



The Risk Disconnection

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In response to a global recession that was blamed on a lack of attention to risk, discussions about risk management have become routine in corporate America. Many companies, under public and shareholder pressure to prevent recurrences of the failures that preceded the financial meltdown of 2008 – have been seeking new or improved processes to control risk. Yet precious few are substantively addressing one of the primary factors affecting any company's risk profile: The degree of corporate risk inherent in the design of performance incentives.

As an angry public complains that executives receive too much money – and now, their tax money - for doing too little or actually doing harm, pressure on compensation plans continues to build. Headlines about employees of banks that received taxpayer dollars getting substantial bonuses make the work of boards and financial executives more difficult because all large companies unfortunately are subject to generalized optics. The legitimate argument that companies can't properly serve shareholders if compensation pressure hamstringing their efforts to attract, motivate and retain talent is barely audible above the din of critical voices.

This argument is better received when it comes from companies mindful of the kind of executive behavior their incentives tend to motivate and take action to control the degree of risk involved. Few do. Companies in all sectors would do well to take a hard look at their compensation plans and ask: Do they encourage executives to take risk to the extent that it prevents or impedes the achievement of strategic business goals?

Amid the current consternation, there is little discussion of managing risk-linked compensation proactively – an undertaking that is not only good for companies but also serves as a preemptive move to keep the government from doing so retroactively. Several weeks ago, the Obama administration announced plans to do precisely that by clawing back compensation that some at bailed-out banks were getting for taking what it deemed to be too much investment risk.

Taking risks, of course, is essential to the success of any company; taking too few is unhealthy. However, risk must be controlled so that it is calculated and appropriate. There are ways to manage, control and balance risk at any kind of company from the top down. Doing so

successfully means changing executives' incentive plans to encourage them to be not only enterprising in their risk-taking but also judicious.

In recent years, companies have been focusing on the relationship between pay and performance. Meanwhile, risk – the third dimension of compensation -- has received scant attention relative to its importance. Many companies fail to establish incentive structures that acknowledge and balance risk's relationship to pay and performance.

Nevertheless, risk has figured prominently in incentives designed to induce executives to take more chances than they otherwise would. Therein lies the fundamental disconnection between risk-linked compensation and corporate risk management. Paying management to take risks defeats the purpose if the type and degree of risk isn't controlled to prevent unintended consequences.

At some financial institutions, incentives to take risks without the right controls produced pay structures that resulted in negative outcomes, so the government is seeking to moderate risks inherent in compensation plans. The Treasury Department's Troubled Asset Relief Program requires companies 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 U.S. Securities and Exchange Commission will likely be requiring a thorough discussion of compensation risk assessment in 2010 proxy statements.

Governance pressure on the fullness and specificity of these disclosures will be intense. As is often the case with newly required disclosures, companies will be working to change their compensation plans to put their best feet forward.

Few compensation plans currently balance executives' incentives to take risks with measures designed to ensure that they don't go so far that the original purpose – enhancing shareholder value – is defeated.

So companies will want to take a hard look at their risk-inducing incentives to assure that they're soundly designed. This design should incorporate the right checks and balances for the particular company's industry, market position and business strategy. Here are some fundamental forms of risk offsets and controls:

- **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.
- **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.
- **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 control the risk that management might be overpaying for acquisitions. The board might want to tie EBITDA growth to return-on-investment metrics to ensure that management pursues acquisitions judiciously, with the interests of shareholders in mind.

After analyzing potential impacts of risk-linked compensation, companies can build in such controls to prevent unintended consequences.

To the extent that governance opinion stems from by proxy statement disclosures, companies that positively change their incentive plans to better control risk and then tell the world about it will avoid the stinging criticism, governance actions and share-price punishment awaiting those that don't. This will bring positive optics and renown for being part of the solution, not part of the problem.

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