations (CMOs), embraced risks that were not adequately recognized or understood, access to capital for the rest of the organization dried up. The consequence was that the enterprise was left with operations and risk profiles that could not be supported via existing capital positions. The risk then spread beyond that organization’s walls to third parties, such as counterparties backing some portion of the risk, and then to shareholders of a wide range of enterprises tied together either by design or because of the inter-relatedness of the various risk exposures accepted.

In retrospect, what could a Compensation Committee have done to understand what was at stake, critique and remedy the problem, and effectively realign pay with measures that did not put shareholder value-creation at risk?

The answer: a Compensation Committee alone could not have spotted and rectified the situation. To even have a chance of forecasting the dangers, they would have needed a governance process that:

- Identifies sources of risk where problems are most likely to occur.
- Relies on experts and/or committees that have multiple perspectives on the risks themselves, how they originate, and

how they can get out of control. Seeking the perspectives of others is similar to a patient about to undergo a risky surgical procedure getting first, second, and third medical opinions to help assess the risks.

- Identifies those elements of behavioral finance that are often pre-conditions to inappropriate risk-taking on the front-end. These elements include insufficient grasp of global market conditions and trends that enhance risk, a preoccupation with near-term gain, an aversion to ambiguities and a thirst for simple explanations, an adherence to the status quo, a belief that programs should be continued because of their “sunk-cost” investment, and a tendency to take higher-risk/speculative positions to retrieve losses and “turn the company around.”
- Is able to model the risk-reward dynamics so that factors influencing risk can be isolated and a “cost of capital equation” connected with these risks can be constructed, along with the returns and capital required to cover the downside risk. If this had been done before the financial implosion, more banks may have seen that their capital — or the capital of their alliance partners — was inadequate to cover the risk being embraced. That said, to fix the problem would have required enormous audacity to break from the pack that was generating outsized short-term returns, that we now know were value destroying.
- Looks unflinchingly at how short- and long-term incentives may have over-emphasized risk-taking in pursuit of short-

RECENT DEVELOPMENTS

Certain large financial companies covered under TARP have recently indicated they will be increasing base salaries of their top executives and top-earning employees. However, they plan to adjust the *balance* between these employees’ fixed and variable pay rather than increase their total annual compensation. In light of existing restrictions imposed on executive compensation at these institutions (as discussed in [Part One](#)), the method of this adjustment is not surprising. In addition, the Treasury Department has indicated it will issue guidance in the next several weeks that will serve as an overhaul of compensation practices of financial organizations, whether or not they are TARP participants. Interestingly, these adjustments may be a reasonable reflection of less “risk-focused” business strategies for profit generation, a direction supported by the deleveraging of such businesses over the last year.

term gain (including managing the company on a quarter-to-quarter basis). For instance, was the executive pay architecture such that the majority of pay was a “reward” for the company’s short-term profit and quarterly management of financial results derived from risky business practices, such as credit default swaps and collateralized mortgage obligations on inadequately evaluated risks? Did this reward depend on something over which the company had no ultimate control, such as the role that counterparties globally may have played? Did this reward depend on assets and other collateral that was packaged and evaluated for due diligence purposes by others unconnected to the firm’s risk management function?

- Evaluates whether certain pay vehicles, such as stock options (which can reward price volatility as effectively as sustained value creation) with an executive timing element and ability to capitalize on quarter-to-quarter market movement, contribute to an excessive short-term risk-taking perspective.

With these objectives in mind, the Compensation Committee should typically evaluate risk in six major areas as part of its executive pay governance process and cross-relate pay to each of these areas.

1. Strategic: Reward systems typically reinforce management’s intention to take risks in the pursuit of strategic-tactical goals with a clear risk-reward equation in mind. The question for the Compensation Committee is whether or not there has been adequate due diligence in assessing the changing market environment and whether the planning assumptions are based on well-researched facts or primarily on management’s traditional biases.

Business strategies that do not adequately reflect current market realities, the rate of change or discontinuity with previous conditions, the ability to maintain an adequate cost-of-capital return in volatile scenarios, and management’s core ability to be adaptive/responsive have a much higher likelihood of failure. The ability to construct “what if” scenarios and stress-test the impact that various events or plans will have on the current business plan provides the first indication of how sound that business strategy is. Boards should be increasingly asking for more in-depth and frequent scans of the environment, including opportunities to consider low-probability/high-impact scenarios.

This probing process is the responsibility of the Board, its functional committees, top management, risk management committee, internal audit committee, various functional experts, and external consultants. The probing should occur while business plans are being developed and rolled out. It

should have enough rigor, supporting rationale, and transparency so the Compensation Committee can determine whether or not the business plans are likely to deliver the shareholder value expected.

2. Operational: Reward systems can reinforce operational risk embraced in pursuit of achieving corporate and unit goals. Functional or silo risks, such as application of technical, investment, or trading solutions, or unilateral marketing or product-delivery campaigns, may be developed and rolled out without understanding the cross-boundary, enterprise-wide and codependent risks that these actions impose on other operations. These risks may spread beyond the company’s walls to collaborating partners and even customers. When an unintended consequence occurs, such as a drop in profitability because period-to-period costs exceed revenues, it is often the result of not having fully accounted for these cross-unit variables.

3. Financial: Reward systems can inadvertently reinforce financial engineering and balance sheet management that can change the risk profile for the company. Enron was an extreme example of this, mostly because financial engineering veered decidedly from sound principles to transactions allegedly designed to deceive, reward uncontrolled self-interest, and obfuscate. In today’s economy, cash flow management (sources and uses of cash) is particularly important when cash-starved companies need to use cash sparingly to fund critical investments. Cash conservation tactics can often create better near-term results while at the same time putting the firm in a less favorable risk position when business conditions change.

4. Reporting: There are risks associated with over-management of reported results. One gambit is to imply that earnings are meeting expectations when revenue is, in fact, generated from a one-time sales transaction. Extraordinary period-to-period expense management efforts to achieve analyst expectations are another example that can ultimately result in mortgaging the future to achieve current results. There is also the obfuscation of results, which, thanks to the complexity or opacity of reporting techniques, camouflages how money is actually earned. In general, the new reporting model calls for transparency, uniformity, and simplicity so all audiences understand what is being communicated.

5. Regulatory and compliance: Risks arise when insufficient motivation or insufficient controls are in place to ensure compliance with applicable regulations. Often these risks are embraced by a part of the organization in response to pressure to achieve overall business objectives. Without proper reporting and controls, senior management may not

even be aware that such risks are being taken. Risks associated with noncompliance can endanger the company, its reputation, its legal status, its shareholder relations, and its overall financial condition. Noncompliance can result in fines, partial or full shut-down of operations, third-party suits, and denial of advantaged tax or accounting treatments. For instance, noncompliance with Sarbanes-Oxley regulations imposes penalties that can affect executive compensation.

6. Reputational: Pursuing results at the expense of good business judgment and ethical decision-making can be corrosive to a company's reputation. A company that investors cannot trust or that is likely to take reputational risks has been shown time and again to damage shareholder value. Consumers may start withholding support of – and actually boycott – such companies. Companies may be sued for pursuing policies and selling products that endanger the health of their employees or customers, even though it is apparent that internal resources were alerted to the dangers. Shareholder value is often affected negatively.

Challenge Two: Structuring Executive Awards that Motivate Good Decision-Making

Executive compensation — particularly short- and long-term incentives — *can* encourage decision-making that optimizes shareholder value creation and discourages the opposite when the measures that drive performance-based awards are well defined and their implications are well understood. The objectives to be achieved are assigned a relative importance (weighting) and attainment levels (minimum, target, and outstanding). Relative levels of payout depend upon

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performance (e.g., 10th-90th percentile levels versus relevant peer groups). However, these elements of pay architecture must fit into the larger picture of shareholder value creation and avoidance of risk that destroys shareholder value.

A complication is that the risk-reward equation needs to be viewed through a filter of factors that influence the risk posture of an enterprise but which have not traditionally been assessed in designing and monitoring executive pay plans. These factors include the need to understand and assess:

- **Behavioral risk.** The executives' mind-set itself, with all of its biases, can make them less able to see and make good decisions on behalf of shareholders. In addition, the incentive compensation design can result in executive behaviors that are not in sync with longer-term shareholder value goals. Until recently, such assessments were not even considered.
- **Lack of an adequate due diligence process linking all the value chain's pieces.** A key oversight requirement is the ability to critique strategy formulation and delivery through every business process and execution stage and do a risk management assessment at critical points over time. This area of risk management has typically been outside the purview of Compensation Committees. In addition, few companies have the sophistication to apply risk assessment analysis in every relevant area with the required level of discipline. This is an area of current research, as companies increasingly rely on collaboration outside traditional corporate boundaries to deliver their value proposition and, therefore, proper due diligence needs to extend beyond the enterprise's normal borders.
- **Ambiguity of the planning process and the structuring of reward scenarios in shifting economic circumstances.** This planning and structuring must "anticipate" minimum, target, and outstanding performance in a matrix of worst, anticipated, and better-than-anticipated business environment scenarios.
- **Peripheral factors that typically have not been viewed as part of the hardcore pay-for-performance challenge.** These factors include reputational, regulatory, legal and compliance, reporting and accounting, environmental, and disaster recovery or business continuity.
- **Codependent variables that operate together to amplify period-to-period cash flow and profitability risk.** Stress-testing the business plan is necessary to find out how these codependent variables react in different business scenarios. Do incentive programs take an already high risk profile and amplify risk by motivating aggressive pursuit of more speculative outcomes?

- **The company’s contextual position, which includes perspectives on its opportunities and constraints and its relative strengths and weaknesses.** The Board’s and Compensation Committee’s understanding of the company’s contextual position will give them an appreciation of how much maneuvering room the company has regarding its use of cash or equity vehicles and the relative riskiness of specified levels of performance expectations. For example, performance challenges for top tier performing and capitalized companies can be very different from the challenges of bottom tier performing companies. Relying too heavily on relative comparisons, particularly over limited time frames, may drive speculative actions to achieve desired results. Furthermore, the current economy has created drastically different situations for winners and losers — and, in fact, has moved many former winners into the losers’ circle.

To the extent that a new scorecard can be designed to reflect perspectives on the processes, risks, and measures of seven key organizational functions that Compensation Committees should consider, it would look like Figure 1. Note that these categories may be tailored to accommodate specific business sectors but the concept would remain the same.

The Compensation Committee would use the scorecard as a tool to help it determine significant gaps within any of the seven

functional areas that can result in a flawed pay-setting process. Only by identifying those gaps, preferably early on, can the processes be corrected.

Challenge Three: Putting Executive Recruiting and Retention in Proper Perspective

Using executive pay to attract, motivate, and retain executives is a legitimate and compelling objective, but using pay to put executives first over shareholder performance requirements can be counter-productive in the current environment. That is why recruitment pay premiums, purely time-based or retention awards, and generous severance, perquisite, and golden parachute provisions are increasingly viewed as untenable in today’s dismal financial and stock performance scenarios. We now see clearly the predictable and protected wealth accumulation scenario (see *Mind over Money: The “Insurance Mentality” of Executive Pay* on page six) taking a back seat to the shareholder pay-for-value-created scenario.

Traditional executive pay programs that do not recognize the many direct and indirect ways in which risk can be introduced through cross-boundary and codependent variables are bound to create a misalignment between pay, shareholder value creation, and effective risk management. This can occur as a

FIGURE 1: KEEPING SCORE

	Strategic Planning with Risk/Value Assessment	Risk Management Identification and Quantification	Marketing and Sales	Operations and Finance	HR Talent Management	Governance and Regulatory	Pay Alignment with All the Preceding Functions
Process (Board, Management, Committees, Others)							
Risk Areas (Core and Non-Core)							
Measures (Traditional and Non-Traditional)							

MIND OVER MONEY: THE “INSURANCE MENTALITY” OF EXECUTIVE PAY

In truth, there has always been an “insurance mentality” in the treatment of executive pay. There is a tendency to defray the risk of executives’ undiversified holdings in a limited company stock portfolio by providing longer-term retention grants, opportunistic stock option awards/exercise, and fixed compensation arrangements. Also, severance, supplemental executive retirement plans (SERPs), and golden parachute agreements ensure payment continuity when unforeseen disruptions occur in the wealth accumulation stream. This view holds that, in a highly volatile environment, tamping down volatility and ensuring delivery of a predictable wealth accumulation program are desirable objectives, since executives are already at excessive risk with their volatile, undiversified company stock holdings. They need an offsetting predictability of income in an otherwise chaotic pay situation.

result of human behavioral blind spots, lack of a good understanding about where the market and competitive trends are heading, and faulty strategies or tactics that don’t fully optimize (and may destroy) shareholder value creation. The Compensation Committee needs to carefully monitor the assumptions development and strategy design processes to ensure that the result is built on a solid foundation that recognizes that the current business environment is but one of many in which the firm might find itself.

Further, the Compensation Committee must be able to identify and quantify key risks in the six areas indicated on page three and four. Using either stress testing or risk modeling that effectively recognizes the likelihood of extreme events, it must also determine that the company is positioned properly to respond as needed. Improved pay oversight requires coming to grips with performance requirements before dealing with executive attraction, motivation, and retention issues.

II. STEPS A COMPENSATION COMMITTEE SHOULD TAKE

After factoring in the instances of risk described here, the executive pay-setting exercise should align incentive pay

structures so these structures reinforce strategic and tactical objectives over annual, intermediate, and longer-term time periods. Objectives in each of these three periods should focus on shareholder value creation through a series of short-term, mid-term, and long-term initiatives that allow the company to survive, build longer-term capability, and create abundant shareholder value. Concurrently, there should be a shift away from purely time-based awards that cannot be rigorously justified as enhancing shareholder value. In addition, basic strategies would include avoiding:

1. Certain change-in-control situations, such as single-trigger vesting, walk-away rights, and tax gross-ups to cover executive cost exposure.
2. Excessive fringe benefits or perquisites.
3. Extremely rich severance packages.
4. “Pump-and-dump” sales of company stock by executives. One action to consider in this regard is to impose hold-through-retirement or other post-vesting holding period requirements (with contractual enforcement procedures).

Another strategy that protects shareholder value is the use of contractual claw-back provisions to recoup bonuses or incentives in the event that financial results are materially inaccurate (whether or not financial statements are revised to reflect less favorable results than previously reported).

Note: Some companies are considering expanding claw-backs to cases where executives made faulty business decisions that led to lost company (and shareholder) value. Expanding claw-backs for this reason is an extremely difficult position to take. We are all much wiser in hindsight. The key question to ask when considering an expanded claw-back is whether or not the business decision was faulty at the time it was made based on reasonable facts and circumstances that were known (or should have been known) at the time. Another difficulty with this approach is that it could create an environment that encourages executives to always choose the safest alternative when making strategic business decisions. This could result in virtually no appropriate risk-taking and limited upside potential for companies and their shareholders.

In setting up its governance framework, Compensation Committee members will need to develop a complete understanding of the processes by which the company can

manage the risk areas previously described. The Committee's assessment of these risk management procedures should include the following:

1. Establishing an agreed-upon protocol by which it collects necessary information in the process, risk assessment, and performance metrics areas, including the degree to which separate functional and committee reports are used. The expanded scorecard, shown on page five, helps tie everything together across company boundaries into a cohesive format for evaluation.
2. Achieving a level of comfort that the company can quickly report and correct errors and systemic weaknesses in the business plan and associated pay-for-performance metrics. The Compensation Committee should verify that the company's risk management process executed among the Board, management, risk management committee, and audit committee is fully transparent and supported by appropriate disclosure documents.
3. Conducting and reviewing all existing employment agreements, severance agreements, contracts, change-in-control agreements, incentive award agreements, etc. Identify and address instances of conflicts with guiding principles. (Pay particular attention to ambiguous employment agreement provisions and conflicts between award and employment agreements that can result in significant increases in payment amounts, such as severance, under alternative interpretations.)
4. Developing a complete understanding of the processes and controls in place that determine whether performance measures underlying incentive arrangements are adequately accounted for. This will require understanding various financial measurement methods: US GAAP vs. IFRS vs. EBITDA vs. ROI vs. Value and Cash Flow-based metrics. It will also entail understanding the pros and cons of competing methodologies. In addition, it will involve understanding the adequacy of the systems in place that track and report financial period-to-period changes. Finally, this will include understanding where and how the financial data might be manipulated or engineered to present a false impression of the company's financial condition.
5. Developing procedures for measuring risk-taking behaviors and determining if such behaviors align with corporate-level risk tolerance. Essentially this means structuring risk measures with and through the risk management and audit committees, and developing risk-reward curves for every initiative in the company's portfolio of initiatives.
6. Considering the need to develop and use tools, such as a "contingency-driven" wealth accumulation analysis, tally sheets, and internal pay-disparity assessments. A rigorous wealth accumulation analysis may reveal that an executive's current incentive structure enables an accumulation of wealth that is inconsistent with an attract and/or retain objective. Either too much wealth accumulation opportunity is being created to achieve this objective or awards that are designed to attract/retain are insufficient given the executive's current wealth position. Alternatively, such an analysis could reveal that an executive's expected wealth accumulation is reasonable. As pressure continues to build over executive pay, we believe it would be prudent for companies to incorporate a "contingency driven" wealth accumulation analysis that factors all pay elements into the executive pay-setting process.
7. Considering expanding the discussion of risk management techniques and executive compensation to the MD&A portion of the company's annual report with a tie to the CD&A portion of the company's proxy statement.
8. Assessing the financial well-being of third parties in cases where the company relies heavily on third-party outsourcing arrangements. For example, many companies outsource their document and data management functions. If third parties became insolvent, that could jeopardize its ability to adequately manage and secure the data. Become familiar with the adequacy and quality of the third party's support functions as well as its ability to achieve agreed-upon cost reduction or revenue-enhancement goals.

Improved pay oversight requires coming to grips with performance requirements before dealing with executive attraction, motivation, and retention issues.

CONCLUSION

Regardless of the principles and processes that companies and committees follow, the challenge for Compensation Committees today is to establish a more holistic governance process that incorporates a sophisticated risk assessment along with a specific assessment of how executive compensation design affects risk. Unless companies and their Compensation Committees proactively identify and construct the risk management framework, the Federal government and shareholder advisory groups will step into the void — creating rules that hamstring the company's ability to deal flexibly and creatively with pay-for-performance alignment and risk.

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