

Director Alert

Human Resource and Compensation Issues during the Financial Crisis – questions for directors to ask

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Introduction

The current financial crisis is significantly impacting Human Resources and Compensation Committees, presenting them with new challenges and spawning increased scrutiny of their work. Committees are struggling to address the implications of the recent market volatility and economic downturn on compensation and other human resource programs.

The executive compensation landscape is shifting due to issues around performance volatility, risk management, shareholder engagement and legislative and regulatory changes. Institutional investors and proxy advisory firms are seizing the moment and calling for increased transparency and simplification of compensation plans and constraints on a range of compensation and severance arrangements. They are continuing their demands for “pay for results” and, in some cases, an annual advisory vote on executive compensation or “say on pay”. Some companies are burdened by unfunded retiree health care plans or underfunded pension plans, and others are having trouble retaining key talent.

While risks abound, there are also opportunities to be seized during these turbulent times. There are crucial areas in which the Committee can help the company navigate the current crisis and set the stage for future growth, including:

- assessing the effectiveness of the total compensation program in motivating top executives to drive company performance and in aligning their pay with sustainable results,
- understanding and adjusting for the risks that incentive plans may encourage,
- reviewing the company’s talent management strategy to strengthen the leadership team, and
- engaging with shareholders regarding compensation practices and decisions.

To optimize the Committee’s performance in the current environment, directors in general, and members of HR and Compensation Committees in particular, are encouraged to ask questions about the following:

- executive pay levels,
- equity compensation,
- talent management,
- pay for performance,
- say on pay, and
- pensions.

HR and Compensation Committees may find it useful to draw on the expertise of external advisors, such as compensation consultants, for assistance in fulfilling their various responsibilities, especially in areas where the Committee may lack sufficient knowledge.

The questions that follow are not intended to represent a complete checklist, but instead to stimulate discussion on these important topics.

A. Executive Pay Levels

The determination of executive pay levels and awards is the subject of tremendous scrutiny in the current economic environment. For example, in reviewing and approving executive compensation programs, many Committees and their advisors are being challenged to diverge from traditional benchmarking and pay-setting approaches. Since the rapidly changing landscape has rendered many of the conventional sources of market data obsolete, they may have to play a more modest role in decision making for 2009, with increased focus on qualitative considerations instead.

1. Do available survey and proxy data reflect pay levels and practices that are relevant, given the considerable changes in the economic environment? If not, what other sources of information can be used to understand how compensation trends are evolving?
2. Have we examined pay through multiple lenses, such as:
 - share of profit,
 - tally sheets of total compensation,
 - wealth accumulation,
 - internal equity, and
 - its directional alignment with performance?
3. Are we considering pay practices and not strictly pay levels when assessing competitiveness and consistency within our industry, such as vehicles used and emerging trends for perquisites and benefits?
4. Are we sufficiently exercising our judgment and discretion in pay decisions?

B. Equity Compensation

In light of the current market volatility, Committees may need to review the effectiveness of outstanding equity awards as well as the number of shares available in their equity pay plans. Because the majority of mid- to large-sized companies calibrate their equity awards using a dollar value rather than fixed share guidelines, in a down market the number of shares needed to deliver the same theoretical value may increase significantly. Shareholders may object to the increased dilution and, if the company requires shareholder approval to increase the available equity under its incentive plans (because its reserves are running low), shareholders may vote against such requests.

1. Are changes needed in the eligibility, vehicles and mix of equity plans to address shareholder considerations such as cost and dilution, as well as employer and employee perceptions of value?
2. To what extent are standard valuation approaches still applicable in setting equity grant levels? If they are not, what other approaches could be used?
3. Should a cash-based long-term incentive replace or supplement an existing equity-based plan to reduce the emphasis on stock price in our pay program?
4. At what point might we consider an option exchange program, based on a review of:
 - the degree to which stock options are underwater,
 - the duration for which options have been underwater,
 - the remaining term of options and their potential for recovery,
 - shareholder and employee optics,
 - how different employee groups are impacted, and
 - other alternatives to retain key employees?

C. Talent Management

The rapid deterioration of the capital markets and overall economy has resulted in a number of issues for companies and employees, including the impact of downsizing and difficulties with retention and succession planning. Retaining key executives during tough economic times can be difficult where equity retention hooks have been diminished through a decline in share value. This can be particularly challenging for smaller companies, which may have fewer alternatives available to reward top performers. The Committee should evaluate whether core capabilities are being sufficiently retained to prepare the company for future success when the economy recovers.

1. Should we conduct an executive talent assessment to ensure that key contributors are identified, rewarded and retained?
2. What are the company's overall talent needs and how are they expected to change over time?
3. To what extent may the deterioration of personal savings and investments lead to employees delaying their retirement plans and how might this impact the company's workforce planning in the near term?
4. To what extent might a downsizing cause gaps in the leadership team or key skill areas and how can we retain key skills to allow the organization to bounce back quickly when the economy improves?
5. Is there sufficient differentiation of rewards based on individual performance and potential?
6. How can we use career opportunities and other non-monetary "rewards" to differentiate employees who are the strongest performers and have the greatest impact?
7. Should we be actively trying to recruit top-notch talent to fill gaps in the leadership team?

D. Pay for Performance

New disclosure rules as well as the recent momentum gained by say on pay are adding to the pressure on companies to demonstrate that pay is supported by concrete results. The leverage of stock option compensation has been dramatic – tremendous value has been created and lost very quickly – calling into question pay and performance links. Shareholders are also questioning why compensation programs sometimes "pay for failure". Committees should step back and assess the overall pay program and how it supports delivery of responsible executive compensation.

Concerns have also been raised about whether incentive compensation plans encourage participants to take unnecessary and excessive risks that may threaten the value of the company; hence, some organizations are beginning to look at risk in connection with their executive pay programs as a good governance practice.

1. Have we considered the broadest perspective of whether the program adequately "pays for results", and how performance is defined?
2. Have we examined the full range of pay program parameters to confirm the role and appropriateness of each aspect, including:
 - the compensation philosophy;
 - salary, incentives, pensions, benefits and perquisites; and
 - employment agreement provisions, including golden parachutes?
3. Is each program attribute defensible in the context of business objectives, cost and shareholder requirements?
4. How can we best balance the organization's interests in attracting, retaining and motivating key talent with the shareholders' interests in pay for performance?
5. Is there "balance" in the pay program across multiple dimensions, including:
 - vehicle selection (e.g., cash versus equity),
 - time horizon,
 - performance metrics,
 - measurement approach (e.g., absolute versus relative), and
 - target setting?

6. Have we reviewed the parameters of the compensation program to ensure inappropriate risk-taking is not inadvertently encouraged, and noted “red flags” such as:
 - too much emphasis on short-term, such as quarterly or annual, results;
 - uncapped incentive plans;
 - over-reliance on highly leveraged equity vehicles;
 - one-dimensional performance measurement within plans or use of the same metrics for both annual and long-term incentive plans;
 - lack of focus on the quality of earnings and sustainable performance;
 - failure to “stress test” plans for outcomes under extreme scenarios;
 - poor ties between the compensation time horizon and the time horizon for sustainable results; and
 - lack of appropriate equity holding requirements (including but not limited to post-retirement holding requirements) and incentive payout deferrals?
7. Does the Committee receive adequate pay and performance information on the company’s highest paid employees (including but not limited to the senior executive team) and understand the drivers and related risks (see Question 6) in their compensation program?
8. Do we engage in a rigorous performance evaluation process by assessing performance against targets on a historical and cumulative basis to provide a holistic perspective?
9. What role, if any, should Committee discretion play in the final determination of annual and long-term incentive awards?
10. Have we adequately documented the reasons underlying our pay decisions as we make them and sufficiently considered the implications of disclosing these decisions and their rationale to shareholders and regulators?
11. Are there aspects of our compensation program that are “hot button” issues that could detract from our efforts to align pay with performance, such as:
 - severance and change-of-control benefits,
 - perquisites, and
 - supplemental retirement plans?

E. Say on Pay

“Say on pay” policies are quickly catching on among some of Canada’s largest companies. A say on pay policy gives a company’s shareholders an annual advisory vote on its executive compensation program as set forth in the company’s proxy circular.

In deciding whether to adopt a say on pay policy, companies should carefully consider the pros and cons and the best way to implement say on pay. Although say on pay votes are advisory in nature and are not binding on the company, if a majority of investors vote against the executive compensation program, the company may feel obliged to change its pay program in response to shareholder concerns. However, a high or low vote by itself may not give the company sufficient information to determine which aspects of the company’s pay program are causing concern. Thus, it is important for companies to consider the best way to solicit feedback from investors to determine which aspects of the compensation program to address.

1. How might the company respond to a shareholder request to adopt a say on pay policy, if one is received?
2. To what extent might the following render say on pay unnecessary:
 - existing corporate governance procedures that address accountability to shareholders,
 - the company’s pay for performance philosophy and its alignment of management and shareholder interests, and
 - the level of detail and transparency in the company’s proxy disclosure?
3. Have we evaluated the company’s executive compensation programs, awards and related disclosure against views expressed by institutional investors and proxy advisory firms?
4. How can we better engage with shareholders on executive compensation matters? Consider:
 - shareholder discussions with management and the board or Committee,
 - written communications to management and the board or Committee, and
 - an opportunity to ask questions at the annual meeting of shareholders.

F. Pensions

The changing economy has also created concerns about underfunded pension plans. The Committee, together with the audit and pension committee (if there is one at the board level), may need to consider the potential impact of the decline in pension fund asset values and a low interest rate environment on the company's cash requirements and financial statements in the future. While it is always essential to review the pension program at regular intervals, the current financial environment reinforces the importance of confirming that it continues to meet the company's long-term needs and objectives.

1. What impact may decreases in the pension plan's funded status have on the company's cash requirements over the next few years?
2. What impact may shortfalls in investment returns and changes in accounting and auditing standards have on the financial statements of the sponsoring company?
3. What risks is the company exposed to under the pension plan (e.g., volatility in cash contribution requirements, surplus, etc.) and how can those risks be mitigated by refinements to plan design or investment strategies?
4. Do the role and design of the pension plan(s) continue to meet the long-term needs of the company in terms of workforce planning and in the context of total compensation?
5. What enhancements might be made to annual reporting to plan members in order to provide comprehensive communication of the impact of recent developments on the plan?

New Challenges, New Opportunities

While these questions may be difficult, the process of asking them and the insights they may reveal will undoubtedly better position the Committee and the company to weather the economic storm. The Committee's governance processes and procedures are currently the subject of close scrutiny; hence, now is the time to review them against best practices. The Committee's annual calendar should be updated to ensure ample time is available on the agenda to address key topics, and Committee members should be engaged in regular updates of trends in this volatile environment, to ensure their discussions are comprehensive and their decisions are defensible.

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