

In Practice



Risk-Adjusted Compensation: What Every Compensation Committee Needs to Know

By Richard W. Leblanc

Operating efficiency indicators that were in vogue before the financial crisis—such as profit, revenue, productivity, costs and volume metrics—and some market measures, such as share price and total shareholder return, by and large, continue to be used by many compensation committees and consultants. These measures are short term and do *not* properly incorporate the explicit risks, costs and time to materialize of managements' actions. Metrics like these are analogous to steroids—all gain and no pain. Management is driven to “max out” based on these types of metrics, offering compensation committees limited discretion, up front or at the back end. “If I hit, you pay” becomes the operative norm.

Compensation drives behavior, and it is the compensation committee's responsibility to take all reasonable steps to ensure

that management is not taking imprudent risks by virtue of their pay structure, and to require—if not insist—that any retained compensation consultant recommends a “risk-adjusted compensation” regime that reflects the true costs and risks for management compensation, for the specific company within its industry. The compensation committee, however, has an obligation to employ its own judgment, skill and experience in approving and recommending this regime to the board.

It is important to note, however, that risk-adjusted compensation is not attempting to control the *amount* of executive compensation—only to ensure that the compensation be sufficiently aligned with actual performance and appropriate risk mitigation.

Varied Approaches

There are two main time frames and four types of approaches to

align compensation with risk: before and after compensation accrues or is awarded; and quantitative, qualitative, explicit and implicit approaches. The compensation committee should be familiar with timing and approaches, as well as their interactions.

1. Adjustments for risk before compensation accrues or is awarded. By adjusting for risk before executive compensation is accrued or awarded, the compensation committee takes into account future potential adverse developments. However, while these types of adjustments (e.g., a risk “surcharge” associated with activities or positions in a cost-of-capital context of a bank) are timely and may have an immediate effect on risk-taking behavior, in the absence of sufficient time for the full extent of assumed risks to emerge, measures such as these often prove to be unreliable, and their impact may be overwhelmed by short-term performance measures.

Therefore, risk adjustments should also be implemented *after* risks fully materialize (e.g., losses realized, employee misstatement of risk or errors in performance during the accrual period) to accurately capture fully the true costs of risk. See approach No. 4, below: “Adjustments for risk based on actual results.”

2. Using quantitative measures to adjust for risk. Quantitative measures are numerical or financial measures that may be predefined and transparent, and can influence behavior directly. Examples of risk-adjusted quantitative measures in the financial services sector include risk-adjusted return on capital (RAROC), return on risk-adjusted capital, economic profit, internal economic risk capital, net economic contribution, and risk-adjusted cost of funding or pure accounting adjustments.

However, quantitative measures, even with embedded qualitative adjustments to correct for error, are still inadequate to

capture all risks or all elements of performance (e.g., the “how” in differentiating performance among executives; the back-office work that is weakly related to risk outcomes, such as compliance with risk control measures; or others described in item No. 3 below). Therefore, additional qualitative measures are necessary.

3. Using qualitative measures to adjust for risk. Qualitative measures are more difficult to define in terms of measurable triggers or targets. They generally rely on greater use of judgment from the compensation committee than do quantitative measures. Examples of qualitative measures include the following: adherence to risk-management policies, limits, measures and audits; compliance with external and internal rules; the resources and behaviors used to achieve the results; cooperation with other business units and control functions; and other broad areas such as leadership, board relations, teamwork, employee engagement and stakeholder satisfaction. These measures should be employed before compensation accrues or is awarded, and should provide balance to the quantitative measures.

4. Adjustments for risk based on actual results. Boards may adjust accrued compensation during a deferral period (e.g., via “malus,” the opposite of “bonus,” which permits a board to prevent vesting of all or part of the amount of deferred management compensation) or after a deferral period (e.g., via clawback). In this way, the board has a second chance to align compensation as the performance and risks materialize, and to control for unanticipated outcomes or misjudgments that the board or compensation committee may have made. These types of adjustments—and the embedded negative discretion by the compensation committee—therefore become a very important source of behavioral modification. Management through

undue influence over terms and conditions may resist them.

5. Explicit risk adjustments to compensation. Explicit adjustments occur when the board or compensation committee adjusts management compensation by means of a malus arrangement or a clawback clause (e.g., by lowering cash remuneration or by awarding a lower number of instruments). This type of risk adjustment should always be performance-related and respond to the actual outcome of management’s actions. The extent to which an adjustment is needed depends upon the accuracy of the initial adjustment undertaken before compensation accrued or was awarded.

6. Implicit compensation adjustments. When variable compensation takes the form of instruments (e.g., equity or options), implicit adjustments occur when the final payout to management hinges on market prices during the deferral or retention period, rather than actions by management. Under no circumstances should the movement of the stock price (known as an “implicit” adjustment) occur in lieu of an explicit *ex post* risk adjustment. Price movements often occur as a result of factors unrelated to management action.

Risk Applies to All

Risk-adjusted management compensation applies to the company as a whole, to individual business units and to individual executives or “risk takers.”

Not only does applying risk adjustment to compensation throughout the entire organization make sense, but it will increasingly be the law, as rules and/or codes of best practices apply to compensation committees and boards if any person within a organization (e.g., a “risk taker”—a trader, for example, or even a person dealing with hazardous materials) takes inappropriate or imprudent risks, incited to do so by

compensation arrangements, and thereby putting the organization or a major segment of it at risk.

Relative vs. absolute measures. Relative performance measures pose the risk that variable compensation that is not supported by the long-term success of the business unit or firm will be paid out anyway, and thus may encourage greater risk taking. For example, during sector-wide positive financial performance, relative measures could lead to a “herd” mentality, providing incentives to take on excessive risk. During downturns, however, relative measures may lead to insufficient contraction of total variable remuneration, even if absolute performance has deteriorated. As a result, relative measures should always be used judiciously and supplemented with other metrics and controls.

Internal vs. external measures. For internal measures (e.g., profit), although it is easier to introduce internal risk-adjustment features than external measures (e.g., share price) because of the availability of in-house risk-management techniques, internal measures still can be manipulated by management to create distorted outcomes on a short-term basis. For external measures, these are significantly driven by market segment (not necessarily internal value creation) as well as other external factors. Thus, external measures should be used with care (and balanced with internal measures). They are less subject to manipulation by management, and may not be suitable (alone) to provide effective incentives to management.

Adjustments Needed

To bring all this together, let’s take a look at each of the four quadrants, using examples of emerging practices recommended by regulators and undertaken by companies in these four areas.

1. Quantitative risk adjustments

before compensation accrues or is awarded. Using financial services as an example (although the principles apply to other companies, as all organizations have risks), when measuring the profitability of the firm and its business units, measurement should be based on net revenue where *all* direct and indirect costs related to the activity are included. Compensation committees should make sure that remuneration pools are not being “back-fitted” to meet compensation demands.

Compensation committees now need to be attuned to all three levels—company, unit and individual—in overseeing and aligning compensation and risk.

Further, the factors that should be used as a basis for adjusting variable compensation to risk include the cost and quality of capital required for the risks of various activities; the cost and quantity of liquidity risk assumed in the course of business; and indirect liquidity costs.

Additionally, performance measures used in setting the compensation pool may not capture all the risks being undertaken; therefore, further adjustments should include consideration of severe risks or stressed conditions (scenario testing would apply). Risk-adjusting variable remuneration quantitatively should occur at the business-unit level, further down to the trading desk (or other risk takers), and even to the individual level, with boards, led by the compensation committee, approving the level of granularity appropriate for the institution.

For example, to apply the above to financial services, remuneration pools and individual awards should incorporate funds-transfer pricing adjustments for risk (interest rate and liquidity), and valuation

adjustments should reflect true (e.g., third-party) liquidation values, model risks and counterparty risk.

Quantitative risk adjustments to compensation should be subject to challenge (specifically by the risk function, control function experts and other directors), just like any other component of the risk-management process.

2. Qualitative risk adjustments before compensation accrues or is awarded. The compensation committee should actively

engage the risk-management function in recommending qualitative risk adjustments to compensation pools. Qualitative adjustment should occur at the individual level of analysis and include reporting to the compensation committees on governance, risk, compliance and internal control scorecards, breaches, breakdowns and/or overrides (e.g., based on internal audit findings), irrespective of the level of management.

There should be no undue influence from executive or business-unit management over risk and compliance experts, who should be involved in the risk-adjustment determination. Judgment or discretion employed by the compensation committee should be as transparent as possible, with clear and complete documentation.

Companies should be prepared to disclose “detailed records” to supervisors (regulators, in the financial services context, who call for compensation disclosure to “facilitate constructive engagement” of “all stakeholders”). Firms should be

prepared to provide “further details” if the final management compensation after applying qualitative adjustments proves significantly different from the initial result using quantitative measures. Supervisors are also empowered to review the minutes of compensation committee meetings to understand how the judgmental factors are applied in risk adjustments at an individual or business-unit level. They may also review cases of contestation by staff (when relevant) of formulaic or judgmental risk adjustment.

3. Explicit risk adjustments based on actual results. Deferred cash and instruments should be subject to an explicit adjustment, once performance and risks have materialized, including back-testing of the underlying performance, possibly leading to a reduction in payout, as the outcomes of management’s actions are assessed. This may include a potential adjustment to zero if the variable compensation is truly variable. This explicit adjustment is necessary to improve full alignment of the compensation policy with risk.

The intention here is to try to time the payout (cash and instruments) with the impact of the managers’ actions, and ensure that follow-on risks to the managers’ actions are addressed.

Malus arrangements, for example, could include conditions such as “Vesting of cash and instruments takes place only if *none* of the following events occur”:

- The financial condition of the firm or business unit is adversely effected (with specific indicators, such as material misstatement);

- Significant changes occur to the firm’s economic or regulatory capital base, supported by a qualitative assessment of risks;

- Misbehavior or serious errors by the individual occur (with specific indicators,

especially concerning internal risk management and code-of-conduct breaches, and external rules);

- No malus for other employees of the firm has occurred; or

- The executive departs.

To have the greatest impact on incentives, the above variables should closely mirror the outcomes as they relate to the level of decisions made by each executive subject to the explicit adjustment.

As opposed to a malus arrangement, a clawback typically operates in the case of fraud or misleading information. But it is more difficult to enforce, as the cash or instruments have already vested—although clawbacks could operate for a long period of time. Malus analysis occurs prior to vesting; vesting to management would require an affirmation by the compensation committee and/or board of directors.

Risk adjustment should be based on both quantitative measures and fully documented qualitative/judgmental measures. The benefit of qualitative measures (e.g., “board relations,” or behavior in respect of risk treatment more broadly) is that they reflect factors that may not be reflected in a formulaic approach (such as a CEO or risk officer not being fully candid or transparent with a board or a committee—which, in itself, can pose a significant risk for any board).

4. Implicit compensation adjustments. The description of implicit *ex post* adjustment is brief, as this occurs due to market forces when the value to compensation already accrued and awarded changes due to market conditions. Implicit adjustment is distinct from explicit adjustment, which is defined as an adjustment to remuneration that has already been accrued and awarded as a result of observed risk and performance outcomes. For example, the market-wide price of equity-market risk may change

(an example of an implicit adjustment), whereas the compensation committee may recommend for board approval malus or clawback clauses (e.g., by lowering the value of deferred cash compensation or by reducing the number of shares that the manager ultimately receives), either through a predetermined formula, qualitatively or both.

Driving Reform

These approaches are emerging practices for addressing risk and compensation in the aftermath of the global financial crisis. To expect that management, compensation consultants or industry associations, alone or even in combination, will advance or implement the above reforms is ambitious, and perhaps misguided. Management’s interests may often be contrary to the practices recommended above. Compensation consultants may prefer simplistic metrics, that are not risk-adjusted, that can be used and explained, and that can be rolled out firm-wide.

To implement such reforms, compensation committees should employ their experience and judgment; retain independent, qualified compensation consultants; and insist upon tailored, risk-adjusted compensation advice and reporting.

Institutional shareholders and proxy advisors would also be wise to consider this sort of explicit linking of risk and compensation when voting upon or assessing pay-for-performance linkages and compensation regimes, as risk-adjusted compensation may prove to have a higher alignment with shareholder value creation than more simplistic, non-risk-adjusted performance measures. ■

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