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The risk that lies within

Compensation risk reviews can unearth unintended risks and areas in need of attention

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One of the issues the recent financial crisis highlighted for many people was that ill-designed executive compensation programs can lead to inappropriate risk-taking by executive teams, causing catastrophic losses for an organization and its shareholders.

"Ill-designed" here refers to a level of risk, embedded in an executive compensation program, that is outside of an organization's risk appetite.

Regulators reacted by mandating that publicly listed companies include, in their proxy circulars, disclosure around compensation risk analysis.

In 2012, the first year companies had to disclose this information, 53 per cent of companies said they completed a comprehensive review, 46 per cent referenced the review and one per cent did not mention the review, according to our research.

The intricacies of evaluating the quantitative elements of compensation design and qualitative opinions of human behaviour are challenging. Specifically — as stated in the *Notice of Request for Comment – Proposed Amendments to Form 51-102F6 Statement of Executive Compensation and Consequential Amendments* from the Canadian Securities Administrators (CSA) — companies that have completed a risk analysis will be required to disclose:

- the nature and extent of the board's role in the risk oversight of compensation policies and practices
- any practices used to identify and mitigate compensation policies and practices that could potentially encourage a named executive officer (NEO) or individual at a principal business unit or division to take inappropriate or excessive risks
- identified risks arising from policies and practices that are reasonably likely to have a material, adverse effect on the company.

HR's role

Heads of HR at publicly listed organizations have likely seen their role redefined to become more collaborative with various functional areas of the organization. The one area where the role has changed significantly is in the drafting of a portion of public disclosure documents — the Compensation Discussion and Analysis (CD&A) section of the proxy. But knowing what needs to be done, and how, can be challenging.

A good place to start is with financial institutions since they were at the core of the financial crisis. Consequently, via the Financial Stability Board (FSB) based in Basel, Switzerland, they helped draft the foundational roots of principles and standards on responsible executive compensation in an effort to preserve the banking system.

The FSB was established to co-ordinate, at an international level, the work of national financial authorities and international standard-setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.

There are nine principles outlined for sound compensation practices, each of which is subject to a series of substandards. These principles can be categorized as:

Evaluation and oversight (principles one to three): These outline that a board has an active role in overseeing material compensation plans and ensuring plans are acting as they intend by design, as well as stating that functional management roles such as audit and HR should be independent, have appropriate authority and be compensated independent of the business areas they oversee.

While boards have taken a more active role in overseeing material compensation plans, functional roles are not being compensated independent of the business areas they oversee.

Evaluate compensation practices for excessive risk (principles four to seven): These identify that: compensation be adjusted for all types of risk and be symmetrical with risk outcomes; compensation payout schedules align with the time horizon of risks; and the mix of cash, equity and other forms of compensation align with risk.

Evaluating material compensation plans for risk is an involved process. Categories of risk to look at include strategic, financial, human capital, reputational, operational and compliance-based.

Take, as an example, a CEO who executes a major acquisition of a decommissioned manufacturing facility, essentially doubling the forecasted size of the organization's future revenue. This activity results in a significantly positive gain in the share price, based on the notion of the expected future cash flows it will generate. The CEO feels she should receive a special recognition bonus in cash for leading such a game-changing deal and she iterates clearly she will be "out the door" if not given a significant cash award.

But the board is reluctant to pay a significant cash award because, on the one hand, the CEO has delivered significant value to shareholders in the short-term and is deserving of something but, on the other, there's a risk the reopening of the manufacturing facility could fall behind schedule in the future.

This would have a negative impact on share price and engender the risk that estimated revenue levels could fall short of the company's forecasted earnings.

This abbreviated example underscores that even the most basic organizations are subject to the same categories of risk as large, integrated financial institutions, and executive compensation can and should be evaluated and designed to account for all types of risk.

Evaluate transparency and disclosure (principles eight to nine): Highlight the need for ongoing, rigorous supervisory reviews of compensation practices, affirmative action when deficiencies are identified and public disclosure that is clear, comprehensive and timely.

Given the sensitivity of evaluating the alignment of the compensation policies and practices of material compensation plans with an employer's risk appetite, many boards commission this review to be conducted by a third party — and progress is being made on this front.

For example, an executive team's long-term incentive award historically took the form of either plain, vanilla stock options or restricted share units.

Now, more companies are granting total long-term incentive opportunities using multiple forms of vehicles, including performance share units, which further enhance the alignment of executive pay for performance and aim to mitigate compensation risk due to the added layer of achieving a specific level of future performance.

Directors of publicly listed organizations are under more pressure to comply with regulatory standards than ever before. Adding to the regulatory compliance environment are shareholder activist groups that annually publish a series of voting guidelines on how they will vote on specific compensation practices.

By virtue of these changes happening at the board level, there is a cascading effect that impacts management and its role in providing the required materials to keep an organization onside.

This year, as individual director voting becomes the new norm in Canada, directors find themselves exposed to a level of risk that traditionally wasn't there because boards typically were voted in by a slate format.

Directors do not want to be voted off the board for being viewed as acting as a poor director. While that presents a slightly different risk than compensation risk reviews, it warrants mention as a reputational risk — one that is real not only amongst directors but the management team as well as the corporate brand.

Compensation risk reviews go beyond a normal incentive design or compensation review project typically performed by a compensation committee. Risk reviews dig into the DNA of a plan, an organization and the governance surrounding these key areas.

And while they may unearth important, unintended risks that have seeped into compensation plan design, they also identify areas that require immediate attention before the potential risk is exposed, causing material implications for the organization and shareholders.

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