Effective Incentive Design in Today's Market

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Introductions

- **Jeff Bacher**
  - Senior consultant, Hay Group
- **Jim Dickenson**
  - Senior Consultant, Towers Watson
- **And the audience…**
  - Who is engaged in managing compensation programs?
  - Who has designed an incentive plan?
  - How did it work?

Discussion Agenda

Background & Introductions

What is incentive compensation?

Alignment with Compensation Strategy

Basic Components

Impact of “risk” in plan design

Questions and Discussion

This will be a lot more fun if it is interactive!

Background

What is Incentive Compensation?

- May be one of the largest single variable costs for the organization
    - Particularly if it is broad based
- A key management tool
    - Ability to attract and retain
    - Some (but not all) would argue that $ motivates

It is also a very effective communications tool

- People will do what they are paid for
- The reward system tells people that <u>this is important</u>
- Sets the boundaries of acceptable results

Alignment with overall compensation strategy

Objectives of variable pay

Talent management

- Attract high performing, goal-driven individuals.
- Differentially reward those that contribute most to business performance and success.

Risk management

- Move proportion of pay from fixed cost to variable cost.
- Compete more economically in the labour market.

Incentive

- Focus attention on specific areas of performance or results.
- Reinforce or modify behaviour.
- Thank you for helping us achieve business results.

Objectives of variable pay

Inclusion

- Help give clearer identity to divisions and teams.
- Enhance sense of team membership for individual, fostering co-operation and shared identity.

Economic

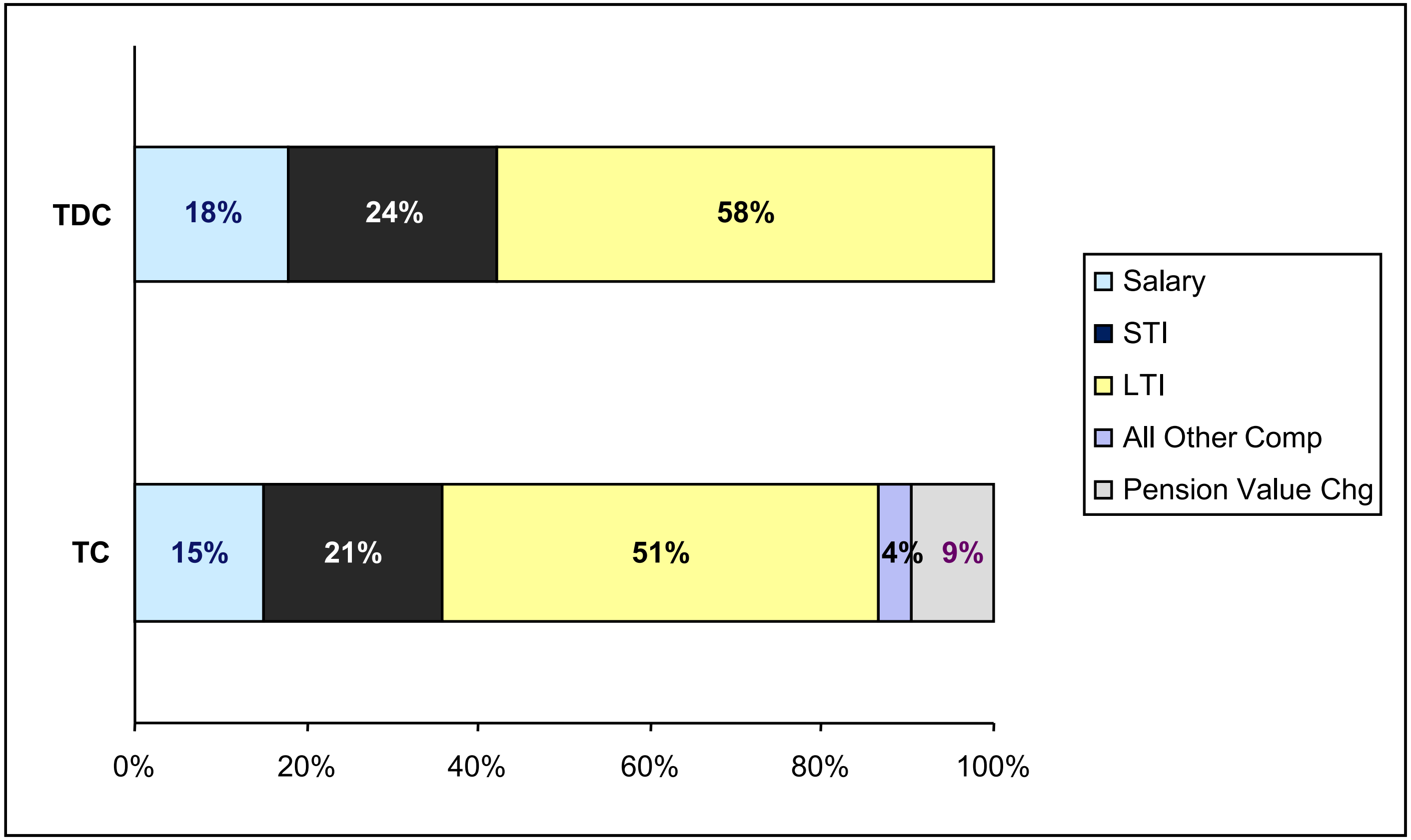
- An element of remuneration that is self-funding.
- Links with fortunes of business.

Competition

- Enhance external market competitiveness.
- To meet competitive market norms & practices.
- To avoid unduly high base pay.

Background

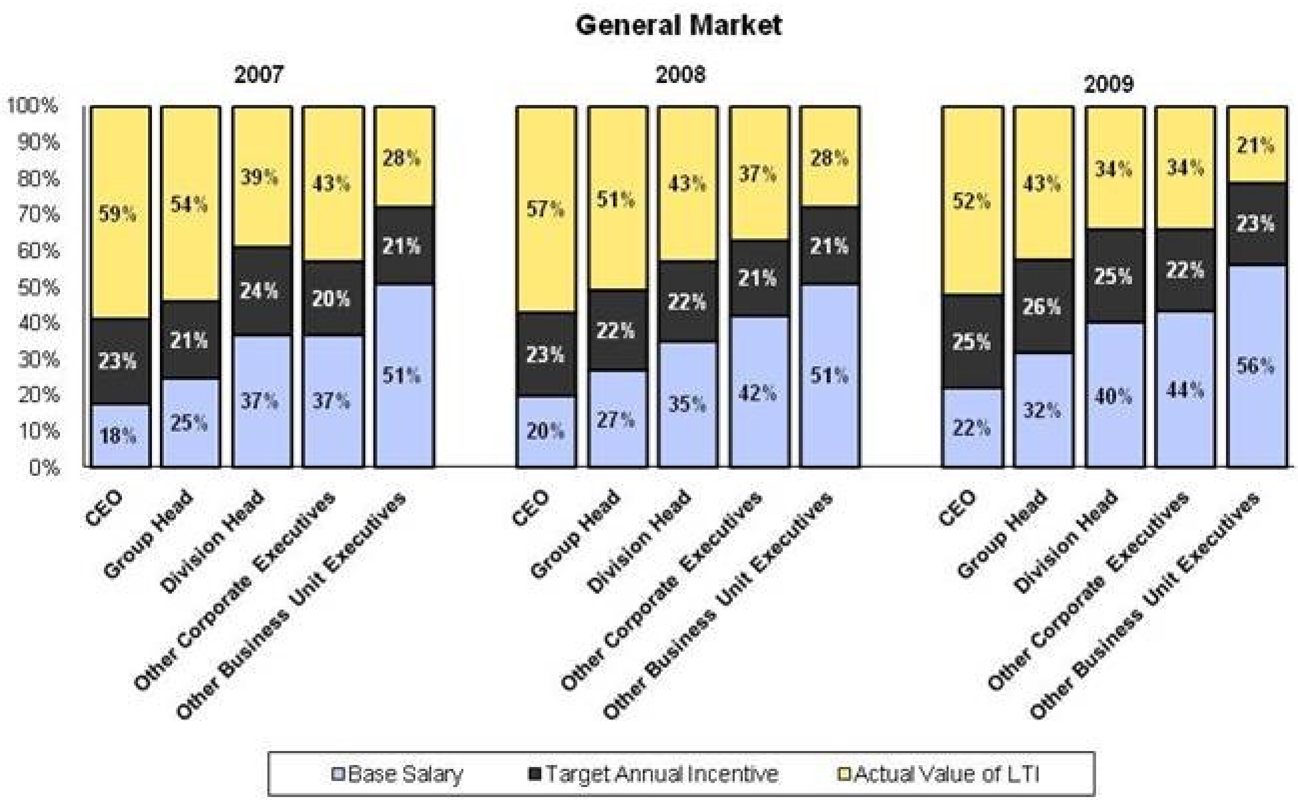
- **At the extreme, (CEO level) incentives are the dominant element of pay.**



Includes only constant incumbents

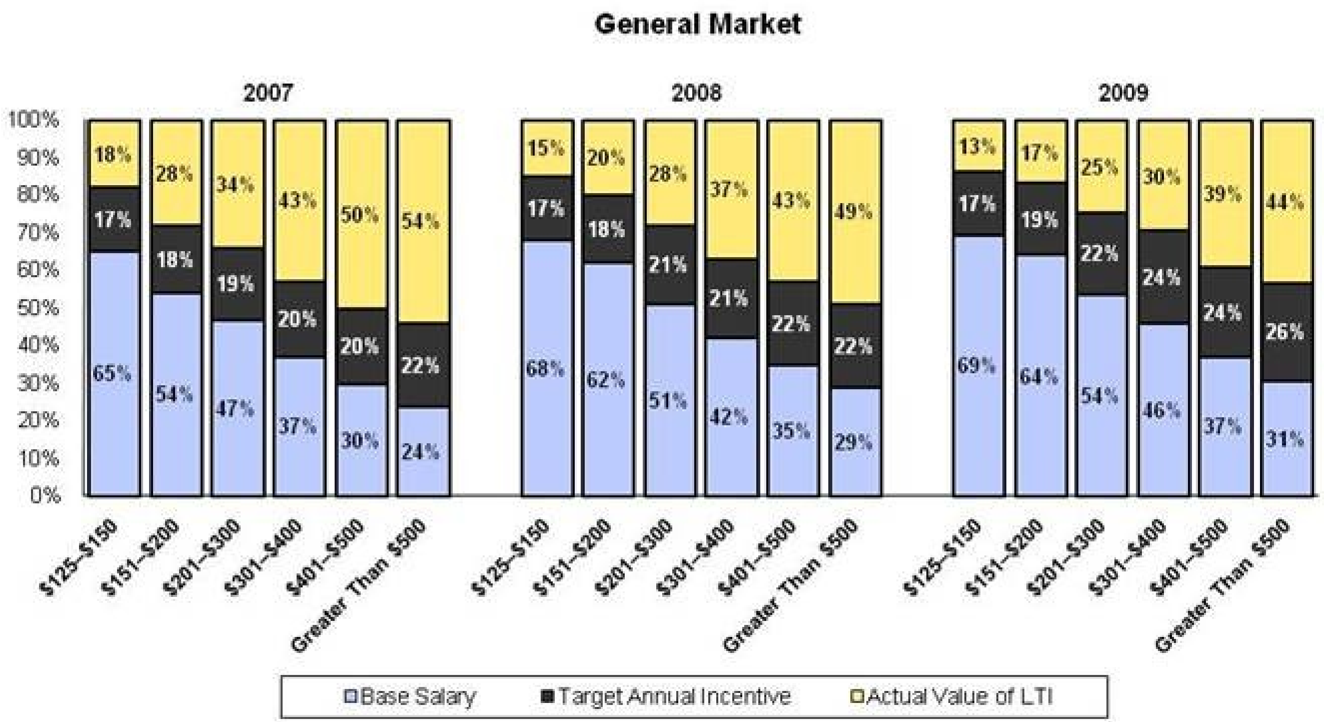
Background

- But incentives are an important element of pay at all levels.
- By job grouping



Background

- But incentives are an important element of pay at all levels.
- By salary range



Theory – why should incentives work?

The following theories all contribute towards understanding the rational and conditions for incentive plans to work

- **Equity theory** implies that if executives perceives that they are at a disadvantage, either in monetary or workload terms, compared to other executives, they will try to correct that inequity through either increasing or decreasing their work effort .
- **Efficiency wage model** implies that organizations that pay higher incentives will benefit from higher organizational performance as
  - they are able to attract & retain higher calibre of staff
  - there is willingness to take on tough tasks
  - in return for the 'gift' of higher incentives, executives are more productive.

Theory – why should Incentives work?

- **Expectancy theory** implies incentives will work if the following conditions are met
  - expectancy that the target is achievable
  - link to performance in that the reward will be paid if the target is met
  - value in that the reward has some value to the executive.
- **Goal setting theory** is based on the principle that incentives can be used to gain commitment as well as encourage and motivate executives to achieve their objectives.
- **Principle/agency theory** implies incentives can be used to change executive's behavior to align the interests of the agent (executive) with the principal (the organization) to achieve corporate objectives.

Criticisms of incentive plans

In 1993, Harvard Business Review published an article by Alfie Kohn, a recognized author. The article outlined six reasons why incentives do not work. These were:

1. **Pay is not a motivator**. If pay is at a competitive level, most employees focus on the work and relationships with colleagues.
2. **Rewards punish**. For every incentive awarded, an incentive is not rewarded.
3. **Rewards rupture relationships**. Incentives force people to compete or rank against each other.
4. **Rewards ignore reasons**. Payouts focus only on the result, not the underlying reason.
5. **Rewards discourage risk-taking**. Research shows that when given an incentive, participants tend to focus only on the easiest thing.
6. **Rewards undermine interest**. Anything presented as a pre-requisite for something else is perceived as less desirable.

Critical success factors

Strategy	Design	Execution
▪ clear understanding of what the corporation/ team/ individual has to achieve and why ▪ minimal external/ uncontrollable factors at play or plan in place for how it would affect the plan ▪ commitment to review and re-evaluate against strategic and tactical criteria	▪ tools/ resources are in place to enable participants to reach goals ▪ ability to reasonably develop targets/ goals for the business within the performance period	▪ clear executive/board support ▪ investment in communication ▪ poor individual performance has been tackled via performance management ▪ participants understand the metrics and the business ▪ Goals are unambiguous

Role of Incentives

Key element in delivering strategic message

- Link to operating and financial targets
- Pay for performance
- Determines degree of achievement expected by the organization
- Sets the level of risk-reward

Need to determine

- Participation—who should be included?
- Performance metrics
- Performance targets - degree of difficulty
- Plan leverage, or “elasticity”
- Timing (annual, quarterly, monthly)

Plan Metrics

Plans typically have multiple metrics

- Reduces the “risk” of too much weight on one factor
- Balance management objectives
- Opportunity to measure and reward for different performance goals
    - Corporate/financial
    - Division/operational
    - Individual/qualitative elements

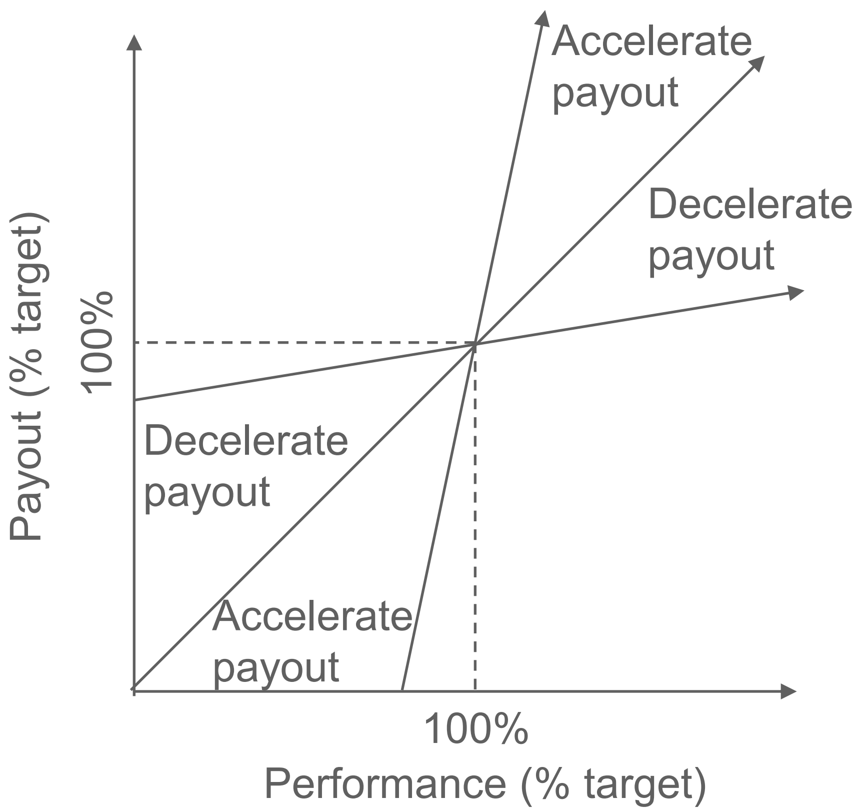
Number of metrics

- 57% of companies have one financial metric
- 30% have two
- 11% have three

Plan Metrics (Fortune 500)

Metric	Number of Companies	Prevalence
EPS	175	35.2%
Income/Earnings	117	23.5%
Return Ratios	67	13.5%
Sales Growth	49	9.9%
Other	90	18%

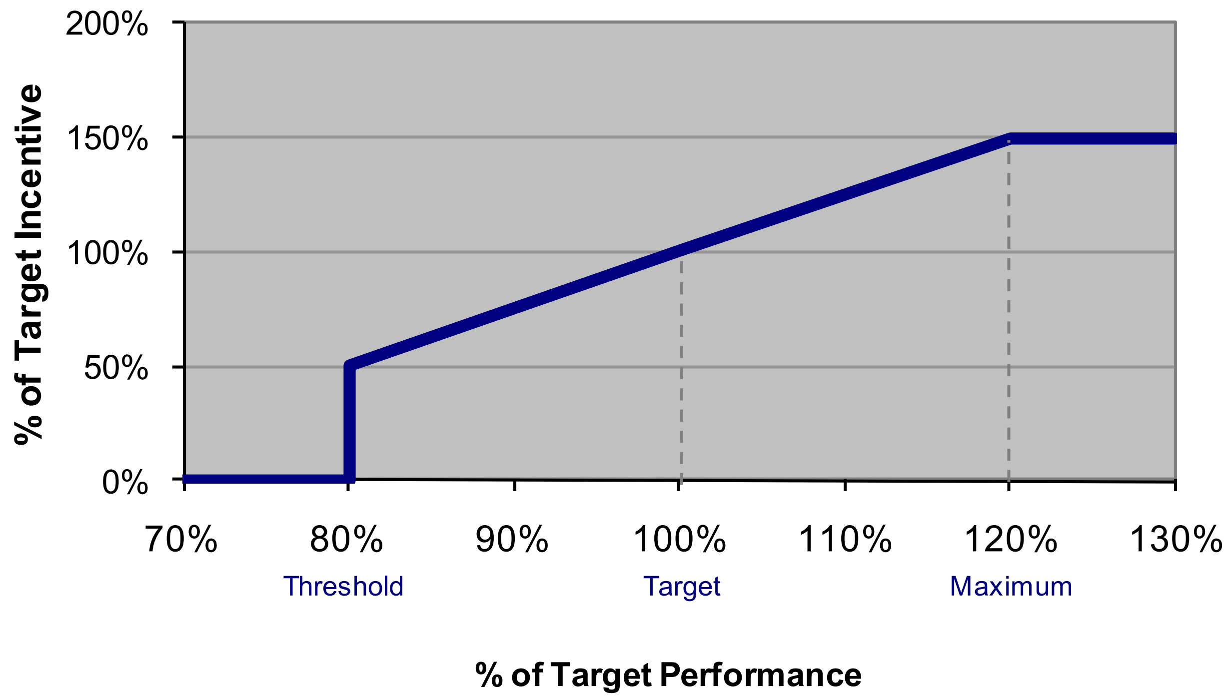
Plan Leverage



	Below target	Above target
Accelerate if…	▪ achievement of target is a stretch ▪ early wins are needed.	▪ focus on rewarding above target performance ▪ above expected performance is more valuable than target performance.
Decelerate if…	▪ target is an expected achievement ▪ progress up to target requires less effort.	▪ goals are set too low ▪ demand variance negatively impacts performance.

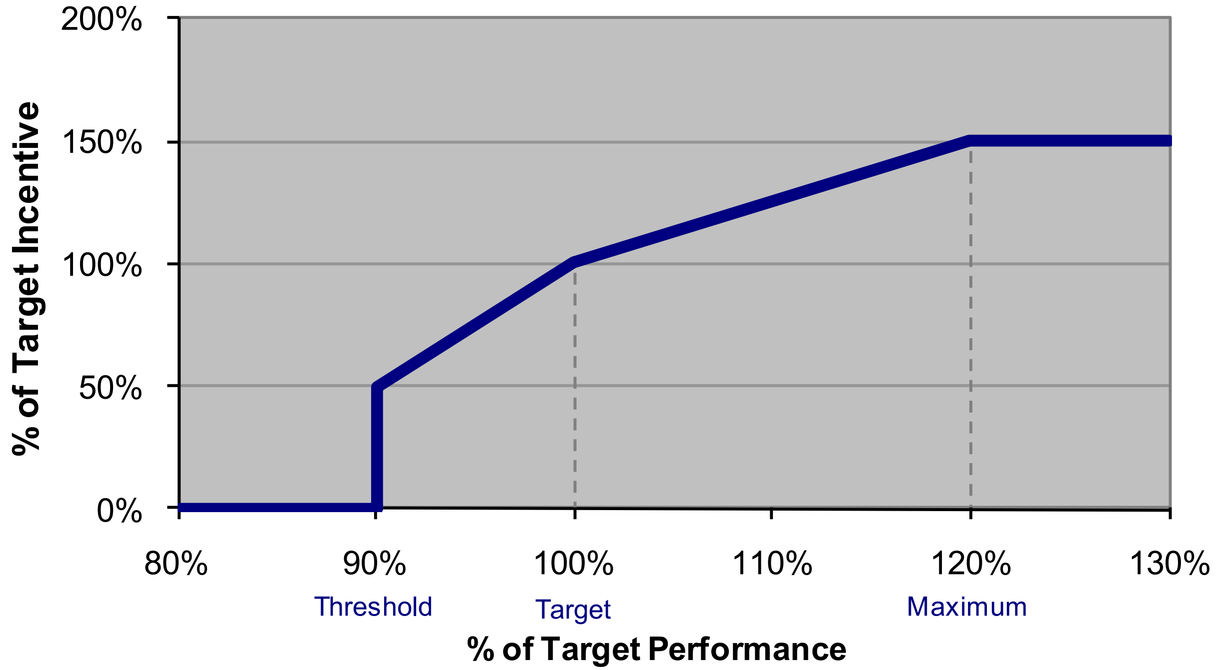
Common Designs

Performance above target is weighted the same as performance below target.



Common Designs

Performance below target is weighted more than performance above target.



Common Designs

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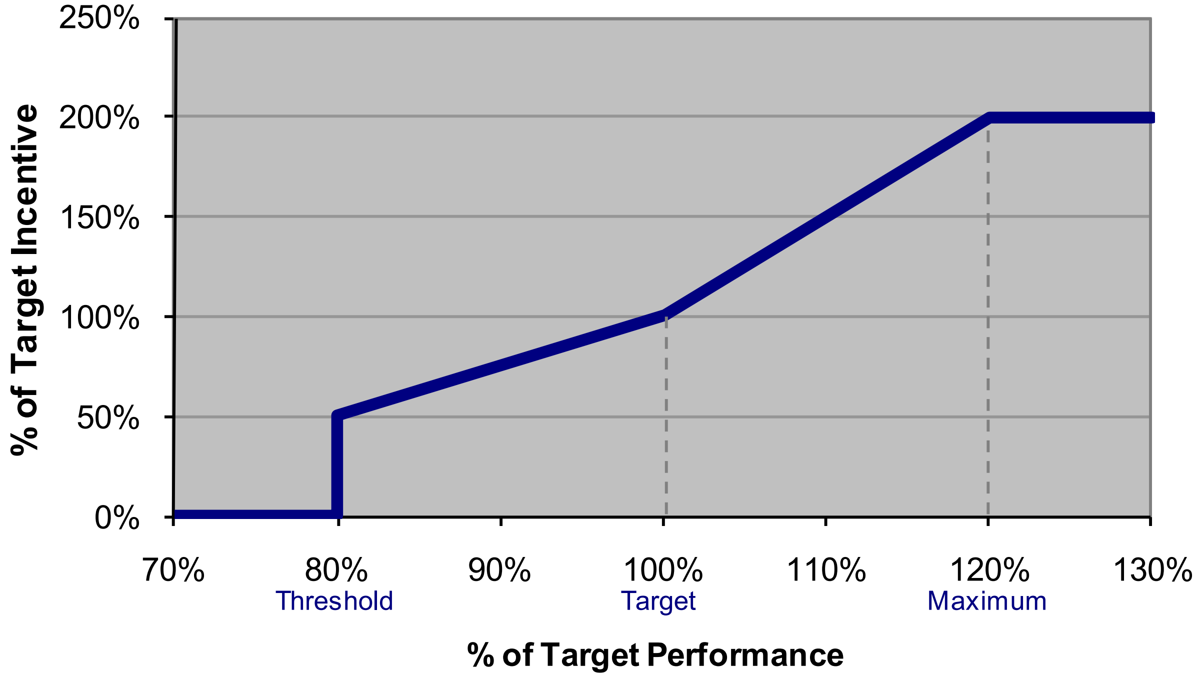


Impact of the downturn

For many organizations, the critical success factors have been thrown in the air this year

- parameters have completely changed
- business plans are rendered obsolete
- demand and expectations are lowered
- lack of clear management support of plans
- nobody is sure what performance will be this year.

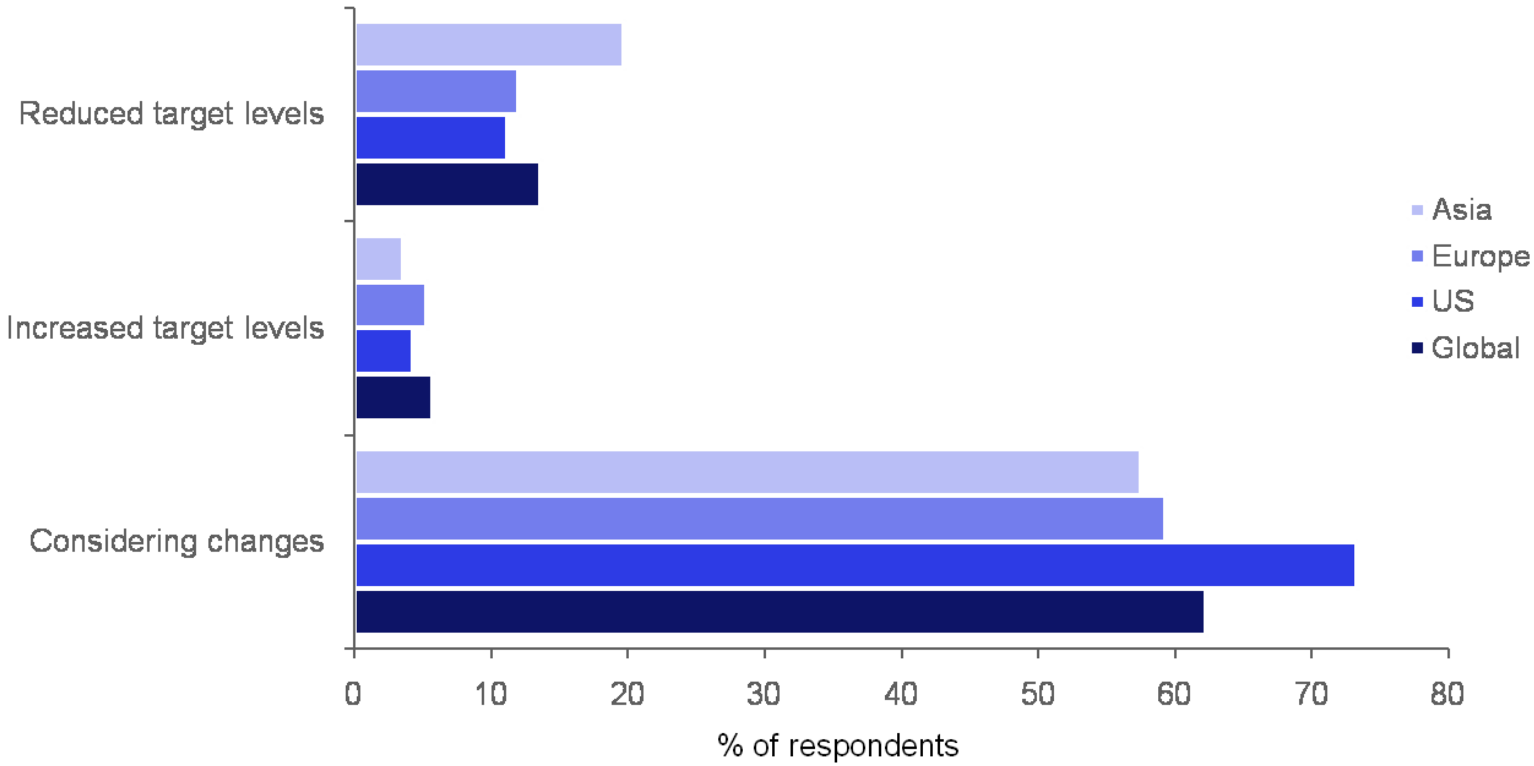
Impact of the downturn

Market reaction to performance downturn

- Flatten the performance curve to recognize volatility and uncertainty
  - Less downside risk
  - Less upside potential
- Shorten the award period (quarterly? Semi-annual?)
- Add relative metrics in addition to budget performance
- Greater use of discretionary and/or qualitative awards for some or all bonus
  - Operational and milestone awards
- Retention awards for top talent

Volatility in the "market"

Some change is in the air, however during 2009 those who decided to reduce target levels outnumber those who have decided to increase them, by a two to one margin.

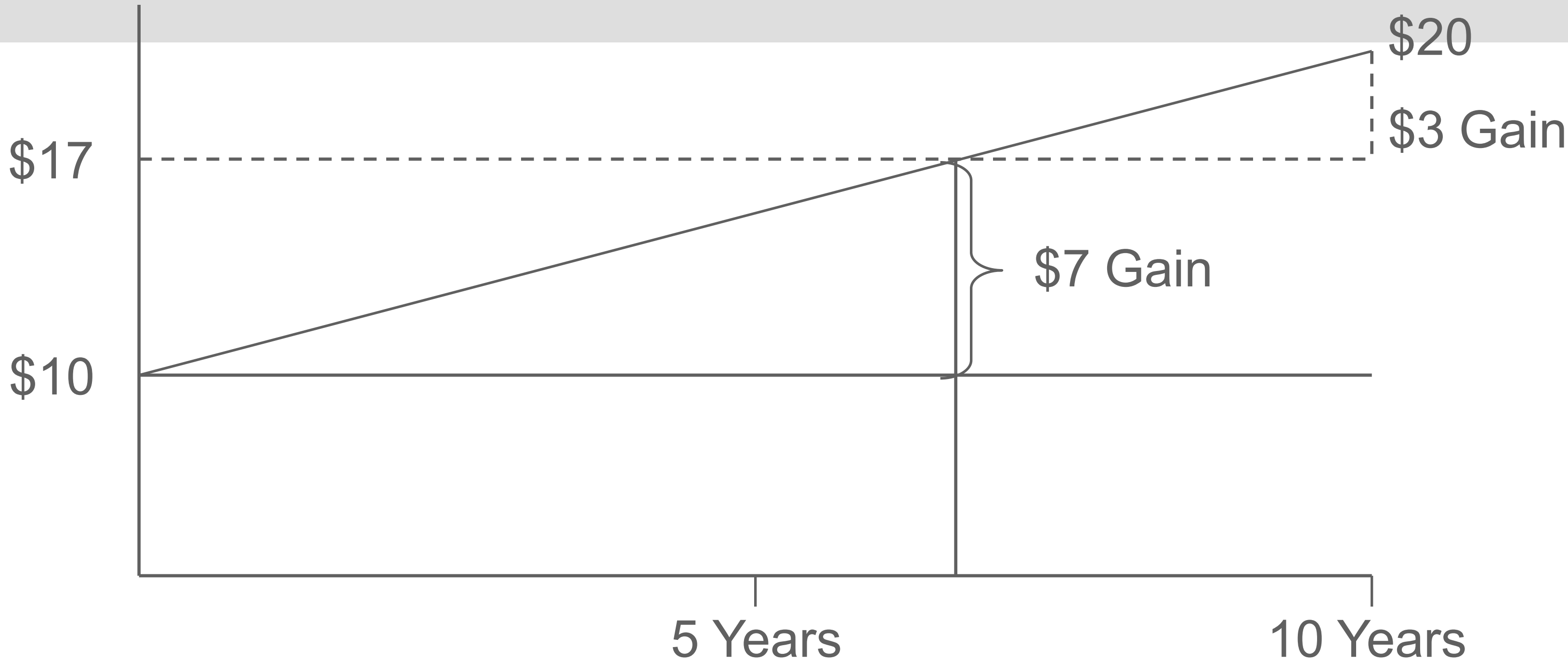


Long-Term/Executive Compensation

Definitions

- **Stock Options** - Opportunity to purchase shares at a fixed price at any time over the term of the option
  - Historically, options carried ***no accounting expense***
  - Beginning in Q3 of 2005, Options had to be ***expensed (FAS 123r)***
- **Restricted Stock** - Grant of a full share with time or performance based vesting restrictions
  - Time
  - Targeted performance
- **Performance plans** - Typically three year performance periods, paid in cash or stock

Stock Options

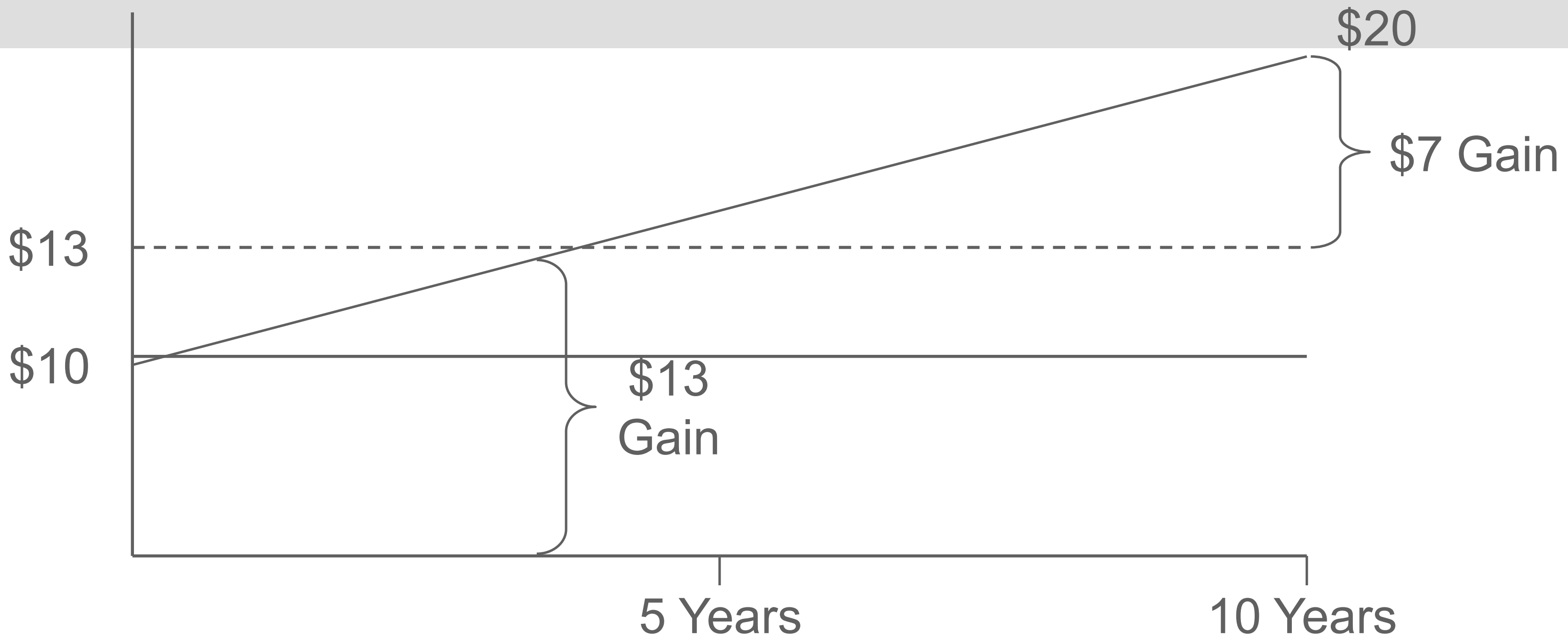


Gain taxed at ordinary rate

Gain taxed as capital gain

Assume
$10 Strike Price
Exercise in year 7
Sale in year 10

Restricted Stock



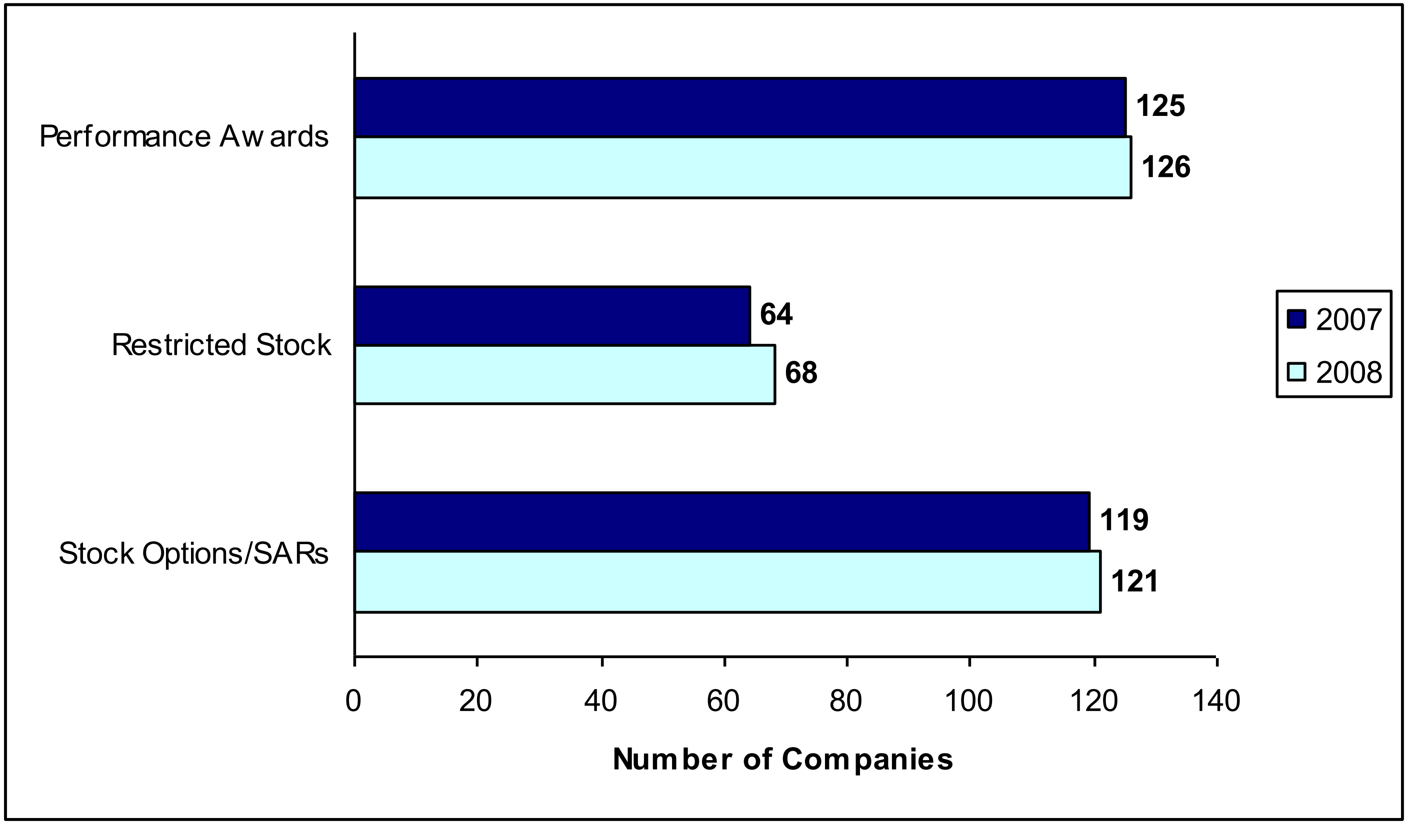
Assume
$10 Strike Price
Vest in 3 years
Sale in year 10

Full value
taxed as
ordinary
income

Gain taxed as
capital gain

Plan prevalence

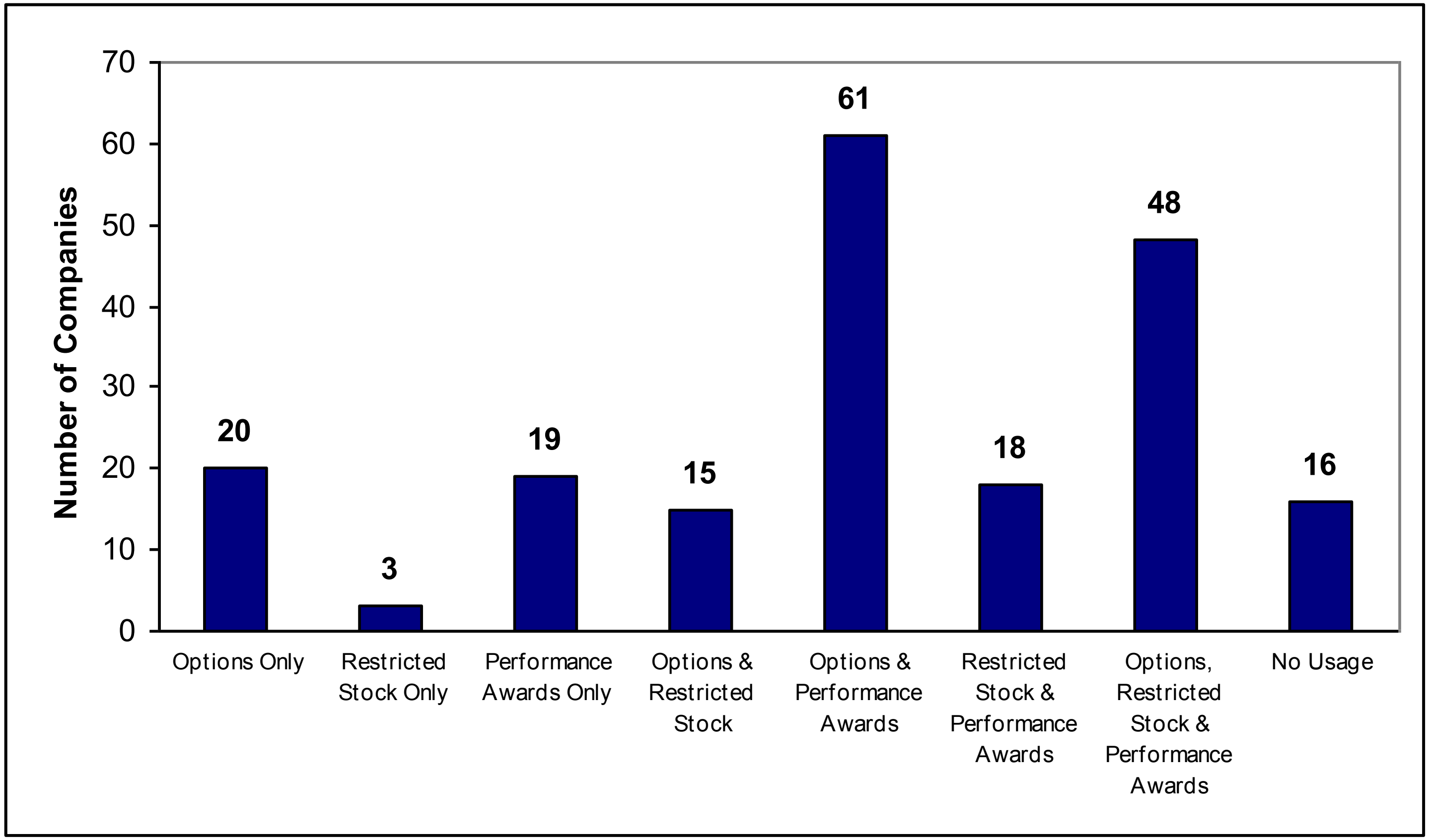
- When we look at only those executives who were in place for all of 2007 and 2008, we see a bigger edge for performance awards and little year-over-year change overall



Includes only constant incumbents

Plan prevalence

- Of companies that grant LTI to their CEOs, 71% of companies now take a “portfolio” approach. This includes a significant gain in companies (24%) using all three vehicles



Plan metrics

Metric	Number of Companies	Prevalence
Total Shareholder Return	71	24.7%
Return Ratios	66	22.9%
EPS	33	20.8%
Income/Earnings	18	11.5%
Other	60	20%

A Time of Change and Regulatory Engagement

New Compensation Principles

- A new concern in plan design is the increased focus on ”risk”.
- Earlier this year the Obama Administration released the **five guidelines on executive pay** as a foundation for sound compensation design. Specifically

:

  - Compensation Plans should properly measure and reward performance
  - Compensation should be structured to account for the time horizon of risks
  - Compensation policies should be aligned with sound risk management
  - Golden parachutes and supplemental retirement packages should be re-examined to see if they truly align the interests of executives and shareholders, and
  - There should be greater transparency and accountability in the process of setting compensation

- Note that two of the five specifically address risk.