



Memorandum

To: Performance, Compensation and Talent Management
Committee (“PCTMC”) of CalPERS

Date: February 2018

From: Eric Gonzaga / Grant Thornton LLP

Re: Recommended Policy Adjustments Use of Discretion in Annual Incentive Plan Award
Determination

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Dear Committee

Background

In 2016, the Performance, Compensation and Talent Management Committee (“PCTMC”) engaged Grant Thornton (“us”, “we”, or “Firm”) to assess proposed modifications to review executive and investment officer compensation at CalPERS. As part of this review, we recommended an annual incentive plan discretionary modifier. The PCTMC has since requested that GT provide further guidelines on how such discretion should be exercised.

We previously assisted CalPERS on a redesign of the incentive compensation program. As part of this redesign, GT recommended a highly outcome oriented annual incentive plan. However, given the dynamic nature of CalPERS, we recommended that discretion be allowed in evaluating, or modifying the award ultimately provided to each plan participant – specifically to ensure that any actual payout is based a combination of team performance and individual behaviors.

In 2016, we had recommended guidelines, summarized below:

- Discretion could be exercised by the PCTMC and Board for the CEO, and by the CEO for those reporting through the CEO (other than INVO), and by the CIO for those reporting through the CIO.
- Adjustments will be based on performance documented in the individual performance review.
- Adjustments could vary by anywhere from +50% to -100% of any calculated award – however no award will ever exceed 150% of the defined maximum incentive opportunity of any participant.
- Adjustments must be exercised in specific increments (i.e., +/- 25%; +/- 50%, +/- 100%), with the intention of ensuring that such specific scale delineation would encourage that any exercise of discretion be fully thought out and documented between levels.
- No award would ever exceed the maximum incentive opportunities, regardless as to discretion exercised.

Recently, the Committee felt constrained by the three specific levels of discretion described above, and requested that GT provide discretionary guidelines that provided more flexibility.

I. Alternatives

We recommend two potential alternatives, with one providing discretionary adjustments in 20 percentage point increments, with the other providing full authority. Proposed changes are bolded:

Alternative A

- An award can be adjusted upward **by meaningful increments of 20%** based on qualitative individual contributions. Discretionary adjustments may not exceed the maximum incentive opportunity; **in the event an adjustment exceeds the maximum incentive opportunity, the maximum incentive will be awarded.**
- An award can be adjusted downward **by meaningful increments of 20%**, or eliminated altogether based on unsatisfactory individual performance.
- For situations of non-adherence to CalPERS' risk management principles, policies, processes, or procedures, an award can be reduced by either 50% or eliminated entirely, based on the severity of non-adherence.
- Adjustments will be exercised based on the overall performance evaluation process, and will take into account qualitative factors such as performance relative to CalPERS' culture and values; leadership; extraordinary contributions, efforts, or results; development and successful implementation of business or stakeholder imperatives; or strategic workforce activities involving succession planning, retention and flight risk, or talent supply or development.

Alternative B

Discretion can be exercised in the following situations:

- An award can be adjusted upward **by any percentage** based on qualitative individual performance. Discretionary adjustments may not exceed the maximum incentive opportunity; **in the event an adjustment exceeds the maximum incentive opportunity, the maximum incentive will be awarded.**
- An award can be adjusted downward **by any percentage**, or eliminated altogether based on unsatisfactory individual performance.
- For situations of non-adherence to CalPERS' risk management principles, policies, processes, or procedures, an award can be reduced by either 50% or eliminated entirely, based on the severity of non-adherence.
- These adjustments will be made based on the overall performance evaluation process, and will take into account qualitative factors such as performance relative to CalPERS' culture and values; leadership; extraordinary contributions, efforts, or results; development and successful implementation of business or stakeholder imperatives; or strategic workforce activities involving succession planning, retention and flight risk, or talent supply or development.

Either approach is reasonable. However, we believe that Alternative A may provide the best approach, as it expands the levels at which discretion can be exercised, while still differentiating between performance levels in a meaningful manner.

We hope this information is helpful to you, and please feel free to reach out to us with any questions.