Kick-Off Discussion
CalPERS
Executive Compensation

January 20, 2016

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Executive Compensation Consulting

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Agenda

- **Environment**
- Compensation Philosophy
- Governance
- "Hot Button" Items
- Suggested Next Steps

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Influencing factors affecting executive compensation

- **"Program optics"** exert significant influence over executive compensation design, decision-making, and governance
  – Key messaging needs to clearly articulate why a plan/program is good for the organization and its beneficiaries
  – Design design needs to strike the right balance between "best practice" and "best fit" as opposed to perceived "safe harbors"
  – No "one size fits all" approach
  – Process is key - know pay preferences and biases of trustees, executives/key talent, and other interested groups

As an additional point of complexity, public service organizations like CalPERS, to varying degrees, typically operate within more narrowly defined and stringent boundaries than their private sector counterparts. This additional set of influencing factors, such as statutory limitations on pay, can create significant challenges in compensation design, governance, and, ultimately, effectiveness related to attainment of talent needs and objectives.

Influencing factors affecting executive compensation

- **Heightened transparency pressures** are continuing to affect compensation programs (e.g., media, unions, shareholder advisory firms, CalPERS taking strong positions on pay levels, P4P, severance benefits, executive to employee pay ratios)
- Companies are conducting compensation **program risk assessment and mitigation programs**
- Today's governance environment demands that all pay actions are viewed through the lens of **pay-for-performance ("P4P")**
  - P4P reviewed from multiple parameters
    - Absolute (internally set metrics)
    - Relative comparisons (carefully selected peers)
    - Discretionary (salary increases, and negative discretion for incentives)

Influencing factors affecting executive compensation

- Pay decisions often reflect the **"war on talent"** (vs. war for talent)
  - People are working longer, exacerbating "talent compression" issues
  - Flight risk for top performers remains high (as are potential business disruption and replacement costs)
  - Pay differentiation is viewed as a key strategy to provide holding power

BlackRock CEO letter – marker of change or a voice in the wilderness?

Key messages

- Stop focusing on short term results
  - 24/7 media
  - Activist shareholders
  - Public policy that fails to encourage long-term investment
- Focus on long-term approach to creating value
- Revise U.S. Tax Policy
  - Long-term treatment only after held for 3 years
  - Decrease tax as you continue to hold

The Basics . . . Executive Pay Market Trends in Financial Services

- 2016 **executive salary** increases projected at > than 3%, aligning with past adjustments and slightly above staff increases (approx. 3%)
- **Incentives** (short-term reward for current period, long-term reward for multi-year period, typically three) at or above target/expected levels
- **Other compensation** remaining constant, with most organizations tending to offer two or three of following supplemental benefits
  - Supplemental retirement
  - Supplemental life insurance
  - Supplemental disability
  - Supplemental long-term care
- **Severance** ("Pay for Failure") is changing… slowly
  - Gradual reduction in benefits to "preferred levels"

The Basics . . . Annual Incentives

Key Design Feature	Typical Market Practice
Eligibility	Typically Director level and above – can be based on salary level, title, reporting relationship, etc.
Target Levels of Opportunity	Varies depending on the executive compensation philosophy and competitive market levels for each role, performance expectations, collateral benefits (retention)
Performance Measures	Financial (might include risk-adjusted metrics or considerations) Operational Strategic, etc.
Performance Level Measurement (> Individual if lower in organization)	Company Department Individual
Performance Metric Weightings	Varies depending upon impact of role and organization's philosophy
Performance Range	Although a typical performance range is 80% to 120% of target performance, many organizations are applying a more rigorous approach to determining performance ranges Negative discretion
Payout Range	The typical payout range is 50% to 150%/200% of target payout
Additional Design Mechanics	Increasing use of a financial trigger or **circuit breaker** to determine if plan will pay out **Potential recapture** for adverse ex poste risk outcomes in certain sectors

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The Basics . . . Long-Term Incentives

- Significant opportunities; option-type vehicles on the decline
  - LTIPS more common now at lower levels in financial services in order to mitigate risk of short-term focus
  - Growing use as deferred compensation subject to recapture (risk)
- Non-profits and government organizations using long-term incentives have multi-year performance plans, functioning similarly to annual plans except measurement considers multi-year performance
  - Correlation (prevalence) tracks with organizational size
  - Assists with balanced performance focus, with typically higher payouts for sustained long-term performance versus annual bonus
  - Assists with retention
  - Again, recapture provisions mitigate excessive risk taking

Discussion on Relative Incentive Metrics

Pros	Cons
▪ Market “sets” goal. ▪ Maintains motivation in both good and poor-performing years. ▪ Pay and performance outcomes are transparent. ▪ Unlike financial metrics, total shareholder return does not require adjustments for special or unusual items.	▪ Often provide little to no linkages with business strategy, risk profiles, etc. ▪ Can create participant uncertainty during "in cycle" period ▪ Payouts can occur if the company performs better than many poor performers (“best of the worst”). ▪ Outcomes may be inconsistent with investor/member expectations.

Point of View: Negative aspects can be managed by using relative metrics as a modifier rather than a primary metric, measuring performance annually and then using an averaging convention across a multi-year period to derive a final "score", limiting or capping payouts for negative results, etc.

Agenda

- Environment
- **Compensation Philosophy**
- Governance
- "Hot Button" Items
- Suggested Next Steps

Effective pay planning and oversight are outputs that result from high quality inputs

- The underpinnings of effective pay planning and oversight reside within a well-crafted **compensation philosophy** and the underlying **processes**; each serve as a key input in generating the desired outputs
- Compensation philosophies create a set of **enduring guiding principles** in terms of organizational views on talent and how it is acquired, developed, assessed, motivated, valued, and retained
  - Change is ever present, requiring a stable and consistent framework within which fair and appropriate decisions can be made
  - Enduring does not mean timeless – compensation philosophies need to evolve to reflect new business and talent needs
  - Example: elevated importance of risk considerations on the design and oversight of incentives and how performance is defined, measured, and rewarded
- Processes ensure that decision makers adhere to and operate within a **sustainable decision making framework** and those tasked with implementing decisions consistently deliver the **specified outcomes**

Where are we as a Board?

Please use your clicker to identify your current perspectives (Agree, Partially Agree, Disagree, Not Sure) regarding the following statements

1. I understand the objectives and mechanics of our compensation ("pay") programs
2. The talent needs of key business areas and the types (skills, experience) of people we reasonably can expect to hire are aligned and realistic
3. The markets in which we compete for talent are accurately defined and appropriate given our public agency status
4. Our compensation programs allow us to attract and retain the right levels of talent
5. Our desired competitive positioning of pay vs. market is appropriate in light of the influencing factors within which we operate
6. Indirect forms of compensation (prestige, culture, work environment, benefits, learning and development, stability, location, etc.) are sufficient to offset any competitive short falls in pay (base salary and incentive)
7. No one else is like us so performance comparisons are inappropriate
8. Turnover levels are appropriate given our prestige and the visibility of our people
9. I receive the information I need to make timely and informed decisions
10. I have a good sense of key employee preferences and priorities (most to least valued) in terms of base salary, bonus, and indirect forms of compensation

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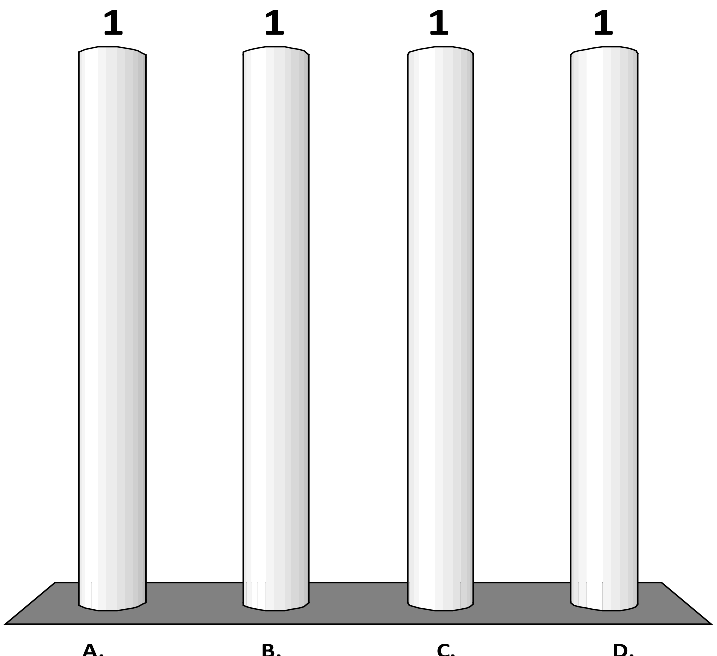

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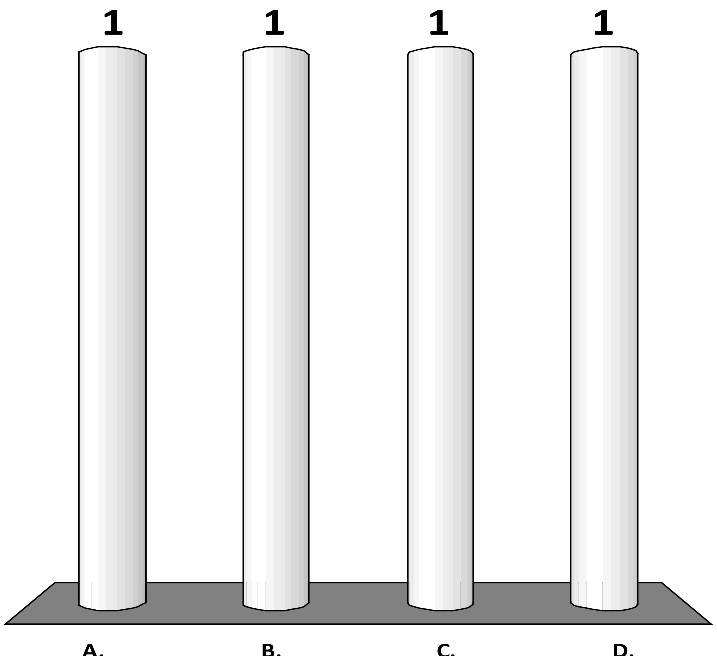

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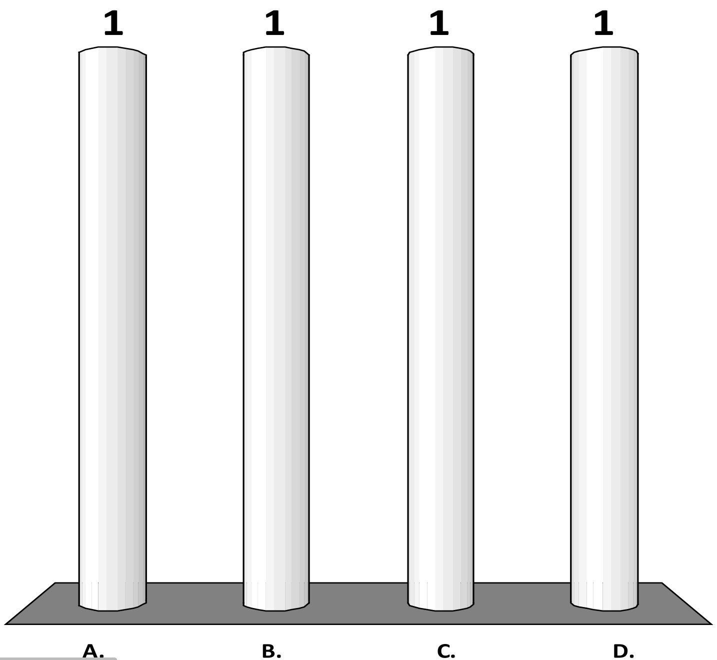

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4. Our compensation programs allow us to attract and retain the right levels of talent

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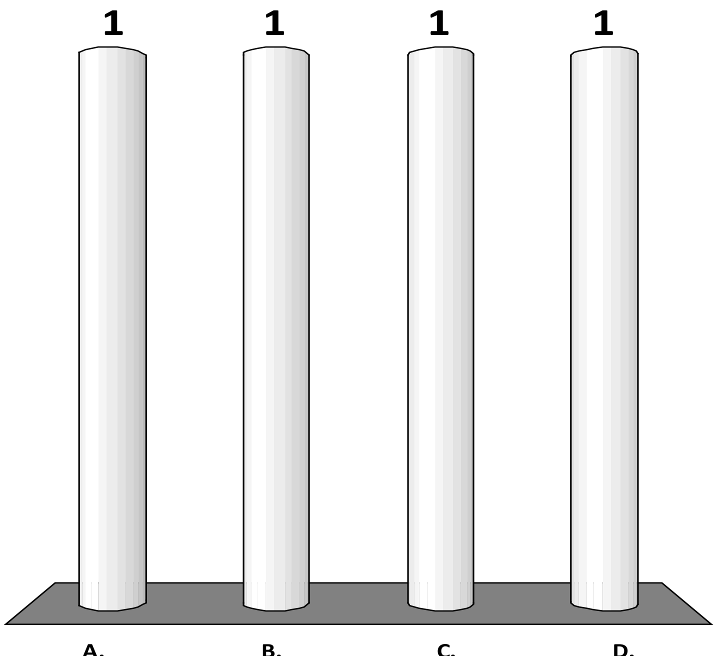

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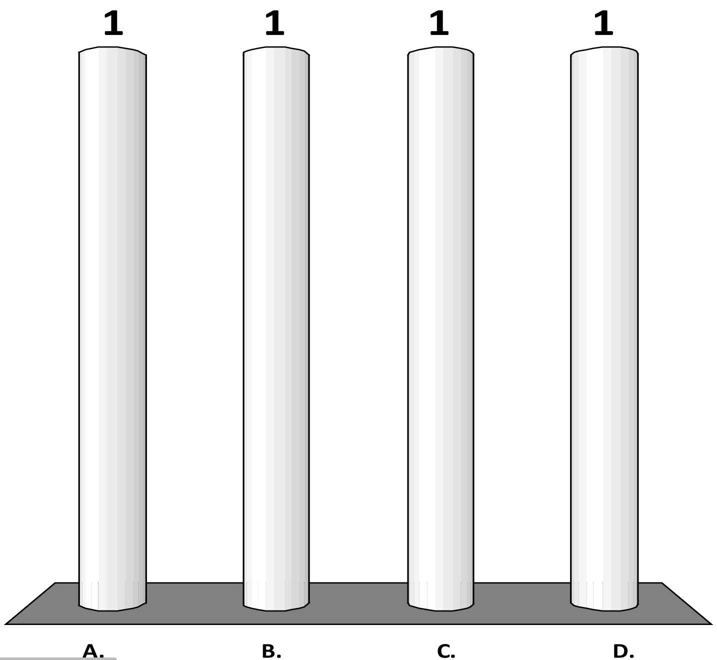

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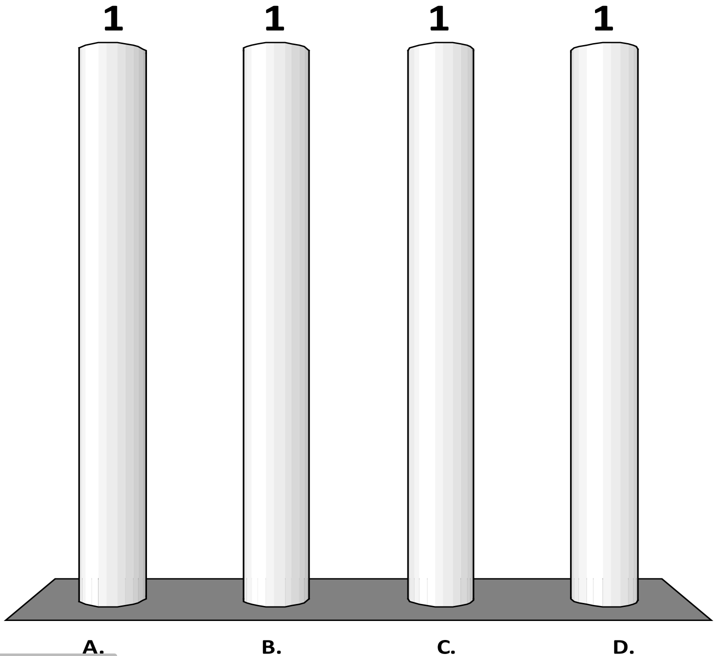

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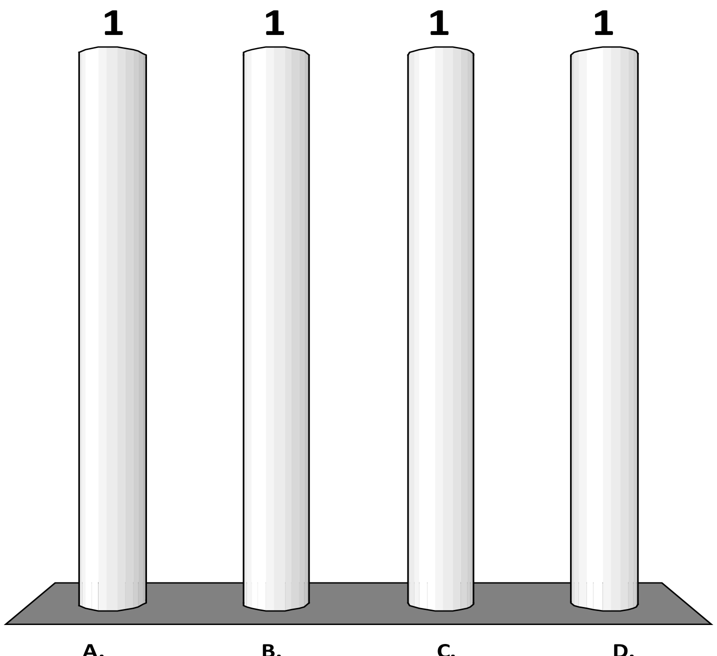

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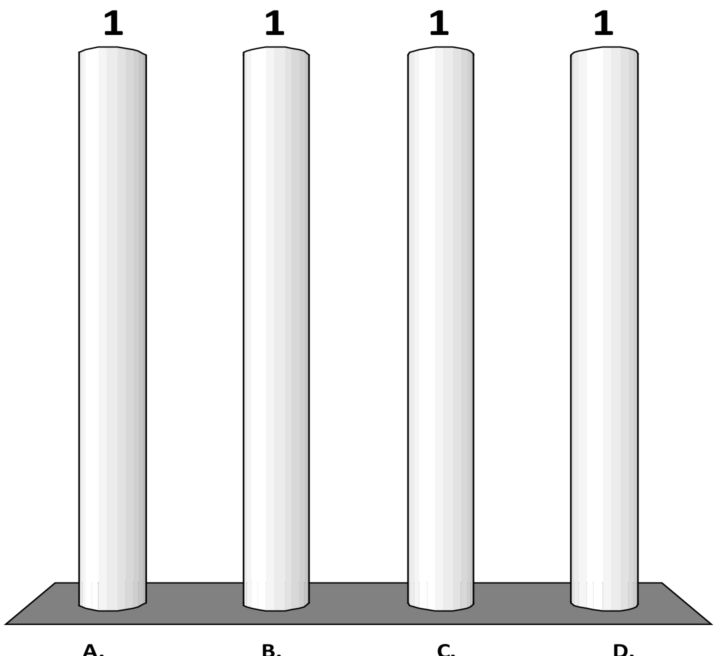

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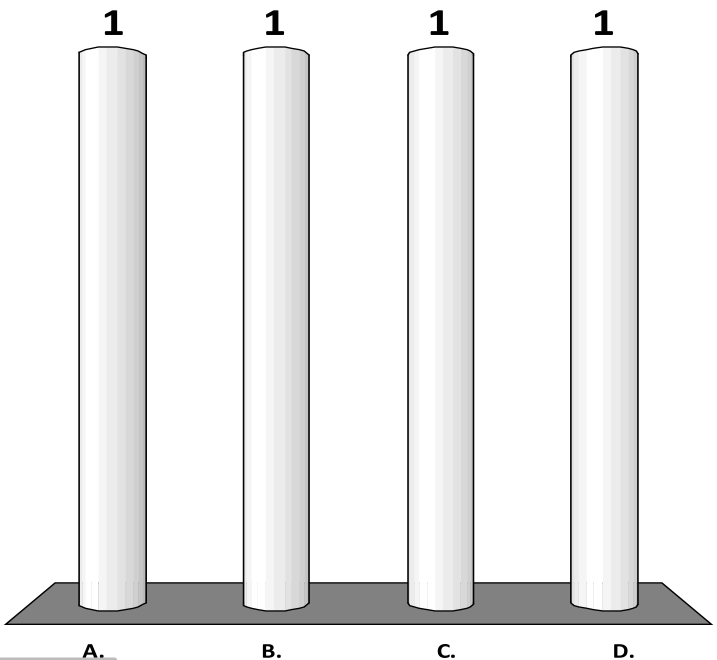

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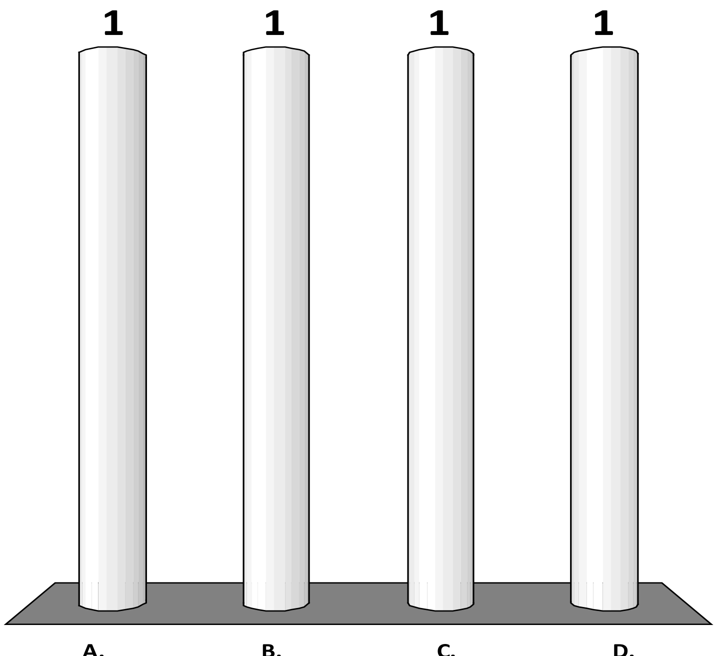

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Effective compensation philosophies typically share a common set of core attributes

- Aligns with **mission and values** – and the applicable legal statutes
- Reflects **talent needs and objectives**
- Conveys a sense of **direction, purpose, stability, and fairness**
- Cultivates **credibility** in the pay planning process, HR effectiveness, management integrity, and board effectiveness among those who matter most
  - Former, existing and prospective employees
  - Former, existing and prospective stakeholders (i.e., members and government officials)
  - Regulators and the public at large
- Helps answer the inevitable questions of **"why and how"** of pay program design and the resulting decisions and outcomes

Industry peers offer the clearest example of the linkage between philosophy and process

- Companies routinely rely on insights to be gleaned from market intelligence (relative assessments) for multiple purposes
  - Performance benchmarks (but not necessarily the associated risks)
  - Pay benchmarks (defining the value of a job but not the person filling it)
  - Organizational design, processes, and efficiency
- In terms of pay, market intelligence offers independent and objective perspectives on performance and pay trends and practices
  - Balance is key in pay design and oversight
  - A singular focus on external trends and practices ignores the most important considerations that are unique to CalPERS

Point of View: The complexity for CalPERS resides within striking the right balance between its internal needs and the divergent and often competing practices within its relevant markets for talent – i.e., government agency, financial services and asset management, health plans, insurance (actuarial, marketing and distribution), technology, customer service, general industry, etc.

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Governance provides the foundation on which effective pay programs are built

- Governance permeates the Board's fiduciary responsibilities and how it goes about its work
- Thanks to the influence of organizations like CalPERS, shareholder activists, and regulators, the governance revolution that began a decade ago has now become common place among publicly-owned companies, the best of whom serve as the standard bearers of good governance practices regardless of structure or status

Point of View: CalPERS operates with a robust set of governance principles, as codified in its "Governance Policy" (Rev. 12/2014). We suggest that CalPERS's view its pay-related governance practices through the lens of best practices, ensuring alignment with the realities and complexities of CalPERS's business model. One example is adding compensation knowledge to the governance or strategic competencies required of Board members. A second example is assigning oversight of risk considerations related to incentives and pay programs to either the Performance, Compensation & Talent Management Committee or the Risk and Audit Committee, ensuring that incentives do not motivate excessive risk taking.

Governance practices continue to evolve but timeless standards anchor the process

- Codified policies and documentation of key decisions
- Independent and qualified board members
- Transparency of process, actions, outcomes and decision points
- Access to training, information, and resources needed to make informed decisions
  - Common examples include sufficient delivery of board materials prior to meetings, access to consultants and other subject matter experts, continuing education, etc.
- Authority to exercise discretion
- Receptiveness to management's thinking and perceptions but not its influence

The quality of execution of governance processes ultimately determines effectiveness

- Considering prior decisions and their intended outcomes vis-à-vis actual experience to help guide decision making and processes
  - Did the action(s) generate the desired result(s)?
  - How effective is the Committee's pattern of decision making?
  - What did we do right/wrong?
- Thinking beyond the immediacy of the "ask" or needed action to fully understand its downstream implications and potential outcomes
  - What might happen if things go other than expected? How would we respond?
  - What are the risks (reputational, operating, financial, legal, talent, etc.)?
  - What are the potential reactions of key stakeholders?
- Streamlining processes and inputs, creating more time for discussion
  - Do we have what we need to facilitate decision making?

And the "best practice" list continues to expand…

Point of View: Asset managers and pension funds have not been forced to take action to the extent of the large banks but emerging risk-centric practices should be considered as potential enhancements

- Among financial services organizations (primarily money center banks with significant assets), elevation of risk considerations have reshaped how Boards work and how key risk takers are rewarded
  - Less variable pay/upside; more fixed pay to diminish risk taking
  - Longer vesting/deferral periods (CalPERS defines "long-term" in relation to pay as five years in its *Governance & Policies* document)
  - Risk-adjusted metrics (regulators have expressed concerns that relative performance comparisons encourage excessive risk taking – although it remains a highly prevalent feature except among money center banks)
  - Pay recapture provisions for adverse risk outcomes attributable to management
- New processes have arisen in response to the risk "work set"
  - Greater interaction with Risk Committees, Chief Risk Officer and risk staff
  - More time devoted to risk-related considerations
  - Greater proclivity and willingness to exercise discretion

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"Hot Button" Items

What initial discussions have surfaced…

- Performance assessment beyond the numbers
- Performance considerations reflective of risk management and relativity
- Aligning business, talent and compensation strategies
- Reconsideration of pay philosophy and design to reflect new strategic imperatives (e.g., bring "in-house" more investment management capability)
- Role of relative performance standards in incentive programs
- Building an enterprise-wide focus and commitment
- Simplifying pay program design and administration
- Enhancing transparency
- Finding the right balance between internal needs and external realities

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- Compensation Philosophy and Peer Groups
- Governance
- "Hot Button" Items
- **Suggested Next Steps**

Suggested Next Steps (early to mid 2016)

- Meeting #2: Review Proposed Executive Compensation Philosophy and Governance Process, with Market Analysis that Corresponds with Philosophy
  - Preceded by Board, Committee and Executive interviews on philosophy, job content, and pay perceptions
- Meeting #3: Review Proposed Refinements to P4P Programs for Senior-Most Executives
  - Preceded by Committee and Executive interviews on critical strategies, performance metrics, and design alternatives
- Meeting #4: Review Market Analysis and Proposed P4P Programs for Key Staff
  - Preceded by Executive interviews on alignment with Senior-Most Executives pay plans, and recruitment/retention considerations

Grant Thornton will transition from design to implementation advisors, working directly with those tasked with implementation and under the Committee's supervision. Our involvement helps ensure that the Committee's directives are implemented as intended and approved.

Comments/Questions?

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