UNCERTAINTY-PROOFING PAY PRACTICES

Designing resilient compensation programs helps companies thrive during turbulent times.

By Ron Rosenthal and Megan Sandquist

AS COMPANIES NAVIGATE through uncertain times, designing and adopting balanced, resilient pay for performance executive compensation programs can help companies forge ahead through stormy waters. If they have not already, compensation committees might consider incorporating certain features, such as non-financial metrics, into the annual incentive plan and ensuring that the long-term incentive program balances the need for retention with paying for performance. Thoughtful plan designs can meaningfully enhance the resilience of these programs, even during periods of uncertainty.

Annual Incentive Plans

For many years, annual incentive plans (AIPs) primarily rewarded participants for achieving key corporate financial objectives, such as revenue, profitability and/or cash flow goals. However, in recent years, with Covid and other events that limited forward-looking financial visibility, some companies placed a partial emphasis on non-financial metrics within their AIP. Financial metrics, while critical, focus solely on financial outcomes for the plan year. AIPs within certain industries, and at times of economic uncertainty, recognize the value of measuring non-financial results as well, with metrics related to customer satisfaction, safety, operational goals and strategic objectives. This shift reflects the understanding that an organization's long-term success is built on a foundation of both strong financial and non-financial performance. Maintaining a healthy balance between financial metrics and non-financial indicators enables companies to measure financial success while at the same time recognizing the criticality of key non-financial drivers.

Using a "balanced scorecard " approach to AIP design can help address volatility associated with financial measures. A balanced scorecard approach to the AIP provides an opportunity for a portion of the program to remain "in the money" and provide a reward to participants for achieving critical strategic and operations metrics even if financial results are lower than anticipated. With a diversified set of performance measures, an AIP can continue to serve as an effective tool in motivating, rewarding and retaining participants even if it becomes apparent during the plan year that the financial goals will payout well below target (if at all).

Another approach that may serve companies well during turbulent times is to set a wider range of performance goals around target. The wider spread between threshold, target and maximum goals (or flatter slope of the performance curve) increases the likelihood of earning some level of payout while reducing the probability of a maximum payout should economic conditions rebound more quickly than anticipated.

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Long-Term Incentive Plans

While it is common for compensation committees to adopt a pay-for-performance philosophy, they must balance several objectives (e.g., motivation, retention, shareholder alignment, stock ownership) when designing long-term incentive (LTI) programs. A program mix that overweighs any single type of award (e.g., performance shares, time-based restricted stock or stock options) may lead to suboptimal outcomes in uncertain times.

For example, performance shares tied solely to total shareholder return or stock options may become "out of the money" due to volatile market conditions and thereby provide little retention value. Therefore, even though time-based restricted stock may seemingly run counter to a pay-for-performance philosophy and is sometimes viewed negatively by outside observers, granting a meaningful portion of executives' annual LTI opportunity in time-based restricted stock (e.g., 25 percent to 40 percent) can enhance the resilience of the LTI program. Maintaining a balanced and resilient LTI program not only enhances retention during uncertain times but can mitigate the need to grant special retention awards outside of the regular program structure, which are typically disfavored by proxy advisors and institutional investors.

Further actions can be taken to enhance resilience of the LTI program when designing performance shares. For example, using multiple metrics to vest awards may increase the likelihood of earning an appropriate payout. In particular, using both absolute and relative performance measures to vest awards can enhance resilience. During periods of uncertainty, measures of relative performance may provide an opportunity to earn a payout when achievement of pre-established financial goals can prove challenging. As with AIPs, setting a wider range of performance goals around the target can also help companies successfully navigate periods of uncertainty and increase the likelihood that a payout is earned.

Periods of high volatility may stress executive compensation programs; however, compensation committees can evaluate whether the existing program effectively balances performance-based pay with design elements that promote resiliency. This exercise can help companies achieve program designs that function well across a range of economic conditions and avoid the need for extraordinary actions that could trigger scrutiny of their pay practices.

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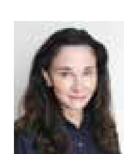

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