

# STRATEGIC RISK ASSESSMENT EXECUTIVE & BOARD ISSUES

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# Strategy and Risk

- The Board of Directors role has changed dramatically since 2005.
- Boards have to become more fully engaged is **both strategy and risk**.
- Both strategy and risk impact and **drive** significant **business** and **pay decisions**.



Brookfield Properties

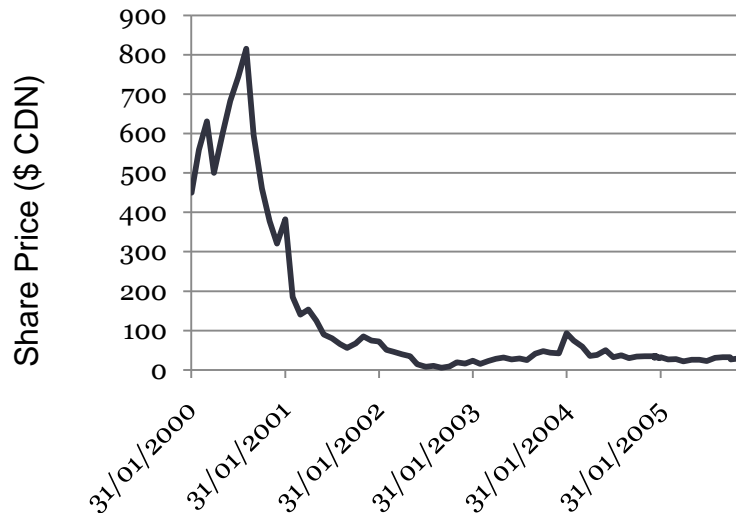


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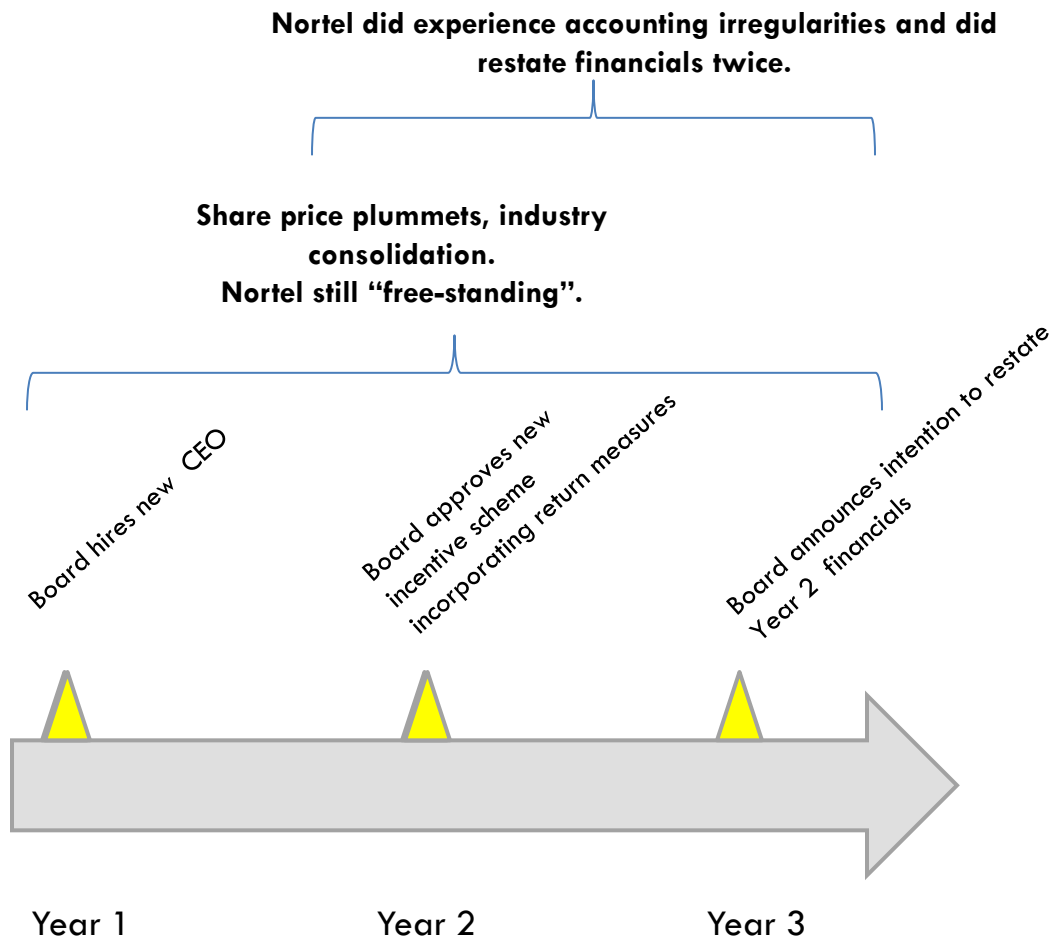


# Nortel Overview

- Nortel is a large multinational listed on the TSX and NYSE.
- The industry experienced a significant downturn - industry consolidation.
- Company was hardest hit; failure to meet revenue targets – falling share price.

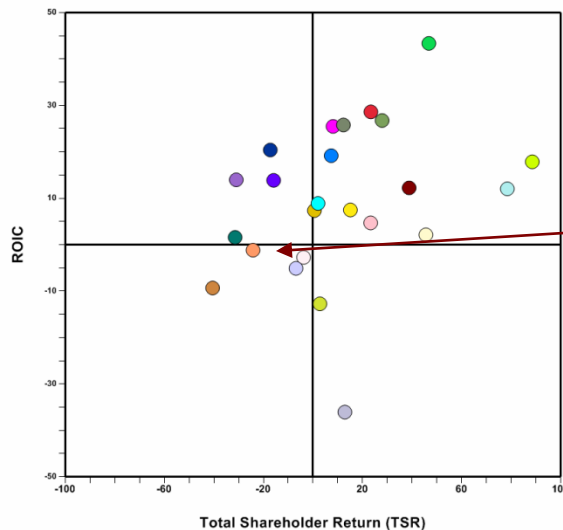


# Timeline - Year 1 to Year 3



# Nortel's Executive Compensation

- HRCC retained **two** compensation consultants.
  - Attract, motivate and retain key talent using Base, STIP, MTIP and LTIP.
- Competitively compensate executives for **total performance** and **contribution**.
  - Benchmark base salary to 23 comparator companies. (\$1M)
  - Examine performance and pay (annual revenues or number of employees).
- Total pay was targeted at the 50th to 75th percentile range of the comparator group.



Actual position of  
Nortel versus their  
Comparator Group  
Currently 19<sup>th</sup> of 23.

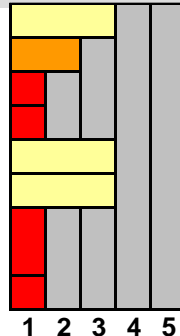
# Executive Compensation Approach

- Compensation includes:
  - **Base salary** for CEO \$1.0 million
  - **STIP Plan:** (STIP)
    - Base salary x target % x individual factor x corporate performance.
      - Corporate performance: revenue (25%), EBIT (50%), and cash flow (25%), it may include customer satisfaction.
  - **LTIP Plan** – stock trades at \$30.
    - Stock Options are 10 year term, 4 year annual vest. (LTIP)
      - Base salary x 2 for number of options.
    - Stock grant is 3 year term, annual vest. (MTIP)
      - Base salary x 1.5 for number of units.
    - Performance stock grants based on 3 year cliff vest. (MTIP)
      - Base salary x 2 for target performance.
      - At 20th position or below – 50% of grant.
      - At 15th position or below – 100% of grant.
      - At 10th position or below – 150% of grant
      - In top 3 – 200% of grant.

# Nortel – Summary of Board Risk Assessment

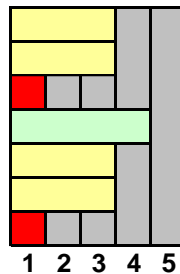
## Financial Markets Risk Summary

- Positive 1-year TSR?
- Positive 3-year TSR?
- 3-year TSR > flat Bond Rate?
- After tax ROIC greater than COC?
- Maintained current market value?
- Positive 12-month stock price volatility?
- Is ROIC > average competitor ROIC?
- Is EPI > median competitors EPI?
- Company EPI vs. EPI of competitors?



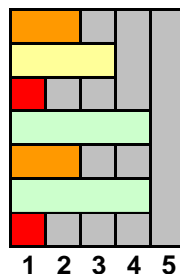
## Executive Leadership Risk

- Has Board developed CEO role/skills profile?
- Does CEO/NEO detailed succession process exist?
- Are succession plans in place for CEO/NEO?
- Board engages with CEO & key management?
- Has Board developed CEO performance program?
- Skills for >5 roles identified in business strategy?
- Has exec talent been assessed for the above roles?



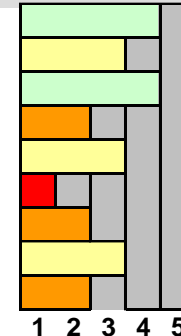
## Performance Based CEO Compensation

- Does HRCC meet perf-based comp guidelines?
- Are qualitative measures disclosed in STIP?
- Did EC decisions use 3-yr TDC vs Perf analysis?
- Did PFP decisions consider 3-year profitability?
- Is there a defensible comp calibration process?
- Is EC theoretically linked to strategic development?
- Does EC actually like to strategic development



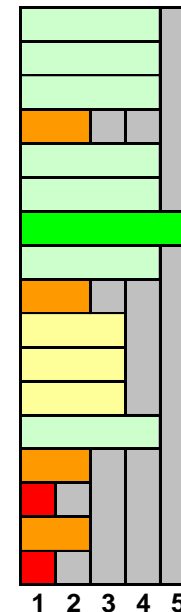
## Organizational Structure and Enterprise Risk Management

- CEO Op Performance Eval > 1 – 2 years?
- Mgmt perf measures on Innovation & Planning?
- Does a documented ERM process exist?
- Is ERM process implemented & under review ?
- Risk assessment assigned to each Board committee
- Annual risk assessment on each Board committee
- Board understands & acknowledges the ERP
- Board discloses major risks & findings w ith execs
- Board confident in corp disaster recovery process



## Board Assessment

- Board has created effective meeting procedures
- Board has stated its strategic duty to shareholders
- Board is continually involved in mission & strategy
- Board assesses workplace safety for employees
- Corp governance practices released to shareholders
- Board disclosure of "in-camera" sessions
- Board meets disclosure guidelines of regulators
- Board participates in key decision issues
- New directors receive adequate strategic induction
- Director election process is appropriate & effective
- Board more effective through utilization of directors
- Chair provides leadership for Board and CEO
- Board members appropriately prepared for meetings
- Board analyses & improves its own performance
- Board compares own performance with peers
- 2 or less active CEOs are sitting on the Board
- CEO's sitting on the HRCC

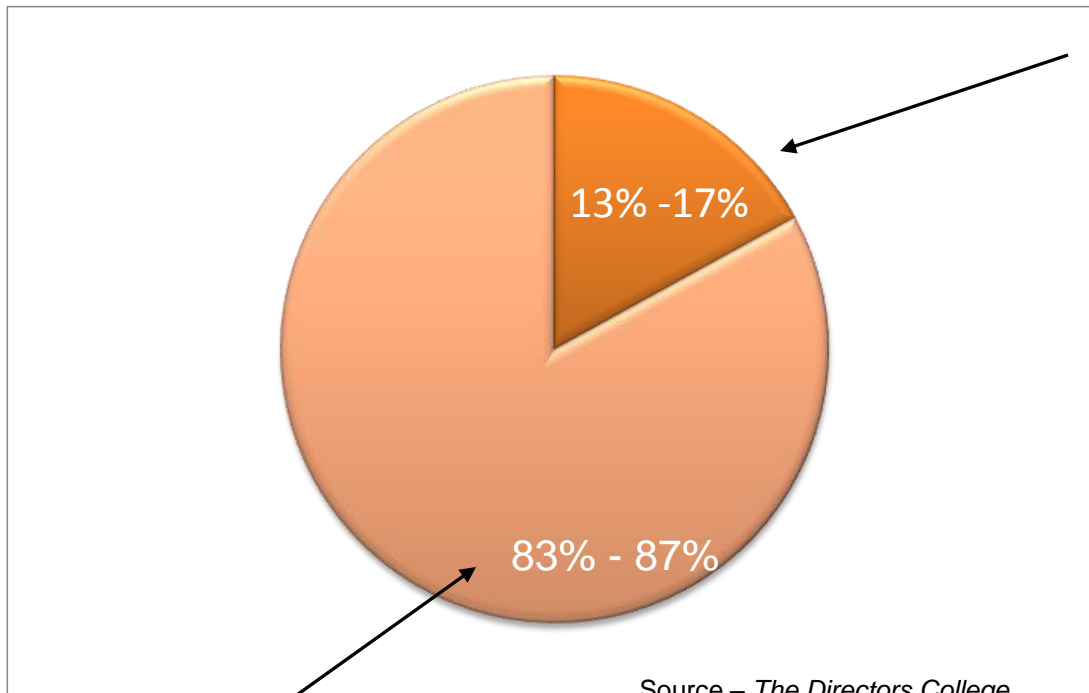


# Role of Risk

- Insight on **strategy** and **risk** are critical for Board of Directors to meet their duties:
  - Fiduciary Duty, Duty of Care, Duty of Loyalty, and Duty of Obedience
  - Crowns/Private – where is governance going?
- The **linkage between strategy and risk**, to business drivers and incentive drivers **sometimes appears overlooked**.
- When **strategy** and **risk** are **not clearly known**, business drivers cannot be determined, and incentive plan design **includes significant errors**.



# Issues of Risk



## Financial Risk

- “Typically” well managed
- Process:
  - Internal Audit
  - External Audit
  - Audit Committee
  - Board of Directors
- Most Boards feel comfortable.
- Audit committee is independent and has sound financial understanding.

## Non-Financial Risk

- Partially overlooked as not well managed like financial risk.
- Includes: Strategic, cyclical, acquisition, capital, and leadership risks.

# Developing Understanding of Risk

- Definition of **Risk** by Board/Management.
  - Has this been discussed?
  
- Board's understanding of **Risk Appetite**
  - Does the Board understand Risk and Risk Appetite at your company?
  
- **Types of Corporate Risk** the Board of Directors must be cognizant of:
  - Strategic Risk
  - Cyclical Risk
  - Acquisition Risk
  - Capital Structure Risk
  - Leadership Risk

# Risk and Risk Assessment

## Where do Boards and Executives sit?

- Sound governance practices demand that Boards seek out and **minimize risk** wherever possible.
  - How do we know the risks?
  - Risk assessments – how is your company doing?
  
- Committees are **less confident** in the oversight of other **significant business risks** and in the coordination of risk oversight activities with rest of the Board.
  - How does this get managed at your company?
  
- Boards have **greater appreciation** for the need to understand the quality of their companies **risk profile, risk appetite, and risk intelligence**
  - Have these topics been discussed with your executive and Board?
  - Are these discussions “continuous”?

# Understanding of Risk

## Significant Issue

- **Understanding of Risk is critical** – to Board and Executives!
- From our experience and assessments, understanding of risk **is all over the map!**
  - Why?
  - Who owns risk in the corporation?
    - Is it executive, Board or both?
    - How is information transferred?
  - What happens to the reports developed for the Board?
  - What is the “true” dynamic between the executive and the Board on Risk?

## Example 2.

# US and Canadian Property Company - Private

- **Sophisticated** Board with exceptional top level executives.
- Corporation operates activities in **numerous countries**.
- Board completed assessment, as did executives, neither group (or individuals within either group) could agree on **strategic direction or risk?**
  - Why?.
  - What are the answers to managing executive to Board risk?
  - How can this be fostered at the executive and Board level?

# Closing the Gap

## Internal Risk and the Board

- Determine the split for the **responsibility of Risk Assessment**.



- Where does Internal Risk process feed into Board Risk?
- Is communication strategy between Board and Executive on Risk appropriate?
- Is there a way to better develop this integrated initiative?

# Summary Observations

- Executive oversight and risk management by boards is a key responsibility – and is often, not well done. (Surveys prove this)
- We have seen some techniques for assisting boards with their task of managing risk. There may be others - we have not found them.
- We have shown examples of the result of Boards attempting to help understand and manage risk. The BOD may do everything right and the “wheels still fall-off”. How do we work through this issue effectively?
- We have discussed one example that offers a mechanism for determining the responsibility for risk assessment. There may be others.
- Where does your organization fit on the spectrum of risk assessment?



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