Global Remuneration and Risk Management
By Jim Sillery, Principal, Compensation Consulting Practice

As we respond to a global recession that has become not only the deepest but also the longest economic downturn in decades, many have begun to look into how and why things went wrong. Risk has emerged as a consistent item in the contributing factors cited. As a result, companies are implementing many strategies that address the need to manage a broad range of risks.

As was not the case in past recessions, risk managers, senior executives and boards of directors today are finding a new and often controversial item assuming a prominent place on their risk management agenda - managing the risk associated with performance-based remuneration programs. This article looks at how global companies can identify and manage that risk.

The Performance Plan Paradox

For some time, the concept of “pay for performance” has been widely accepted as a global best practice in both executive and broad-based remuneration programs. Conventional wisdom holds that by aligning employees’ actions with pre-defined performance objectives and then rewarding them for achieving those objectives, companies can motivate employees to higher productivity and better performance. Global companies use both formal short and long-term incentive compensation plans as the motivators.

In fact, a performance-based plan is a powerful tool in aligning and motivating employees. The paradox is that many companies are finding that the results are often not what was expected nor desired. The results were certainly not what shareholders expected or desired after their investments had experienced substantial losses just before or after some employees received large bonuses. At a time when global markets were under extreme downward pressure, high levels of short and long-term bonuses were being paid out to executives and key employees. The perceived excesses in remuneration levels prompted finance ministers at an EU summit to categorize these practices as “scandalous.” “When we talk about wage moderation and the need to link wage increases with productivity increases, then we also have to say something about levels of remuneration that sometimes don’t seem to reflect productivity at all,” said Joaquín Almunia, the EU Monetary Affairs Commissioner.
Many shareholder groups and other critics went further and directly linked the deteriorating performance of specific companies to short-sighted risks their executives sanctioned in pursuit of short-term gains for the company and huge rewards for themselves. They charged that, as a result, these short-term gains overshadowed long-term stability and lead to unintended behavioral and financial consequences.

Critics also raised concerns that companies did not anticipate the global consequences of the decisions and actions that drove the incentive plans they implemented. In October 2008, as the global downturn worsened, Australian Prime Minister Rudd summed up these sentiments by stating that the global economic crisis was a result of the "comprehensive failure of extreme capitalism" driven by "failures in corporate governance which rewarded greed without any regard to the integrity of the financial system".

The links binding pay, behavior and risk are not new. Empirical evidence of the relationship between compensation and the degree of risk associated with certain business decisions has existed for some time. Likewise, the relationship between wealth creation opportunities for executives and increased stock volatility is well known. The heightened - and now widespread - level of activism in response to excessive compensation is new.

This activism, once limited to executive pay practices in the United States, has spread across geographic borders. Pay restrictions have been proposed or implemented in a number of EU countries, including Germany, Sweden, Switzerland and the UK. In China, the Ministry of Finance (MoF) issued a notice warning state-owned enterprises and state-held companies in the financial sector to keep management salaries at a "reasonable" level. The MOF notice also urged those organizations to suspend stock option incentives and employee stock ownership plans during the global financial crisis. The plans will be suspended until the government releases specific policies regulating such activity.

**Understanding the Risks to Be Managed**

In today’s uncertain global economic, business conditions can easily shift across a range of scenarios. When these shifts do occur, managements must often respond without a clear precedent.

Their responses require a new understanding of many kinds of business risks. Since a company cannot manage risks it does not understand, we focus here on management’s need to understand the risks to stakeholders inherent in the remuneration arrangements it designs. Understanding these risks involves a three-step process.
1. **First:** Management must become more knowledgeable about the fundamentals of behavioral finance and how to incorporate them into remuneration design (See the boxed section on *Behavioral Finance: The Fundamentals*). In this way, they can gain a better understanding of the biases that may cause executives to guide companies down paths that are not in the best interests of stakeholders. For example, a compensation arrangement may provide an incentive to an executive to claim financial success in a business venture with short-term gains that cannot be sustained and, therefore, will not lead to the creation of long-term economic value. There are many such examples in recent investments in global real estate and commodities markets.

When management looks at how these biases can influence executives and other employees to take excessive and inappropriate risks, the clearer understanding of cause and effect that results should make it easier to design remuneration arrangements that discourage imprudent risk-taking.

This level of risk management must become integral to the design of remuneration programs, particularly incentive arrangements. When it does, it can also help identify the design requirements needed to avoid creating an incentive to pursue short-term financial results to the detriment of strategic longer-term objectives.

2. There is not always an obvious cause and effect relationship between pay and performance. Senior management, corporate risk managers and boards of directors must work together to create a risk-reward profile for the company. They must then conduct a comprehensive assessment of the elements of the remuneration program, determining how each can influence specific behaviors of management, key contributors and employees. This assessment should be used to “stress test” remuneration arrangements relative to performance goals to make sure that there is no potential for unintended consequences.

3. These “stress-tests” should first identify those performance metrics that will contribute to sustainable, long-term success, as well as the behaviors and outcomes that will support the achievement of those metrics. The response to performance metrics can then be played out through several scenarios (e.g., worst case, expected results and over-achievement), along with the elements of risk management (e.g., the sources and categories of risk), and the impact of behavioral responses on both operational decision-making and financial results.

For example, consider the behavioral response of the sales force that some believe contributed to the following situation. A medical supply company saw a significant
decline in customer satisfaction following the introduction of a new incentive plan which resulted in sales far exceeding plant capacity and a six month backlog. Profit margins eroded as additional shift were added to fill in orders. While some blamed the sales force for over-selling, the salesmen responded that they only did what they were incented to do.

**Conclusion**

This three-step process will help to ensure a more complete response to risk management by allowing remuneration arrangements to be considered within a risk/reward profile specific to the company. The analysis also provides a platform for good governance by allowing remuneration programs to be considered from the perspective of shareholders and other constituencies as well as in the context of a broader global perspective.

The benefits also extend beyond governance. By understanding and managing the risk inherent in incentive pay, companies can more effectively motivate employees by recognizing and rewarding those behaviors and outcomes that contribute to sustained success.

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**Behavioral Finance; The Fundamentals**

Behavior Finance proposes theories based on psychology to explain anomalies in the market. Its research focuses on decisions related to the stock market, money management and asset valuation.

Behavioral finance assumes that the information structure and the characteristics of market participants systematically influence individuals’ investment decisions as well as market outcomes. Behavioral finance seeks to better understand economic decisions made by consumers, borrowers, investors, and how those decisions affect market prices, returns, and the allocation of resources.

The three main themes in behavioral finance are:

- People often make decisions based on “rules of thumb”, not rational analysis.
- The way a problem is presented will affect the decision a person makes on how to act.
- There are behavioral explanations for observed market outcomes that are contrary to rational expectations and market efficiency.