Incentive Compensation - The White Swan in Risk Management

by Minaz H. Lalani

In his book *The Black Swan, the Impact of the Highly Improbable*, Nassim Nicholas Taleb describes three key attributes of a black swan event. First, it is an 'outlier' event, one outside the realm of regular expectations. Second, it carries an extreme impact. And third, because of its outlier status, human nature leads us to develop after the fact explanations for its occurrence, making it explainable and predictable. In my view, an event underlying incentive compensation ('Incentive Compensation event') has three entirely opposite attributes to those of a black swan event. Incentive compensation payout which is a consequence of the event (e.g., meeting or exceeding a performance threshold, or implementing a strategic objective) is in the realm of regular expectations since the payouts can be reasonably estimated, and the payouts are explainable and predictable *prior* to the event occurring (threshold targets are set at a level where the maximum payout is determinable). Interestingly, a black swan event results in extreme downside losses, whereas an incentive compensation event tends to result in massive upside payouts. Thus, incentive compensation events have opposite attributes to those of black swan events; from a risk management perspective, we can label incentive compensation as white swan events.

White swans are associated with peace, serenity and grace; in this essay, we will note that incentive compensation practices have been relatively unchanged *(peaceful and serene)*, and these practices have been *gracefully* accepted in the market place without much discussion. Here we will discuss incentive compensation within an enterprise risk framework. We will also discuss potential actions and responses to designing and implementing effective incentive compensation programs from a risk perspective.

Risk Framework

All enterprise risk management (ERM) frameworks have similar components. These components include setting risk appetite and risk policy, identifying, assessing and measuring risk, and reporting and monitoring risk measures. Risk management frameworks are usually well defined and structured; however, the framework applied to incentive compensation is implemented to identify risks that impact the achievement of enterprise objectives over a 1 to 2 year period. This means that risk events, which are not expected during this period, are excluded from analysis. This occurrence can be illustrated through the following workforce planning example. If an enterprise has key employees who are expected to retire during the next 5 to 9 years, the loss of these key employees would have a substantial impact on the enterprise. From an incentive compensation perspective we might well ask, should this risk be identified now? Intuitively, the time to act would be now, in the present. The correct solution would be to implement the following: an aggressive succession plan, mentoring and training of new key employees, and the transfer of knowledge and a job-shadowing strategy. However, the likely solution for most enterprises would be to defer any risk mitigation strategies for a later period, since the deterioration in the financial measures in the current period (for a risk event than will occur in 5 to 9 years) would translate into a potential reduction in incentive compensation today.

The board of directors (Board) are responsible for assessing the risk appetite and developing a risk policy. They are also responsible for ensuring that the enterprise's risk exposures are monitored and managed from a downside as well as an upside (opportunities) perspective. From an incentive compensation standpoint, the Board usually delegates its responsibility for compensation issues to the Human Resources Compensation Committee (HRCC) of the Board. In practice, the HRCC focuses on retaining management and key talent; therefore, incentives are significantly weighted towards short-term performance metrics, like Total Shareholder Return (TSR) or Earnings per Share (EPS). Incentive compensation payout for managing key risk categories (strategic, operational or human capital) are weighted to a lesser extent, and there is reduced focus on exceeding non-financial objectives, which could have material or increased risk exposure to the enterprise over the long run.

Risk management breakdown occurs because the HRCC does not effectively integrate strategic, operational and risk decision making processes into determination of incentive compensation. For effective risk governance, the HRCC should coordinate with the Risk and Audit Committee of the Board to bring more holistic risk measures into the designing of incentive compensation while minimizing the risk management breakdown.

Aligning Incentive Compensation with Risk Management

Generally, the term 'risk' in incentive compensation is narrowly defined as a positive outcome (incentive payout) resulting from a positive financial impact. In this definition, the concept of a negative outcome (negative payout) is not acceptable. Minimally, the expectation is that a negative financial impact will result in a 'zero' payout. Incentive compensation designs for management and key talent are asymmetric; that is, they have positive or zero payouts (*'Heads I win, Tails you lose'*). This is clearly illustrated through the example of traders with large position limits who can expose the enterprise to material credit or financial risk. These traders are paid substantial incentive compensations even if risk outcomes are materially worse than expected, so long as significant profits are generated on short term positive results. There are no compensation processes that adjust actual payouts on longer risk outcomes. Nor are there processes for downward adjustment for emerging negative risks that are a consequence of risk outcomes that resulted from the short term positive results.

The incentive compensation focus is on short-term financial objectives rather than on an enterprises long-range financial and non-financial risk objectives. For management and key employees responsible and accountable for managing the risks, incentive compensation components should reflect key activities (marketing, operational, safety, recruiting, etc.) that result in material gains and losses to the enterprise. These activities should include short-term and long-term activities, as well as financial and non-financial activities that have inherent and emerging risk exposures to the enterprise.

In order to align incentive compensation to risk management, the narrow definition of risk has be redefined to ensure symmetry in compensation payouts. Management and key employees responsible for risk management are unlikely to take imprudent risks if their incentive payments are reduced or eliminated for activities that end up imposing significant losses on the enterprise. Potential actions that could be taken to improve incentive compensation designs include the following: adjustment of performance awards retroactively to reflect risk outcomes over a pre-determined (past and future) period, measuring financial and non-financial performance over a longer period while deferring payment of incentive compensation over an extended period and/or payment of incentive compensation over a multi-year period, and reducing the sensitivity of performance to short-term financial measures.

Risk Measures

Annual public disclosure and reporting requires peer comparison of incentive compensation for senior management using TSR (total shareholder return based on share price appreciation and dividends). The acceptable practice is for the HRCC and their compensation consultants to select homogeneous peer comparators (based on revenues, market capitalization, number of employees, etc). The incentive compensation for senior management is, to a significant extent, justified by comparison of the enterprise's TSR against peer comparators. A significant portion of the payout is market-driven, not performance driven; that is, the enterprise's actual performance against objectives are reflected in incentive compensation, but to a lesser extent. By definition, the peer comparators may be a homogenous group based on the stated metrics (revenues, market capitalization, number of employees), but the comparison among these peer comparators is spurious, as each of these enterprises may represent varied industries with different business objectives (strategic, operations and financial), risk profile, workforce and financial maturity. The use of this acceptable practice results in a 'mismatch' risk for determining incentive compensation; therefore, standardized risk adjusted measures (discussed below) should be included when determining the peer comparators.

Enterprises use financial measures (Return on Assets-ROA, Return on Equity- ROE, Return on Capital - ROC, etc.) in their formulaic development of incentive compensation payout. Financial enterprises, due to the nature of their business, are able to determine economic risk capital and have trended towards the use of risk adjusted metrics (Return on Risk Adjusted Assets - RORAC, Return on Risk Adjusted Capital - RORAC, etc.) for evaluating risk-adjusted performance; however, there is still less traction on the use of risk adjusted metrics for incentive compensation. Non-financial enterprises use risk-adjusted performance metrics to a lesser extent due to the lack of publicly available standardized methodologies for the determination of these metrics. In order to establish the link between risk and incentive compensation, a significant shift in current compensation practices would be required by practitioners, and standardized tools and methodologies would have to developed and available in the public domain.

As stated above, TSR is an acceptable and widely used measure . It has many merits (e.g., it allows investors to assess share performance), but this measure is incorrectly used and distorts incentive compensation. There is ample evidence in the public domain showing that 40% of returns are explained by market and sector movements. Additionally, in the short-term, share prices are driven more by *differences* in actual performance and market expectations than by the actual level of performance. It is this difference that produces higher or lower shareholder return to the market or to peer comparators. Despite this, TSR is used in determining a significant portion of market-driven incentive compensation. There are a number of proprietary measures (Economic Value Added, Market Value Added, etc.) that can replace the TSR measure; however, it may be prudent to develop a universal standardized measure to provide a more robust measure, thereby eliminating 'pricing' and 'model' risks in incentive compensation.

Summary

Many beautiful places have a swan or two gracefully floating in a stream or lake. White swans depict graceful movements and are symbols of serenity. The incentive compensation landscape was a beautiful place with white swans; let's stay with this idea, but maybe it’s time to *gracefully* introduce emerging compensation practices that are robust and have direct *peaceful* linkage to risk measures.

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