

# AGENDA

## Opinion: Risk Needs to Be at Heart of Comp Plan Designs

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Since Lehman Brothers failed in September 2008, igniting a financial firestorm, there has been mounting public and shareholder pressure on the need to control compensation-linked risk. We now frequently hear the words “risk management” and “compensation” in the same sentence. This wasn’t the case before the financial meltdown.

In recent years, companies were more focused on the relationship of pay to performance. Risk, the third dimension of compensation, received scant attention relative to its importance. Companies failed to explicitly state risk’s relationship to pay and performance. Meanwhile, risk figured prominently in incentives designed to induce executives to take more chances than they otherwise would.

Paying executives to take risks without adequately controlling or managing the process has produced incentive-pay structures that result in negative outcomes for companies and, as we’ve seen during the financial crisis, for virtually everyone.

So now the government is seeking to discourage what it deems to be excessive risk-taking. An example came recently when the Obama administration announced plans to claw back risk-associated compensation at financial institutions that received government assistance.

The government has taken more far-reaching action, and more is on the way. The Treasury Department’s TARP Capital Purchase Program requires that compensation committees seek to identify features that might encourage top executives to take “unnecessary and excessive risks that could threaten the value of the financial institution.”

And the SEC has issued a proposed rule requiring public companies to discuss their process for assessing and managing compensation risk. The rule is expected to become a mandatory element of the Compensation Discussion & Analysis portion of proxy statements in 2010.

Taking risks is a healthy, necessary part of any successful business; however, risks also must be calculated and appropriate. Soundly designed incentive plans acknowledge risk and incorporate checks and balances for it — also known as risk offsets and controls. Offsets and controls can take three forms:

1. Counterbalanced performance measures. For example, if a company provides compensation incentives designed to grow top-line revenue, it should be aware of the risk that bottom-line sales margins might decrease as a result. To control this risk, the incentive plan design should include profit-margin measures as well as those for revenue growth.

2. Limits and caps. This means limiting the range of performance to be rewarded and capping payouts. For example, if management's incentive pay is based on growth in earnings-per-share (EPS), boards should develop limits to prevent management from achieving this goal simply by repurchasing shares. Buying back a certain number of shares might be appropriate, but not all of EPS growth should be based on share repurchasing. Any buybacks beyond a limited number of shares — or those that would propel incentive payouts beyond a total dollar cap — wouldn't count towards management's incentive compensation.

3. Oversight. This means evaluation by the board of directors. For example, if a company's primary objective is to maximize earnings before interest, taxes, depreciation and amortization (EBITDA), the board should provide oversight to make sure management doesn't achieve this goal by overpaying for acquisitions. The board would only approve acquisitions with proper strategic fit and return-on-investment metrics to ensure that management pursues acquisitions judiciously. Further, these acquisitions need to be done with the interests of shareholders in mind.

After analyzing potential impacts of risk-linked compensation, companies can build in controls like these to prevent unintended consequences. Such strategies can also go a long way in achieving the positive results they were seeking in the first place.