



ENGAGED DIRECTORS. EFFECTIVE BOARDS.®

*Responsible Risk: Effective Incentive Rewards in
Turbulent Times*

Today's Speakers



Yvonne Chen, a Managing Director in PM&P's New York office, has more than 25 years of experience consulting with companies, subsidiaries and joint ventures in the development of compensation objectives, value-based performance measurement and incentive plan design.

Susan O'Donnell, a Managing Director in PM&P's Boston office, has consulted for over 22 years on issues related to executive and director compensation and governance, with significant experience in the banking/financial services industry.

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Risk Assessment – What We Will Cover



NACD Guidance on Risk

- Key Agreed Principles for Boards
- NACD White Papers on priority matters
- Recommendations for executive compensation

Framework for Risk Assessment

- Process for conducting a risk assessment
- Who should (and shouldn't) be involved in the assessment
- The link between business risks and compensation programs
- Acceptable risk-reward relationships

Compensation Risk Assessment Scorecard

- Key questions to ask when reviewing incentive plans
- Plan design changes to mitigate risk
- 2009 disclosures - where do we go from here?

NACD Leading the Charge



- Directors, investors, and lawmakers are all focused on restoring confidence in Corporate America
- In 2008, NACD took the lead by convening directors, the business community and investor groups to codify a set of principles to guide boards of directors
- NACD's Key Agreed Principles enable directors to test their current practices without being prescriptive and avoid a "check the box" approach to good governance
- The goal is to enable boards to make governance decisions in the context of their own corporate strategy



- **NACD's Key Agreed Principles**
 - Provide a blueprint for action for boards to discuss and debate governance issues and practices
- **White Papers: Series I**
 - Dive deeper into priority matters, identifying emerging concerns and guidance in four specific areas:
 - Risk Oversight
 - Corporate Strategy
 - **Executive Compensation**
 - Transparency



Principle 6: Integrity, Ethics, & Responsibility:

Governance ... should promote an appropriate corporate culture of integrity, ethics, and corporate social responsibility

Key Recommendations:

- Rewards should reflect success in reaching both long- and short-term milestones
- Develop internal executive talent
- Foster independence and courage on the compensation committee
- Remain diligent in making decisions based on independent compensation consultants

Source: NACD's Key Agreed Principles to Strengthen Corporate Governance, 2008



“The Buck truly does stop” in the boardroom – 88% of directors surveyed say pay is too high – 54% say it’s due to inadequate performance metrics

What do we need?



Better Performance Metrics

- Reward long-term, sustainable performance
- Consider bonus banks that allow bonuses to be paid out over a period of time to executives who meet predetermined benchmarks

Stronger human capital development

- Avoid exorbitant costs by grooming internal talent to replace upper management. Studies show that internal candidates perform better and at equitable prices.
- Include executive talent management as a component of the evaluation of the CEO's performance



Composition of the Compensation Committee

- Use directors who are not only independent by definition, but who are independent minded as well.

Independent consultants

- Advice from consultants is just one tool in creating a pay package.
- Boards should remain diligent in making decisions based on the company and its performance.

Transparency

- Disclosure of board processes
 - Share information regarding in-boardroom processes and decision-making procedures to shed light on the work
 - Key committees could insert letters into the 10-Ks and 10-Qs to alert shareholders to major decisions and the decision-making processes.

The Process – Charting New Ground

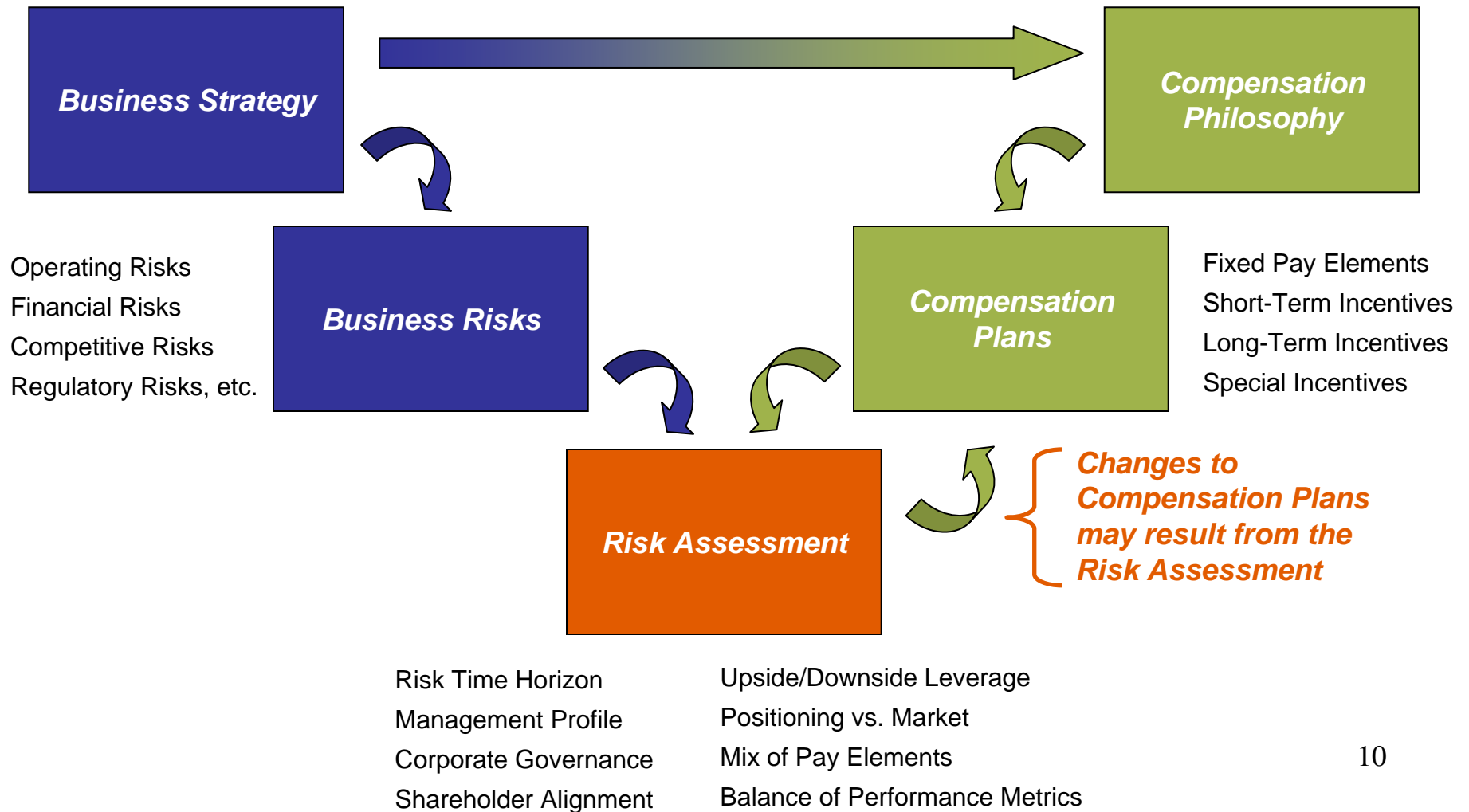


Who Should Conduct an Assessment?	Team Structure
<ul style="list-style-type: none"> • Objective parties • Small group of experts • Individuals with a company-wide view • Advisors with an external market view 	<ul style="list-style-type: none"> • Senior Risk Officer (SRO) • Support from HR, Internal Audit, Legal, Advisors • Report to Compensation Committee • Coordinate with Audit/Risk/Investment Committees
Who Should Not Be Involved?	Considerations
<ul style="list-style-type: none"> • Interested parties • Large management team • Individuals with a narrow focus • External regulators/authorities 	<ul style="list-style-type: none"> • CEO & CFO may lead compliance, but should not review their own compensation and performance • Specialist may provide insights on key risks, but may not have the depth to recognize risk interactions • External parties may govern compliance (for TARP participants) and reporting/proxy disclosure (SEC)
Frequency/Timeframe	Scope
<ul style="list-style-type: none"> • First time process • Annual reviews thereafter • Semiannual reviews for TARP participants • Follow-up on specific items during the year 	<ul style="list-style-type: none"> • Review of business risk • Review of incentive/compensation risk • Stress test based on positive and negative outliers • Identify areas for change and follow-up

A Framework for Assessing Risk



- An understanding of the business strategy and risks should be the starting point for assessment
- Knowledge of compensation plans is also needed to evaluate the risk-reward interaction



Business Risks



- Companies are in business to take risks, and executives need to be encouraged to take appropriate risks.
- But not all risks are acceptable; some risks should not be unduly rewarded.
- Appropriate protections and controls are needed, both within the compensation program and throughout business processes (investment criteria, risk oversight, etc.)
- Business risks may be evaluated using several factors:
 - Type of risk: strategic, operational, financial, competitive, regulatory, etc.
 - Nature of risk: ongoing vs. event-driven; internally vs. externally driven; etc.
 - Potential exposure/impact if the business risk occurs
 - Time horizon for impact
 - Quality of the existing controls and whether it is possible to implement additional controls
- Compensation Committees should take care that compensation plans:
 - Are designed with an understanding of key business risks
 - Do not have design flaws that motivate unnecessary and excessive risk-taking
- There is growing support for linking rewards with “risk-adjusted” returns and capital costs, especially in financial services

Business Risks – Key Questions to Ask



- What are the company's business risks?
- Which risks could most threaten the company's value?
- What is the probability that the business risk will occur?
- Over what time horizon should business risk be measured?
- What controls are currently in place to mitigate risk? What controls should be put in place to better protect the company from excessive risk taking?
- Which risks are connected (directly or indirectly) to incentive compensation?

Risk Matrix – Linking Business Risks with Compensation Programs



- Business risks would typically be prioritized by the Senior Risk Officer (SRO)
- Examples from various industries are shown below

Industry/ Risk Factor	Type of Risk	Time Horizon	Potential Impact	Level of Controls	Action Steps	Link with Incentive Plans
Investment Banking Derivatives Losses	Ongoing; Systemic	Medium	High	Medium; governed by investment policies	Risk is retained by the company or transferred Portfolio diversification and tighter monitoring	Direct: derivatives traders were paid based on current results
Homebuilder Credit Freeze	Event- Driven; Financial	Medium	High	Medium	Risk is retained by the company Manage D/E ratio; review banking relationships	None
Manufacturer Raw Materials Shortage	Ongoing; Operating	Medium	High	Medium	Risk is retained by the company; some hedging may be possible Monitor inventory; improve supply chain reliability & diversity	Inverse & Indirect: 50% wt. on EPS in STIP tends toward low cost supplier & minimal inventory
Utility Employee Safety	Ongoing; Operating & Regulatory	Long	Moderate	High	Risk may be reduced & insured Improve safety standards and “safety first” culture	Direct: 5% wt. on safety in STIP
Retailer Employee Pilferage	Ongoing; Operating	Short	Low	High	Risk may be reduced & insured Maintain security systems, new employee screening and insurance coverage	Indirect: 50% wt. on EPS in STIP

STIP = short-term incentive plan.

Examples of “High Risk” vs. “Low Risk” Compensation Strategies



- “Low Risk” and “High Risk” are not necessarily good and bad
- Despite risk assessment and controls, any system can fail when people fail

“High Risk” Compensation Strategies	“Low Risk” Compensation Strategies
<p><i>Investment Banking Industry</i></p> <ul style="list-style-type: none"> • Salary is less than 10% of total compensation • Heavy reliance on annual performance measures, even if a portion is paid in deferred shares • Uncapped upside opportunity • Multi-year guarantees as part of recruitment 	<p><i>Traditional Utility Industry</i></p> <ul style="list-style-type: none"> • Salary and pension benefits are more than 30% of total compensation • Narrow payout range from 80% to 120% of target for threshold-max; balanced scorecard approach to metrics • Greater reliance on restricted shares with dividends • Little or modest use of stock options
<p><i>Homebuilding Industry</i></p> <ul style="list-style-type: none"> • Total compensation equals a % of annual pre-tax profits • Uncapped upside opportunity • Formula-driven incentive plans do not allow negative discretion for “worst of the best” performance • Entrepreneurial culture favors use of stock options 	<p><i>Not-for-Profit Sector</i></p> <ul style="list-style-type: none"> • Compensation levels restricted to a fraction of total compensation for executives at public for-profit • Emphasis on base salary • Little or no bonus opportunity • Ongoing use of benefits and perquisites

Acceptable Risk-Reward Relationships



Typically Acceptable:

- Defined range of incentive awards (e.g. 50% - 200% of target)
- Majority of incentive compensation weighted toward long-term, equity-based incentives
- Long-term incentive/equity vesting schedules that are three years or more
- Meaningful stock ownership and retention guidelines

May Be Questionable:

- Small variations in performance that result in large variations in pay
- Heavily lopsided reward opportunity, e.g., uncapped upside or guaranteed minimum payouts
- Quarterly bonus payments without “true-up” if full year results fall short
- Immediate (or quick) vesting of equity-based incentives
- Overloading on stock options through mega grants

Compensation Program Risk – Key Questions



- Do incentive plan metrics reflect the company's business strategy?
- Is there an appropriate balance and mix of performance metrics?
- Is the leverage (upside and downside) appropriate?
- Is there appropriate focus on long-term performance?
- Are there protections/controls in place to avoid excessive payouts?
- Do the payouts align with shareholder interests?
- Do the payouts align with market practice?

Compensation Risk Scorecard (partial example)



Risk Factor	Specific Parameters	Effectiveness Rating				
		1	2	3	4	5
Performance Metrics	Incentive plan metrics are selected in the context of the Company's business strategy, goals and key risks					
	There is a balanced "portfolio" of performance measures across short- and long-term incentive plans					
	No one performance measure receives too much weight/impact toward incentive payout					
	...					
Quality of Goal Setting	Target performance levels represent reasonable variation relative to historical performance and investment analyst forecasts					
	The probability of payout at threshold, target and stretch is understood and reasonable					
	Over time, historical payouts track with stock price					
	...					
Pay Mix and Balance	The overall pay mix reflects desired philosophy and objectives					
	There is appropriate balance between short- and long-term performance					
	There is appropriate balance between cash and equity compensation					
					

Compensation Risk Scorecard (partial example)



Risk Factor	Specific Parameters	Effectiveness Rating				
		1	2	3	4	5
Leverage	The full range of total compensation opportunity for low and high performance is known and appropriate (Dynamic Pay Modeling)					
	Incentive plans do not provide for uncapped upside (or controls are in place to manage extraordinary windfalls)					
	Changes in performance result in appropriate changes in payout (i.e. curve)					
	...					
External Reference	The compensation peer group is based on companies similar in size and other key parameters					
	Compensation practices are in line with industry/peer practice					
	Company performance explains any pay variation from market practice					
	...					
Checks and Balances	The company has an audit process for determining incentive plan payouts					
	The company has a defined clawback policy					
	The company has stock ownership/retention guidelines					
					
Other	The Company has formal governance practices related to CEO performance					
					

Example of Incentive Plan Design Changes Resulting from the Compensation Risk Scorecard Assessment



- **Adjust the mix of performance measures**
 - Company had too much weight on one measure (revenues), which was rewarded in both the short- and long-term incentive plans
 - Introduced a return measure to the short-term incentive plan to balance the mix
 - Refocused the long-term incentive plan on sustained long-term performance and stock value
 - Considered both absolute and relative performance measures
 - **Shift toward a longer-term performance horizon in the pay mix**
 - Reduced weight on annual incentive plan; increased weight on long-term incentives
 - Introduced a performance share plan based on 3-year TSR relative to peers
 - **Implement design features that reward sustainability of performance**
 - Introduced overlapping performance cycles for long-term performance share plan
 - Lengthened the stock holding requirements
 - **Implemented protections for “swing for the fences” behavior**
 - Capped upside opportunity to 300% of target
 - **Incorporate Committee discretion** to adjust awards based on “how” results were achieved and “quality” of earnings; at end of day, business judgment should rule
- However, beware that mitigating risk could dampen the pay-for-performance linkage
 - Multiple performance measures, with little weight on each
 - Bonus deferral tends to result in “smoothing” of awards
 - Committee discretion may be applied inconsistently

2009 Proxy Disclosure – Where Do We Go From Here?



- Limited details provided in 2009 proxies
 - Initial focus on TARP participants only
 - New process and rules with little time to execute
 - In a PM&P review of 2009 proxy filings for 50 large companies:
 - 7 of 9 TARP companies discussed “excessive risk”
 - However, only 8 of 41 non-TARP companies discussed “excessive risk”
- Disclosure tended to focus on:
 - Summary of process and who was involved
 - Identification of business risks
 - Examples of plan design features that mitigate risk
 - Overall finding that incentive plans do not motivate excessive risk taking
 - Several non-TARP companies only provided an overall statement with limited reference to plan design features
- A call to action for improvements in 2010:
 - More expectation for all companies to assess risk as part of their compensation review process
 - More rigorous analysis in general
 - Better integration with general business risk analysis
 - Greater investment of time to conduct the assessment and hold discussions
 - Identification of plan design features/changes

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If you have any CDE questions, contact

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Our Next Webcast:

Thursday, June 18, 2009, 2pm ET

The Future of Options

Deborah Lifshay, Managing Director, Pearl Meyer & Partners
Ed McGaughey, Managing Director, Pearl Meyer & Partners

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Educational Resources

1. **Additional NACD Board Advisory Services - In-Boardroom Programs and Evaluations - <http://www.nacdonline.org/services>**
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Thank You!



- A copy of these slides will available by tomorrow at pearlmeyer.com/responsiblerisk.
- Both the replay and the presentation will be available at nacdonline.org or pearlmeyer.com next week.

Thought of a Question After the Presentation?



Please feel free to direct additional questions regarding this presentation to:

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