Risk vs. Executive Reward

Obama Seeks Better Controls, but Experts Split Over the Impact

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Federal officials hope to curb excessive executive compensation by controlling the incentives for risk-taking built into pay packages. But experts can't agree on how -- or whether -- pay plans encourage such risks.

Two recent reports highlight the challenge. In one, a critic of executive compensation says financial institutions, in particular, rewarded top brass for actions that put those companies in jeopardy -- and that the Obama administration's response could make things worse. In another, a prominent compensation consultant says the pay practices blamed for corporate excess had little to do with the financial crisis.

"There's not an easy cause and effect relationship" between pay and risk, says Don Delves, a Chicago compensation consultant. "We don't know how to do it yet."

Nonetheless, federal officials want companies to try. Treasury Secretary Timothy Geithner Wednesday recommended companies assess pay packages to discourage "imprudent risk-taking." Soon after, Securities and Exchange Commission Chairman Mary Schapiro said the agency is considering requiring companies to disclose "how compensation impacts risk-taking" in annual proxy statements. An SEC spokesman declined to elaborate.

"Risk is the hottest emerging issue for compensation committees in 2009," says James D.C. Barrall, head of the global executive-compensation and benefits practice at Latham & Watkins LLP in Los Angeles, and an adviser to several board pay panels. Mr. Barrall says he doesn't know of a major U.S. company that has systematically analyzed the role of executive-pay practices in encouraging risk-taking.

To complicate matters, boards must guard against making executives too conservative, says Linda Rappaport, head of the global executive compensation and employee benefits practice at Shearman & Sterling LLP in New York. "Appropriate risk-taking is still something you want to do in business," she says.

The Treasury requires companies that received funds from the $700 billion Troubled Asset Relief Program to evaluate pay plans for risk. That's produced uneven results, to judge from recently filed proxy statements.

Citigroup Inc. included a lengthy three-part analysis of possible links between risk and pay by the bank's chief risk officer. Among other things, the risk officer assessed whether other senior executives take "appropriate steps to mitigate risks."

But Bank of America Corp. offered a shorter statement, saying its compensation panel had made "reasonable efforts" to make sure pay packages don't encourage top officers "to take unnecessary and excessive risks that threaten the value of our company."

Kevin Murphy, a finance professor at the University of Southern California's Marshall School of Business, says it is possible to control how much risk is built into pay packages. He said compensation fell sharply for CEOs of banks receiving federal bailout money last year, compared with those of other banks and non-financial companies.

Mr. Murphy says paying executives with cash bonuses, restricted stock and stock options creates strong penalties for failure. He says companies also can control risk by paying executives for longer-term, rather than shorter-term results, and "clawing back" pay when big losses wipe out prior profits.

Still, the recent papers highlight how difficult it may be to limit incentives for risk-taking. Harvard Law School professor Lucian A. Bebchuk says financial-services companies' reliance on large amounts of borrowed money offers executives the prospect of big gains while encouraging them to downplay potential risks.

Mr. Bebchuk, who directs Harvard's corporate-governance program, worries that federal officials are pushing banks to adopt practices, such as granting restricted stock and giving shareholders an advisory vote on executive pay, that may make the problem worse. That is because many banks' share prices are now so low that shareholders, with little to lose, may support executives' taking big risks.

He recommends tying executive pay to the performance of a company's bonds and preferred stock, in addition to its common stock, and basing bonuses on measures other than earnings per share.

Other pay experts question whether executive-compensation plans encourage excessive risk-taking. Consultancy Watson Wyatt Worldwide Inc., Arlington, Va., recently evaluated executive-pay plans at 1,000 big companies against a statistical measure of the companies' credit risk from 2005 and 2007. The study found that certain practices now under fire from pay critics -- like big annual bonuses, large amounts of other variable pay and a heavy reliance on stock options -- were more common among companies with lower and improving credit risk.

"A number of the conventional-wisdom solutions will either not work" or steer companies in the wrong direction, says Ira Kay, head of the firm's executive-compensation practice. "We found that very few executive compensation features rewarded executives for increasing their risk."

The study did identify four practices that seem to increase corporate risk: big pensions, using multiple performance measures, paying more than peers, and rewarding executives for improving return on equity.

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