Performance, Compensation & Talent Management Committee

Agenda Item 5

May 15, 2018

Item Name: Pay Philosophy Discussion for Positions Covered Under the Board's Policy for Executive and Investment Management Positions

Program: Administration

Item Type: Action

Recommendations
1. Affirm/modify the Board of Administration's (Board's) compensation policy purpose statement.
2. Affirm peer comparator groups used for establishing base pay ranges for executive and investment management positions covered under the Board's compensation policy.

Executive Summary
This agenda item seeks to affirm the existing purpose statement and peer comparator groups used for establishing base pay ranges for positions covered under the Board's Policy. This item will also review the purpose of targeting a comparator group percentile to set relevant compensation for executive and investment management positions. These three components frame a complete pay philosophy around which compensation can be designed for positions covered under the Board's Policy for Executive and Investment Management Positions (Policy).

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
As stated in the Policy's purpose statement, the compensation policy "…represents the strategic decision that pay must be high enough to encourage individuals to accept and remain in positions, but not so high as to attract candidates solely for the compensation." The Performance, Compensation and Talent Management Committee (Committee) has continued to explore and refine the elements necessary to maintain a sound executive compensation program with the intent of recruiting and retaining highly skilled professionals as a foundation for CalPERS' overall success.

The Board's Policy states that a salary survey may be conducted every two years, or as the Board deems necessary, to ensure base pay ranges are appropriate and relatively competitive with the defined market comparator group. In 2013, the Board adopted a revised comparator group and engaged McLagan to conduct a salary survey for covered investment management positions. As a result of the survey, the Board approved revised salary ranges for several investment management positions, and a two-year phased approach was implemented to move impacted team members into the new range.

The last comprehensive salary survey covering executive and investment management positions was completed by McLagan in September 2015. McLagan reviewed all base pay policy provisions and incentive award schedules, gathered salary data, and conducted a peer group comparative discussion for executive and investment management positions covered under Government Code Section 20098. At the time of the 2015 survey, the Chief Executive Officer (CEO) and Chief Actuary salary and total cash levels also fell near the 25th percentile, while the numbers for the General Counsel and Chief Financial Officer were closer to market median. The survey also confirmed base salary ranges for investment management positions were fairly mainstream and positioned at the competitive median. However, total cash compensation levels (salary plus incentive) for the investment management positions were below the 25th percentile of comparable market data.

As a result of McLagan's 2015 survey findings, the Board approved a revised executive management comparator group for base salary benchmarking that includes leading US and Canadian public funds, select California-based agencies, banks, and insurance companies. The Board also set a salary range for the newly established Associate Investment Manager classification and increased the maximum of several covered classifications by 5% to address incumbents in the fourth quartile. Board members expressed concerns about total cash compensation levels, indicating a desire for further review, especially for positions that were not aligned with the 50th percentile of the comparator group.

In 2016, the Board engaged Grant Thornton as the Board's primary executive compensation consultant (Consultant) to conduct a comprehensive review of CalPERS' incentive compensation programs to ensure alignment with CalPERS' goals and strategies as well as best practice in implementation. Through the review process, existing peer groups for executive and investment management positions were validated as appropriate for CalPERS based on mission, organization size, complexity, and recruitment factors. Analysis also confirmed the 2015 salary survey findings that many of CalPERS base salaries were generally positioned near the competitive median, but that total cash compensation levels were positioned below the market 25th percentile.

As the conclusion of this review, the Board adopted new incentive metrics, including: Total Fund Performance, Enterprise Operational Effectiveness, Investment Office CEM, Customer Service, and Stakeholder Engagement. These metrics were included in the 2016-17 and 2017-18 fiscal year incentive plans of the CEO and Deputy-level positions. The Consultant also made recommendations on design of a long-term incentive plan, as well as several strategies for an updated salary structure to reallocate the mix of pay between salary, annual incentives, and long-term incentives. Attachment 2 includes a list of the strategies that were presented and status indicating progress or where further consideration is needed.

In 2017, rather than conducting a full-scale salary survey, existing data sets were updated to provide the Committee with relevant information and options to adjust existing salary ranges. These data sets included the data gathered and presented by McLagan in September 2015; results of an externally-conducted compensation study of public pension funds in which CalPERS and 58 other state entities participated; and additional public sector salary data collected internally for positions at reciprocal agencies which have positions similar to those under the Board's compensation-setting authority. As a result, the Committee approved modest increases to the salary ranges of several covered positions to allow some salary movement for incumbents near the maximum of their corresponding salary ranges. It is important to note that this modified salary survey was limited to base salary and did not address total cash compensation levels.

Analysis
In March 2018, the Committee directed CalPERS team members to bring back an action item with options for a fixed compensation model (salary only) for the CEO position, in addition to other compensation plan options for consideration. Team members have worked with the Board's Consultant to review compensation data and determine next steps in identifying a revised salary range that would establish a fixed-compensation model. As part of the process, information is being provided for the Committee today to review and affirm the current program purpose statement and comparator groups. Information is also included on the typical approach of targeting a comparator group percentile around which compensation would ultimately be positioned. These three elements – the purpose, comparator group, and target percentile – serve to frame CalPERS' pay philosophy with the goal to attract and retain highly skilled professionals.

The Policy's purpose statement explains that "compensation policy… represents the strategic decision that pay must be high enough to encourage individuals to accept and remain in positions, but not so high as to attract candidates solely for the compensation. Moreover, compensation systems must be carefully structured to both recognize labor market forces and reinforce maximum performance through placing a substantial portion of total annual compensation at risk." This statement is intended to set the direction of the compensation program and the tone for decisions around salary and incentive ranges for covered positions.

Having a pay philosophy will aid team members in presenting options at future meetings so the Committee can select appropriate salary and incentive ranges for all covered positions, starting with the Executive-level positions. Based on the Committee's prior direction, a fixed compensation (salary only) range will be determined for the CEO position. For other positions, the Committee will select base pay and incentive ranges to reflect the desired positioning against market data. In addition, the Committee will be presented with information regarding long-term and/or deferred compensation options which they may choose to apply as part of an overall compensation package.

It's important to understand that any salary range revisions do not automatically result in raises for incumbents. Salary increases will continue to be considered annually as part of the year-end appraisal process in accordance with relevant Policy provisions. In a situation where an incumbent's salary falls below the minimum of the revised salary range, it has been past practice to bring the impacted incumbent's salary to the minimum of the revised salary range. In the case of the current CEO incumbent, the transition to a fixed compensation (salary only) model, including placement in a revised salary range and ongoing performance discussions, will be addressed during the regular year-end evaluation process in September. The Board will continue to assess the CEO's overall performance annually in determining future salary increases.

Budget and Fiscal Impacts
Any costs that arise from the recommendations in this agenda item, such as salary range changes, would be requested through the formal budget process.

Benefits and Risks
The periodic review of market compensation data demonstrates good governance and risk management practices, and aids in the refining of strategies for the recruitment and retention of highly skilled executives and investment managers.

Risks associated with adopting a revised compensation structure could include a negative public perception for considering compensation increases. However, in the event existing salary ranges are not competitive, there is a risk of potential difficulty in the hiring and retention of qualified candidates for key positions integral to CalPERS' ability to successfully achieve strategic goals.

Attachments
Attachment 1 – Presentation Slides
Attachment 2 – Grant Thornton Pay Design Strategies

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