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Risk Management

Companies Advised to Conduct Reviews Of How Risk Affects Incentive Programs

■ ***Practice Tip:*** *All public companies should consider strongly the adoption of a ''risk review'' process that involves having an internal group such as the compensation committee conduct regular assessments of how risk impacts incentive programs.*

In light of the financial crisis and heightened compensation disclosure requirements, companies should conduct regular ''risk reviews'' to assess how risk affects their incentive plans and practices, Kelly Malafis, a partner at executive compensation consulting firm Compensation Advisory Partners LLC in New York, told BNA March 17.

According to Malafis, a risk review involves creating a process, developing a framework to examine incentive plans and practices, assessing current plans, and communicating results and identifying refinements.

''At first, some companies may find risk reviews difficult to conduct due to the newness of the tasks involved,'' Malafis said. Also, companies with a large number and wide variety of incentive plans may find the process more complex, she said.

Review Is Key to Avoiding Bad Risk. The purpose of a risk review is to identify plans or practices that may encourage employees to take unnecessary or excessive risk that might threaten business, Malafis said. ''The enhanced management oversight that accompanies a risk review is good business practice,'' she said.

Most companies are now viewing the risk review as a necessary process, Malafis said. ''In many cases, the compensation committee of a board will take the lead in the risk review process,'' she said. This tends to involve cooperation with management, as well as the risk and audit committees, when appropriate, she said.

The compensation committee may ask that their own compensation consultant—or, if the company prepared the review, that the company include a consultant in the review process as well, Malafis said. ''Afterwards, the compensation committee would present its findings to the full board,'' she said.

''When creating the risk review process, internally based risk and finance professionals would likely be closest to understanding where the underlying risks lie in terms of financial details of a company,'' Malafis said.

''Within the financial services sector, the risk management function has been highly elevated in recent years,'' Malafis said. ''This is why internal insight is extremely important,'' she said.

Recurring Risk Reviews, Monitoring Needed. A risk review is not a one-time event, according to a March 1 CAP newsletter co-authored by Malafis. The process needs to be updated continually so that ''in the future, incentive plans will be more regularly monitored and reviewed by a designated internal group with the authority and independence to raise issues and make recommendations,'' it said.

''Additionally, while the SEC does not require companies to make any affirmative disclosure if they do not believe that their incentive plans create risks with material adverse consequences, we expect many companies to describe the risk assessment process in their proxy statements,'' the newsletter said.

How regularly a company needs to conduct risk reviews depends on many factors, including the type of and industry to which a company belongs, Malafis said. ''Most companies will likely eventually build the risk review process into their compensation committee's list of annual tasks,'' she said.

Key Questions for Assessing Incentive Plans. Kelly Malafis, a partner at executive compensation consulting firm Compensation Advisory Partners LLC in New York, told BNA March 17 that a good framework for assessing incentive plans and practices should address questions such as:

- How are incentive pools developed?
- Are the incentive pools capped or uncapped?
- Are the metrics appropriate given the type of business?
- Are operational controls in place to prevent participants from manipulating results?
- Is the plan unduly focused on short-term results?
- Do incentive time frames match income recognition?

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''While companies may find the initial rounds of risk review very time-intensive, the process will be simpler in the future, once an infrastructure is established,'' she said.

Review Process Requires Diverse Teamwork. According to the newsletter, a comprehensive risk review requires a multidisciplinary team composed of human resources, risk management, legal, finance, and corporate and business unit leaders.

''In the initial phase human resources professionals (including compensation) compile comprehensive information about the company's incentive plans,'' the newsletter said. This includes identifying all incentive plans, revisiting the organization's compensation philosophy, summarizing key incentive plan design features, and reviewing historic pool levels and pay mix to determine if a ''risk adjustment'' is needed, it said.

The team will serve to identify the types of risk—operational, credit, market, and reputational—that exist in the company and the behaviors and actions that need examination and monitoring, the newsletter said. ''Although all incentive plans should be reviewed, the focus initially will be on the lines of business and the individual contributors with higher risk profiles,'' it said.

Incentive Plan and Philosophy Need Validation. Companies need to validate both the plan and the compensation philosophy against the company's risk profile, because other plans will be aligned with these principles, the newsletter said. ''In fact, many of the issues addressed with respect to senior executives will apply to other employees,'' it said.

Finance, risk management, and human resource staff need to have an ongoing role in developing and reviewing business unit compensation plans, the newsletter said. These individuals need to have the ''authority to make recommendations for change,'' and also need to be ''compensated in a manner that ensures that their independent oversight of the process is not compromised,'' it said.

Finally, the chief risk officer needs to lead the team in presenting its assessment to management and the compensation committee, the newsletter said. ''This consists of an evaluation of executive and other employee incentive plans that have the potential to create unnecessary or excessive risk,'' the newsletter said.

By Tina Chi

The CAP newsletter is available at http://www.capartners.com/uploads/news/id10/capartners.com-capflash-mar01.pdf .

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