GUIDING PRINCIPLES FOR COMPENSATION COMMITTEES: Governing the Link Between Pay, Performance, and Risk

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ABOUT THE DIRECTORS AND CHIEF RISK OFFICERS GROUP (THE DCRO)

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.

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# Table of Contents

**Introduction** ......................................................... 2

**Pay Governance in Practice** ........................................ 3

**The Guiding Principles** ............................................... 4

- Depth ........................................................................ 5
- Design ....................................................................... 7
- Transparency ............................................................ 12
- Expertise ................................................................... 14
- Resiliency .................................................................. 16

**Conclusion** ............................................................... 20

**Additional Reference Documents** ............................... 21

**Appendix** ................................................................... 22

- I. Some Notes on the Psychology of Incentive Design ....... 22
- II. Risk Capacity, Risk Appetite, and Risk Tolerance ........ 24
- III. Information Flow and Compensation Committee Annual Cycle ........ 25
- IV. DCRO Compensation Committee Risk Governance Council Members ... 26
- V. DCRO Guiding Principles for Risk Governance by Compensation Committees ... 28
INTRODUCTION

The purpose of this document is to provide both Boards of Directors and board-level Compensation Committees (alternatively known as Remuneration or Human Resources Committees) a set of Guiding Principles for the governance of risks associated with compensation philosophy and pay culture.

Risk-taking is essential for any organization to achieve its goals. Hence, risk should never be viewed solely as a negative. Within the context of this document, risk is taken to have both positive and negative potential. In terms of compensation risk, the positive element is the expectation of higher performance when employees can earn incentive pay beyond their base compensation. This notion of a positive reward-feedback mechanism has led to increasingly more complex and incentive-heavy compensation structures, especially at for-profit entities. But, as behavioral misdeeds at all levels of organizations have also been associated with incentive pay – the negative side of compensation risk, the call for more transparent, accountable, and intelligent pay governance has grown.1

The very specific risk governance work of Compensation Committees is among the most difficult of board duties. These Guiding Principles have been written to help boards ensure that the tactical implementation of their compensation philosophy stimulates employees to achieve their organization’s goals, within the desired corporate culture and expressed values. Further, they establish guidance on mechanisms for corrective action when the stimulated actions are inconsistent with these norms. And, while different organizations will find themselves at different levels of maturity in terms of their pay governance, the fullest practical implementation of these Guiding Principles should be pursued to realize greater fulfillment of a board’s Duty of Care.

These Guiding Principles are designed to enable Boards which effectively apply them to realize more predictable behaviors among employees and create greater long-term value in service of their respective missions.

Management vs. Governance

We distinguish between the management of employees via pay and the governance of the compensation philosophy of the organization for which they work. Management is taken herein to be the day-to-day tactical implementation of a strategy to attain the corporate objectives established by the board of directors, within the behavioral boundaries defined by that same entity. This tactical implementation is done via employees of the organization and others with whom the organization has interactions (the organization’s “social network”). Governance is taken herein to mean the process of deliberating, establishing, monitoring, and adjusting strategy, defining and communicating the rules by which strategy is implemented, and hiring, monitoring, and evaluating the senior executive team. It is both the domain and fiduciary duty of the Board of Directors.

The terms risk management and risk governance enjoy similar distinctions.

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1 See the Appendix for a discussion of important psychological research around incentives and behavior.
PAY GOVERNANCE IN PRACTICE

Organizations operate in different industries, political economies, and regulatory environments. Each, therefore, has a different set of expectations and rules that determine what constitutes effective risk governance. However, the purpose of risk governance is common to all — to create and maintain an environment that makes it possible to maximize the value of what an organization does.

Specifically, in the realm of pay governance, some questions that must be addressed in the process leading to value creation include:

1. What should be emphasized: short-term, medium-term, or long-term performance?
2. Should pay be primarily fixed (salary) or variable (incentive), and how do you balance these with the risk-taking responsibilities of the employee?
3. Do the chosen incentives reinforce each other or are they in conflict?
4. Should personal or corporate performance be more heavily weighted?
5. When should accrued pay be at risk?
6. Should performance be measured against internal or external benchmarks?
7. Should accelerating payouts be made for performance that grows beyond expectations?
8. Should pay be determined by rigorous metrics, through human discretion, or both?
9. What process should be used to determine if pay should be adjusted after the evaluation period has ended and more is known about how the performance was achieved?

Through thoughtful contemplation and discussion of these questions, a board will be better prepared to pursue the positive outcomes of risk-taking.

However, to fulfill a board’s Duty of Care around pay governance, it must ensure that compensation philosophy includes an effective communication of the goals an organization is pursuing, validate that the organization is carrying out that pursuit within the boundaries the board has set, and, both ex ante and ex post, understand the potential downside to risks that have been taken. Realized pay must then incorporate the board’s understanding and evaluation of all three of these components into a successful culture, and should not solely contemplate and reward financial objectives that have been reached or exceeded. The failure to consider potential negative risks when determining incentive pay means that the Duty of Care cannot be fulfilled.
THE GUIDING PRINCIPLES

We examine the principles of risk governance by Compensation Committees in five specific areas: Depth, Design, Transparency, Expertise, and Resiliency, defined as follows:

1. **Depth** - The type of employee whose pay structure should be governed by the Compensation Committee either directly or indirectly.

2. **Design** - The elements of compensation which are the keys for long-term success.

3. **Transparency** - The methods by which the organization ensures that key parties to its success are engaged in governing the link between strategy, risk, performance, and pay.

4. **Expertise** - The skills and attributes necessary for success of individual members of the Compensation Committee and the committee-as-a-whole.

5. **Resiliency** - The processes designed to allow the organization to effectively respond to opportunity as well as negative instances of behavior or performance.
Depth

**Principle 1:** The Compensation Committee has both direct and indirect pay governance responsibilities through which it defines the desired compensation culture for the whole organization.

The Compensation Committee, like all board committees, is challenged by a scarcity of time and other resources in proportion to the challenge of their task. Ably fulfilling both direct and indirect pay governance responsibilities is essential for the successful governance of pay.

Direct governance responsibilities include the establishment and continual review of corporate-wide compensation philosophy, as well as the governance of compensation plans for the senior management team that implements said philosophy. The specific roles for which they are directly responsible include that of the Chief Executive Officer, his/her direct reports, and any other potential successor to the Chief Executive Officer that might fall outside of his/her direct oversight.

Its indirect governance responsibilities are to ensure that sufficient resources and processes exist to properly care for the organization’s incentive plans in any place where direct governance by the Compensation Committee is not practical, and that those plans are broadly aligned with corporate strategy and desired culture. Their sphere of indirect governance responsibilities crosses any lines of decentralization and includes the following employees (taken to mean employees and contract workers) of the organization who are not already under direct governance by the committee:

1. Any employee whose job function involves a material use of the corporate balance sheet
2. Any employee responsible for the performance of a material segment of the company’s operations
3. Any employee responsible for the performance of a new strategic operation
4. The gatekeepers of the company’s integrity, including the Chief Risk Officer, the Chief Audit Executive, the Chief Financial Officer, President/COO, Chief Compliance Officer, Chief Human Resources Officer, General Counsel, the Chief Information Security Officer, and Chief Technology Officer
5. Employees with direct customer interface or who are the public face of the company and have incentive compensation plans driven by individual performance

6. Any employee whose incentive compensation may exceed their base compensation

Because this is an impractically large number of employees for the Compensation Committee to directly govern, indirect governance is carried out through planned and regular interaction with the existing senior management, risk management, audit, and human resources infrastructure. Through this interaction, the committee can clearly articulate the risk tolerance of the board-as-a-whole and can engage in an iterative process of oversight, feedback, and response to ensure that pay-related behaviors and risks are governed consistently throughout the organization. This process is reviewed in more detail in our discussion of the importance of resiliency and is the focus of this document’s final Guiding Principle.
Design

**Principle 2:** In the design and communication of compensation philosophy, incentive pay for corporate performance should be emphasized, while incentive pay for individual performance may be carefully applied where appropriate to the role.

At all companies, there is a spectrum of desired risk-taking behavior ranging from the high risk-taking of an entrepreneur to the desired high-quality/low-variance performance of operational and production roles. Compensation design may reflect these variations in desired individual behavior, but the dominant feature of incentive compensation must be broader than individual performance. Arguably, few high-impact employees, especially those whose compensation design is directly governed by the Compensation Committee, should have a large portion of their incentive pay based on individual outcomes.

At many organizations, compensation philosophy has moved rapidly towards rewarding individual achievement over corporate achievement in a manner that is both corrosive and not in the long-run interest of owners. Where individual performance is most-valued, collaboration may suffer. Further, organizations may suffer from a concentration of high-impact employees whose incentives for the long-term success of the organization are not aligned with owners and other stakeholders as they put primary importance on individual reward. Abundant failures of pay to incent desired behavior, or incentive pay leading to undesirable individual or group behaviors, demonstrate the downside risk of inappropriately designed individual compensation plans overwhelming the intended corporate culture.

An emphasis on reward for corporate performance will benefit organizations in their management of this downside risk.

**Principle 3:** The total compensation of the Chief Executive Officer, key executives in the succession plan, and the guardians of the company’s integrity, should be driven by their impact on a balanced view of the enterprise, including how effectively the organization takes risk.

Boards are charged with oversight of a long-run strategy that maximizes the value of the organization and its ability to fulfill its mission. However, organizations often rely on shorter-term internal financial benchmarks for determination of compensation – for example, KPIs (Key Performance Indicators) like revenue growth, or return on assets.
In the absence of correlated risk KPIs, these internal benchmarks can be misleading and suggest to high-impact employees that behaviors that may not be in the long-run interest of the organization are those that receive greater reward. To address this risk, we recommend the use of risk-adjusted KPIs, as well as a balanced scorecard and Integrated Reporting approach to performance evaluation, noting the need to ensure that these reflect any general regulatory distortions to the efficient use of capital.2

Total pay should also be determined by the impact of performance on the value of the organization. Value can be defined both financially and via feedback mechanisms from key external parties to the success of the organization including customers, suppliers, creditors, equity investors, regulators, ratings agencies, and analysts. The value of an organization is determined by the strength of these relationships over time; changes in their perceptions of the company will affect the value of the organization.

Total Shareholder Return (TSR) is a common metric used at publicly traded companies when evaluating senior executive performance, as it is believed to be an external valuation of the company by a key stakeholder group. Even as a relative measure (rTSR), it is a flawed metric for purposes of compensation, as it often does not fully reflect the degree to which risk has been assumed by the company in pursuit of short-term stock price appreciation. Most of the key stakeholders described above do not have full transparency to the risk being assumed by the company, so the value of the stock price does not always reflect a true risk-adjusted value of the organization.

TSR is also biased by broad market or industry specific factors that are outside of management influence. Moreover, as it is an ex-post measure of stock price performance, it provides little visibility to the drivers of future value creation, which the board seeks to emphasize. Its use, therefore, should be highly limited and its flaws should be widely understood by Compensation Committee members.3

We recognize that the use of options as part of risk-taking incentive design may be desired by some employees, or may be driven by perceived standard practices in a specific sector or company. However, we recommend against any significant use of option-based compensation. In part, option value increases when the volatility of the underlying instrument grows. This is in stark contrast with the desire for long-term predictable performance and the perceived value of the organization to the members of its social network. Further, options are one-sided payouts and are usually awarded with little or no cost to the recipient. They are, in effect, lottery tickets for which no fee has been collected and have little downside risk. This stands in stark contrast to the interests and risk/reward profile of owners and stakeholders.4

To the extent that options are used in compensation design, the Compensation Committee should ensure it has a thorough understanding of these concerns and it should employ efforts to mitigate them.

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2 See http://www.integratedreporting.org for information and resources about Integrated Reporting and links in the Appendix for information and resources about Integrated Reporting and the Balanced Scorecard

3 See Schwarte, Eric, Total Shareholder Return Paints an Incomplete Picture, June 23, 2016, Morgenson, Gretchen, When the Stock Price Hides Trouble, New York Times, October 12, 2013, for example

4 See BYU study: Option-loaded CEOs strike out swinging for the fences and Wm. Gerard Sanders and Donald C. Hambrick, “Swinging for the Fences: The Effects of CEO Stock Options on Risk-Taking and Performance,” Academy of Management, 2007
**Principle 4:** The use of external benchmarking for executive pay should be minimized and replaced by more internally-focused evaluations of performance.

The rapid ratcheting-up of CEO pay that has brought so much criticism and attention to pay governance is due in large part to the practice of benchmarking pay to that realized by external peer groups. There are two major flaws in the peer-benchmarking approach. The first is that the process by which peer averages are determined virtually ensures that any executive whose continued service is desired must be an above-average employee and, therefore, deserves above-peer-average pay. When companies only choose well-performing peers, this vicious circle results in the continued ratcheting higher of the average pay of the peer group as no board wants to suggest the employees they wish to retain are anything but above average.

The desire to pay competitive compensation for the role of CEO must not overwhelm the fiduciary responsibility of the board to ensure that such compensation also be fair. Fulfilling this responsibility is best served through evaluation of the internal, risk-adjusted impact that individual has on the organization. It can be measured, where possible, with risk-adjusted KPIs, and should incorporate feedback from the organization’s stakeholders, facilitating a discretionary override when warranted.

The second flaw is the belief that executive skill is fully portable, and senior executives are, therefore, constantly at risk of being poached by competitors. A significant portion of the value that any senior executive brings to the organization is their knowledge of the inner workings and idiosyncrasies of the company. These skills do not transfer and may in some cases be considered intellectual property. Hence, their value externally is diminished in proportion to their internal value.5

Increasing CEO compensation has also brought more attention to the growing disparity between the income of a CEO and that of an average worker. There have been loud and repeated calls to limit the ratio of CEO pay to this average. Limiting the ratio for this measure is not a value judgement, although it is often presented as one. Well-governed organizations are complex adaptive systems that can be designed to successfully adjust to the loss of a key executive.6 If the board sets a limit on this ratio, it can signal to employees and stakeholders that the culture values corporate performance over that of the individual, and that sound succession planning is in place to mitigate the risk of loss of a high-profile employee like the CEO.

The existence of initiatives like “say on pay” reflects the failure of organizations to adopt effective pay governance procedures. Over-reliance on external peer-benchmarking in lieu of a greater effort to model the internal impact of key executives on an organization’s value is an example of why “say on pay” voting has come to exist when boards were intended to serve as an effective proxy for distant owners on such matters.

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5 See, for example, Elson, Charles M. and Ferrer, Craig K., “Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect and Solution”

6 For a quick definition, see Business Dictionary: Complex Adaptive Systems
**Principle 5:** Incentive compensation should be “at risk,” subject to significant deferral periods, and subject to vesting horizons that emphasize the organization’s long-term performance.

To be consistent with the notion of long-term value creation, it is especially important that the incentive compensation of employees who are directly governed by the Compensation Committee, as well as the guardians of the company’s integrity (CRO, CFO, CAE, President/COO, CHRO, CCO, General Counsel, CISO, and CTO), are aligned with risk-adjusted corporate performance over multiple-year cycles.

Further, when any individual in the organization receives a significant sum of incentive pay (in excess of 100% of their base pay, for example), that pay should be considered “at risk” and subject to significant deferral periods to ensure that the long-term interests of the company are primarily served.

Putting incentive compensation payments into extended deferrals that are always “at risk,” creates stimulus for internal network self-governance and for the CEO to emphasize the strength of succession via the executive bench. Without multi-year deferrals, pay will not truly be viewed as being “at risk.” Under this approach, the value of key employee incentive payments would always be dependent on future corporate performance. Therefore, there is a strong incentive to monitor the behavior of others and to escalate or address any abuses that endanger this deferred compensation.

Incentive compensation should never accelerate and fully vest upon the departure of an employee, except for double-trigger clauses where both a change-in-control and employee termination occur simultaneously. Otherwise, we recommend that incentive compensation remain at risk for a minimum of three years after an employee departs the firm and would suggest that vesting terms of three to five years may be more appropriate for both active and departed employees. This structure creates an element of incentive pay that more clearly aligns with the long-term health of the organization.

Finally, so-called claw-back provisions, whereby realized pay can be recovered due to employees’ misdeeds, must be present in both policy and in practice, further reinforcing a corporate culture of quality and integrity.
**Principle 6:** Discretion must always be present in final incentive pay determination.

Even through the improved use of risk-adjusted KPIs, a balanced scorecard and Integrated Reporting approach to executive evaluation, compensation plans can be quite complex. Complex compensation plans may be difficult to understand, and may invite gaming and abuse. Simplicity and clarity will help to mitigate comprehension asymmetry where the employee understands the payout better than the Compensation Committee, or vice versa. We therefore recommend that, wherever possible, organizations be highly judicious in the use of rules-based formulas for determining incentive compensation. They should also make all such formulaic approaches subject to discretionary override whenever the culture of the organization is perceived to have been violated in pursuit of such pay. For CEOs, the quality of culture — something that is not fully captured by metrics-based evaluations — should always be an important component in the determination of their annual performance evaluation and final rewards.

This approach will also address the risk of underpayment for quality work whenever the CEO’s management skills through extraordinary circumstances may justify incentive compensation above that suggested via rigid formulaic approaches.

We understand that outside pressures for transparency, predictability, and defensibility, have driven a shift towards reliance on metrics by Compensation Committees. Given what is now well-understood via experience, and which was predicted in theory, we believe the pendulum has swung too far and recommend that a balance be restored through more thoughtful and transparent use of discretionary overrides on incentive pay.²

Principle 7: Compensation Committees should provide full transparency to the board-as-a-whole on performance reviews and compensation design for the CEO, as well as for those individuals in the succession plan.

The process of CEO performance review begins, as does the process of CEO engagement, with the input of all board members. The responsibility for taking that feedback and melding it with any other performance reviews may be managed by the Compensation Committee. However, the full details and final awards must be reviewed and approved by the board-as-a-whole, where the fiduciary responsibility for the evaluation of the CEO and successor performance resides.

While the delegation of many duties to board committees is common, without full transparency to the comprehensive details of the chief executive’s performance, the data from risk-adjusted KPIs, and a thorough discussion of recommended discretionary overrides that drive the proposed compensation, it is not possible for any individual member of the board to sufficiently contribute to the key fiduciary role of the board-as-a-whole in evaluating the CEO. These board-as-a-whole reviews may include summaries from the Compensation Committee, but should also contain detailed reviews by key internal and external stakeholders (360-degree reviews, for example) whenever such assessments are conducted. We recommend they be performed at least once every two years, if not annually.

Additionally, if any changes are made in the contracts or compensation plans for the CEO, these adjustments should be fully transparent to the board-as-a-whole and subject to its approval. All board members should review the CEO’s contract before it is signed. Further, all board members should be aware of revisions to key corporate policies that will affect senior executive compensation, including those imposed on the organization by outside entities, significant accounting rule changes, or any other factors that will alter the computation of the metrics used in compensation formulas from that originally understood by the board.

Finally, to further the governance of risk around the departure of the CEO, the entire process should be repeated for all executives who are part of the corporate succession plan. We note that in some jurisdictions, the board of directors is responsible not just for the hiring and evaluation of the CEO, but also for the hiring and assessment of several key executives. This may be an evolving best practice.

The desire to allocate key board duties like CEO review to a board committee is sometimes a reflection of an environment where managing board members’ time takes precedence over their need for information. Meanwhile, the link between full transparency and best practice risk governance is clear and stands counter to any limited disclosure. Transparency around compensation matters among board members is an indication of how the board values transparency elsewhere in the organization and furthers the overall risk governance process of the board-as-a-whole.
Principle 8: Compensation Committees should publicly certify that their processes of governing pay risk and compensation philosophy are fit for purpose.

Owners of for-profit companies have empowered the board of directors with the duty of pay governance. Failures in this arena have made Compensation Design & Analysis (CD&A) among the most closely read narratives of the proxy statement for publicly traded for-profit companies. How a company discloses its thinking on pay is often a strong indicator of its overall understanding of the link between transparency and risk. Much like the statements signed by an organization’s principal officers certifying the integrity of its financial reporting, the execution of a “fit for purpose” statement by the Chair of the Compensation Committee provides an accountable assurance to distant owners and key stakeholders that the company has performed due diligence on its pay governance processes.

In addition to the signed “fit for purpose” statement, we recommend as part of its CD&A in the proxy statement, or an equivalent disclosure, an in-depth discussion of how a company is working to assure that incentive pay is consistent with corporate strategy and reflective of risk-adjusted performance on internal benchmarks – not simply metric-based compensation on non-risk-adjusted KPIs. This discussion can also include information on the process used for consideration and execution of discretionary overrides of formula-driven incentive pay.

In some cases, poor communication about the effective governance practices of boards and Compensation Committees has contributed to greater efforts to exert external checks on board activities. We recommend that, at least annually, publicly traded companies communicate directly with the governance teams of proxy advisory services and significant owners like pension funds, whereby they discuss the foundation and merits of the “fit for purpose” declaration. Such communication can include, where practical, in-person discussions.
**Expertise**

**Principle 9:** Compensation Committee members should be independent, with diverse backgrounds and experience, have expertise in risk, finance, and management “through the cycle,” and should cross-populate both the Risk and Audit Committees.

Pay is for performance. How successful performance is achieved is the domain of competent leaders. How that success is attained on a risk-adjusted basis requires additional skills and expertise for individual board members that are described in the *DCRO Qualified Risk Director Guidelines*.

The members of the Compensation Committee must be chosen carefully, so that they understand how profits or surplus are derived, how successful strategy is developed and communicated, and comprehend risk well-enough to be able to determine how KPIs and qualitative assessments can more accurately reflect the potential downside risk assumed by the organization.

They should also be familiar with the workings of contracts, have experience with compensation consultants, and it is helpful if they have been on the receiving end of the work of Compensation Committees.

For success with the resiliency of the pay governance process, the Compensation Committee must cross-pollinate the Audit Committee and the Risk Committee. We recommend that at least one member of the Compensation Committee serve on each of these committees.

By nature, Compensation Committee members must not be timid. They must feel comfortable challenging the standing order of compensation design, as well as any recommendations and analysis by outside consultants. Collegiality of the Compensation Committee is of secondary importance to fortitude.

In some organizations, the Compensation Committee may be treated as the safe place for board members with little organizational leadership experience. The vital importance that pay culture plays in creating a positive long-term focus, rather than a culture susceptible to unintended behaviors, should drive an elimination of this practice. While the Compensation Committee can be an excellent training ground for new members, they must come with the requisite competence in management, through both good times and bad, and have a sufficient understanding of risk and the impact of corporate culture on human behavior.

We recommend that the Chair of the Board of Directors be excluded from possible membership on the Compensation Committee due to the close relationship that the Chair inevitably has with the Chief Executive Officer. Where a Lead Director is present, his/her independence must be maintained, or the same exclusionary guidance applies.

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8 DCRO Qualified Risk Director Guidelines, The Directors and Chief Risk Officers’ Group, June 5, 2013
Outside guidance on complex subjects like pay and risk governance is almost always necessary for boards to be effective in their governance of pay. Where Compensation Committee members do not have the requisite familiarity with compensation design and pay governance, there may be a tendency to show an unhealthy deference to external compensation advisors’ guidance. The services of these providers do indeed have value, but several past cases of failed understanding of the link between compensation design and risk-taking behaviors indicates a blind spot which Compensation Committees must be sufficiently experienced to address.

We recommend two necessary steps to resolve these concerns. First, the Chief Human Resources Officer and General Counsel may be invited to be present for some discussions that the committee has with external compensation consultants. Second, either internal or external risk management experts should similarly be included in the regular process of compensation philosophy development and review. If sufficient infrastructure exists in the organization, the Chief Risk Officer can serve in this role. Where such infrastructure is not present, or is insufficient, external risk consultants should be engaged. We note again the cautionary statements about the members of the Compensation Committee needing to have sufficient skills, expertise, and fortitude to challenge the guidance from these consultants as well.

Regarding any recommendations from either compensation or risk consultants, the Compensation Committee must sufficiently gain an understanding of the following:

a. Where has this recommendation worked well? What were the conditions under which it worked well? How does that compare/contrast to the situation at this specific company?

b. Where has this recommendation gone wrong? What were the conditions under which it failed? How does that compare/contrast to the situation at this specific company?

c. What are the perceived risks in our compensation plan?

d. What are our guard rails against abuse? Who is responsible for their implementation and monitoring? How are these expected to be implemented?

e. Are our employee contracts aligned with our compensation philosophy?

f. How does this plan help us to achieve our strategic objectives?

g. What other work is the consultant doing for the company outside of that being provided to the Compensation Committee?

h. Are there any other potential conflicts of interest? For example, has the consultant been hired at another company where the CEO serves as a non-executive director?

As a matter of process, before meetings are held with any external consultants, the Compensation Committee must have pre-agreed goals around risk-adjusted compensation design, as described in Principles 2 through 6.
Resiliency

**Principle 10:** Compensation risk governance is an ongoing process that must foster corporate resiliency through formal collaboration, feedback, review, and escalation channels among board committees and the organization’s social network, so that a properly designed and established compensation philosophy and culture for the whole organization can thrive.

Resiliency is a key component of any risk governance function. It is the ability of an organization to respond to unexpected opportunities and threats in a manner that enhances long-term value. This concluding principle is perhaps the most important of all principles outlined in this document as adherence to it will strengthen the value of the preceding nine principles. Meanwhile, a failure to adhere to this principle will likely result in an undermining of even the most diligent implementation of the aforementioned pay governance principles and potentially lead to the failure to recognize and address the unintended and unanticipated consequences of believed-to-be-prudent compensation plans.

We view the process of resiliency as a feedback loop. The process begins with planning by the board-as-a-whole, using a timeline that allows for a repeatable annual cycle which aligns with general meetings of owners or key stakeholders. The primary purpose of a feedback loop is a post-implementation review to ensure that behaviors match expectations and when they do not, to make corrections to bring those behaviors back into line with corporate values.

In this loop, Compensation Committees must be in dialog with the CEO, CRO, CHRO, and the CAO to answer the following questions:

1. What behavior was expected when the pay plan for an individual or group was devised?
2. What behavior was realized by this individual or group?
3. What changes were made that might have caused a divergence?
4. What changes were made to address this divergence?
5. How might someone game our compensation plan?
6. Does our pay plan confer the same message as our corporate value statement or does pay send contradictory messages that may override our desire for behavior?
7. When above-expectation performance has been realized, what were the reasons that things went so well?
8. When below-expectation performance has been realized, what were the reasons for that?

9. What were the sources of any unexpected volatility in risk-adjusted KPIs?

10. What measures indicate that our risk culture is consistent with our expectations?

11. Does the feedback from the organization’s social network indicate behaviors consistent with our expectations?

12. What avenues are available for escalation of concerns regarding behavior and have they been utilized?

13. Are all KPIs risk-adjusted and do they continue to be relevant for our goals?

14. How are KPIs independently validated?

15. Where there has been a risk event, was our compensation plan a leading driver? What role did our compensation philosophy and plan play?

16. What continuing education do members of the Compensation Committee and senior executive team undertake with regards to risk-adjusted pay governance?

Some of these questions involve sensitive matters that may require the Compensation Committee to meet in camera with the Chief Human Resources Officer, the Chief Risk Officer, the Chief Audit Executive, and/or mid-level executives outside of the C-Suite. Such meetings should be scheduled as a matter of course in the due diligence process of the committee.

We also recommend that the Compensation Committee meet jointly with the Risk Committee and the Audit Committee at least annually. The Audit Committee can validate that the compensation plan is being executed as planned and the Risk Committee can confirm that compensation plans are rewarding the right behaviors.

Meetings with the Risk Committee may include the following discussions:

1. Are our compensation plans consistent with our values and objectives?

2. How are we measuring performance versus these objectives?

3. How do we measure risk relative to performance?

These two committees can then work jointly towards a framework for creating risk-adjusted KPIs and a compensation structure that matches risk-taking and performance goals.

All board committees should inform the Compensation Committee of contextual changes that could affect compensation plans. Changes in accounting rules, for example, may impact how KPIs are calculated as accounting numbers are derived under different rules. The Compensation Committee must understand what incentives or risk behaviors might change as a result of the accounting change. This is another example of the importance of cross-pollination of the Compensation, Audit, and Risk Committees.
Risk assessment is also part of the Compensation Committee’s due diligence process. Meetings with the Chief Risk Officer or external risk consultant should include the following discussions:

1. What kind of behavior will our growth targets stimulate?

2. If our primary goal is “growth greater than our peers,” what will have to give to achieve this?

3. What stress tests are included in our review of pay plans?
   a. If a high-impact employee leaves unexpectedly (retirement, medical issues, loss to competitor)?
   b. Just how much could someone make under this plan in really good times?
   c. What is the prevalence of plans where the upside is unlimited and what is the psychology behind such plans?
   d. What could cause large pay disparities between senior executives and their direct reports in the succession plan?
   e. Are there any elements of our compensation plans that have created or will lead to prevalent disparities in pay between genders or other places where there is a disparate impact upon specific groups? (gender and other pay gaps are a sign of possible corporate culture risks)

4. What scenarios do we run our compensation plans through and are there any outcomes that are of concern?

5. What is the shape of an incentive compensation curve when results are achieved at the 50%/80%/90%/110%/120%/150% levels of expectations? Do these, in effect, create an option-like payout for substantial outperformance or under-performance, and/or do they incent manipulation of results at inflection points?

6. What risks does our compensation plan introduce to the company?

7. Does our compensation plan align with our desired risk profile?

8. How has our risk profile changed over time, and are there any links between this and changes in our pay plan design?

9. Where are our target risk-adjusted KPIs materially more aggressive than the industry norms or our historical experience?

All aspects of the risk assessment should be regularly communicated to the board-as-a-whole, so that statements about risk culture can be modified or amplified, as appropriate.

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For a helpful and illustrative discussion of some of these risks, see Hodak, Mark, *Finding and Avoiding Perverse Incentives*, Directorship Magazine, 2017

Citations of this document should reference the originating work of the DCRO Compensation Committee Risk Governance Council of the Directors and Chief Risk Officers Group (the DCRO).
But answers to these questions are only helpful if the Compensation Committee has also dedicated time to the review of how key risk executives are being compensated. Do they have any downside to their pay? Is their compensation sufficiently skewed to the long-term success of the company? Do they have any incentives not to escalate pay governance issues to the Compensation Committee?

Likewise, the compensation of board directors, whether cash, equity, or other, should be consistent with the corporate philosophy and design. Director behavior must not be mis-incented.

Within the whole corporate culture, an expectation must be set that if anyone sees things moving against the board’s risk appetite or compensation philosophy, they have an obligation to raise the issue. This is not just the responsibility of the Chief Risk Officer or Chief Audit Executive. Further, regular meetings with key external members of the firm’s social network can provide early warning of sales practices, or other practices, that are perceived to be inconsistent with the company’s values. This may be achieved through the committee’s indirect governance mechanisms when direct governance in this manner is impractical.

The quality of a board’s ability to assess corporate performance is critical and is an early indicator of both board and company culture.

Even with all of this in place, the Compensation Committee should have some triggers that mandate a review and discussion of any individual or group plan where incentive pay exceeds some ratio of base pay. The specific ratio is to be determined by the committee in advance. Additionally, they should discuss and review any cases where total pay has increased for any individual or group by more than a specific percentage – again, determined by the committee in advance. These automatic triggers ensure that such cases are not deferred during a benign or outperforming period where discussions of risk are often seen as unnecessary or constricting. This may be achieved through the indirect governance processes, provided that the expectations of escalation to the committee are well-understood and executed.

Succession planning, as previously noted, is an essential part of resiliency. Consistency in the process by which compensation of executives in the succession plan is determined is critical to the success of the plan. Continual feedback from this select group builds resiliency. But succession planning must also be applied to the Compensation Committee to ensure a continuation of effective practices.

Finally, all compensation plans should have an effective sunset clause that forces the Compensation Committee to go through a “whiteboarding” exercise where plans are reimagined from the ground up and compared with existing plans for areas of conflict or improvement.

No board committee or executive can anticipate everything. The admonition that “you’ve thought of everything that you’ve thought of” should be ever-present for Compensation Committees in their implementation of a resiliency building feedback loop.
CONCLUSION

Boards-of-directors have been entrusted by multiple entities that make commitments to engage an organization, including investors, suppliers, regulators, lenders, customers, and employees. High-commitment relationships like these are essential for success. The goal of effective pay governance is to support a culture within an organization where prudent, tactical risk-taking by its employees is rewarded and aligned with long-term value creation.

In a way, corporate compensation philosophy is akin to a Pavlovian bell that signals an upcoming reward for the desired behavior. Communication about this philosophy must show how it aligns with the overall values of the organization and implementation of it must not create perverse incentives that override these values.

Boards-of-directors must view all employee performance in a manner that is reflective of the potential downside to the risks they have taken in pursuit of corporate goals. As a reflection of the importance of this risk-adjusted mindset, governance ratings agencies MSCI and Sustainalytics now penalize companies that don’t have risk governance expertise among their board members.10

Still, even with careful deliberation around compensation philosophy and the design of compensation plans that account for the risks taken, Boards of Directors need to repeatedly examine whether the organization’s compensation philosophy is a positive or negative contributor to its ability to create value and to use continual feedback processes – such as those described in these Guiding Principles – to take corrective actions. In the absence of this feedback loop, the efforts put into compensation design and communication may well be undermined.

Pay governance issues continue to permeate almost all industries.11 Ably fulfilling the board’s Duty of Care around compensation philosophy and its tactical implementation requires the practical pursuit of these DCRO Guiding Principles for Compensation Committees, even if that pursuit involves significant cultural change and effort. Companies are penalized for failing in the practices of risk and pay governance. They are also handsomely rewarded for long-run success in these areas, making an investment in better pay governance a high priority.

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10 The DCRO Qualified Risk Director Guidelines were established several years ago to help organizations identify board members who qualify as risk experts. These guidelines benefit the overall discussion of risk governance, including pay governance, which is ultimately the responsibility of the board-as-a-whole as part of its Duty of Care.

11 One example is that fully ten years after the financial crisis that was brought on by the mis-selling of financial products, we still see significant governance failures in the mis-selling of these products.
ADDITIONAL REFERENCE DOCUMENTS

Compensation Committee Best Practices
- 2017 Compensation Committee Guide — Harvard Law School
- Compensation Committee Guide — Wachtell, Lipton, Rosen, and Katz
- Compensation Committee Best Practices — Fenwick & West, LLP
- NACD Blue Ribbon Commission Report on the Compensation Committee
- A Guide for Boards and HR Committees in Addressing Human Capital
- Compensation Committee Checklist for Assessing Incentives and Risk
- The UK Corporate Governance Portal: Executive Pay
- The Investment Association Principles of Remuneration
- The Value of Getting CEO Succession Right

Compensation Design and Risk
- The Alignment Gap Between Creating Value, Performance Measurement, and Long-Term Incentive Design
- Aligning Compensation Systems with Risk Management Objectives
- The Human Reaction to Risk and Opportunity
- Transparency Is Not Enough; Combatting Comprehension Asymmetry
- Neither Rigged nor Fair — Bosses Pay in the Rich World
- Executive Pay Needs Reforming to Spur Business to Long-Term Growth
- Finding and Avoiding Perverse Incentives

Corporate Governance Principles
- G20/OECD Principles of Corporate Governance
- ICGN Global Governance Principles
- King IV Report on Corporate Governance
- The UK Corporate Governance Code
- Commonsense Corporate Governance Principles

Enterprise Risk Management and Corporate Governance
- ISO 31000 — A Practical Guide for SMEs
- COSO Enterprise Risk Management Framework
- Enterprise Risk Management: From Incentives to Controls
- Governance Reimagined: Organizational Design, Risk, and Value Creation
- Risk Management and the Board of Directors
- DCRO Qualified Risk Director Guidelines

Performance Reporting
- The International Integrated Reporting Framework
- A Practitioner’s Guide to the Balanced Scorecard
- Guide to a Balanced Scorecard Performance Management Methodology
- The Short and Simple Guide to the Balanced Scorecard
APPENDIX

I. Some Notes on the Psychology of Incentive Design

Incented Behavior — Rewards-Driven, or Driven by the Environment?

The notion that rewards will drive good/desired behavior has generally gone unchallenged in the corporate setting as the Skinnerian psychology behind it seems almost rote. Yet, recent work has revealed some holes in the behaviorist approach – namely that it has never been validated in a truly scientific way.12 If rewards can’t be proven to drive behavior, then what can? The same neuroscience research that questions the scientific validity of rewards-driven behavior notes that environmentally stimulated behaviors — those induced by the environment in which the being operates — do have rigorous scientific backing.

In the famous Pavlovian demonstration, a dog salivates at the sound of a bell, before the receipt of food. The sound of the bell is a forward-predictive signal. In the world of corporate governance, the equivalent of Pavlov’s bell is the corporate culture. Corporate culture is, in essence, a bell that sends a signal to employees regarding the integrity of company values, and what types of deeds it will tolerate and reward in pursuit of its goals.

We do well to emphasize in our thinking about pay governance that the environmental trigger is the only one scientifically proven, while the rewards-driven feedback mechanism has only been assumed by most to have been proven as a positive influence. In fact, the rewards-driven response may be quite different and quite negative. This change of mindset will bring the process of pay governance more in line with general risk governance principles, where the importance of a positive corporate culture in generating value for owners is well-established.

Downside Risks from the Over-Reliance on Metric-based Incentives

While giving comfort through quantification, movement towards greater emphasis on metric-derived compensation based on peer comparisons of key performance indicators (KPIs), ignores the warnings about overly metric-based evaluation schemes and their unintended consequences. Princeton Professor Emeritus of Psychology John Darley pointed this out back in 1994. His adage, which has come to be known as Darley’s Law, states:

“The more any quantitative performance measure is used to determine a group or an individual’s rewards and punishments, the more subject it will be to corruption pressures and the more apt it will be to distort and corrupt the action patterns and thoughts of the group or individual it is intended to monitor.”13

Darley’s research found that rigid or overly quantified incentive systems can create new risks of their own, which are unknown or unexpected to those involved.

He also suggested that highly objective systems might cause unintended and morally-surprising outcomes, including certain pressures on the actors within the system that may not be at all what the performance-measurers intended.

Three general sorts of occasions arise when a metric-based compensation system is not designed or monitored well:

1. A person, in hopes of advancement or in fear of falling behind, cheats on the performance measurement system by exploiting its weaknesses to make her numbers. Others who see this — and especially if this action succeeds — are then under pressure to cheat also. There is a diffusion of a corrupt innovation that corrupts the individuals within the system. This group behavior can

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become pervasive. Consider two employees at the same level in an organization, both seeking advancement. If one succeeds in cheating, the second may perceive his chances for promotion slipping away. That person is thus pressured to engage in the same or better cheating. The increased cheating is more likely to stimulate copycat behavior by other advancement-hungry peers.

2. A person with the best will in the world does what optimizes her performance measurements, without realizing that this is not what the system really intended. A performance measurement system is a powerful communication tool indicating that the authorities have thought these issues through, and want what they reward. The individuals in the system are to some extent relieved of their responsibilities to think through the system goals, and to independently determine their contributions to those goals. In this instance, the rules of the game have been defined and the employee simply plays the game to her highest benefit.

3. A person who has the best interests of the system in mind may game the performance measurement system in various ways, to allow the continuation of the actions that best fulfill his reading of the system goals. However, this behavior takes those activities underground, and diminishes the possibilities of a dialogue about system goals or modifications in the system's measurements.

**Anchoring and its Impact on Fair Compensation**

Anchoring is a behavioral/cognitive bias that describes how people tend to over-rely on the first piece of data with which they are presented, even if it is not relevant to the question being studied. For example, if you ask a group of people what the average temperature is in Singapore, but you give them no other information, their answers will have a different mean and greater variability than if you begin your question by saying something like “The average temperature in Hong Kong is 73 degrees Fahrenheit.” In the latter case, the answers for Singapore's average temperature will tend to be closer to 73 degrees, which is, in fact, a figure below the average low temperature for all months of the year in Singapore.

Anchoring has its biggest impact on the work of Compensation Committees when external peer compensation groups are used for determining the pay of those directly governed by the committee. Once an anchor is set — the mean or average level of peer compensation, for example — other judgments are made by moving away from that anchor, not from an unbiased starting point like an estimate of the direct impact on the value of the firm attributable to the specific individual.

**Broad Use of Incentives to Encourage Behavior Like Owners**

Traditional beliefs suggest that employees who are rewarded like owners will behave like owners. This seems desirable. Yet, not all people have the same risk-taking preferences as an owner. Further, not all positions at an organization should necessarily be compensated in a manner that is subject to the volatility that an owner’s payout can realize. Quality control, data integrity, and security, for example, are functions where high quality is essential and even small failures can have significant downside consequences. And these are roles where there is no commensurate upside variation associated with “better high quality.”

Aligning people with the risk-taking preferences best suited for the desired risk-taking of a particular role, is critical.
II. Risk Capacity, Risk Appetite, and Risk Tolerance

Measures of performance used by the Compensation Committee need to incorporate the notion that performance can be accurately determined only when viewed relative to adherence to an explicit statement in the strategic plan of risk appetite, and viewed in combination with the potential downside risks knowingly accepted by the company (risk-adjusted performance). Risk appetite is a term that has been used inconsistently and, thus, can be incorrectly interpreted. For clarity, we bring forward specific definitions of three key measures which need to be discussed and communicated by boards of directors to facilitate the effective governance of pay in relation to risks taken. By knowing and effectively communicating statements of Risk Capacity, Risk Appetite, and Risk Tolerance through both policy and pay, an organization can more effectively develop a sound risk-taking culture.14

Risk Capacity: The maximum level of risk an organization can assume before breaching constraints determined by regulatory capital, liquidity needs, debt covenants, operational obligations, or from a reputational perspective to members of its social network.

Risk Appetite: The aggregate level and types of risk an organization is willing to assume within its risk capacity to achieve its strategic objectives.

Risk Tolerance: The level of risk to which an organization is willing to be exposed, taking into account its financial strength, liquidity, complexity, and the infrastructure needed to adequately manage the risk.

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III. Information Flow and Compensation Committee Annual Cycle

Receive proposals from management for compensation plans

Review existing risk-adjusted KPIs for alignment with strategic objectives and risk statements

Conduct annual risk assessment of pay philosophy with risk infrastructure and Risk Committee

Ask if policy addresses the right targets and reaffirms a culture of right behavior

Receive input from consultants

Review and update CEO succession plan

Agree to goals around risk-adjusted compensation

Issue “Fit for Purpose” certification

Present final compensation policies and any revised contracts to the board-as-a-whole for approval

Committee meets in camera with CRO, CHRO, CAO, and consultants regarding pay proposals

Review results of board annual review process

Solicit feedback

Review results

Modify committee membership and leadership

Plan for additional training of committee members

Begin 360-degree review process of Compensation Committee

Committee presents final recommendations to the board-as-a-whole

Board Annual Process:

Review and update corporate values statements

Gather input from external stakeholders

Review and update corporate strategy

Review and update corporate risk capacity and risk statements

Compensation committee receives CEO’s pay recommendations on other directly governed employees

Committee meets with Audit Committee, then in camera with CRO, CHRO, CAO regarding pay proposals

Begin the process of 360-degree review of CEO and executives in succession plan

Discuss total rewards targets with board-as-a-whole

Board-as-a-whole reviews the results of 360-degree reviews of CEO and executives in succession plan

Gather input from individual board members regarding performance of the CEO and executives in the succession plan
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V. The DCRO Guiding Principles for Risk Governance by Compensation Committees

**Principle 1:** The Compensation Committee has both direct and indirect pay governance responsibilities through which it defines the desired compensation culture for the whole organization.

**Principle 2:** In the design and communication of compensation philosophy, incentive pay for corporate performance should be emphasized, while incentive pay for individual performance may be carefully applied where appropriate to the role.

**Principle 3:** The total compensation of the Chief Executive Officer, key executives in the succession plan, and the guardians of the company’s integrity, should be driven by their impact on a balanced view of the enterprise, including how effectively the organization takes risk.

**Principle 4:** The use of external benchmarking for executive pay should be minimized and replaced by more internally-focused evaluations of performance.

**Principle 5:** Incentive compensation should be “at risk,” subject to significant deferral periods, and subject to vesting horizons that emphasize the organization’s long-term performance.

**Principle 6:** Discretion must always be present in final incentive pay determination.

**Principle 7:** Compensation Committees should provide full transparency to the board-as-a-whole on performance reviews and compensation design for the CEO, as well as for those individuals in the succession plan.

**Principle 8:** Compensation Committees should publicly certify that their processes of governing pay risk and compensation philosophy are fit for purpose.

**Principle 9:** Compensation Committee members should be independent, with diverse backgrounds and experience, have expertise in risk, finance, and management “through the cycle,” and should cross-populate both the Risk and Audit Committees.

**Principle 10:** Compensation risk governance is an ongoing process that must foster corporate resiliency through formal collaboration, feedback, review, and escalation channels among board committees and the organization’s social network, so that a properly designed and established compensation philosophy and culture for the whole organization can thrive.
The Directors and Chief Risk Officers Group

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