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Compensation and Risk

Regulatory Update and Risk Review Process

By Greg Loehmann
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Introduction

To reward, to retain and to motivate – it is a phrase that often sits at the core of a compensation program philosophy. To achieve these goals, companies use a wide array of compensation vehicles. Among them, incentive programs are the most relied upon component of total reward used to motivate and encourage alignment of individual and organizational goals.

The bonus has historically delivered a larger percentage of pay in financial services than it does in most other industries. This follows from the fact that a relatively large percentage of employees are revenue generators whose individual actions have a measurable impact on organizational performance. Given this dynamic, a strict relationship between reward and production is not only possible, but is also generally viewed as a powerful motivational tool.

At the same time, compensation designed to affect behavior brings with it the possibility of unintended consequences. Without proper controls, employees designing, trading and selling complex financial products can expose their employer to significant risk as they strive to achieve production-based goals and maximize personal earnings in the current year. Looking to the past, the magnitude of compensation's role in Wall Street's failings in 2007 and 2008 can and surely will be debated. Looking ahead, there is no doubt that managing the relationship between compensation and risk will be a permanent fixture in the financial services regulatory landscape.

In this paper we consider the delicate balance between desired motivational components of compensation and incentives that encourage unwanted excessive risk taking. An earlier McLagan Alert considered a more fundamental question: "What Do They Mean by Unreasonable Risk?" (September 9, 2009). We later introduced a framework for evaluating incentive programs focusing on questions to ask when assessing incentives for risk taking ("Holistic Risk and Competitive Review of Incentive Plans," December 1, 2009). Here, in addition to an update on the current regulatory landscape in the United States, we provide specific guidance by highlighting plan features that may be viewed as inconsistent with regulatory mandates.

Regulatory Landscape

The most recent TARP compensation related regulations were published on June 15, 2009. For TARP taking firms, a moratorium on cash incentives and golden parachute payments coupled with limits on restricted stock awards made the most headlines and, at least initially, generated the most angst. As many of our clients know all too well, a disproportionate amount of time and effort went into retooling compensation programs, determining salary stock levels and trying to understand exactly what was allowable.

Equally significant, but less headline-worthy, TARP also includes a requirement that a Compensation Committee discuss, evaluate and review compensation programs at least every six months to ensure they do not encourage excessive risk taking or

CHICAGO
Aon Center
200 East Randolph Street
Tenth Floor
Chicago, IL 60601-6421
Tel: +312 381 9700

DUBAI
Dubai International Financial Centre
The Gate Village, Building 07,
2nd Floor, Unit 9
Dubai, United Arab Emirates
P.O. Box 506706
Tel: +9714 425 5747

HONG KONG
Room 1401A, Sunning Plaza
10 Hysan Avenue
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Hong Kong
Tel: + 852 2840 0911

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Lloyds Chambers, 5th Floor
1 Portsoken Street
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England
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199 Water Street, 12th Floor
New York, NY 10038
Tel: +212 441 2000

SHANGHAI
42nd Floor, Jin Mao Tower
88 Century Boulevard
Pudong, Shanghai 200121
P.R.C.
Tel: +86 21 3865 8399

STAMFORD (Headquarters)
1600 Summer Street
Suite 601
Stamford, CT 06905
Tel: +203 359 2878

TOKYO
Akasaka Kato Building
2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
Japan
Tel: +813 5549 1850

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Aon Center
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Tel: +312 381 9700

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manipulation of earnings. As it turned out, these rules were only the first installment in a spate of regulatory initiatives around compensation and risk taking.

In October 2009, the Federal Reserve published its own preliminary guidance regarding Sound Incentive Compensation Policies. Although it is still reviewing comments, the Fed is trending toward rules that will have a similar but more comprehensive impact as those of TARP. Namely, they will require a proactive role by Compensation Committees and management teams in the *identification and elimination* of incentives for excessive risk taking.

Most recently, in December 2009, the SEC issued final rules regarding compensation disclosure for the 2010 proxy season. Their requirements include disclosure around instances where compensation programs and policies are considered “reasonably likely to result in a material adverse impact on the company.” Living within the realm of its authority, the SEC’s focus is on *identification and disclosure*: By shining a light on potential problems, together with the prospect of say-on-pay and enhanced shareholder proxy access, the SEC likely believes that disclosure will bring about change through what would be more of a free market – as opposed to regulatory – solution.

With all of this on the table, many of the questions we get from our clients boil down to one: What should we be looking for in our own programs to ensure compliance and avoid unwanted risk?

Risk Review Process

Our belief is that incentive plan design and the risk review process should both begin with a solid understanding of plan objectives. After all, compensation is a powerful tool for encouraging – or discouraging – different types of behavior and communicating what the organization believes is important. It follows that determining which behavior we hope to encourage is a necessary first step.

We recommend looking past the far-reaching mantra cited in our opening paragraph (i.e., reward, retain, motivate) and establishing more narrowly defined goals and priorities. Objectives can vary widely and all plan features should support the overall goals and be reevaluated regularly to consider whether circumstances have changed. To give a sense of the diversity possible within incentive compensation we list some examples of plan objectives:

- Executive compensation plans generally seek to encourage stewardship by balancing short term performance with careful attention to the long term health of the organization.
- Front office programs may be designed to encourage a singular focus on profitable production.
- Programs can also be designed to encourage and accommodate bursts of innovation as opposed to consistent results.

The current focus on risk taking implies that the objectives of many plans have changed. For example, it was once common to suggest that the objective of a program was to encourage maximum possible production. After all, if encouraging a given level of production is good, then encouraging an even greater level of production should be better. In fact, certain levels of production can only be achieved through a shift in strategy or risk profile. In this example the objective has evolved from “encouraging maximum possible production” to “encouraging maximum possible production *given a desired risk profile*.” And of course, when objectives change, plan design should follow.

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Aon Center
200 East Randolph Street
Tenth Floor
Chicago, IL 60601-6421
Tel: +312 381 9700

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Dubai International Financial Centre
The Gate Village, Building 07,
2nd Floor, Unit 9
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P.O. Box 506706
Tel: +9714 425 5747

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Tel: +86 21 3865 8399

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Suite 601
Stamford, CT 06905
Tel: +203 359 2878

TOKYO
Akasaka Kato Building
2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
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Tel: +813 5549 1850

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Our incentive plan design framework includes key parameters covering the most material features of an incentive program. Within each parameter there are design alternatives that will support different objectives to varying degrees. While not an exhaustive list, we hope that specific examples of what to look for in an incentive plan risk review will contribute to a more effective review process and an easier path to compliance.

Eligibility	
The employee population eligible for awards in a given program.	
What the Fed Says?	Considerations
Employees of interest include: senior executives; individual employees, including non-executive employees, whose activities may expose the firm to material amounts of risk; and groups of employees who, in the aggregate, may expose the firm to material amounts of risk.	Conflicts of interest are an important consideration. Employees with oversight responsibilities should not be eligible for compensation programs meant to reward their colleagues whose risk taking activities they monitor. Two notable examples are risk management employees paid primarily for business unit performance and credit officers/underwriters and loan salespeople on the same program.

Plan Type
In addition to discretionary programs, we use formulas, commissions, targets and balanced scorecards to set compensation. Plan type addresses the methodology for determining total compensation spend and determines whether a program is budgeted or funded. Within each plan type, the methodology for funding at the aggregate and individual levels should be considered separately.

Aggregate Funding	
The methodology for determining total compensation spend in a plan. May be based on targets, a percent of revenue/profit, or discretionary.	
What the Fed Says?	Considerations
Incentive compensation arrangements should balance risk and financial results in a manner that does not provide employees incentives to take excessive risks on behalf of the banking organization.	Formulaic approaches to funding can drive a singular focus on production that may not be appropriate for all employees (e.g., executives with broad leadership responsibility).
Individual Allocation	
Individual awards may follow naturally from the aggregate funding (e.g., sum of targets or commission programs). However, many firms combine different approaches (e.g., discretionary allocation of formulaic or target-based funding).	
What the Fed Says?	Considerations
Incentive compensation arrangements should balance risk and financial results in a manner that does not provide employees incentives to take excessive risks on behalf of the banking organization.	Is the process for determining individual awards well documented? Are discretionary awards based on a rigorous performance appraisal process?

Award Opportunity	
The magnitude of the incentive compensation opportunity should be considered in terms of total value, as a percent of salary and as a percent of total compensation.	
What the Fed Says?	Considerations
The size of an employee's incentive compensation payments in relation to the employee's total compensation package may affect the likelihood that the incentive compensation arrangement may induce the employee to take excessive risks.	From a risk management perspective, award opportunities can be too low or too high. For example, if production based variable compensation is viewed as low relative to market practice the employee may pursue riskier strategies in order to deliver what they view as competitive compensation. On the other hand, incentives may represent a very large percentage of total compensation. In this case, a year without a bonus may not be acceptable to the employee, leading an individual to greater risk taking in order to earn production-based incentives. Many companies are looking closely at the mix of salary and incentive awards. Deferred salary disguised as bonus compensation can be problematic.

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Performance Measurement	
Performance measurement is characterized by four questions: Which and how many measures? Absolute or relative performance? What non-GAAP adjustments are allowable? Is risk explicitly priced/accounted for?	
What the Fed Says?	Considerations
The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage excessive risk-taking.	Single performance measures can often be manipulated. For example, short term earnings can be increased with high risk, high return assets. A comprehensive review of liquidity, profitability and credit quality is important. Risk adjustment should place individual and group profitability in the context of risk taking. Performance measurement should also account for the time horizon of activities in which revenue is recognized in one period but balance sheet risk extends for a number of years. If risk cannot be explicitly measured and accounted for in these examples it should be addressed in other ways (i.e., at-risk deferrals).

Thresholds, Caps and Leverage	
Together, thresholds, caps and leverage define the shape of the payout curve for target or formula plans.	
What the Fed Says?	Considerations
The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives.	A high threshold can have negative effects comparable to those of underwater options, which can either de-motivate or encourage excessive risk taking. On the other end of the curve, an uncapped plan can encourage excessive risk as employees may seek to achieve very large awards in the current year, potentially at the expense of future performance. Increasing leverage is one way to compensate for the presence of caps and focuses the individual on results within the probable performance range given the business strategy.

Equity	
Equity is typically used as a carve-out of an annual incentive or as a stand-alone program.	
What the Fed Says?	Considerations
The payment of deferred incentive compensation in equity or equity-based instruments may be effective in restraining the risk-taking incentives of senior executives and other employees whose activities may have a material effect on the overall financial performance of the firm.	Equity plays an important role in efforts to balance incentives for excessive risk taking. However, this is most true for senior employees or those or take material risk on behalf of the firm: the behavior of a less senior employee in a large organization will likely not be as affected given the modest link between their actions and corporate results.

Time Horizon of Pay	
A long term view can be encouraged either through multi-year performance measurement or long term vesting of equity or deferred cash awards.	
What the Fed Says?	Considerations
Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.	Time horizon should be tailored to the activities of the individual. Multi-year performance measurement, as opposed to simply long term vesting, adds an additional layer to the long term nature of pay.

Governance	
The administrative processes around incentive plans, including tracking of employee awards, vesting, performance goals, account balances, terminations, incentive award calculations, and communication.	
What the Fed Says?	Considerations
Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk management and other functions.	As programs evolve to comply with regulation it will be critical that internal compensation functions keep pace and have adequate resources to monitor and administer what may be more complex programs. In addition, Compensation Committee qualifications are coming under more intense scrutiny: Does the Committee have sufficient understanding of the risks involved in the business strategy?

Tax, Accounting and Disclosure	
Compensation decisions are impacted by a wide variety of financial and regulatory constraints. Among many, FAS 123r, §162m, 409A and CD&A requirements feature prominently.	
What the Fed Says?	Considerations
Although the Fed doesn't comment directly, their mandates are causing fast-paced compensation changes. Care should be taken to avoid unintended consequences.	A company should ensure that changes undertaken to comply with regulations do not introduce adverse accounting or tax outcomes.

Conclusion

Despite what we do know, many questions remain unanswered. The Fed continues to work through comment letters as well as data requested in its Horizontal Review. In the meantime, we will have to wait for final regulations to know how prescriptive they plan to be. Looking overseas, international regulators are also still drafting the details of their own guidance. Global banks may have to wrestle with conflicting mandates.

Nevertheless, with proxy season upon us and regulators setting an ambitious pace there is no choice but to move forward with incomplete information and a readiness to change course in mid-stride. As a result, and as many have already learned, 2010 most likely will not offer a break from the harried pace of 2008 and 2009. Fortunately, an objective, fresh look at incentive plan design should help organizations stay ahead of the curve and adapt to regulatory change more easily. ■

Greg Loehmann is a Vice President in McLagan's executive compensation practice. He received an MBA from the MIT Sloan School of Management in 2008 and a BA in Economics from Colgate University in 2000.

Greg is located in New York City and can be reached at (212) 441-2163 or GLoehmann@mclagan.com.

CHICAGO
Aon Center
200 East Randolph Street
Tenth Floor
Chicago, IL 60601-6421
Tel: +312 381 9700

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Dubai International Financial Centre
The Gate Village, Building 07,
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