March 20, 2018

Item Name: Review of Chief Executive Officer's Compensation Plan

Program: Administration

Item Type: Action

Recommendations

- Approve an incentive plan structure for the Chief Executive Officer position to become effective in fiscal year 2018-19.
- Approve or provide direction on an approach to set a compensation structure for the Chief Executive Officer position to become effective in fiscal year 2018-19.

Executive Summary

In addition to the current incentive plan and compensation structure for the Chief Executive Officer (CEO), the Board's Executive Compensation Consultant (Consultant), Grant Thornton LLP, has provided two alternatives for the Performance, Compensation and Talent Management Committee's (Committee) consideration. Depending on how they decide to move forward, the Committee may also wish to select an approach to establish a revised compensation structure. Included in the item are potential approaches and examples to aid the Committee with their decision.

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 our organizational priorities.

Background

In February 2018, the Committee requested team members work with the Consultant to design and recommend incentive plan alternatives which would differentiate the CEO's incentive plan from those of her direct reports and their respective direct reports.

Analysis

The Consultant's Opinion Letter (Attachment 1) details plan alternatives and the Consultant's related opinions regarding each one. Changes to the CEO's incentive plan structure would become effective July 1, 2018.

It is the Consultant's primary preference to continue with the current plan structure and maintain the CEO's incentive plan consistent with other executives. However, the Consultant has also offered two alternatives for the Committee's consideration.

CEO Compensation Plan Alternatives:

- No change: current plan design
- Alternative A: increase base pay, eliminate incentive (base pay only structure)
- Alternative B: increase base pay, reduce incentive, and measure performance based on qualitative factors only

If the Committee chooses to maintain the current design for the CEO's incentive plan, no changes would need to be made now. Team members and the Consultant will return to the Committee at a future meeting to discuss compensation design options for all program participants, at which time the Committee may consider implementation of a revised compensation structure for the CEO position.

If the Committee chooses Alternative A, the Consultant recommends increasing the CEO position base pay range by all or a portion of eliminated incentive opportunity. Essentially, the CEO position would no longer be subject to an incentive plan and would be compensated based on salary only. The Consultant also recommends maintaining the existing year-end performance review process to evaluate the incumbent CEO's overall performance and determine any annual base pay increase to become effective for the subsequent fiscal year.

If the Committee chooses Alternative B, the Consultant recommends increasing the base pay range for the CEO position by a modest amount and reducing the incentive opportunity. The Consultant also recommends the incentive award be based on an incentive plan with qualitative factors.

Table 1, below, provides the current base pay and incentive opportunity ranges for the CEO position and how they could potentially be altered. If the Committee chooses Alternative A or B today, they may also wish to use these examples to select a compensation structure. Alternatively, the Committee may wish to provide more direction for team members to return at a future meeting with additional options. If the latter is preferred, team members will return no later than June 2018, as that is the timeframe by which the CEO's plan is generally approved by the Committee for the subsequent fiscal year.

TABLE 1

APPROACH		*Base Pay Range*	*Incentive Opportunity*	*Maximum Potential*
CalPERS CEO Position Compensation Structure		$224,000 to $352,800	0% to 40% (target 27%)	$493,920
ALTERNATIVE A EXAMPLES: increase base pay and eliminate incentive opportunity				
1	*Increase current base pay by current incentive target (27%)*	$284,480 to $448,056	0%	$448,056
2	*Increase current base pay by recent three-year incentive average earned (35%)*	$302,400 to $476,280	0%	$476,280
3	*Increase current base pay by current maximum incentive opportunity (40%)*	$313,600 to $493,920	0%	$493,920
ALTERNATIVE B EXAMPLES: increase base pay and reduce incentive opportunity				
4	*Increase current base pay range and decrease incentive opportunity each by 25%*	$280,000 to $441,000	0 – 15% (target 10%)	$507,150
5	*Increase current base pay range and decrease incentive opportunity each by 10%*	$246,400 to $388,080	0 – 30% (target 20%)	$504,504

Table 2, below, is provided for comparative and informational purposes. This information requires no action from the Committee, unless the Committee wishes to use it to set revised base pay and/or incentive ranges for the CEO position. These examples are based on CalSTRS current CEO position base pay and incentive data, as well as salary data previously provided to the Committee.

TABLE 2 *for comparative and informational purposes*

APPROACH		*Base Pay Range*	*Incentive Opportunity*	*Maximum Potential*
CalPERS CEO Position Compensation Structure		$224,000 to $352,800	0% to 40% (target 27%)	$493,920
CalSTRS CEO Position Compensation Structure		$325,000 to $475,000	0% to 80% (no target)	$855,000
BASE PAY RANGE SETTING EXAMPLES				
1	*Use McLagan 2015 CEO comparator group base pay only mid-point ($400,000) and set range 20% below and above*	$320,000 to $480,000	0% or TBD	$480,000
2	*Use McLagan 2015 CEO comparator group total cash (base pay + incentive) mid-point ($779,000) and set range 20% below and above*	$623,200 to $934,800	0% or TBD	$934,800
3	*Use CalSTRS CEO current base pay mid-point ($400,000) plus 40% (half of the incentive opportunity) to determine a mid-point of $560,000; set range 20% below and above*	$448,000 to $672,000	0% or TBD	$672,000
4	*Use CalSTRS CEO current base pay mid-point ($400,000) plus 80% (maximum incentive opportunity) to determine a mid-point of $720,000; set range 20% below and above*	$576,000 to $864,000	0% or TBD	$864,000

NOTE: If Table 2 ranges were used to establish a base pay plus incentive opportunity plan, the noted base pay range would be reduced by a proportionate percentage of incentive opportunity added; and the maximum potential would vary based on percentage applied.

Any decision made by the Committee today, other than maintaining the current incentive plan design for the CEO position, will result in changes to the Policy. Based on the Committee's decision, team members will conduct a thorough review of the Policy and update relevant sections to mirror and align with the decision(s). Policy changes may include things such as revising the base pay and incentive range table, removing references to the CEO's plan and related approvals in various sections and tables, etc., consistent with Committee's decision.

Budget and Fiscal Impacts

Budget and fiscal impacts will vary based on the alternative selected by the Committee and any subsequent revisions the Committee may choose to make to the existing CEO compensation structure. If the Committee chooses a base pay only structure aligned with the existing earning potential, budgetary impacts would be neutral; or up to approximately $45,000 in savings, depending on the range selected. If the Committee chooses a structure to increase base pay and reduce incentive opportunity, budgetary impacts will be minimal since the changes should offset one another. If the Committee were to implement a revised salary range, budgetary impacts will be based on the difference between the existing and revised earning opportunity. For example, using the comparator examples provided, budgetary impacts could result in a savings of approximately $13,000 (lowest maximum listed in Table 2) to an increased expenditure of up to approximately $441,000 (highest maximum listed in Table 2), annually, depending on the final selected approach and pay ranges.

Regardless of the alternative selected, it's important to note retirement would be impacted only in instances where a CEO has classic member status and is not subject to the Public Employees' Pension Reform Act.

Benefits and Risks
As identified in the Consultant's letter, the benefit of Alternative A is that it creates the simplest approach. The benefit of Alternative B is that it provides a meaningful portion of pay at risk, based on performance.

Also, as identified in the Consultant's letter, the risk associated with Alternative A is that pay would be entirely fixed, with no ability to reward outstanding performance or address performance that does not meet expectations. The risk associate with Alternative B is a less than optimal alignment of pay for performance between the CEO and executives.

Attachments
Attachment 1 – Grant Thornton LLP Opinion Letter

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Tina Campbell, Chief
Human Resources Division