SESSION 8.5

The Role of Equity in Risk-Balanced Compensation

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The Role of Equity in Risk-Balanced Compensation

Pay and Risk: A Hot Topic

- The financial crisis raised concerns that executive pay in financial firms can produce excessive incentives for risk taking
- Risk assessments of pay programs were first required in the US for TARP participants
- From 2009 pay and risk formed part of the UK FSA regulatory regime
- FSB guidance to regulators issued on pay and risk 8 December 2009
- Since then, a growing emphasis on pay and risk has developed beyond the financial services industry and is becoming a part of good governance for all companies
- Company management and compensation committees are struggling with what they might need to do
What We’ll Cover

• An overview of published guidance
• Our perspective on pay and risk generally
• The role of equity in risk-balanced compensation
• Alternative approaches to pay-risk assessments
• Key actions in a successful pay-risk assessment

US Guidance

• Obama administration and Treasury Department
• Both houses of Congress (Schumer and Frank bills introduced in 2009)
• Federal Reserve guidance for banks (October 2009) and in-process reviews of large bank compensation programs
• New SEC disclosure rules (December 2009)
US SEC Disclosure Rules

- Companies must disclose any compensation policies and practices that create risks that are *reasonably likely* to have a *material adverse effect* on the company.
- While the higher disclosure threshold relative to the proposed rules will catch fewer companies in its net, companies still need to *inventory and evaluate* all compensation plans annually to determine whether disclosure is necessary.
- The disclosure is part of the proxy, not the CD&A, so the responsibility to conduct the analysis falls with management, not the Board or compensation committee.
- Even if the threshold is not met, there is a separate disclosure required about the Board’s involvement in the risk oversight function, which might warrant a discussion of the connection between pay and risk.
- Similarly, compensation committees will need to determine the extent to which they focus on the connection between pay and risk taking as they make pay-decisions related to NEOs.

Other Guidance

- UK ABI Position Paper, 15 December 2009 – 6 risk references
- UK Corporate Governance Code, effective 29 June 2010 – 3 risk references
- CIPD Change Agenda Report, Risk & Performance
- Other FS Guidance:
  - Financial Stability Board principles and standards, 8 December 2009
  - And much else besides in all major jurisdictions:
    - The 24 major jurisdictions have all either regulated, introduced supervisory oversight/powers or are in the process of doing so, for:
      - The FSB 9 Principles; and
      - The FSB 15 Standards
- Basel Committee Guidance – January 2010
The FSB Thematic Review, March 2010

10 key recommendations including:

• Regulators and firms need to continue progress
• New international College of Supervisors proposed
• Supervisors should check expertise and independence of compensation committees
• Basel Committee should:
  • Consult by October 2010 on risk and pay, deferred comp and application to firms; and
  • By end 2010 consider equity disclosure on compensation within Pillar 3 of Basel II

FSB Thematic Review of Risk adjustment:
“much room for improvement” (March 2010)

• Many banks are still considering how to action the topic
• Various approaches have been seen
• Some use compensation committee discretion to risk adjust
• Others are more formulaic using economic capital or EVA
• Some ignore long-tail risks, but instead add ‘provisions’ for uncertainty and illiquidity
• Few calculate and risk adjust bonus pools below divisional level
• Trend is towards ‘more varied mix’ away from cash equity and options to more use of ‘equity linked instruments’
• And non-FS?
  • Largely nothing, aside from US listed disclosure preparation
Our Perspective on Pay and Risk

There are no prescriptive ways to structure a pay program so that it does not encourage excessive risk-taking. The specific design of the program depends on the business model, risk issues, job duties, governance system, expected returns, and the values of the organization and its employees.

<table>
<thead>
<tr>
<th>Potential Red Flags</th>
<th>Potential Mitigating Features</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries that do not cover living expenses</td>
<td>High levels of stock ownership</td>
</tr>
<tr>
<td>High short-term cash opportunity for employees who can harm business long term</td>
<td>Cash bonus paid in stock or with malus clause</td>
</tr>
<tr>
<td>Steep incentive curves and uncapped payouts</td>
<td>Goal setting in line with reasonable expectations</td>
</tr>
<tr>
<td>Totally formulaic awards and unrealistic goals</td>
<td>Deferrals in line with risk tail</td>
</tr>
<tr>
<td>Payout timing not aligned with risk tail</td>
<td>Performance metrics that reflect quality of earnings</td>
</tr>
<tr>
<td>Performance metrics that do not reflect sustainability</td>
<td>Strong governance and/or ERM system</td>
</tr>
</tbody>
</table>

Our Perspective on Pay and Risk (cont’d)

- Risk-taking, intrinsic to all businesses and a paramount element of financial services businesses, should not be eliminated but rather understood, managed, and appropriately encouraged and rewarded
- Each company must determine the level of risk and expected return it is comfortable with in its various functions and lines of business
- Effective risk management requires a thorough understanding of the company’s risks, controls, and governance – at corporate and business units – all embedded in the culture and reinforced by the pay system
- The pay component of an effective risk management system is a structure of rewards – not only for senior management but also for employees throughout the organization – that encourages acceptable risk-taking and high performance through optimal pay mix, performance metrics and calibration, and timing
- Incentives should balance the encouragement to take appropriate risk with the temptation to take excessive risk
The Role of Equity in Risk-Balanced Compensation

- In many respects, equity has many features that are favorable from a risk-management perspective:
  - Long-term perspective:
    - Performance period
    - Retention period
  - Metrics – stock price, possibly total shareholder return – typically reflect
    - Corporate performance
    - Quality of results
  - Mix of a variety of long-term vehicles can meet different objectives and provide balance
  - Stock ownership retains tie to corporate performance
  - If pay annual bonus in stock, provides an inherent “clawback” feature – if annual performance is unsustainable, will impact stock price
  - Program administered and controlled by corporate (Compensation Committee)

The Role of Equity in Risk-Balanced Compensation (cont’d)

- But equity is no panacea:
  - Appropriate to have balance of components: fixed/variable; annual/long-term; cash/equity
  - Also appropriate to balance corporate vs. division/individual performance measures
  - Equity is potentially problematic too - e.g. may encourage short-term stock price rises which are captured via executive’s option exercise
  - Long-term performance share plan can have the same issues as annual incentives - e.g. pay-performance calibration; payout cap; overlapping cycles
  - Look at AIG’s Financial Products unit and Lehman’s executives: multi-millions of stock did not discourage risk-taking (or bad decisions)!
  - Need to look at pay programs holistically, not just isolated components, such as equity
The Role of Equity in Risk-Balanced Compensation (cont’d)

• FSB Thematic review notes issues with equity for FS:
  • Dilution is an issue
  • Upside inherent in ownership right, may increase gearing effects overall
  • Use of ‘Equity based’ instruments beginning, but hazy on what this might mean
  • Notes the personal ‘non alienation and non-hedge’ rules in some jurisdictions, but far from universal application

Alternative Approaches to Pay-Risk Assessments

A. Incentive Plan Checklist Risk Assessment
   - Identify features of selected incentive plans that may drive inappropriate risk taking based on their design or governance parameters
   - Can be done collaboratively, led by consultant or client
   - Direction to client about areas for further review and analysis

B. Incentive Plan Risk Audit
   - Identify features of incentive plans that may drive inappropriate risk taking based on a comprehensive review of incentive design and governance features as well as historical payouts
   - Results in a score for each plan that helps to prioritize areas for further review

C. Strategic Compensation Risk Assessment
   - Identify risks in each business unit and map back to positions and incentive plans; consider risk management mitigators
   - Reflects understanding of pay program links to business model and risk management program and relative risk of all business functions and related positions
   - Can be done collaboratively with client’s or our ERM resources
A. Incentive Plan Checklist Risk Assessment
Pay Philosophy and Structure

<table>
<thead>
<tr>
<th>Element</th>
<th>Considerations</th>
<th>Client’s Plan Rating</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Philosophy</td>
<td>Pay objectives contemplate how programs may encourage risk taking</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Fixed vs. Variable</td>
<td>The mix of pay between fixed and variable is balanced appropriately to neither discourage proper risk taking (through too much fixed) nor encourage excessive risk taking (through too much variable).</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

B. Incentive Plan Risk Audit
Approach to Assessing Pay and Risk
Our approach and model includes a Scorecard that evaluates each individual sales incentive plan

<table>
<thead>
<tr>
<th>Plan Name:</th>
<th>Corporate Finance SICP</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Unit:</td>
<td>Corporate Finance</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assessment Category</th>
<th>Significance</th>
<th>Score</th>
<th>Weighting</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incentive Design</td>
<td>These factors assess the degree to which selected plan design feature affect risk-taking</td>
<td>13.3%</td>
<td>30%</td>
<td>Red</td>
</tr>
<tr>
<td>Stg. Alignment and Goal Setting</td>
<td>These factors assess the alignment of the plan metric with enterprise strategy and the degree to which realistic goals can be set.</td>
<td>23.3%</td>
<td>30%</td>
<td>Red</td>
</tr>
<tr>
<td>Pay Opportunity</td>
<td>These factors consider the degree to which competitive compensation data was used to establish overall pay opportunity.</td>
<td>6.7%</td>
<td>15%</td>
<td>Red</td>
</tr>
<tr>
<td>Process</td>
<td>These factors consider the checks and balances in the sales or post award approval process.</td>
<td>30.0%</td>
<td>25%</td>
<td>Orange</td>
</tr>
<tr>
<td>Monitoring</td>
<td>These factors consider whether the company is administering and monitoring an appropriate number of plans.</td>
<td>100.0%</td>
<td>5%</td>
<td>Green</td>
</tr>
<tr>
<td>Administrative</td>
<td>These factors consider the degree to which plan information is documented and reviewed for legal implications and that plan calculations are automated.</td>
<td>13.3%</td>
<td>5%</td>
<td>Red</td>
</tr>
</tbody>
</table>

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<tr>
<th>Modification Category</th>
<th>Significance</th>
<th>Score</th>
<th>Modifier %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Characteristic</td>
<td>These factors take into account the impact of the overall size of the business relative to other businesses on the plan assessment, along with the ERM risk assessment for the business.</td>
<td>9</td>
<td>4.0%</td>
</tr>
<tr>
<td>Incentive Plan Characteristic</td>
<td>These factors consider the impact of the overall size and payment volatility of the plan that is being assessed.</td>
<td>6</td>
<td>4.0%</td>
</tr>
</tbody>
</table>
C. Strategic Compensation Risk Assessment

**Business Risk Context Enables a More Robust Pay Risk Assessment**

- **Analysis of Business Model**
  - Understanding the business model and risk management program

- **Analysis of Risk Management Program**
  - Prioritization of Businesses and Positions
    - Ranking business segments and functions/positions according to level of risk and magnitude of potential loss

- **Risk Analysis of Pay Plans**
  - Ensuring that pay plans in high priority business segments and functions do not encourage excessive risk-taking

- **Change Plan**
  - Determining changes to plan design and/or governance to prevent excessive risk-taking

Activities may already be under way through company’s risk management function.

**Incentive Plan Checklist Risk Assessment**

**Pay and Risk Management**

A well constructed compensation program should:

- Encourage and not discourage appropriate risk taking
- Discourage and not encourage excessive risk taking

**Company XYZ’s compensation programs appear to:**

- Not encourage, and moderately discourage, excessive risk taking
- Not encourage, in fact discourage, appropriate risk taking

**EXAMPLE**

<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Encourage</th>
<th>Discourage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excessive</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Appropriate</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Excessive</td>
<td>No</td>
<td>Somewhat</td>
</tr>
<tr>
<td>Appropriate</td>
<td>No</td>
<td>Yes</td>
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</table>
Key Actions in a Successful Pay-Risk Assessment

1. **Assemble a multi-functional team** – including HR, risk management, finance, legal, and business leaders. The Board and compensation committee must determine their level of involvement.

2. **Prioritize the Oversight** – inventory pay plans and identify those that relate to the highest-risk businesses and positions, which should be monitored most closely.

3. **Pay Philosophy Should Consider Risk and Seek a Balanced Structure** – In most situations, avoid the extremes: balance fixed and variable pay, cash and equity, short- and long-term incentives, and corporate, business unit and individual performance goals.

4. **Address Plans With Red Flags** – look for red flags, such as very steep incentive curves, uncapped payouts, totally formulaic awards, and misaligned timing of payouts; and consider risk mitigating features, such as clawbacks, bonus banks/deferrals, and shareholding requirements.

5. **Get Performance Metrics Right** – reflect risk and use of capital, quality and sustainability of results, and employee line of sight.

6. **Define pay plan governance processes** – clearly define oversight roles throughout the organization to ensure that pay plans are aligned with business goals and risk tolerances, stress tested under realistic assumptions, and balanced between corporate standards and business-unit autonomy.

Is it all worthwhile?

**A TRAGEDY OF HUBRIS AND NEMESIS**

*By John Gapper*

FT.com comment

“In Greed and Glory on Wall Street, Ken Auletta’s book about the last time Lehman Brothers collapsed, in 1984, Richard Fuld appears as the fierce, proud…"