Aligning Risk Management and Executive Compensation

Topical Areas: Board Risk Oversight; Executive Compensation; Risk Incentives

Main Theme: Boards of directors are charged with corporate governance tasks that include setting executive compensation and developing the corporation’s strategic agenda in light of its risk tolerance. Using short-term performance metrics, like stock price or earnings per share, to determine executive compensation may encourage executives to make decisions that are not aligned with the corporation’s strategic plan or risk appetite.

Summary of Article: The corporate board of directors is responsible for assessing overall stakeholder appetite for risk and overseeing the company’s risk exposure to ensure it is in line with that appetite. Especially during a financial crisis, the board should closely consider management’s fundamental risk management parameters and monitor emerging risks and opportunities. The company may be vulnerable because the financial distress of vendors or customers may have consequences for the continuity of the company’s operations and management may be making business decision for compensation benefits that expose the business to unwanted risks.

The issue of pay for performance has gained attention as financial managers were awarded huge bonuses in 2008 while their companies accepted government funds or merger proposals to continue operations. A 2008 study conducted by The Wall Street Journal and ERI Economic Research Institute found that the median CEO salary of a Standard and Poor’s 500 company increased 20.5 percent from the previous year while corporate revenues increased only 2.8 percent.

Boards Responsible for Risk Oversight

Corporate boards of directors are responsible for overseeing the company’s risk exposure, which becomes more difficult in turbulent financial times. The fiduciary duty of boards includes approving a business strategy that will preserve and generate long-term shareholder value. To generate shareholder value, the board should ensure that management is effectively managing key financial risks, which include:

- Liquidity risks, including the cost of capital
- Interest rate, currency and commodity price volatility risk
- Possible asset impairments resulting from fair value accounting
- Financial reporting risks, especially related to assets that are difficult to value
- Regulatory and compliance risks
- Market risks, including the impact of a recession on business operations

Aligning Risk Management and Executive Compensation

Boards face the challenge of designing executive compensation that will allow the company to recruit and retain management talent while creating a disincentive for managers to increase the company’s risk exposure to meet short-term compensation targets. Aligning executive compensation with the company’s long-range objectives
should limit executives’ incentive to make decisions that improve short-term metrics but increase the company’s risk exposure.

Boards should be aware that certain business risks might present opportunities for managers who are driven by short-term incentives to profit personally while creating greater risk exposure for the company. Executive compensation that is largely based on performance metrics like stock price or earnings per share can create an incentive for executives to put their interests before those of the company thereby introducing risks to the enterprise that may exceed risk tolerances. These metrics can be manipulated, for example, by management decisions related to revenue and expense recognition or through stock buybacks at the end of the period.

Executive turnover makes aligning shareholder value creation and executive compensation based on long-range performance more difficult. Research by RiskMetrics Group in 2008 found that short-term profit pressures have rapidly decreased the tenure of CEOs. Management succession is a strategic business risk and impairs the company’s ability to smoothly execute its long-range strategic plan. The compensation package offered to executives will not only affect their behavior, but also the board’s ability to recruit and retain key talent.

Use of Non-Financial Measures to Assess Performance
The Conference Board suggests that boards design executive compensation to attract and retain key talent in a competitive environment, motivate managers to pursue long-term goals and reward managers based on their actual performance. A measure of long-term value creation is the quality of long-term institutional investors the company attracts to its stockholder base. Because institutional fund managers invest based on a company’s risk exposure and the sustainability of its business strategy, an increase in the number of institutional investors likely signals that the company is well managed to create long-term value.

In recent years activist shareholders have pushed for bylaw amendments that would allow non-binding shareholder ratification of executive compensation and contractual “claw back” provisions that would allow the company to recoup bonuses and incentive compensation in the event of financial restatements. The Conference Board suggests that boards consider non-financial measures, like product quality improvements or customer satisfaction, when awarding compensation. Other solutions to align executive compensation with long-term strategic business goals include:

- Adopting stock retention policies that require top executives to hold a substantial portion of any equity award after ending their tenure with the company and until their retirement
- Granting restricted stock that is forfeited unless “earned out” over a stipulated employment period
- Designing stock option plans which vest the options only when certain long-term performance goals, unrelated to the stock price, are met
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