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Aligning Executive Compensation with Risk and Achievement

Risk-adjusted compensation expected to be the norm

THE GOVERNANCE REPERCUSSIONS OF Enron and WorldCom, as we all know, have been the establishment of independent audit committees and auditor relations, CEO/CFO certifications, internal controls over financial reporting, and whistle-blowing procedures within companies.

Two important legacies of the more recent global financial crisis are expected to be increased board control over risk management and executive compensation. Prudent Canadian directors will start watching now to see the new tools and techniques coming over the horizon in the next few years.

Risk and compensation themselves have become very technical. Their intersection – otherwise known as "risk-adjusted compensation" – is even more complex. Regulators are now coming to grips with the technical challenges of adjusting executive compensation to incorporate risk assessment. Frameworks, definitions and consensus are emerging. The objective is to have sophisticated and efficient tools to assist boards in their oversight. Increasingly, ICD members will need to understand and apply these techniques to adjust compensation for risk.

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. For example, current operating efficiency indicators – such as profit, revenue, productivity, costs and volume metrics – and some market measures, such as share price and total shareholder return, continue to be used by many firms and compensation consultants, although these measures are very short-term and do *not* incorporate explicit risk adjustment. Since risks have not been properly factored into compensation based on these traditional metrics in the past, more complex solutions are necessary. A key principle of these new solutions is that they address the periods both before and after (otherwise known as *ex ante* and *ex post*) the actual compensation accrues or is awarded.

Although the types of solutions described below apply initially to financial institutions (including boards of directors of Canadian banks), there is no reason that similar principles and practices should not spread to other financial and non-financial public companies (including their boards of directors), as well as not-for-profit organizations and Crown corporations, either through Canadian regulation or osmosis of best practices.

Table 1: Approaches and Adjustments to Align Executive Compensation with Risk and Achievement

Type \ Timing	1. *Ex ante*
2. Quantitative	"*Ex ante* quantitative risk adjustment"
3. Qualitative	"*Ex ante* qualitative risk adjustment"

Type \ Timing	4. *Ex post*
5. Explicit	"Explicit *ex post* risk adjustment"
6. Implicit	"Implicit *ex post* adjustment"

The emerging philosophy of risk-adjusted incentive compensation is highly technical, but this article will attempt to sum things up through a table, plain language, examples and a figure. See the above table,

followed by six definitions of approaches to align executive compensation with risk and achievement (all in brown). They in turn are followed by four adjustments (in green) that result from combining those six approaches.

The six approaches to be used by boards and compensation committees to align executive compensation with risk and achievement are *ex ante*; quantitative; qualitative; *ex post*; explicit; and implicit in nature.

Six Approaches to Align Executive Compensation with Risk and Achievement

Each approach (see Table 1) will now be described. Fasten your seat belt; things may get bumpy.

1. Ex Ante: *Ex ante* means "beforehand." By adjusting for risk as executive compensation is accrued or awarded, the compensation committee takes into account future potential adverse developments. Whilst *ex ante* adjustments are timely and may have immediate effect on risk-taking behavior, in the absence of sufficient time for the full extent of assumed risks to emerge, *ex ante* measures (e.g., a risk "surcharge" associated with activities or positions in a cost-of-capital context of a bank) often prove to be unreliable, and their impact may be overwhelmed by short-term performance measures. Therefore, *ex post* risk adjustments to be implemented once risks fully materialize (e.g., losses realized, employee misstatement of risk, or errors in performance during the accrual period) more accurately capture the true costs of risk: see approach 4, below.

2. Quantitative: Quantitative measures are numerical or financial measures that may be pre-defined 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.

A special note about over-reliance on quantitative assessment, and risk:

Model errors and false assumptions may severely impact the *quality* of quantitative assessment. Quantitative measures themselves rely on judgmental inputs (the derivation of which may lack transparency), and therefore quantitative measures should include discretionary corrections to apply "safety margins." (For example, when a bank uses quantitative cost-of-capital and liquidity measures to risk-adjust a profit-and-loss measure, it may apply discretion to account for model error.) These corrections are to some extent subjective, but should not be (or perceived by management to be) arbitrary in nature. Therefore, judgmental adjustments to quantitative measures – such as the example just mentioned – should be supported by policies and procedures that document the rationale behind discretionary adjustments. The greater the adjustment made or recommended by the compensation committee to the board, the more precise the documented rationale should be.

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 3 below). Therefore, additional qualitative measures are needed.

3. Qualitative: 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: adherence to risk-management policies, limits, measures and audits; compliance with external and internal rules; the resources and behaviors used to achieve the results; co-operation 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 on an *ex ante* (beforehand) basis, and should provide balance to the quantitative measures.

4. Ex Post: Please see Figure 1 below, illustrating deferral and other *ex post* risk adjustments to compensation. *Ex post* means "after the fact." 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. *Ex post* adjustments therefore become very important and a source of behavioral modification.

5. **Explicit:** Explicit adjustments occur when the firm (via the board of directors 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). See below for specific examples of how this is done. *Ex post* risk adjustment should always be performance-related, and respond to the actual outcome of management's actions. The extent to which an *ex post* adjustment is needed depends upon the accuracy of the initial *ex ante* adjustment. The compensation committee should recommend to the board that executive compensation packages include both *ex post* and *ex ante* risk adjustments.

6. **Implicit:** 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 (see figure), 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.

Seeing Risk-Adjusted Compensation Holistically

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 an organization (e.g., a "risk-taker" – a trader for example, or even a person dealing with hazardous materials) takes inappropriate or imprudent risks, incented to do so by compensation arrangements, and thereby putting the organization or a major segment of it at risk. Compensation committees now need to be attuned to all three levels – company, unit and individual – in overseeing and aligning compensation and risk.

Other dimensions and inputs relevant to the risk-adjustment of compensation include relative vs. absolute measures, and internal vs. external 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.

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.

Four Adjustments to Align Executive Compensation with Risk and Achievement

To bring all this together, let's take a look at each of the four quadrants in Table 1 (on page 20), using examples of emerging practices recommended by regulators and undertaken by companies in these four areas.

1. **Ex ante quantitative risk adjustment**
   Using financial services as an example (although the principles may apply to other companies), when measuring 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 (several *ex ante* adjustments therefore become necessary). Compensation committees should make sure that

remuneration pools are not being "back-fitted" to meet compensation demands. Further, the factors that should be used as a basis for adjusting variable compensation to risk include: (i) the cost and quality of capital required for the risks of various activities; (ii) the cost and quantity of liquidity risk assumed in the course of business; and (iii) indirect liquidity costs.

Third, performance measures used in setting the compensation pool may not capture all the risks being undertaken; therefore, further *ex ante* adjustments should include consideration of severe risks or stressed conditions (again, various *ex ante* adjustments are now necessary, and scenario testing would apply). Fourth, 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 *ex ante* 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. Ex ante qualitative risk adjustment

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.

Firms 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"). These records will indicate "how qualitative factors have been applied." Further, firms should be prepared to provide "further details" to the supervisor 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 minutes of compensation committee meetings to understand how the judgmental factors are applied in *ex ante* 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.

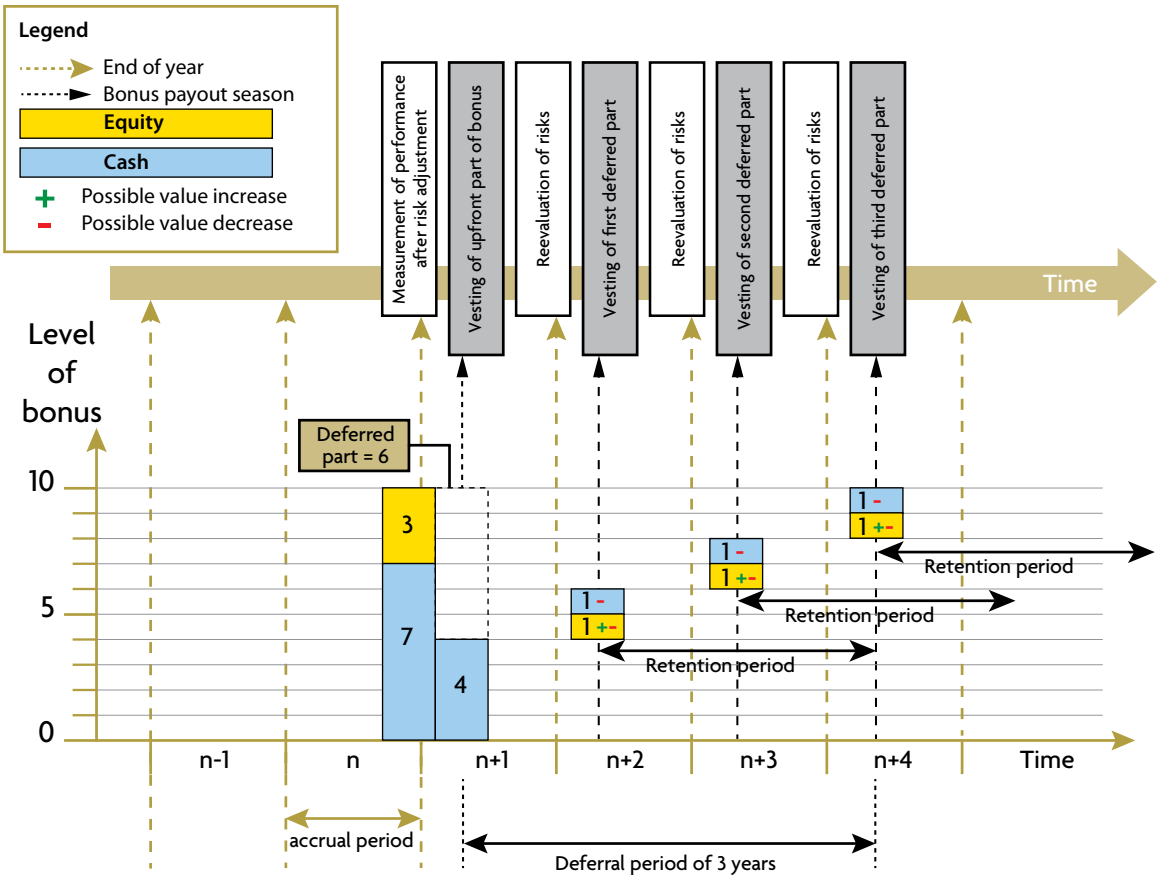
Figure 1: Deferral and Ex Post Risk Adjustment of Compensation

The following chart (see next page), published by the Basel Committee on Banking Supervision, in its consultative document entitled "Range of Methodologies for Risk and Performance Alignment of Remuneration" (issued last fall), illustrates the process of explicit and implicit *ex post* risk adjustments.

Designing a risk-adjusted deferred management compensation regime

The figure is dense, but reflects a schematic overview of an *ex post* (after the fact) risk-adjusted compensation regime instituted by a compensation committee. It includes the following key mechanisms:

- A deferral period of three years with yearly spreading;
- An explicit re-evaluation of risks by the compensation committee and recommended to the board prior to the cash and equity vesting to management (the "malus," in the white columns);
- A retention period of two years (otherwise known as a "hold" period, when shares and share-like instruments have vested to management, but payouts, transfer or exercising may not occur);



- A clawback (implied in the figure); and
- An implicit adjustment (see the green and red "+" and "–" symbols).

Therefore the elements of a defensible and robust risk-adjusted deferred compensation regime include the following:

i. The time horizon of the deferral (see "Deferral period of 3 years" in Figure 1, at the very bottom);
ii. The proportion of variable compensation being deferred (see the "Deferred part = 6" box in above figure, which indicates that 6 of 10 parts are now subject to the deferral regime);
iii. The speed at which the deferred remuneration vests to the executives (see the four grey columns in above figure);
iv. The time span from accrual until payment of the first deferred amount (see "Vesting of first deferred part" in the second grey column in above figure). The first vested amount should not occur sooner than 12 months after the accrual;
v. The form of deferred remuneration (see the "1" and "1" equal mix of cash and shares or share-linked instruments in each of the three small boxes to the right, which sum to the six deferred parts from [ii]);
vi. The nature of the *ex post* adjustments (implicit and/or explicit, malus and/or clawback) and their conditions/triggers (see "Measurement of performance after risk adjustment" and "Reevaluation of risks" in white columns in Figure 1); and
vii. The existence and duration of transfer restrictions (see "Retention period" in above figure). The transfer-restriction period (or retention period) is independent of the deferral period (in (i)) and should not be considered a substitute for a longer deferral period, for purposes of interpreting regulatory standards. The two periods accomplish different purposes.

Let's get back to items 3 and 4 of Table 1 (page 20).

3. Explicit ex post risk adjustment

Deferred cash and instruments should be subject to an explicit *ex post* adjustment, including back-testing of the underlying performance, possibly leading to a reduction in payout, as the outcomes of management's actions materialize. 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 *ex post* 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.

Similar to *ex ante* risk assessment, *ex post* 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 ex post adjustment

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 *ex post* adjustment is distinct from explicit *ex post* adjustment (item 3), which is defined as 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 *ex post* 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 pre-determined formula, qualitatively, or both.

Conclusion

The above approaches, complex as they seem, 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.

The drivers of the above reforms will have to be compensation committee chairs and committee members themselves, who understand the need for such approaches and commit to mastering these emerging standards. To implement such reforms, with board support and employment of their experience and judgment, they should retain independent, qualified compensation consultants and insist upon tailored, risk-adjusted compensation advice and reporting. Institutional shareholders would also be wise to consider this sort of explicit linking of risk and compensation, when assessing or voting upon compensation regimes.

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