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Meridian Client Update

Compensating to Manage Risk: Paying for Prudent Performance

By Christina Medland

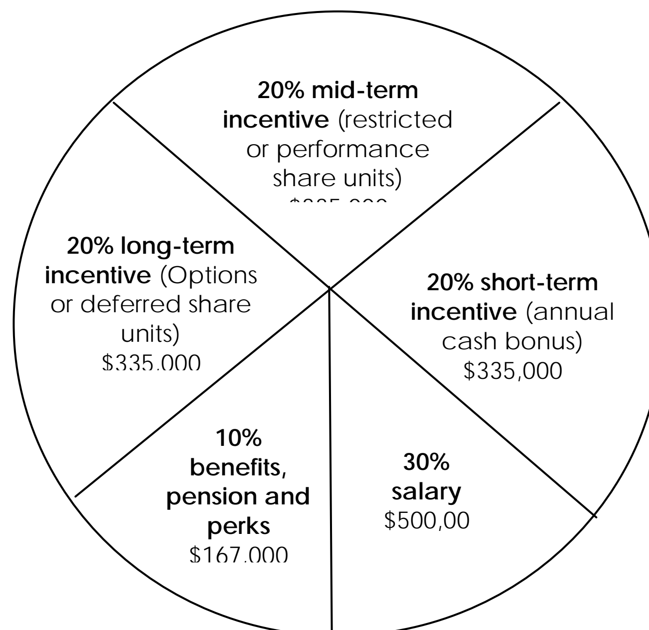
The recent financial crisis has put "pay for performance" under the microscope. Many believe that compensation programs that focus on short-term profits without regard to risk and stock options and that encourage volatility rather than value were partly responsible for the financial crisis. Companies, particularly financial institutions, are reviewing their compensation programs and facing the difficult task of ensuring that their compensation programs reward performance but penalize excessive risk taking.

Genesis of Compensating Risky Behaviour

Compensation programs have been changing in response to increased shareholder focus on pay for performance, quantifiable metrics and discipline in the design of compensation plans. As a result, complex, cash and share-based compensation programs with performance metrics have emerged.

Typical Executive Compensation Package

The current C-suite executive compensation package, assuming target performance, looks something like this:



At target performance total compensation is $1,672,000 and compensation at risk is just over $1,000,000. This package provides all the elements shareholders expect – pay at risk, retention features and alignment through share-based incentives.

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Flaws in Current Compensation Packages

Compensation programs create a strong incentive to achieve maximum performance goals (a laudable incentive), which can exponentially increase compensation. Executives are significantly rewarded for home runs and not equally penalized for strikeouts. This breeds a "swing for the fences" mentality, which can lead to excessive risk taking.

The primary reasons for this are

- **the nature of awards and excessive leveraging;**
- **lack of discipline in setting targets and assessing performance;**
- **failure of incentive plans to match timing of payouts with risk realization;**
- **failure to integrate risk into incentive plans.**

Nature of Awards and Leveraging

The two most common forms of share-based compensation in Canada are stock options (Options) and Performance Share Units (PSUs). Options are, by their nature, a form of compensation that encourages risk taking. One of the key factors in the value of an Option is share price volatility. The greater the volatility, the higher the Option value. Furthermore, Options usually vest over a fairly short period (3 to 4 years), but are exercisable over a longer period of time (often 10 years). This allows the holder to choose a time when there is a short, high spike in share price to exercise and maximize the holder's value, without achieving sustained value for shareholders. This disconnect with shareholder value is exacerbated because most Options are exercised and the underlying shares sold immediately. Many companies were moving to require that shares underlying Options be held for a period of time following exercise or cessation of employment. The March 2010 federal budget, which imposed tax when Options are exercised rather than when the underlying shares are sold, will likely limit this good practice.

PSUs are structurally suited to providing pay for prudent performance and are the form of share-based compensation currently most favoured by shareholders. PSUs create alignment with shareholders because each PSU represents the value of one share of the company, including the right to the benefit of dividends. In addition, PSUs vest to the extent that performance targets are achieved. Commonly, PSUs have either a vesting "hurdle" (i.e., they do not vest unless a minimum EBITDA target is achieved) or a vesting multiple (e.g., below threshold performance 0% of PSUs vest; at threshold performance 50% of PSUs vest; at target performance 100% of PSUs vest; and at maximum performance 150% of PSUs vest).

PSUs can fail to motivate prudent performance if they are too highly leveraged. This happens if there is a significant vesting multiple (e.g., 200% of PSUs vest on above-target performance) and there is downside protection (e.g., a minimum of 50% of PSUs vest regardless of performance).

Lack of Discipline in Setting Targets and Assessing Performance

Targets that are too easy to achieve, particularly if they differ in quantum or substance from business plan targets, can result in plans with little downside and excessive upside for executives. A lack of discipline in anticipating payment levels under the plan at expected performance levels based on the business plan may result in overcompensation or a disconnect between business objectives and payments under the plan. Employment contracts, principles of constructive dismissal under Canadian employment law and board reluctance to penalize executives can, in practice, create a minimum payout or "floor" – effectively reducing compensation actually at risk for poor performance without a corresponding ceiling for above-target performance.

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Failure of Incentive Plans to Match Timing of Payouts with Risk Realization

The timing of annual payouts under cash bonus plans and the three-year deferral limitation under Canadian tax laws for most restricted share unit plans may mismatch payment and the period of risk. Accelerated vesting (often assuming target performance) on cessation of employment or a change of control may also disconnect the time of payout from the time of risk realization.

Poor analysis of expected results may result in plans that overcompensate for moderate performance. Cash plans are not naturally aligned with shareholder interests and so are very sensitive to the particular targets chosen. More quantitative, automatic plans can grossly overcompensate or undercompensate executives. However, adding a discretionary element tends, as a matter of human nature, more often to create a compensation floor than a ceiling.

Failure to Integrate Risk into Incentive Plans

Most compensation plans do not factor risk into the plan. In practice, this means that there is no penalty if a good result is ultimately achieved, even if achieving the result exposed the company to a high level of risk. In addition, the reward paid to an individual who achieves a good result without excessive risk taking is usually no greater than the reward paid to the individual who achieves the same result while exposing the company to great risk. Traditionally, risk has been a separate matter dealt with by the compliance or audit function. The lack of express consideration of risk in compensation plans is exacerbated by a timing mismatch between the achievement of the result and the materialization of the risk.

To take a simple example from the financial services area, assume Employee A grants – with income checks – mortgages of $1 million that do not exceed 50% of the value of the underlying property; Employee B grants – without income checks – mortgages of $1 million that equal 90% of the value of the underlying property. A typical bonus program would be based only on the value of mortgages granted ($1 million in each case). The risk component of the business would be dealt with by compliance and approval processes that do not approve high-risk mortgages. The lack of integration between bonus and risk level encourages employees to maximize the dollar value mortgaged, limited only by the need to meet compliance and approval requirements. There is no incentive to grant less risky mortgages and the consequence for granting risky mortgages is often not realized until a default many years after payment of the associated incentive amount.

Financial Stability Forum Principles for Sound Compensation Practices

The need for compensation programs to account for excessive risk taking started with financial institutions and was brought to the forefront by the Financial Stability Forum (FSF), which introduced Principles for Sound Compensation Practices (Principles) in April 2009. This was followed by Implementation Standards in September 2009.

The FSF Principles set out the following key requirements for financial institution compensation programs:

- **The board must actively oversee the compensation system's design and operation.**
- **The board must monitor and review the compensation system to ensure it operates as intended.**
- **Staff engaged in financial and risk control must be independent, have appropriate authority and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.**
- **Compensation must be adjusted for all types of risk.**
- **Compensation outcomes must be symmetric with risk outcomes.**
- **Compensation payout schedules must be sensitive to the time horizon of risks.**

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- **The mix of cash, equity and other forms of compensation must be consistent with risk alignment.**
- **Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.**
- **Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.**

The Principles recognize that financial institution "risk has become more multi-dimensional and complex and the array of means of taking risk has grown large." This broad risk focus makes the Principles applicable to almost all types of enterprises, not just to financial institutions.

Compensation Programs That Encourage Prudent Performance

The key to encouraging prudent performance is to integrate prudence into the structure of incentive plans so employees will strive for prudence rather than only to meet compliance and approval standards.

To use our mortgage example, the program would pay a higher bonus percentage for low-risk mortgages. This would provide a definitive reward for and encourage prudent performance.

Clawbacks

Currently, to the extent that incentive programs deal with risk, this is done by requiring the employee to repay bonus amounts that later turn out not to have been earned. These clawbacks are generally limited to situations in which a material misrepresentation results in a restatement of the company's financial statements. Clawbacks are not generally triggered by the materialization of a business risk.

The difficulties with using solely a clawback mechanism to deter excessive risk taking are the following:

- **A clawback does not encourage prudent performance. It punishes after the fact, which, perversely, can increase business risk by deterring disclosure, a situation that might result in the application of the clawback.**
- **Expanding the clawback to deal with excessive risk taking is difficult because the focus needs to be on risk-taking behaviour rather than on an occasional unexpected poor result.**
- **A clawback forces the company to recover funds from the employee, which is legally and practically difficult. Courts are unlikely to enforce clawbacks unless they are clear and unambiguous. Moreover, the company will need to incur legal and other costs to recover incentive amounts, and the employee may no longer have the funds to repay the amount.**
- **Dealing properly with taxation of a clawed-back bonus is complex.**

Timing Payment to Coincide with Risk Realization

Synchronizing the timing of payment and risk realization is the easiest method of discouraging excessive risk taking. Several techniques can achieve this:

- **Payment of incentives based on results net of realized risks, with payment deferred until the associated risks have been realized. This provides for an integrated result and risk-based incentive.**
- **Payment of incentives based on results, with payment held in escrow until the end of the risk-realization period. However, it can be complex to assess the effect and quantum risk and properly define the risk-realization period.**
- **Payment of incentives in the form of share-based compensation, with the shares held in escrow until the end of the risk-realization period. This allows share price to be a proxy for the real cost of realized risk, which can materially simplify the plan.**

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Incentive plans with payment deferred until the end of the risk-realization period can also be used as retention plans. These plans can still compensate short-term results (i.e., a series of annual grants will, over time, lead to an annual series of payments), but with payments delayed.

The same alignment of the timing of incentives with realization of risk can be achieved through longer vesting periods for Options (e.g., vest one-third at the end of each of the third, fourth and fifth years) and impose post-exercise hold periods for shares underlying Options (but this now creates tax issues for the optionholder). In addition, the following more shareholder-favoured incentives can have longer tax deferral periods if properly structured: grants of restricted stock, performance-contingent PSUs (which are subject to a material risk of no payment), deferred share units and treasury issuance restricted share units. The longer tax deferral allows these plans to match time of payment to the risk-realization period, provide alignment with shareholders and provide awards that inherently take risk into account.

Combination Programs

Prudent performance is encouraged by the current practice of providing incentives that cover different time periods (i.e., annual, mid- and long-term incentives) and that include performance-focused cash incentives and share-based compensation. Further, taking the lead from private equity investors by requiring senior executives to make and maintain a personally meaningful investment in the company helps to ensure that employees are not taking excessive risk. Employees who feel like owners are likely to factor risk levels into their decision making. This alleviates some of the need to determine how to measure risk in advance.

Thoughtful Plan Set Up, Careful Monitoring

The area of biggest concern in incentive plans may be in the rigour applied to setting them up. It is not uncommon for the targets used for incentive plans to be different from or determined on a different basis from the targets in the company's business plans or for threshold, target and maximum incentive plan performance levels to be different from those used in the business plan.

The Compensation Committee or board must be rigorous in several key areas:

- **Establishing plan terms, set up and targets.**
- **Assessing expected payout levels.**
- **Monitoring performance against expectations and financial realities.**
- **Correcting errors.**
- **Having the courage to exercise discretion in both directions (increase payments when a plan does not generate a payment in deserved circumstances and decrease payments when the plan terms provide for overpayment). Allowing discretion requires real trust between the board and the executives, because the flexibility must be in the plan, and with it comes the risk that the board may reduce compensation even when targets are met.**
- **Ensuring that excessive risk taking is factored into payments under the plan. This includes the tougher exercise of identifying this behaviour in the context of the business, so it can be reflected in the structure of the plan.**

Even thoughtful plans can falter if the termination and change-of-control provisions accelerate vesting or deem performance at target because this can create a mismatch between the time of payment and the realization of risk, so the plan no longer deals appropriately with excessive risk taking.

Challenges of Implementing Pay for Prudent Performance

Paying for prudent performance is obviously desirable, but there are hurdles to implementing this, particularly if executives perceive that they are likely to be paid less or must meet additional performance hurdles in order to be paid.

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To surmount these hurdles, the goal of these plans should not be to reduce compensation but to pay compensation, in part, for the achievement of goals that reduce the risk to the business. This is similar to the current practice of many mining companies that include environmental and occupational health and safety performance (key risk elements of the business) as components of their incentive programs.

It is also difficult, as the economy recovers and as executive mobility increases, for companies to take the lead on this issue. Thanks partly to the FSF Principles, a shift in market practice is starting, which will mitigate, somewhat, the first mover disadvantage to introducing pay for prudent performance.

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