# What Do They Mean By Unreasonable Risk?

**By Brian Dunn**
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Virtually every regulatory body has come out with some pronouncement or other admonishing financial institutions to curtail compensation programs that "encourage the taking of unreasonable risk." Two parts of that statement are problematic.

First, there is no definition of what the regulators mean by "risk"—it seems like everyone is siding with Associate Justice Potter Stewart when he said he could not define pornography but that he would sure know it when he saw it. So it is left to regulators, bank executives and directors to define risk and to certify that no unreasonable risk has been taken. It is this latter phrase that is even more troubling.

Since banks, securities firms, asset managers and every other type of financial institution are essentially in the business of taking risks, who is the best one to decide that *after the fact* the risks taken were unreasonable? This may seem like an exercise in semantics, but this statement is at the heart of regulatory reform. The compensation reforms require many institutions to have their senior executives and/or their directors certify that they believe that the institution does not have any compensation plans that encourage unreasonable risk taking.

This article is written to assist executives, regulators and directors with ensuring that their compensation plans are properly constructed to avoid the inducement to take unreasonable risk, and yet, motivate behavior that provides a reasonable return to shareholders. This is a difficult line to navigate. We will come at this from four separate directions:

- Defining the different forms of risk to be managed
- Outlining the ways a prudent organization can best manage risk
- Highlighting observable phenomenon that can indicate a possible disconnect between incentives and prudent risk management
- Describing the characteristics of compensation plans that optimize the risk/return relationship

## WHAT IS RISK

Risk definition is a prerequisite for determining if risk-taking is reasonable. There are a number of types of risks including:

- **Credit risk.** Loss due to adverse changes in the borrower's ability to meet their financial obligations under agreed upon terms.
- **Market risk.** Loss due to changes in the market value of assets and liabilities due to changes in interest rates, exchange rates and equity prices.

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- **Currency risk.** Loss due to the unfavorable movement of currency rates.
- **Liquidity risk.** Arises from the possibility that funds may not be available to satisfy current or future obligations based external macro market issues, investor perception of financial strength, and events unrelated to the company such as war, terrorism, or financial institution market specific issues.
- **Operational risk.** Arises from the inherent day to day operations of the company that could result in losses due to human error, inadequate or failed internal systems and controls and external events.
- **Reputational risk.** Arises from the loss of trust and/or confidence in the institution based on the real or perceived commission of acts that diminish the esteem by investors or counterparties.
- **Regulatory / compliance risk.** Arises from the failure to adhere to the rules, regulations guidelines and/or laws applicable to the organization by governments and/or their regulatory bodies.

These risks are interrelated and therefore cannot simply be understood and managed individually. In the world of complex financial instruments it is no longer simply a question of whether a single counter-party has the ability and willingness to live up to its obligation.

Such things as wrong-way risk (exposure increases as counterparty credit quality declines), fat tail risk (multiplicative risk at the far ends of the probability curve), crowded trade risks (over concentration in a product, asset class, sector, geography or industry), inaccurate valuations (under dramatically different financial scenarios), adverse correlation (concurrent events that have a geometric impact on the cost of an outcome), etc. complicate the assessment and management of risk. Reputational and regulatory/compliance risk are intimately connected, notoriously difficult to quantitatively measure and are both a cause and effect of changes in other types of risk.

Having systems and people who are knowledgeable, motivated and empowered to make the best decisions on how to price mitigate and offset various forms of risk is essential to the long-term viability of any financial institution. Compensation plans should support those efforts not impede them.

## MANAGING RISK

The effective management of risk requires an understanding of all elements of risk in addition to a culture, organizational structure and emphasis on managing risk starting at the very top. Compensation is a supporting player in this equation. Specifically one can tell if an optimal risk management culture exists by observing if the following are true:

- The Risk function reports outside of business management
- There is an active risk committee of senior business managers
- The committee regularly sets, reviews, monitors, revises and enforces risk limits
- There is regular firm-wide stress testing and scenario analysis
- There are working systems to ensure that comprehensive risk information is disclosed to the committee on a timely basis

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- All assets are marked to market on a daily basis, even for assets and portfolios where MTM is not required
- There is an independent verification of valuations
- Risk charges are updated regularly
- Risk analysis regularly triggers corrective action
- The risk process includes credit, legal, operations, compliance, treasury as well as the business areas
- The risk people are well paid and rotate to/from business management

## POSSIBLE DISCONNECTS BETWEEN COMPENSATION PLANS AND RISK MANAGEMENT

In this highly complex process of risk management it is important to ensure that compensation programs do not interfere with, but rather, support optimal decision making. There are a number of danger signs that could point to problems. Before identifying these factors it is important to note that (1) compensation may have been an accelerant to the credit crisis but it did not cause it—inadequate understanding and management of the risks were the cause, (2) the following are only an indication that there might be a problem—they do not provide certainty that there is a problem. With that caveat, the following are potential signs that compensation and effective risk management are NOT fully aligned.

- Incentives are paid on the basis of the valuation of investments and those valuations are performed by the same people who receive the incentives.
- Short-term incentives are paid for earnings based on unrealized (e.g., mark-to-market) earnings for illiquid assets.
- Incentives based on asset acquisition are paid to those who are involved in asset valuation and/or credit decisions.
- There is no mechanism in the incentive plan to recover future losses.
- Individuals are consistently paid at the 90th percentile or above.
- Incentives are based entirely on the performance/contribution of a single person and/or business unit.
- There is no provision for management discretion in the ultimate determination of incentive payments.
- Company stock and/or some other form of deferred compensation are not used as part of the compensation program for highly compensated individuals.
- The pay of risk managers is determined by the business leaders whose business they evaluate.
- Compensation amounts are delivered in an offshore or other vehicle that obscure their source and amount.

If any of these factors exist in your current incentive plans it is important that such an activity trigger further investigation. As mentioned above the presence of one or more of these practices may have a valid purpose. However, it is important that it be exposed to the harsh light of day to ensure that it can withstand skeptical evaluation.

## BEST PRACTICES

In the design of compensation plans in this post financial crisis/highly regulated environment there are a number of features that should be considered.

- **Pay mix should be appropriately balanced:** Quite simply, the mix of pay should reflect the balance of a salary sufficient to provide for basic cost of living, an incentive that rewards expected performance with an upside for outstanding performance and, depending on the role, a long-term equity incentive to reward long-term share appreciation.

- **Incentives should be paid when the institution realizes a profit:** Incentive compensation should not be pre-paid for the potential of longer term earnings for the institution. In other words, there should be some delayed gratification for the employee until the firm gets paid. The greater the uncertainty of that future payment the longer and the higher the deferral of incentives. In simple terms, incentives should be designed to better reflect the true earnings realization of the business/product rather than be force fit into an annual cycle. Each year incentive amounts could be calculated based on what we know today. If that income has not actually been realized then some portion of the incentive should be deferred until such time when we have a more accurate assessment of when the institution will actually net a profit. If the net is higher, more money should go into the incentive payment and vice versa.

- **Nobody gets to calculate their own bonus:** All performance calculations and payment of incentives should be managed by a third party who does not directly benefit from the payment.

- **Short-termers should be disadvantaged relative to long-termers:** Those mercenary employees who shop their services from institution to institution should be disadvantaged relative to those who are willing to and do go the distance. This can be accomplished in a number of ways including avoiding guarantees, paying compensation in long-vesting stock, having mandatory deferral of a portion of cash incentives, service based pension plans, etc. The rationale behind this practice is to align compensation with the duration of employment because individual and institutional performance do not line up neatly in one-year increments.

- **Stock options are elegant:** Admittedly, it may be difficult to convince some employees that stock options are valuable when they have 5 to 10 years worth of grants that are underwater. One could argue however, that such a circumstance occurred because the plan actually worked; reflecting declining shareholder returns. Options are uniquely designed to get employees to drive and share in the future upside of the firm. Stock options have and will continue to create vast amounts of executive wealth for creating outsized shareholder returns. It has been said that it was the desire to create outsized shareholder returns that caused financial institutions to over leverage their balance sheets, make unwise acquisitions and create confounding financial instruments. I would argue that this is not an issue of compensation but governance.

- **Pay the risk people independently and well:** Since so much of the future viability of the institution is in the hands of those that monitor and manage risk, they should be paid as well as business leaders. In fact,

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they should rotate on and off the line so they have both knowledge and credibility. During the time spent in risk, they will get higher salaries, largely deferred incentives (based on firm wide results) and company stock.

This is a complicated discussion that we have tried to reduce to a few pages, but in summary:

1. The abdication of good decision making including performance and risk management to incentive plans is naïve and dangerous.
2. Risk is a many faceted concept that requires senior management attention and focus.
3. Pay plans should be simple—they should reward the behaviors that are in the long term interests of the firm and its shareholders. If you can't measure the risk explicitly and reliably and adjust for performance on the front-end, then reserve and defer larger amounts for recovery on the back-end.
4. Pay practices are a powerful communicator about what the organization thinks is important. Longevity, prudent decision making and sustained results should get top priority.
5. Even the best designed incentive plans have risk. It is understanding and managing the risks that make the difference.

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Mr. Dunn's articles have been published in *Benefits & Compensation Digest*, *Chief Executive*, *American Banker*, *Personnel*, *ABA Banking Journal*, *Compensation Planning Journal*, *Bankers Magazine*, *AsiaBanking* and *Equities Magazine*.

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