Performance, Compensation & Talent Management Committee

Agenda Item 7b

April 19, 2022

Item Name: Compensation Review and Recommendations for Statutory Positions

Program: Administration

Item Type: Action

Recommendation

Provide direction on compensation alternatives presented by Global Governance Advisors (GGA), the Board's Primary Compensation Consultant for Executive and Investment Management Positions.

Executive Summary

GGA will present compensation alternatives for positions covered by the Board's compensation setting authority under Government Code section 20098 and in alignment with the Board's Compensation Policy for Executive and Investment Management Positions (Policy). The Performance, Compensation, and Talent Management Committee (Committee) may choose to adopt one of these alternatives or may provide additional direction.

Strategic Plan

This agenda item supports CalPERS' Strategic Goal to promote a high-performing and diverse workforce in the 2017-22 Strategic Plan. The Executive Compensation Program provides a means for recruiting, retaining, and empowering highly skilled executives to meet organizational priorities and strengthen the long-term sustainability of the pension fund by generating returns to pay member benefits.

Background

In February 2022, McLagan presented compensation survey data based on the Board's policy-defined comparator groups for executive and investment management positions, including the Chief Executive Officer, Chief Actuary, Chief Financial Officer, Chief Operating Officer, General Counsel, Chief Investment Officer, and other investment management positions. GGA reviewed the survey data and presented their key findings from the compensation review related to the competitiveness of compensation at CalPERS compared to market compensation levels, highlighting gaps between current compensation levels for covered positions and current market pay levels withing the policy-defined comparator group. The Committee asked GGA to return in April 2022 to share potential alternatives intended to close the gaps in compensation.

There are currently five executive team members at or near the maximum of their base salary ranges: Chief Actuary, Chief Health Director, Chief Financial Officer, General Counsel, and Chief Investment Officer. For the approximately 125 covered investment management positions (including Associate Investment Managers, Investment Managers, Investment Directors, Managing Investment Directors, and Deputy Chief Investment Officer), 22% are in the first quartile, 34% are in the second quartile, 40% are in the third quartile, and 4% are in the fourth quartile of their respective salary ranges.

It should be noted that any changes resulting in an increase to the existing base salary ranges will not result in an automatic pay increase to staff unless an employee falls below the newly approved base pay range. Pay increases continue to be considered at the end of each fiscal year as part of the annual performance appraisal process, consistent with the Board's Compensation Policy for Executive and Investment Management Positions. Currently there is one employee whose salary would fall slightly below the proposed new base salary range minimum.

Analysis

This item presents GGA's recommendations on potential adjustments to compensation levels for covered positions to remain market competitive, and GGA will present two potential alternatives for the Committee's consideration to fill observed gaps to the market (see Attachment 1).

GGA has identified that CalPERS base salary levels are generally competitive for most roles but target total cash and target total compensation levels at CalPERS are less competitive when compared to the policy-defined comparator group. To better align CalPERS compensation with the relevant market, GGA has proposed a couple of alternatives focused primarily on positioning the annual and long-term incentives more competitively, as well as adjusting the base salary ranges for a few classifications that are under market. GGA's proposal represents an increase to the "at-risk" portion of pay (pay for performance), as the disparity there appears to be most significant. For a few positions, the alternatives also include base salary range revisions to better align the base salary range midpoints with the comparator group base salary median. The alternatives intend to align total compensation opportunities for these positions with total compensation opportunities of the comparator group.

The Chief Health Director (CHD) position was not included in the McLagan data, as they do not survey similar positions and it's uncommon to find a health function in CalPERS' comparator group organizations. CalPERS team members will continue to work with GGA to identify potentially comparable compensation data which will be brought back to the Committee at the June 2022 meeting.

It should be noted that while data is being presented for the Chief Operating Investment Officer position, it is not currently a classification being used at CalPERS. However, it is an existing classification available to CalPERS, so it is beneficial to maintain market-aligned compensation ranges, should there be a future desire to re-establish the use of the position.

Any changes adopted by the Board to salary or incentive ranges will become effective July 1, 2022 or phased in as directed by the Board. CalPERS team members will also incorporate any approved changes to base salary ranges, incentive schedules, and any other plan design options into the Board's Compensation Policy.

Budget and Fiscal Impacts

The alternatives proposed by GGA impact Executive Management and Investment Office compensation included as Personal Services expenses in CalPERS' Administrative Operating Cost budget. Alternative 1 proposes to:

<u>Executive Management</u>

- Increase the salary bands for four Executive Management positions
- Increase the target and maximum annual incentives for the CEO and four Executive Management positions
- Increase the long-term incentive range for the CEO
- Establish long-term incentive ranges for four Executive Management positions

<u>Investment Office</u>

- Increase the salary band for 41 Associate Investment Manager positions
- Increase the target and maximum annual incentives for all 140 positions in Investment Office classifications eligible to be paid incentives
- Increase the target and maximum long-term incentives for all 140 positions in Investment Office classifications eligible to be paid long-term incentives

Alternative 2 also impacts Executive Management and Investment Office compensation, but with the following changes:

<u>Executive Management</u>

- Provides larger increases (compared to Alternative 1) to the target and maximum annual incentives for the CEO and four Executive Management positions
- Does not provide long-term incentives for the four Executive Management Positions

<u>Investment Office</u>

- Provides larger increases (compared to Alternative 1) to the target and maximum annual incentives for all 140 positions in Investment Office classifications eligible to be paid incentives
- Increases the target and maximum long-term incentives for 38 positions in the Chief Investment Officer, Deputy Chief Investment Officer, Managing Investment Director, and Investment Director classifications, but to a lesser degree compared to Alternative 1
- Decreases the target and maximum long-term incentives compared to the currently approved plan for 102 positions in the Investment Manager and Associate Investment Manager classifications

The 2022-23 proposed Administrative Operating Cost Budget is $561.6 million as detailed in Finance and Administration Committee Agenda Item 6a. Based on review of GGA's proposal with two-year bridging and using the same assumptions considered to develop the budget, the estimated impact in 2022-23 for Alternative 1 is a $4.4 million increase (0.8%) in proposed Administrative Operating Costs. Subsequently in 2023-24, the Administrative Operating Cost

Budget will increase $7.9 million (1.4%). Over two years, the impact is approximately $12.2 million.

Alternative 1 Budget Increase

($ in 000's)	2022-23	2023-24
Exec Mgmt Salary Increases	$10	$10
Exec Mgmt Incentive Increases	300	600
INVO Salary Increases	650	650
INVO Incentive Increases	3,400	6,600
Total: Budget Increase	$4,360	$7,860

The impact of Alternative 2 on the Administrative Budget is an estimated increase of $8.9 million (1.6%) in 2022-23. This impact is greater because Alternative 2 provides larger annual incentive increases that would be effective July 1, 2022. The following year will see an increase of $16.9 million (3.0%), totaling $25.7 million over two years.

Alternative 2 Budget Increase

($ in 000's)	2022-23	2023-24
Exec Mgmt Salary Increases	$10	$10
Exec Mgmt Incentive Increases	800	1,600
INVO Salary Increases	650	650
INVO Incentive Increases	7,400	14,600
Total: Budget Increase	$8,860	$16,860

While Alternatives 1 and 2 include increases for both salaries and incentives, most of the cost impact is resulting from adjustments to incentives. The table below details the estimated impact that the proposed alternatives will have on budgeted incentive payments for the next two fiscal years. Any board-approved changes effective on July 1, 2022 will be reflected in the Mid-Year Budget Revision presented to the board in November 2022.

Incentive Payouts

($ in 000's)	2020-21 Actual	2021-22 Authorized Budget	2022-23 Proposed Budget	2022-23 Revised Mid-Year	2023-24 Projection[1]
Status Quo	$11,470	$18,990	$20,200	$20,200	$32,000
Alternative 1	$11,470	$18,990	$20,200	$23,200	$38,500
Alternative 2	$11,470	$18,990	$20,200	$28,500	$46,700

[1]Fiscal Year 2023-24 includes $11.4 million projected for the first year payment of long-term incentives approved by the Board in 2019-20.

The fiscal impact of new increases to long-term incentive plans presented in this item will not be realized until fiscal year 2026-27. Determining a reliable estimate is difficult because of changing variables over the next five years including vacancies, classification levels, salary increases within compensation ranges, length of employment, fund performance, and individual performance and metrics. However, under the same assumptions used to develop the 2022-23 Budget, the new long-term incentive plans are likely to add another $4.0 million, but payouts would only occur if fund performance meets or exceeds the Board-approved expected rate of return (currently 6.8%); if fund performance is below the expected rate of return, no long-term incentive payouts will occur.

Investment Office salaries and incentives are nearly all paid from the Public Employees Retirement Fund (PERF), with a small percentage charged to certain affiliate funds. In contrast, Executive Office salaries and incentives are cost allocated to the PERF and all affiliate funds. To the extent Executive Office salaries and incentives increase, there will be added pressure to the three funds capped by the Legislature: the Health Care Fund (HCF), the Public Employees Contingency Reserve Fund (CRF), and the Old Age Survivor's Insurance Fund (OASI). Additionally, Executive Office compensation is categorized as a pension administration expense reported to CEM and included in the CEM cost per member calculation.

Of the nearly 125 current employees covered by the compensation program, only a small subset, approximately 7%, are classic members with no cap on their pensionable earning potential. The remaining participants are subject to Internal Revenue Code and Public Employees' Pension Reform Act (PEPRA) caps on their compensation that can be considered as pensionable. Annual and/or long-term incentive compensation, as paid at CalPERS, is never pensionable. It is important to understand the impacts to compensation that can be reported vary considerably, depending on individual factors such as membership start date or past service. Although it's anticipated the group subject to caps will continue to grow, the actual number covered by caps can increase or decrease as employees may come to CalPERS from other agencies or leave CalPERS for other opportunities.

Benefits and Risks

The conducting of a regular salary survey demonstrates good governance and risk management practices. The benefit of revising compensation levels based on the policy-defined comparator group is to align with the Board's compensation philosophy, as well as aiding in CalPERS' ability to continually recruit and retain of highly skilled executives and investment managers.

Risks associated with adopting revised salary and/or incentive levels could include a negative public perception for considering compensation increases. However, in the event existing compensation is not competitive, there is a risk of difficulty in hiring and retention of highly qualified candidates for key positions.

Attachment

Attachment 1 – Global Governance Advisors Compensation Review and Recommendations

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Michelle Tucker, Chief
Human Resources Division