Optimizing the Retention Impact of the Executive Pay Program

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Summary

Talent retention is one of the executive pay program's most important objectives. In order to minimize situations when retention is an issue with the pay program—rather than one of its characteristics—it is important to ensure the core elements are well designed and operating effectively. A strong pay program foundation includes target pay opportunities at market-competitive levels, incentive plans understood by participants, and payouts commensurate with performance. Companies can optimize retention within the existing pay program by implementing certain approaches, such as applying differentiation in individual award opportunities and incentive payouts or improving incentive design line of sight. If special pay plans are needed for retention, additional incentive opportunities customized for retaining critical employees can be implemented.

Is the Core of the Pay Program Strongly Supporting Retention?

When the issue of retaining employees via the pay program arises, one must first ensure the regular pay program is appropriately designed. Specifically, the best form of pay program retention is a well-designed and functioning core consisting of the following:

Foundation Pillar	Overview
1. Target Pay Levels	• Market-competitive base salary, annual incentive award opportunities, and long-term incentive (LTI) award opportunities • Often, retention can be optimized with: — Transparency in the pay setting process, particularly in the definition of market and targeted market pay positioning, along with pay administration guidelines — Flexibility to differentiate target pay levels, pay increase amounts (including promotions), incentive payouts, development opportunities, and other reward elements
2. Incentive Design	• Incentive goals and award opportunities calibrated appropriately, reflecting strong alignment between the "What?" and "How much?" • Often, retention can be optimized with: — Strong metric line of sight by participants — Regular key driver communication to maximize performance results

3. Pay-for-Performance (P4P) Alignment	• Incentive measures and associated payouts that are understood by recipients and reinforce the linkage between performance (both individual and company) and pay outcomes • Often, retention can be optimized with: — Strong P4P alignment; this is particularly powerful if a company has performed at levels that earn incentive payouts at target or above in most years. However, many companies experience incentive cycles that earn no or below target levels or periods when the stock price declines or plateaus for several years. — Regular communication of performance to date, actual payouts (and the specific metrics that earned these amounts), and key drivers of future success

Before considering the need for special retention awards, one must ask some fundamental questions to evaluate the regular pay program and ensure the core supports the company's talent retention:

1. Are highly-qualified executives departing (or not joining) solely/primarily due to pay?
2. Do employees understand the pay program, particularly their ability to impact performance/incentive payouts?
3. Are salary and target incentive award opportunities at the desired market positioning level?
4. Are incentive goals and award opportunities appropriately set, with strong P4P alignment?
5. Do participants have a clear line of sight as it relates to incentive plan goals and how they can influence performance?
6. Does the pay program allow sufficient flexibility to differentiate award opportunities and pay outcomes?
7. Do executives understand the value (and potential range of outcomes) of outstanding awards?

Overview of Approaches for Maximizing the Retentive Impact

If focused solely on maximizing retention, there are approaches that can be implemented within regular or special plans. As described above, the regular pay program provides opportunities to strongly facilitate the retention (and attraction) of employees—particularly those that are deemed as "key", "hot skill", or consistently "high-performing" (collectively referenced hereafter as "retention critical employees")—through higher target pay opportunities and customized incentive plan designs. If these approaches are insufficient, companies may consider special retention or additional incentive plan opportunities, which are covered in the last section of this document. Their success depends on many factors; in applying these approaches, one should document their rationale and application (eg, position versus individual, applicable time period, etc) in order to mitigate requests from other employees/operating units.

I. Providing Higher Target Pay Opportunities within a Stated Market-Based Range

Companies' pay administration guidelines can allow for the flexibility to deviate from the "target" market position within a stated range (eg, on average within ±10% from the median). If used selectively, this flexibility can be applied within the existing market-based pay philosophy while strategically investing additional dollars for targeted higher pay opportunities and retaining critical employees. However, a key caution: if higher target pay opportunities are applied to the majority of employees, the pay philosophy may need to be rewritten. For senior executives—particularly proxy-reported officers—the most viable approach may be higher target award opportunities within the market-based range since payouts are due to performance results and the market-based pay philosophy is maintained (ie, target pay is above the market-based range for a few positions but on average within the market-based range).

Approach	Overview	Cautions
1. Set Higher Base Salary Within the Market-based Range	• Raise retention-critical employees' base salaries, such as: — At the high end of the market-based range — Above the market-based, with the requirement that *on average* employees' salaries are within the market-based range	• Avoid "salary creep", whereby most employees have salaries at or above the high end of the market-based range
2. Set Higher Annual Incentive Target Award Opportunity Within the Market-based Range	• Provide a higher at-risk award opportunity within the market-based range while aligning to annual performance results	• No certainty; pay is "at-risk" • Doesn't reinforce/reward individual performance if there isn't an individual component or modifier • The company's pay structure may not have the flexibility to incorporate a different incentive award opportunity calibration
3. Set Higher LTI Award Opportunity Within the Market-based Range	• Provide a higher at-risk award opportunity within the market-based range while aligning to future stock price changes (if primarily provided in equity) and, if the award has performance conditions, multi-year results	• *Same as annual incentive award opportunity (above), and…* • Retention impact is dependent upon the vesting period and, if required, performance conditions • Not all retention-critical employees may be eligible for regular LTI grants (see alternatives for special retention/incentive plans below)

S&P 500 Snapshot
In our analysis of 50 S&P 500 industrial companies, 90% that disclosed their pay philosophy targeted total direct compensations at the market median but typically administered pay within a range.

II. Customizing the Existing Incentive Plan Design

Companies can increase retention-critical employees' perceived value of the award opportunity while at the same time optimizing the company's reward investment by incorporating greater line of sight in existing incentive plans. If used selectively, these approaches can be applied within the existing market-based pay philosophy without increasing target award opportunities.

Approach	Overview	Cautions
1. Increase the Weighting of Individual or Operating Unit Performance in the Annual Incentive Plan	• Provide a greater portion of the annual incentive award opportunity based on metrics more strongly impacted by retention-critical employees • For example: — Increase the weighting of individual performance or, if there isn't an award component, increase weighting on the component with the strongest line of sight (eg, business unit) — Apply individual performance as a modifier to the formula-calculated award	• Ensure appropriate parameters (eg, minimum weighting on company or business unit financial results) and other safeguards • Determine the acceptable level of customization • Retention impact is dependent upon goal setting and performance results
2. Carve-out a Portion of the LTI Opportunity for Operating Unit Performance	• Include business unit measures (or closer alignment area) as the majority of the LTI award opportunity for retention-critical employees	• No certainty; pay is "at-risk" for both performance and stock price changes • May be too much customization • Could be challenging to set appropriate multi-year goals • Retention impact depends on the performance metrics and assessment/vesting period
3. Shift the LTI Grant Mix to Emphasize Restricted Stock/Units	• Increase the weighting of, or grant only time-vesting restricted stock/units to, retention-critical employees • Note: Not all retention-critical employees may be eligible for regular LTI grants (see alternatives below)	• Approach may not be viable for proxy-named officers • May be too much customization • Retention impact is dependent on the vesting period

S&P 500 Snapshot
In our analysis of 50 S&P 500 industrial companies, nearly 50% included non-financial metrics for a portion of the annual incentive award opportunity (this may be in the form of "individual", "strategic", or other categories). For LTIs, the use of business unit metrics for executives is uncommon (<10% prevalence). While many companies do not disclose this, the award opportunity is often provided primarily in time-vesting restricted stock/units at lower levels of regular LTI participation.

III. Implementing Special Retention/Incentive Plans

If it is determined that the regular pay program is insufficient for retention, other special retention approaches can be implemented. In contrast to the approaches previously discussed, these actions would involve creating a new plan or providing additional award opportunities (over and above the regular target pay opportunities). In applying these approaches, consistent guidelines must be used to determine recipients and grant levels.

Approach	Overview	Cautions
1. Additional Time-Vesting Equity Awards	• Grant additional restricted stock/unit awards directly provided to facilitate retention	• Retention impact is dependent upon the vesting period
2. Guaranteed Cash Award	• Certain amount of cash paid at a specified period as a lump sum or in installments	• No tie to future performance or stock price changes • Retention impact is dependent upon the vesting period
3. Additional Incentive Award Customized to Area of Focus	• Provide a special annual, milestone, or multi-year incentive plan focused on operating unit or "individual" metrics impacted by critical employee retention	• No certainty; pay is "at-risk" • May be too much customization • Could be challenging to develop appropriate multi-year goals for non-corporate metrics • Retention impact depends on the performance metrics and assessment/vesting period

Conclusion

Companies must attract, retain, and motivate highly qualified employees to execute their business strategy to increase shareholder value. The pay program serves an important role in achieving these objectives. In order to maximize the retention of critical employees, it's important to ensure the core pay program is operating optimally while also maintaining a market-competitive pay philosophy. Although many companies may still find it necessary to implement special retention plans, companies should first examine whether retention issues can be addressed through the core pay program.

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