CEO AND EXECUTIVE INCENTIVE PAY ARE THE FOCUS OF NEW INTERNATIONAL GOVERNANCE INITIATIVE

An international group of board directors, chief risk officers, and other C-level executives has taken up the challenge of providing guidance to boards on how to best govern the link between pay, performance, and risk. Its report is released this week.

January 9, 2018 - Examples of employee misbehavior driven by incentive pay were abundant last year. They included the scandal over fraudulent accounts at Wells Fargo and alleged bribes paid by representatives of Adidas to high school basketball players and their families to secure promotion of the sport retailer's products. The list of similar stories is long.

As awareness of the link between incentives and employee behavior becomes more apparent, boards of directors have a responsibility to ensure that the proper risk-taking culture is being stimulated and not counteracted by the design of executive and employee incentive compensation plans that unintentionally encourage negative behaviors. "Effective compensation alignment is a key area where board members can either enhance or weaken the competitive advantages of their companies," said Darlene Halwas, who serves on multiple boards in Canada and was the head of risk management for three different companies.

During the fall of 2017, the Directors and Chief Risk Officers group, also known as "the DCRO" formed the DCRO Compensation Committee Risk Governance Council, of which Halwas is a member. The governance council has been working collaboratively in an endeavor to assist organizations in their fulfillment of the key fiduciary duty of care around compensation design.

"Incentive pay plans have long been known to stimulate both good outcomes and misdeeds," said David R. Koenig, Founding Principal of The Governance Fund and the founder of the Directors and Chief Risk Officers group. "Boards certainly want to steer behaviors towards positive outcomes," he continued.

Released this week, DCRO Guiding Principles for Compensation Committees report lays out ten guiding principles across five categories: Depth, Design, Transparency, Expertise, and Resiliency. Detailed explanation of each of these key components offers valuable information and strategies to:

- Provide both boards of directors and board-level Compensation Committees a set of Guiding Principles for the governance of risks associated with compensation philosophy and pay culture.

- Support a culture within an organization where prudent, tactical risk-taking by its employees is rewarded and aligned with long-term value creation.

- Enable boards to realize more predictable behaviors among employees and create greater long-term value in service of their respective missions.

"This is a challenge to the status quo and serves as a guide for investors and regulators in their ongoing assessments of risk governance practices across institutions of all kinds," Koenig noted. He added that primarily, though, the guiding principles "have been written to be used as a practical tool for boards of directors to advance the sustainable pursuit of their stated goals and objectives." Halwas agreed, saying "these principles help guide board members with key questions to be answered during the compensation design process, and will no doubt, enhance the company's competitive advantage,"

Given the clear upside of success, companies seek to create a corporate culture that stimulates positive behavior in employees, minimizing the risk of misdeeds — both deliberate and unintentional. That is why an increasing number of C–level executives and boards of directors devote so much attention to this topic.

"No corporate governance issue has been more studied, and more misunderstood, than executive compensation," said governance council member Jon Lukomnik, Executive Director of the IRRC Institute and Managing Partner of Sinclair Capital. In that respect, he noted, "the DCRO guiding principles are a thoughtful revisit to first principles: What are we trying to accomplish, who is responsible, how do we define and measure success?"

Professor Moorad Choudhry, a former bank CEO and Board Director noted, "the importance of having in place the 'right' culture in ensuring best-practice in banking cannot be over-emphasized. The principles contained in the DCRO Guiding Principles represent, for me, a sound baseline of actions and behaviors that a good compensation culture would incorporate."

One of DCRO's key guiding principles calls on boards of directors to publicly issue a "fit for purpose" assurance to investors, regulators, and key stakeholders. In effect, it is a promise from the chair of the Compensation Committee that the committee has worked diligently on the main issues related to pay and performance, and believes them to be aligned with the organization's intended objectives.

The DCRO Guiding Principles for Compensation Committees provide clear guidance for such an evaluation. "It is a comprehensive tool kit that ties executive pay to corporate culture, and the company's risk appetite, offering an independent body of knowledge for Directors to oversee compensation design," said Carol Gray, Independent Director and member of People and Remuneration Board Committee of IFM Investors in Melbourne, Australia. She added that "The results should lead to improved transparency with shareholders and compensations that are not only competitive but also fit for purpose."

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Increasingly disproportionate CEO pay, as compared to salaries of average employees, has brought on initiatives like "say on pay" where shareholders express support or rejection of the compensation plans the board has been entrusted to govern. The DCRO Guiding Principles address this issue head-on, noting two key faults in the most common approaches to determining CEO remuneration. The use and reliance upon peer benchmarks for compensation is seen as a fundamentally flawed approach and the belief that senior executive skills are fully transferable and constantly under threat of being lost leads to a more defensive compensation posture than may be necessary. In each case, this costs owners. “Compensation Committees have struggled to keep pace with competitive executive pay schemes that have been largely driven by peer benchmarking data,” Gray pointed out.

In the end, the intent of incentive pay is to stimulate extraordinary performance and to reward employees when their organization achieves successful outcomes. “The DCRO Guiding Principles for Compensation Committees is an exceptional tool,” said Louise Redmond, who serves on multiple boards in the UK and is a past Human Resources Director for the Bank of England. “The extensive experience of governance council members is captured in the Guiding Principles and makes them a must-have reference for Compensation Committee members and advisors everywhere.”

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According to Martin M. Coyne II, Board Member at Eyenuk, Inc. and Chairman and Founder, CEO Learning Network, LLC, "these principles provide a practical perspective on compensation risk management, incorporating the views and experiences of a globally diverse group of experienced directors and risk professionals." Coyne has extensive experience in the work of Compensation Committees, having served as the Chair of the Compensation Committees at both Akamai Technologies and RainDance Technologies.

Others agree with Coyne’s assessment. “I have been particularly impressed with how the DCRO council members have shared their knowledge of international standards and how to make them work in practice,” Redmond said. Lukomnik added that “The DCRO Guiding Principles provide a roadmap to navigate through all the clutter.”

Coyne, Redmond, Choudhry, and Gray also joined more than twenty global experts in lending their vast skills and experience to the DCRO’s initiative. The DCRO Guiding Principles for Compensation Committees are freely available for download.

The DCRO was formed in 2008 to focus on the top-level governance of risk in practice. Bringing together leading board members, chief risk officers, and other c-level officers whose jobs include a fiduciary responsibility for governance and risk management, the DCRO counts more than 2,000 members from large and mid-size for-profit and nonprofit organizations, coming from over 115 countries. DCRO members participate in facilitated meetings, conference calls, benchmarking research, and governance councils that allow them to compare current practices with those adopted by fellow members, those being required by regulatory bodies, or those expected by investors. Membership in the DCRO is strictly limited to active or recently active, board members, chief risk officers, or c-level executives with risk governance responsibilities.