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February 2017

# On the board's agenda | US
## Assessing risk in incentive compensation plans

Boards and compensation committees should consider reassessing how risk reviews of employee incentive compensation arrangements are conducted

**Recent events have elevated the importance of risk reviews of incentive compensation plans**

Over the years and in the aftermath of the financial crisis of 2008–2009, there have been numerous examples of incentive compensation programs motivating behaviors and activities that resulted in unintended consequences that damaged company reputations, financially harmed companies and its shareholders, and culminated in employee/executive terminations.

While incentives can be powerful tools to properly align employees with the achievement of the company's objectives, boards of directors should consider whether there is a process in place to identify and mitigate the potential risks of incentive programs. It is also important to think broadly about the types of risks an incentive compensation plan could create, including financial risk, reputational risk, employee retention risk and operational risk. For example, does the annual incentive plan

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encourage the maximization of short-term results at the expense of long-term growth? Will the incentive plan adversely impact the relationship with customers due to aggressive product pricing?

While boards of directors regularly provide oversight of the risks associated with the executive compensation program, it is equally important that they evaluate the risk of **all employee** incentive compensation plans. Ignoring incentives for lower-paid employees or screening incentives based on the magnitude of the payments may potentially overlook high-risk programs.

## The risk review rules

Risk reviews and proxy statement disclosure requirements were initiated by the Securities and Exchange Commission (SEC) for fiscal years beginning after December, 2009. The SEC only requires proxy statement disclosure if the "features of a company's compensation policies and practices have the potential to incentivize its employees to create risks that are reasonably likely to have a material adverse effect on the company." However, a significant number of companies disclose that they do not believe their incentive programs are likely to cause material adverse risk, and some also detail the risk mitigation features of the incentive plans and the process used to evaluate risk. The SEC requirement applies to most US publicly traded companies, regardless of industry, and covers all employee incentive compensation plans, including those for non-executives.

Since the rule was implemented, no public company has disclosed that its incentive programs "are reasonably likely to create material adverse risk." However, board members should consider asking more questions about the risks associated with incentive compensation and consider whether their companies require a more robust process in evaluating incentive compensation risk.

The financial services industry is several years ahead of most industries in assessing incentive plan risk due to the consequences of the financial service industry meltdown and regulatory efforts to curb future risk. Specifically, in the aftermath of the 2008–2009 financial crisis, the Federal Reserve Board and the other five agencies responsible for regulating the industry issued "Final Guidance on Sound Incentive Compensation Policies" in 2010 that defines risk much more broadly than just financial risk and states, *"to be fully effective, balancing adjustments to incentive compensation arrangements should take account of the full range of risks that employees' activities may pose for the organization, including credit, market, liquidity, operational, legal, compliance, and reputational risks."* While this Guidance was directed to the financial service industry, the framework can be applied to all companies.

The six regulatory[1] bodies also re-proposed rules in early 2016, under Section 956 of the Dodd-Frank Act, that define risks that could result from incentives to include *"significant financial or reputational harm to the covered institution, fraud, or intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation."* According to the re-proposed rules, reputational impact or harm includes the potential weakening of confidence in an institution as evidenced by negative reactions from customers, shareholders, bondholders and other creditors, consumer and community groups, the press, or the general public.

While risk reviews to-date may have prompted companies to make adjustments to the design, monitoring and/or governance of their incentive compensation plans, board members should ask if the incentive arrangements are aligned with the company's objectives beyond financial results alone and make sure compensation risks have been thoroughly vetted from a reputational and operational perspective.

## The elements of incentive plan risk reviews

To help mitigate the self-serving behaviors and unintended consequences that can result from ill-conceived or poorly executed incentive plans, companies should consider whether their incentive plans encourage inappropriate behaviors. For example, employees that are incentivized based on customer satisfaction scores may be motivated to pressure customers to complete the customer experience survey with only the highest scores possible. This behavior therefore has the opposite effect of what the incentive plan intended to do (i.e., enhance customer service). Similarly, requiring call center employees to handle a certain number of calls within a prescribed time frame is likely intended to enhance customer response timeliness, but may result in a lot of unresolved customer issues. Compensation committees are generally tasked with overseeing whether these or other risks can arise from incentive plans in which executives participate, but compensation committees should also ask that this type of review be completed for all employee incentive plans, regardless of participant level in the organization.

In particular, compensation committees should be satisfied that there is a process for properly evaluating the following six aspects of incentives where risk can emerge, but still be mitigated:

- **Compensation philosophy:** Companies should have an overarching philosophy or strategy that clearly states how incentive awards will be used to compensate employees; the compensation philosophy should serve as a foundation for an organization's pay program and clearly articulate the performance that will be rewarded. For example, a philosophy that emphasizes "pay for performance," but only considers financial performance may be missing an opportunity to measure and reward employees for achieving a wide range of company objectives that are critical to the long-term success of the company.

[1] Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Federal Housing Finance Agency (FHFA); National Credit Union Administration (NCUA); and US Securities and Exchange Commission (SEC).

- **Pay mix (e.g. fixed compensation vs. "at-risk" compensation):** The mix of pay can vary among employee groups, and compensation committees should ask their management teams to confirm how pay mix links pay to performance and if the "at-risk" portion of pay is appropriate for each employee group. For example, if relatively low-paid employees have the opportunity to earn significant incentives, it creates significant pressure on those employees to achieve goals tied to those incentives. That is likely one of the reasons the hourly rate for retail bank employees has been increased at a number of banks recently (i.e., the focus is on fixed pay for this employee group vs. "at-risk" pay).

- **Performance measures:** The performance measures used to award incentives should reflect the short- and long-term objectives of the organization. Companies should consider using a mix of financial and non-financial measures to minimize over-emphasis on one metric at the detriment of other(s).

  The compensation committee not only has the responsibility of reviewing and asking management to explain how incentive plan measures for executives tie to and help reinforce the overall company goals and culture, but should also ask for confirmation that incentive plan goals for all other employee groups serve to reinforce the objectives and values of the organization and reflect a responsible balance of risk and reward.

- **Performance and payout curves:** The "performance and payout curves" represents the relationship between the level of company performance achieved and the corresponding incentive plan payout to plan participants.

  Performance curves and the associated threshold, target and maximum goals can vary for different performance measures, and concerns can arise when curves are not well designed. For example, a very steep performance curve allows small changes in performance to have a significant impact on incentive payments. This type of performance curve can be warranted in certain circumstances, and it is important that the compensation committee and management recognize the potential risks associated with a performance curve that provided a significant increase in the value of incentives following a relatively small increase in performance level.

  Compensation committees should also be satisfied that management has carefully considered a range of possible performance outcomes and that the plans at each level appropriately balance risk, performance, and reward.

- **Goal setting:** Companies generally set incentive plan goals in one of three ways: (i) relative to the company's budget/forecast, (ii) relative to a peer group or index, or (iii) a "fixed standard".

  Regardless of the method used, it is important for the compensation committee to evaluate the reasonableness of the goals. On the one hand, the goals should not be too easy, as it may result in out-sized payouts that are not supported by the company's performance. On the other hand, if the goals are set too high, it might encourage a "swing for the fences" mentality, wherein managers may make risky decisions to achieve unrealistic goals. For example, achieving a reduction in maintenance or R&D costs might allow a company to achieve short term results, but at a cost to long-term value creation. Additionally, unreasonable sales goals can cause overly aggressive interactions with customers and unethical behavior to achieve results that in all likelihood are impossible to achieve. Thus, goal setting and the degree of stretch built into the goals is a critical area where risk should be reviewed and mitigated appropriately.

**Key takeaways for the board of director's role in risk reviews:**

The full board of directors, along with the compensation committee, should oversee the incentive compensation risk review process. The following are key takeaways board of directors and compensation committees should consider when discussing incentive compensation risk at their companies:

1. When asked to approve a new incentive compensation plan, the board of directors should confirm that the compensation committee has considered whether the plan has the potential to drive excessive risk-taking by plan participants, resulting in financial, operational and/or reputational risks.

2. Boards of directors should review the structure of the management team charged with risk evaluation and mitigation, meet with the team to assess its capabilities, and consider whether there is sufficient bench strength on the team as part of routine management succession planning efforts.

3. Boards of directors should review the desirability of hiring outside parties to independently evaluate incentive compensation arrangements and help the organization stay abreast of emerging marketplace changes in incentive plan design.

4. Boards of directors should review and discuss the process used to determine disclosure of risk and its relationship with incentive compensation programs in the company's annual proxy statement and the formalized system for the board to "sign off" on the disclosure.

5. Boards of directors should consider that key company risks, including incentive plan risk, are properly assigned to either a committee (e.g., audit, compensation, etc.) and/or the full board.

6. Finally, boards of directors should seek to avoid committee "balkanization," all committees should give detailed reports to the full board and incentive compensation and other forms of risk should be discussed at the full board level to ensure that nothing falls through the cracks with regard to risk.

- **Calculation and verification of performance:** Companies should have a reliable system in place to accurately capture and calculate performance. This can range from a system of spreadsheets to elaborate software solutions. In addition, companies should have a system of checks and balances that are used to verify the results of incentive performance calculations. Internal audit can and often does play a critical role in ensuring calculations are accurate and anomalies are identified and investigated in a timely manner. For example, if a region is outperforming other regions 3:1, this may be the result of great performance or something could be amiss in the incentive performance calculations. Whatever the reason, the calculation of performance should be reviewed more closely.

  Compensation committees should consider asking their management teams to describe the process and tools that are used to monitor, calculate, document, verify and ultimately report on all incentive plan performance results.

- **Participant communications:** Compensation committees should review incentive plan communications and ask whether plan participants fully understand the mechanics of a plan and the ways in which their performance directly ties to the accomplishment of plan goals. In addition, employee communications should regularly remind employees of the company's "Code of Conduct" and the consequences of engaging in unethical behavior (e.g., loss of job, claw back of incentive compensation, etc.)

- **General oversight:** All companies should have a system of rules and processes in place that govern the operation and administration of incentive compensation plans. These rules should address everything from plan design to the detailed processes a company uses to conduct incentive plan risk assessments. The governance system should also specify the role of the management team and the individuals involved in incentive plan administration.

## Next steps

In light of these considerations, it is important that boards of directors reconsider how their organizations conduct risk reviews of incentive compensation arrangements, evaluate all potential risks and outcomes, and ensure the company has a system in place to monitor employee behaviors for unintended consequences.

Risk assessments need to be conducted annually, comprehensively, and holistically. In addition to looking for risks that could cause a material adverse effect on the company, these assessments need to look for employee behavior and conduct that could jeopardize an organization's operations and reputation, given the years it could take an organization to recover from a damaged reputation. This incentive compensation plan assessment process can play a key role in shaping the organization's culture and should include the compensation committee and the board in a key oversight role.

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**Acknowledgements**
Deloitte would like to extend special thanks to Christine Robovsky for her contribution to this publication.