

How To Use Compensation To Manage Risk

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It's a matter of putting the right controls on the incentive pay executives get.



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Since inattention to risk started bringing down major financial institutions last year, and crippled the global economy, risk has become a corporate fixation. Talk of risk management is everywhere. After all, a lack of it--or, in some cases, upper management's turning a blind eye to warnings from risk managers--led to the time bomb of perilous mortgage-related investments that exploded in 2008.



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The government's ensuing rescue of major financial institutions made obsolete the argument that non-shareholders should have no say in corporate compensation. Critics' complaints that too many executives are paid too much for too little performance--and, now, for causing harm--have won new credibility. Yet there has been scant discussion of managing corporate financial risk by addressing one of its root causes: the design of incentive compensation plans.

Now the government is intervening retroactively in some cases, where companies have failed to do so themselves. The Obama administration is clawing back compensation that key people at bailed-out banks were receiving for taking on what the government considered excessive investment risk.

To keep the government out of the boardroom and make good on their duty to enhance shareholder value, directors should consider redesigning components of their incentive pay plans.

Taking risks is, of course, essential if companies are to succeed, so compensation plans should encourage it--in the right measure. They should seek to achieve desired business strategies by yoking executives incentive pay to their meeting relevant performance goals.

Over the past few years, companies have been feeling pressure to more closely link pay to performance. Yet many have failed to consider to what extent rewarding executives for certain types of performance creates unintended consequences contrary to corporate goals. All too often, pay incentives motivate executives to achieve certain goals in isolation. The more executives are paid to concentrate on the trees, the more they ignore the forest. That's human nature. Thus, the business strategies that the incentives were meant to promote are jeopardized.

To prevent this from happening, companies should place the right controls on specific aspects of executive performance. One important step is simply to set the right limits. For example, if management's incentive pay is based on growth in earnings per share, the board should set limits to prevent management from achieving this goal by merely repurchasing shares. Buying back a certain number of shares might be appropriate, but buybacks beyond a limited number of shares, or those that would propel incentive payouts beyond a total dollar cap, shouldn't count toward management's incentive compensation.

Another useful risk-control device is to offset one performance measure against another. For example, when directors have established compensation incentives for management to grow top-line revenue, they need to manage the risk that bottom-line sales margins might decrease as a result. So the incentive plan should also take into account profit-margin numbers.

Companies can devise controls to regulate virtually any kind of behavior that if carried too far creates corporate risk. 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 overpay for acquisitions. The board might want to tie EBITDA growth to return-on-investment metrics to motivate executives to pursue acquisitions judiciously.

At financial companies, these controls must necessarily extend from the C-suite down through the ranks, as at these companies in particular non-management people can significantly affect the corporate bottom line.

Encouraging executives to take risks without the right controls has hurt companies--and, as we've seen since the 2008 meltdown, the whole economy. Now that many companies have improved their links between pay and performance, they can and should concentrate on managing risk by controlling the specific kinds of performance their incentive pay encourages. Companies that do so successfully will end up ahead. Those that don't will be punished by governance critics, shareholders and an intolerant public alike.

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