Finding and Avoiding Perverse Incentives

How to pair the right metrics with the right goals to incent superb results.

By Marc Hodak

EDC was an American energy company that successfully financed, developed, and operated power plants around the world. It made large investments in complex projects and recouped them by leasing the plants to its customers. The company paid bonuses to its senior managers based on each plant's operating profits above a 25 percent return on capital. This plan provided a useful set of incentives, including keeping a lid on capital costs and building the plant so that it could begin operating profitably as soon as possible, and for a long time to come. In 1990, the company promoted a new leader. She had noticed, and perhaps resented, that the bankers that provided the capital for these projects were paid handsomely as soon as they closed on the financing, while her managers, who made those rewards possible, had to wait. So she changed EDC's incentive plan to pay her and her managers like the bankers, i.e., based on a percentage of the capital raised for the projects. This new incentive plan was consistent with her strategy of ramping up the number of deals.

If you step back from the sizzle of the strategy, it is easy to see that the company's incentives were now completely reversed. Management became indifferent to the amount of capital expenditures in new plants. In fact, more investment could translate into higher bonuses. Similarly, post-construction operating efficiency was no longer of any consequence to their pay. They were rewarded far more for chasing new deals than for paying attention to projects that had already been funded. This altered the company's focus, which, combined with it's prior track record, enabled it to do many deals in the ensuing years. As the quantity of deals surged, however, the quality of the deals dropped precipitously, and the company found itself increasingly bogged down with complaints about plant completion and operating performance as returns deteriorated. Seven billion dollars later, EDC's cumulative investment in new projects had become a major drag, not just on its own returns, but on the overall returns of its corporate parent—Enron.

While most of the Enron story is appropriately focused on the accounting shenanigans that top management used to hide its underlying financial problems, it is worth considering the perverse incentives that were at the root of those problems. By the time Jeff Skilling became president and, to his credit, promptly cancelled EDC's incentive plan, it was too late. Declining returns were baked into

THINKSTOCK/GETTY IMAGES

Enron's financials for at least the next several years. Management pay was about to be severely hit by those declines. When Andrew Fastow, Enron's enterprising CFO, offered a solution to this problem, Skilling was unfortunately ready to hear him out.

The Enron example highlights two factors that figure prominently in compensation-induced governance risk: defective incentives, and a high sensitivity of pay to performance consistent with those incentives.

Metrics Matter

The appeal of pay for performance is obvious. We want managers to benefit from their own strong performance and to feel the pain of deteriorating performance. But many companies make the mistake of implementing metrics that, although they may reflect good performance when everyone is doing what they're supposed to, may actually drive bad behavior when they become the primary focus of decision making. For example, revenue growth often goes hand in hand with value creation, but if we pay for revenue growth, we may encourage management to "buy" revenues via lax controls on expenditures. Operating income generally reflects the health of the company, but if we pay exclusively for operating income, we may encourage over-investment in growing that income, yielding deteriorating returns. If we pay to maintain or enhance already high returns on capital, we may encourage management to hold back on value-creating investments for fear of diluting those returns. All compensation metrics have potential downsides that can undermine performance.

Proxy advisors recommend a balance of incentive plan metrics to limit the risks posed by a focus on a single metric, but there is no evidence, or even good theory, to support why that would help. Multiple incentive-plan metrics provide numerous opportunities to gun it for the short term in ways that may undermine shareholder value. Not only can managers game each metric, but they can choose which metrics to game at the expense of the rest when it becomes plain that some will pay out and others will not. Companies are far better off basing their incentive plans on fewer, more comprehensive measures of performance that best serve as a reasonable proxy for value creation, even if they do so imperfectly. A company can tailor such a measure (or measures) to their business model and strategy, then rely on a combination of management integrity and board oversight to contain the residual imperfections.

An engaged board can partially mitigate against unintended behaviors driven by even the best metrics by reserving some discretion with respect to the quality of achievement against incentive plan goals in deciding what ultimately to pay out. Exercising discretion, however, requires balancing the mitigating effect of board judgment against the motivation and accountability provided by objective measures.

Dangerous Curves

Incentive plans drive behavior, for good or ill, to the degree that pay is sensitive to performance. If incremental performance creates rewards that are too great or penalties that are too severe—typical of what we would call a steeply leveraged incentive plan—then we invite risky behavior.

Many companies define their incentive plan curve by determining performance levels for threshold and maximum awards. They often do this by defaulting to common practices, such as 80 percent and 120 percent of target performance, respectively, instead of relating compensation risk to business risk in calibrating

An engaged board can partially mitigate against unintended behaviors driven by even the best metrics by reserving some discretion with respect to the quality of achievement against incentive plan goals in deciding what ultimately to pay out.

an appropriate pay-performance sensitivity. Consequently, some companies have relatively low pay variability while others expose themselves to an unnecessarily high level of pay risk. Highly risky compensation plans for senior executives may cascade down into the organization, inducing commensurately risky behavior on the part of subordinates while, at the same time, reducing the motivation for their bosses to be on the lookout for how, exactly, people might be "making their numbers."

For example, cross-selling is a time-honored retail strategy. Most of the accounts that Wells Fargo & Co. opened for existing customers were approved by them. The bank's reputation was trashed over relatively few fake accounts yielding a couple extra million dollars in revenues, hardly enough to move the needle on corporate earnings. The warning signs were ubiquitous, but senior managers simply failed to look closely into a machine that was generating such great results—and rewards for themselves.

Incentive Land Mines

Even when companies are careful about plan leverage in the performance range between threshold and maximum awards, they often plant a big incentive land mine right at the threshold. One of the most common compensation structures in the corporate world is to have between 25 percent and 50 percent of target awards suddenly cut in when a threshold level of performance is achieved. At this point, the pay-for-performance curve is not just steep, it is vertical. To managers, that might mean millions of bonus dollars for hitting their number, or zero if they fall a dollar short.

Unsurprisingly, about half of corporate scandals over the past two decades have happened with performance in a range right around an all-or-nothing threshold level. That is where you see "window dressing" decisions such as deferred maintenance or temporary layoffs, or borderline behavior such as channel stuffing or the manipulation of accounting reserves, or illegal behavior such as bribery and fraud. Enron, WorldCom, Rite-Aid, and Sunbeam all engaged in behavior that led to scandal and bankruptcy in the vicinity of that all-or-nothing threshold.

> **The seeds of Mylan's EpiPen scandal were planted** when management became eligible for millions of dollars if they hit 90 percent of their cumulative earnings target. If they merely achieved 89.9 percent of their goal, they would lose out on all of it.

Likewise, the seeds of Mylan's EpiPen scandal were planted when management became eligible for millions of dollars if they hit 90 percent of their cumulative earnings target. If they merely achieved 89.9 percent of their goal, they would lose out on all of it. If your team were $89 million toward a $90 million threshold performance, what would you do for that last million?

In the third quarter of 2000, WorldCom's hard work on cost containment in the face of a general telecommunications decline had gotten it to 45.3 cents per share. But its incentive plan target, and its earnings guidance to Wall Street, was 46 cents per share. The last two-tenths of a cent that enabled WorldCom to round up to its target earnings per share (EPS) came from a deceptive revenue recognition decision that may very well have gone unnoticed if the telecommunications market turned around. But that deception was repeated on an ever-larger scale as the sector continued its decline, and WorldCom's goals became increasingly unrealistic, until they had accumulated $11 billion in fraudulent earnings. WorldCom CEO Bernie Ebbers is serving a 25-year prison sentence for telling his CFO: "We have to hit the number."

One might think: "But our management would never engage in short-term behavior that compromises value." In a 2013 landmark academic study, "Earnings Quality: Evidence from the Field," the authors surveyed hundreds of senior financial executives, and over three-fourths of respondents said that they would sacrifice economic value in order to hit their number. What makes this so astonishing is not that so many executives admitted this (albeit, without attribution), but that many of them rationalized this behavior as being good for shareholders, reasoning that if they didn't game the system in this way, they would "lose credibility" in the markets by falling short of expectations, making it more expensive to raise capital later.

When looking at large amounts of data, we can clearly see how company performance clusters around discrete points on the incentive plan curve, such as thresholds, targets, and maximums. It would be generous to attribute all of that to people pushing themselves in value-added ways to get over a visible hurdle. But the evidence suggests that a potentially significant part of that performance grouping is due to decisions and actions that would confound owners if they knew about them.

Compensation and Governance Risk

Another significant, and easily overlooked, contributor to pay sensitivity is the percentage of total pay at risk. The combination of pay-at-risk and incentive-plan leverage determines overall compensation risk for the manager and, therefore, potential governance risk for the company.

The past several decades have seen investor demand for ever higher portions of executive pay to be based on performance. While the basic idea makes sense, some investors and proxy advisors have morphed it into a fetish for putting nearly every element of executive pay at risk. The typical large company today will claim—even boast—that 80 percent or 90 percent of their CEO's pay is at risk. There is good reason to suspect that this is too much of a good thing.

A sensible businessperson would not ordinarily put their employee's pay at that much risk. It might be all right for a commissioned salesperson, where we can feel confident that the more they earn by selling goods and services, the better off the company will be. But for someone in an administrative or management role, as noted above, it is much more challenging to rely on incentive metrics as a driver of value creation. And the imperfections that lurk in every incentive plan are magnified in proportion to compensation risk.

Ironically, the compensation risk associated with 90 percent variable pay almost certainly results not only in greater governance risk, but also in higher overall pay—the opposite of what was intended by the monomaniacal push for pay for performance. Investors would never accept higher risk without a higher expected reward; they should not expect that their managers would behave differently.

Mitigating Risk

When Dish Network Corp. granted its CEO 1.2 million performance options based on meeting subscriber growth and free cash flow goals, it would have been easy to conjure scenarios where he could have maximized on one measure or the other to the detriment of the company's value in order to earn an extra million dollars over the three-year period of the plan. But given that his personal holdings in Dish went up or down by an average of $70 million per day, it is unlikely he was thinking about how to sub-optimally wring the last million from this incentive plan in ways that might have undermined the long-run value of his holdings.

Many risk mitigation practices have been proposed, including a diversity or balance of metrics, payout caps, and clawbacks. But research so far indicates that the only pay practice that makes a positive difference is significant, enduring management exposure to the company's market value. If a manager's personal net worth is materially (but not excessively) affected by the ups and downs of the stock price over time, that impact may dwarf the behavioral effect of relatively modest gains or losses from any incentive plan.

For a manager who does not come into his or her position with a high level of stock ownership, the most effective way to create significant exposure to the stock price would be through a large, up-front grant of time-based equity. This practice is typical of private equity-backed companies looking to create an immediate sense of ownership and urgency among their top executives.

Up-front, time-based grants are far less appealing to public company investors. In fact, the trend has been to make an increasing proportion of what used to be time-based equity awards into performance-based awards, making long-term plans look more like annual plans, except with longer performance periods and equity instead of cash rewards.

Consequently, the all-or-nothing pay thresholds that are typical of annual incentive plans are also increasingly creeping into long-term plans. Given how much of CEO pay is driven by these plans, it is no longer unusual to see a quarter of total target CEO pay cutting in based on a single dollar or single percentage point of achievement relative to a threshold level of performance.

Learning the Right Lessons

The whole point of incentive programs is to drive behavior. Most boards and compensation committees understand the importance of getting metrics right in terms of how they relate to the business strategy, but still miss out on how those metrics may actually drive behavior in unintended ways. Even the best metrics can lead to catastrophe if they are coupled with unrealistic goals or embedded in incentive structures that drive short-term, parochial, or illegal behavior. Such structures may include excessive pay at risk or overly steep (or infinite) plan leverage, which can motivate managers to hit their numbers by doing things that owners would never do if they were managing their own company.

Most of the dangers of perverse incentives are largely avoidable with sound metrics and plan structures. The remaining imperfections in the plan can then be mitigated with equity programs that give managers significant skin in the game, or with additional controls or attentive board oversight where the weak links in the incentive system have been identified. Directors owe it to their companies' investors to know where to find those weak links, thus avoiding the inadvertent encouraging of bad behavior. Moreover, they owe it to their managers to avoid forcing them into a position of being penalized for doing the right thing. D

Marc Hodak is a partner at Farient Advisors, an independent executive compensation and performance consultancy. Hodak is also an adjunct professor at New York University, where he has taught "Corporate Governance" and "A History of Scandal."