CalPERS

Performance, Compensation & Talent Management Committee

Agenda Item 5a

April 17, 2023

Item Name: Compensation Review and Recommendations for Statutory Positions

Program: Administration

Item Type: Action

Recommendation

Approve or 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.

Strategic Plan

This agenda item supports CalPERS' Strategic Goal to promote a high-performing and diverse workforce in the 2022-27 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 2023, 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 all investment management classifications. This was a follow-up from February 2022, when McLagan also presented similar compensation survey data. At that time, the Committee decided to re-assess the comparator group and have McLagan return with revised data. GGA reviewed the revised 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 within the policy-defined comparator group. The Committee asked GGA to return in April 2023 to share alternatives intended to close the gaps in compensation.

In January 2023, the Board of Administration approved increases to the maximum of the ranges for four classifications where the incumbents were at or near the maximum of base salary range. Even with these changes and applicable base pay increases, incumbents in the following classifications remain at or near the maximum of the revised salary ranges: Chief Actuary, Chief Health Director, Chief Financial Officer, General Counsel, and Chief Investment Officer. For the approximately 120 covered investment management positions (Associate Investment Managers, Investment Managers, Investment Directors, Managing Investment Directors, and Deputy Chief Investment Officers), 21% are in the first quartile, 32% are in the second quartile, 38% are in the third quartile, and 9% are in the fourth quartile of their respective salary ranges.

It should be noted that any approved increases to the existing base salary ranges will not result in automatic pay increases to incumbents unless an employee's current base salary is less than the minimum of newly approved base pay range. Pay increases for incumbents will 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 falls slightly below the proposed new base salary range minimum.

Analysis

This item presents GGA's recommended adjustments to compensation levels for covered positions to remain market competitive. GGA's analysis presents alternatives for the Committee's consideration to fill observed gaps to the market in salary and incentive opportunity (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 opportunities with the relevant market, GGA has proposed 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 to the market appears to be most significant in that regard. 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 worked with GGA to identify comparable compensation data for the Committee's consideration, including a number of California-based health organizations and districts. Factors considered included identifying organizations CalPERS could potentially lose talent to or gain talent from, as well identifying roles with key functions that included oversight of health benefits programs, policy, research, plan contracting, plan administration, rate management, account management, or long-term care. Based on alignment of essential functions with the Covered California Chief Deputy Executive, Program (Plans, Sales, and Service) position and consideration of required duties and expertise, it still presents as the closest comparable for the CalPERS CHD role.

Any changes adopted by the Board to salary or incentive ranges will become effective July 1, 2023, or phased in as directed by the Board. CalPERS team members will incorporate any approved changes to base salary ranges, incentive schedules, and any other plan design options into the Board's Policy.

Budget and Fiscal Impacts

The compensation adjustment alternatives proposed by GGA impact Executive and Investment Management compensation, included as part of Personal Services expenses in CalPERS' Administrative Operating Costs.

Alternative 1 proposes to:

<u>Executive Management</u>

- Adjust the salary ranges for four Executive positions
- Adjust the salary ranges with a higher base salary for the CHD position
- Remove annual incentive eligibility for the CHD position
- Increase the target and maximum annual incentives for the CEO and four Executive positions, with all executives directly reporting to the CEO receiving the same annual incentive opportunity except for the CFO
- Increase the long-term incentive target and maximum for the CEO

<u>Investment Management</u>

- Adjust the salary range for 43 Associate Investment Manager positions, the CIO position, and the Chief Operating Investment Officer (COIO) position
- Increase the target and maximum annual incentives for all 142 eligible positions in Investment Management classifications within the Investment Office
- Increase the target and maximum long-term incentives for all 142 eligible positions in Investment Management classifications within the Investment Office

Alternative 2 impacts Executive and Investment Management compensation with the following changes:

<u>Executive Management</u>

- Adjust the salary range for four Executive positions
- Adjust the salary ranges with a higher base salary for the CHD position, but to a lesser degree than Alternative 1
- Continue annual incentive eligibility for the CHD position
- Increase the target and maximum annual incentives for the CEO and four Executive positions, with all executives directly reporting to the CEO receiving the same annual incentive opportunity
- Increase the long-term incentive target and maximum for the CEO

Investment Management

- Adjust the salary range for 43 Associate Investment Manager positions, the CIO position, and the COIO position
- Increase the target and maximum annual incentives for all 142 eligible positions in Investment Management classifications within the Investment Office to provide a larger annual incentive opportunity to the DCIO (in comparison to Alternative 1)
- Increase the target and maximum long-term incentives for all 142 eligible positions Investment Management classifications within the Investment Office to provide a larger long-term incentive opportunity to the Deputy Chief Investment Officer (DCIO) (in comparison to Alternative 1)

The 2023-24 proposed Administrative Operating Cost Budget is $585.5 million as detailed in the Finance and Administration Committee Agenda Item 5a. Based on review of GGA's proposal with a two-year phased approach, and using the same assumptions considered to develop the budget, the estimated impact of Alternative 1 in 2023-24 is approximately $5.6 million. The cost in 2024-25 will be approximately $10.1 million. Over two years, the total impact for Alternative 1 is an estimated $15.6 million.

Alternative 1 Budget Increase

($ in thousands)	2023-24	2024-25
Executive Management Salary Increases	$8	$8
Executive Management Incentive Increases	634	1,264
Investment Management Salary Increases	790	790
Investment Management Incentive Increases	4,128	8,003
Total Budget Increase	**$5,560**	**$10,065**

Using the same assumptions, the estimated impact of Alternative 2 in 2023-24 is approximately $5.7 million. The cost in 2024-25 will be approximately $10.4 million. Total cost for Alternative 2 is an estimated $16.2 million.

Alternative 2 Budget Increase

($ in thousands)	2023-24	2024-25
Executive Management Salary Increases	$8	$8
Executive Management Incentive Increases	733	1,463
Investment Management Salary Increases	790	790
Investment Management Incentive Increases	4,209	8,166
Total Budget Increase	**$5,741**	**$10,427**

While Alternatives 1 and 2 include increases for both salaries and incentives, most of the cost impact is resulting from adjustments to incentives.

The impact of Alternative 2 is greater, because it maintains the annual incentive opportunity for the CHD position and includes a greater annual incentive opportunity for the DCIO and CFO positions.

The following table details the estimated impact the proposed alternatives will have on budgeted incentive payments for the next two fiscal years. Any board-approved changes effective on July 1, 2023 will be reflected in the Mid-Year Budget Revision presented to the board in November 2023.

Incentive Payouts

($ in thousands)	2021-22 Actuals	2022-23 Authorized Budget	2023-24 Proposed Budget[1]	2023-24 Revised Mid-Year[1]	2024-25 Projection[2]
Status Quo	$14,009	$20,213	$31,488	$31,488	$31,689
Alternative 1	14,009	20,213	31,488	36,249	40,956
Alternative 2	14,009	20,213	31,488	36,430	41,318

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

[2] Fiscal Year 2024-25 includes estimated first year payment of CEO long-term incentive approved by the Board in 2020-21.

The fiscal impact of new increases to long-term incentive plans presented in this item will not be realized until fiscal year 2027-28. 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 2023-24 Budget, the adjusted long-term incentive plans are likely to add another $5.1 million, but these 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 controlled by the Legislature: the Health Care Fund, the Public Employees Contingency Reserve Fund, and the Old Age Survivor's Insurance Fund. Additionally, Executive Office compensation is categorized as a pension administration expense reported to CEM Benchmarking (CEM) and included in the CEM cost per member calculation.

Of the approximately 130 current employees covered by the compensation program, only a small subset, approximately 7%, are classic members with no limit on their pensionable earning potential. The remaining participants are subject to Internal Revenue Code and Public Employees' Pension Reform Act limits 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 limits will continue to grow, the actual number covered by limits can increase or decrease as employees may come to CalPERS from other agencies or leave for other opportunities.

Benefits and Risks

The conducting of a regular compensation 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 to ensure the ongoing and long-term sustainability of the fund.

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. This may result in a negative impact to the fund, as well.

Attachment

Attachment 1 – Global Governance Advisors Compensation Review and Recommendations

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