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Assessing the Role of Compensation in Encouraging Risk: Farient Advisors' Quantitative Approach

A New Focus for Compensation Committees: Risk Assessment

"Risk" is the newest keyword in the world of compensation and corporate governance. The financial services meltdown in late 2008 demonstrated that there were a number of cracks in the corporate governance system, and some in the media and government are blaming compensation practices at the major financial services institutions for encouraging excessive risk-taking. Whether or not you believe compensation is at the root of the problem, the government is beginning to regulate risk oversight, and responsible boards and compensation committees are already having "the risk discussion" to at least ask the question, "Could we have a problem?"

Up until now, there has been very little guidance as to what is meant by "encouraging excessive risk," and compensation committees are struggling to evaluate the relationship between compensation and risk in a credible, clear, and consistent manner. At Farient Advisors, we know that companies are in business to take prudent risks to optimize long-term shareholder value. But shareholders and boards alike need to understand whether executives and other employees are being encouraged by the pay system to take financial risks that are inappropriate for the business.

This is the challenge: how can companies determine whether compensation programs encourage excessive risk-taking given the business context?

To help companies evaluate the appropriateness of their risk-taking behavior, Farient developed the Quantitative Risk Assessor™. Farient's Quantitative Risk Assessor™ evaluates the propensity of the compensation system to cause undue risk-taking relative to a company's business context.

How the Quantitative Risk Assessor™ Works

Farient's Quantitative Risk Assessor™ works by first evaluating the riskiness of our client's business. We do this by comparing the company's growth, size, financial leverage, volatility, capital intensity, and other risk indicators to the S&P 1500 to determine the long-term risk profile of the business. We then quantify the total direct compensation package in terms of leverage, upside potential, performance measures, goals, time horizon, and other risk indicators to assess the compensation system's effect on risk-taking. Finally, we compare the business risk to the compensation risk to identify any areas of misalignment, highlight any areas that should be "on watch," and suggest any changes that should be considered.

We gather our data for the Quantitative Risk Assessor™ through a combination of publicly available financial and compensation data, as well as through a brief questionnaire to be completed by the company. We then generate a concise, one-page summary of the risk assessment, in which we rate business and compensation risk by each risk indicator as well as in total. This summary provides a platform for a rich discussion about where the risks are residing, and the remedies that might be considered.

Case In Point

The Compensation Committee of a large publicly-traded company (disguised in this case for confidentiality) was interested in obtaining a better understanding of whether its executive compensation program might encourage inappropriate risk-taking. The Committee wasn't really worried that any immediate problem existed, but wanted to make sure that the compensation system wasn't creating an environment in which problems would arise. It also wanted to make sure that the performance measurement system adequately recognized risk.

This assessment was important for the company, because as Farient's Quantitative Risk Assessor™ showed, the company was in a long-term, capital-intensive, and moderately high-risk business relative to the broader universe of companies. Our analysis highlighted some important related compensation issues, as shown in the table to the right.

Issues	Risks
The performance measures were weighted solely on revenue (25%) and income growth (75%), with no weighting (0%) on return.	This system was inconsistent with the capital-intensive nature of the business (over 100% assets to revenue ratio compared to a median of about 50%) and could have encouraged risking capital for growth's sake without an adequate return.
The pay mix was highly risk-oriented (90% of CEO pay weighted to incentives, compared to 83% leverage in the market; 30% of incentive weighting was on short-term incentives and 60% was on long-term incentives).	Even though the lion's share of the leverage was on long-term incentives, this pay risk profile could have incentivized "swinging for the fences" to show short-term gains, perhaps at the expense of sustained long-term gains.
While the vesting and measurement cycles in the total pay program were competitive with the market, they were relatively short in duration (i.e., two and four years respectively across the entire pay package) compared to the business time horizon (ten years).	The short-term orientation of incentive pay plans without holdbacks or ownership guidelines, relative to the business time horizon, could have allowed for short term profit taking before long-term returns would be known, and could have encouraged burdening new projects with back-end liabilities.
The company had no equity holdbacks or ownership guidelines, although clawbacks in the case of financial restatements or wrongdoings had been put into place.	

Results

Farient worked with the Compensation Committee to address these issues and develop customized solutions. The Committee instituted a return measure and ownership guidelines, and effectively lengthened the vesting time horizon on stock-based awards by requiring holdbacks on stock acquired through these plans. The Committee decided not to change its compensation risk profile given the other changes that had been made. As a result, the compensation risk profile was put "on watch" and its effects will be closely monitored.

The Compensation Committee presented Farient's Quantitative Risk Assessor™ analysis and its recommended program changes to the full Board in a day-long "risk retreat." This quantitative approach fit well with the risk "heat map" that was developed by the full Board. At this point, the Committee is sufficiently armed with detailed information to write a meaningful discussion on compensation risk in the Compensation Analysis and Discussion section of the company's proxy statement.

Go Ahead and Plan a Compensation Committee Risk Discussion

Find out how Farient's Quantitative Risk Assessor™ can help you ask the right questions and find the right answers for your company. Call one of our senior advisors to schedule a discussion.

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