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Now is the Time to Test and Report Your Pay and Performance Relationship

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Creating alignment between pay and performance is critical in today's environment of executive pay scrutiny. **However, understanding how to assess the relationship and communicate it effectively can be challenging.** There are many different methodologies and perspectives that should be considered. Following are several important considerations for testing and reporting the alignment between executive compensation and performance.

Testing the Relationship

Assessing the relationship between pay and performance requires establishing methodologies for calculating pay and evaluating performance, as well as determining the time period to analyze.

The most traditional view for reviewing the pay and performance relationship reflects actual compensation granted, which includes base salary, annual incentive paid and grant date value of long-term incentives. **While this is consistent with proxy reported information, it does not reflect actual pay received nor a full picture of performance.**

We believe multi-year analyses (e.g. over three and five years) that focus on actual value of compensation earned provides a broader perspective on the effectiveness of executive compensation over time. There are two primary alternative views of pay that companies are considering:

- **Realized compensation** focuses on the actual value received by executives, comparable to their W-2 income. It includes long-term incentives that are realized, such as restricted stock that vests and the value of exercised options.
- **Realizable compensation** assesses the current value of compensation awarded during the time period, whether it has been realized or remains outstanding. Long-term incentives are valued based on the current stock price, with stock options included based on their in-the-money value.

Each methodology has advantages and disadvantages. While actual compensation reflects the committee's decisions, it does not consider that the value received by the executive will be based on the ultimate value of long-term incentives, which may be driven by stock price and have additional performance hurdles. Realized compensation emphasizes the value actually received by executives, but are influenced by awards granted before the beginning of the performance time period or by timing decisions of the executive, such as the exercise of stock options. Realizable compensation attempts to focus on the value of compensation granted and earned during the performance period, but may require challenging assumptions when long-term performance plans are included.

Reporting Pay for Performance

A key responsibility of the compensation committee, whether public or private, is to test and ensure proper pay-performance alignment annually and over multiple years. The committee should oversee the selection of the peer/reference group, approve the performance measures used in the pay program and analyze how pay (awarded, realized and realizable) aligns with performance over defined periods of time.

Graphs and charts can be an effective way to illustrate trends. For example, how has pay tracked against total shareholder return, return on assets and earnings relative to the company's own internal goals as well as an industry/peer group? **Results provide direction as to whether there is alignment between pay and performance or possible deficiencies in the pay program.** For example, if a company regularly misses internal budget goals but exceeds peer performance that might indicate stretch goals that may not be achievable. Likewise, if incentive plans are consistently missing thresholds or hitting stretch, that may be an indication of misalignment of goal setting.

While the Dodd-Frank Act required the Securities and Exchange Commission (SEC) to develop rules for companies to disclose the relationship between executive compensation actually paid and financial performance, the SEC has yet to develop proposed rules. **However, many companies have started disclosing this in the compensation discussion and analysis of their proxy reports.** Likewise, proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis & Co. have their own methodologies for evaluating pay and performance when they develop recommendations for the annual say-on-pay votes required of public companies. For example, ISS looks at the relationship between CEO total compensation and three- year total shareholder return compared to peers and the company's own five-year total shareholder return. Where their methodology identifies a disconnect, the proxy firms may recommend shareholders vote "against" the pay package. Although it is an advisory vote, it is important for company management and compensation committees to understand the influence of these firms and the potential consequences of a negative vote, which can bring lawsuits and public scrutiny.

Even though the SEC has not yet required a pay-for-performance disclosure, public companies may want to consider whether any disclosure based on the perspectives described above would be useful in their proxies. Whether or not disclosed publicly, all compensation committees should evaluate whether their bank's programs are creating pay-for-performance disconnects and determine if program changes are needed.

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