

# How Well Do You Understand The Relationship Between

# PAY & RISK

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## QUICK LOOK

- ➔ The financial crisis raised two issues in the area of reward and risk: Was there too much risk inherent in business models and consequently too much risk inherent in the pay model?
- ➔ Solutions intended to limit executive compensation excess and reduce business risk have unintended consequences.
- ➔ If the business model is flawed and too risky (or too conservative), the pay model may only exacerbate the resulting problems.

The financial meltdown of 2008 and early 2009 raised questions on pay and risk, especially whether executive compensation plans that encouraged executives to take too much risk caused financial problems. The Obama administration and Congress are aiming at this issue and propose rules preventing excessive risk-taking. The rules under the Troubled Asset Relief Program (TARP) call for an expanded review of compensation arrangements for “unnecessary and excessive risk.” These rules require institutions to review



and disclose the reasons for the design of their compensation programs for senior executives and other employees so the plans do not encourage excessive and unnecessary risk-taking.

The pay programs of the financial services industry produced huge payouts, but most firms paid bonuses one-half in cash and one-half in restricted stock (with three- to five-year vesting). As most of these financial companies required executives to hold the stock, the executives suffered large losses when the market declined significantly in first quarter 2009.

The financial crisis raised two issues: Was there too much risk inherent in the business model (especially with financial firms) and consequently too much risk inherent in the pay model? Looking back, although many believe that the compensation plans encouraged executives to take on too much risk, even with today's 20/20 vision, questions still remain:

- How do we define risk, and how much of it is excessive?
- Don't we want executives to take some risk to deliver above-average results?

- Did current pay plans encourage executives' excessive risk-taking? (Did the desire to "beat the performance of the peer group" distort management's short- and long-term views and development of a unique business model versus the lemming tendencies of follow the leader?)
- What is the relationship between pay and risk now, and what should it be going forward?

### What Is the Definition of Risk?

To determine if compensation encouraged excessive risk, we need to understand the definition of risk

and how short-term and long-term incentives were used to mitigate or encourage executive risk-taking.

A company's risk is mainly composed of financial risk and business risk. Financial risk is mainly linked to the level of debt, and business risk is mainly linked to the company's industry and the overall economic climate. If a company is entirely financed by equity, it would pose almost no financial risk, but it would still be susceptible to business risk or changes in the overall economic climate. For companies operating in the financial services industry, systemic risk is another risk in place

and is defined as a collapse of an entire financial system or a single market (for example, the Icelandic banking system).

Executive pay is primarily delivered through various company stock plans. How accurately does stock price reflect the company's financial and business risk? The efficient-market hypothesis (EMH) asserts that prices on traded stocks already reflect all known risks, and instantly change to reflect new information. Privately owned companies use a more formulaic approach based on accounting statements. However, the financial crisis showed everyone that stock prices and accounting measures do

TABLE 1: TYPES OF RISKS AND THE IMPLICATIONS OF THE TWO MAJOR PAY ELEMENTS

Type of Risk	Definition	Annual Incentives	Long-Term Incentives
Financial	Financial risk is the additional risk a shareholder has when a company uses debt in addition to equity financing. The more debt a company has, the higher its financial risk because more cash flow is needed for interest and principal payments and less is available for investment and dividends.	To ensure that managers deliver on the company's operating plans, most organizations use internal earnings versus budget or other lagging indicators that are captured by their financial reporting system. However, return on invested capital is better as a measure as it reflects return on total capital, which includes debt. Another method is using economic profit (economic value added) but it is not widely used due to its complexity.	To correct for the owner vs. manager conflict of interest, managers receive grants of equity-related rewards that are tied to the share price. For the long term, the impact of leverage and excessive risk is reflected in the stock's price, as per the EMH. Thus, the use of stock options and restricted stock should encourage executives to limit risky behavior — otherwise the stock price will drop.
Business	Business risk is defined as internal or external factors affecting the business, and is also known as operational risk. An example of an external factor is the economy. Internal factors like declining sales may be due to a weak salesforce. Restructuring the sales effort will reduce this risk.	From an operational perspective, organizations usually structure their annual incentive plans to address the most important business issues and risks, from increasing sales to improving customer service and manufacturing efficiency, which would act as leading indicators and help balance financial metrics, which measure after-the-fact results.	Again, from the long-term perspective, the theory is that the performance of the business and the risk of nonperformance are eventually reflected in the stock price and the company earnings. But in the real world it is often about using multiple measures to ensure balance and good judgment — and there is no "one size fits all" measure.
Systemic	This is risk that the entire financial system or market will collapse as a result of a catastrophic event. An example of systemic risk is 9/11, or the banking crisis in Iceland where all lines of credits to the major banks were cancelled in a very short span of time-causing all liquidity to dry up.	Cash on hand is perhaps the best way to protect your organization from this risk. For example, Warren Buffet keeps considerable cash on hand and has a rule not to allow his cash to drop below \$10 billion. He feels this will enable him to survive a catastrophic event.	The stock price, in theory, reflects all available information. Some highly leveraged firms were caught in a bind as they did not have enough of a cash cushion as the financial system shut down. Although systemic-risk events rarely occur, as we have recently seen, they do happen and all firms, especially financial firms, need an adequate capital cushion to withstand such an event. Financial firms that are exposed to systemic risk need to stay out of some risky businesses — the capital-cushion requirement will be too expensive to maintain. This is where government guidance and regulation is required.

If goals are too **easy**, an undeserved windfall is generated. If goals are too **stringent**, then good performance can go unrecognized.

not always reflect the amount of financial and business risk in a company.

Table 1 on page 40 shows the types of risks and the implications of the two major pay elements where annual incentives focus on tactical goals and the long-term incentives focus on strategic objectives.

### Animal Spirits: Executives Must Take Some Risks to Succeed

Back in 1936, the famous economist John Maynard Keynes wrote about human nature and the tendency for men to take risk in *The General Theory of Employment, Interest and Money*. In this writing he said, “Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits — a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.”

Government regulations are designed to prevent animal spirits from getting out of control. For example, under President Theodore Roosevelt, corporate trusts and monopolies were broken to encourage competition and prevent price gouging. The current administration has proposed increasing regulations for banks and hedge funds to prevent another financial crisis and

it has also proposed compensation rules preventing executives from taking excessive risk. How do you do this, and is it feasible? While no easy answers exist, here are a few suggestions.

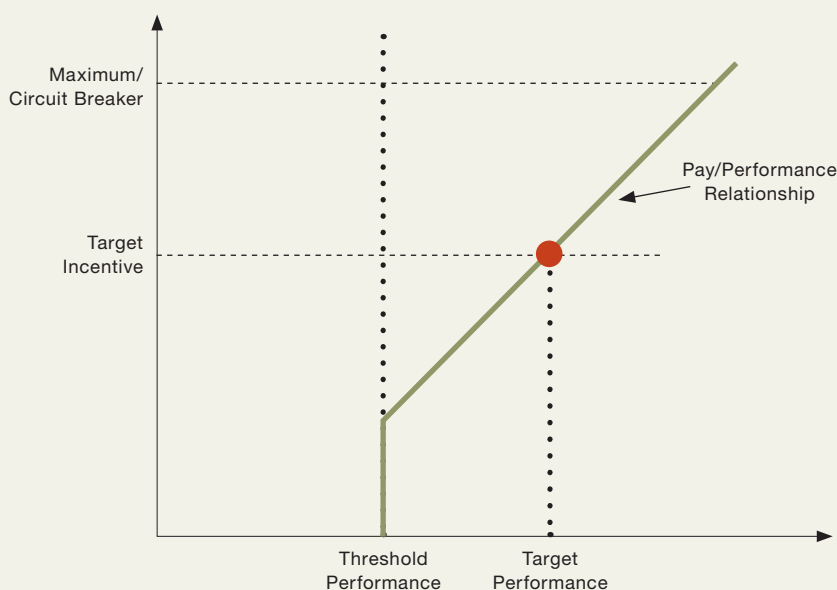
### Compensation and Excessive Risk

Until recently, most compensation experts felt they had a good understanding of the relationship between pay and risk. They used each pay element — base salary, annual incentives and long-term incentives — to balance the risk-adverse desire to “keep your job,” and

balance year-by-year short-term performance with increasing the long-term value of the enterprise.

The typical incentive plan design illustrates the relationship between pay and performance above a minimum or threshold level of performance (See Figure 1.) Two factors significantly impact this line: the way goals are set (probability of achievement) and the amount of pay for each goal. If goals are too easy, an undeserved windfall is generated. If goals are too stringent, then good performance can go unrecognized.

FIGURE 1: THE RELATIONSHIP BETWEEN PAY AND PERFORMANCE ABOVE A MINIMUM OR THRESHOLD PERFORMANCE LEVEL.



One simple way to limit excessive pay and possibly excessive executive risk is a pay “circuit breaker.” In Figure 1 this is shown as the maximum level of pay for a specific level of performance. If a circuit breaker is in place, board approval is needed for any payout above this level. This simple provision helps prevent excessive pay, especially if poor goal setting produces a windfall and a vigilant board is in place. Most critics believe executive pay has gotten too high. A circuit breaker will help boards keep pay aligned with performance and allow for more discretionary decisions to be taken, such as dealing with an unintended rise in commodity prices that could impact stock prices.

To prevent an entitlement mentality, goals should be set according to probability-of-attainment guidelines. (See Figure 2.) Many firms use budget to set target goals; however, if the budget has an 80-percent to 90-percent probability of achievement, budget should be the minimum goal. Executives need to take some risks and incentives and should encourage and reward high performance. The process for setting goals is complicated, and firms use either a top-down approach led by the CEO or a bottom-up approach, where each division’s budget is rolled into a total company number. The company culture and its historical practices largely influence the approach used and how the final number is determined. It is ironic that executive

compensation is heavily dependent on pay for performance and yet the goal-setting process varies widely from company to company.

In terms of balancing the short-term tactics and execution with long-term strategy, a possible incentive-design feature is combining the executives’ annual incentive target opportunity and the target long-term incentive grants into a one-target reward opportunity. That incentive is then delivered in cash and equity-type vehicles in varying proportion depending on internal and external conditions. For example, when companies are short on cash, such as in a recessionary economy or new ventures, the company could deliver 30 percent in cash and 70 percent in restricted stock and, when conditions improve, shift the ratio to 50/50 cash and equity. In addition, the pay mix can also be adjusted

to changing external and internal conditions; for example companies with a long-standing culture of using stock options could introduce a full-value stock-type vehicle (restricted stock, etc.).

### Today’s Solutions to the Pay Problem Can Produce Unintended Consequences

Today’s solutions are intended to limit executive compensation excess and reduce business risk, but they have unintended consequences and may do little to reduce executive pay and executive risk-taking. Some consequences are reviewed in Figure 3.

### The Real Solution is Complicated

Executives and boards adopting a follow-the-leader strategy caused the current financial crisis. Everybody wanted to increase their exposure to

**FIGURE 2: GOALS SHOULD BE SET ACCORDING TO THE PROBABILITY OF ATTAINMENT GUIDELINES**

Goal	Probability of Attainment
Minimum/Threshold	80%
Target	50%-60%
Maximum/Circuit Breaker	20%

**FIGURE 3: SOLUTIONS AND UNINTENDED CONSEQUENCES**

Solution	Explanation	Unintended Consequence
Use a claw-back provision	Helps the company get pay back from executives in the event of fraudulent accounting.	This sounds powerful, but as fraud is rare, this rule does little to prevent high pay or excessive risk. However, if a portion of the bonus was set aside and banked until the performance could be confirmed, this might help executives manage risk.
Increase salaries and reduce incentive opportunity	Increases fixed pay and fixed costs. Currently many financial firms are considering shifting more pay to salaries, as salaries in this industry are very low and incentives high. This is also one way to address pay restrictions for TARP recipients.	As executives will get this regardless of performance, this will reduce risk only in cases where it represents less than 20 percent of total pay. If companies give more fixed pay, they need to offset this with a larger drop in at-risk pay.
Replace stock options with restricted stock	Outright grant of stock with time-based or performance vesting. Requires fewer shares than stock options (less dilution) and gives executives less upside.	Limits downside, as share price doesn’t have to increase for restricted shares to provide value. If the price drops, it’s a “we-win-you-lose” scenario.
Set performance relative to your peer group	Measuring how well you are doing (earnings, market share, return on invested capital) relative to your peer group.	What if the peer group is pursuing a risky business strategy? If you don’t follow it, you will underperform until the strategy fails. Companies need to do a better job of measuring performance on a risk-adjusted basis.

mortgages due to the low historical default rate. Companies that did not get into this lucrative business had earnings below their peer group. CEOs felt they had to get into this business, or their jobs would be in jeopardy.

Recent thoughtful research uses the Z-score to measure risk and the Z-score relative to the peer group to determine excessive risk. Banks use the Z-score as a measure to determine the bankruptcy risk of a client. Today, most banks use more complex models to measure bankruptcy risk, but both the Z-score model and today's complex models did not predict today's financial and economic problems.

Companies need to do a much better job of measuring performance on a risk-adjusted basis. No easy formula exists, as many factors must be evaluated. The following questions need to be honestly answered:

- What are the long-term risks to the profitability and viability of our business?
- Does the pay program measure and reward how executives respond to these issues, or is it an entitlement program to deliver pay “to retain key talent?”

Figure 4 illustrates how companies in the same business — peers — can have much different business models. While Firm A and Firm B both have a 2-percent return on equity, A has more debt and a higher profit margin.

This type of analysis can help companies and boards evaluate a company's risk and determine what performance measures to use to improve weak areas. For example, B needs to improve its profit margin and A, its asset turnover. Identifying these issues may lead to a more in-depth analysis of executive risk-taking relative to the business and pay model.

### Conclusion

Measuring the amount of executive risk-taking inherent in the pay model cannot be solved with one equation. Pay models are designed to support the business models, not the other way around. If the business model is flawed and too risky (or too conservative), the pay model may only exacerbate the resulting problems that will inevitably develop.

These general proposals should be considered to strengthen your compensation program and avoid generating excessive executive risk-taking:

- Governments, in any part of the world, should not try to regulate executive pay and executive risk-taking — the solutions are too complicated and will likely produce many unintended consequences. (Companies impacting the viability of our financial system require strong business-model regulation.)
- Do not always follow the peer-group leader in pay or in strategy.

Understand your organization's strengths and build a unique business and pay model on that platform.

- Use a circuit breaker to prevent windfall pay and to mitigate poor planning and goal-setting.
- Use probability of attainment, rather than budget, to set goals. Executives need to take risks and be rewarded for a successful performance.
- A company's stock price — in the long run — is the best measure of a company's risk, but many risk factors need to be considered by managers and the board of directors. WS

### ABOUT THE AUTHORS

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- Determining Pay For Executives (Competitive Market Pay) Seminar
- Principles of Executive Rewards Certification Course: C6.

FIGURE 4: HOW COMPANIES IN THE SAME BUSINESS HAVE DIFFERENT BUSINESS MODELS

	Firm A	Firm B
1. Profit margin (operating profit/sales)	30%	12%
2. Asset turnover (inventory/sales)	20%	36%
3. Return on assets (1*2)	6%	4%
4. Interest expense	5%	3%
5. Leverage (total assets/total equity)	2.00	1.50
6. Return on equity (3-4) * 5	2%	2%