Pearl Meyer

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Leading Minds of Compensation: Discussing Non-Financial Performance Metrics

Transcript

Pete: Good morning, I'm Pete Lupo, senior managing director at Pearl Meyer and I'm joined today with Dick Schapiro. Dick serves on the compensation committee of Molina Health and Transamerica. Good morning.

Richard: Good morning.

Pete: Okay. Well, this time has come to change things up a little bit. Compensation committees have been a little bit quiet on a lot of issues because regulations haven't been there. Accounting rules have not changed, but times have changed, and the world is getting more complex. And what I've seen is some very effective conversations at the committee level about including nonfinancial metrics in the incentive plans. There's a lot of ways to structure incentive plans to include nonfinancial metrics. When you think about that, and you think about your compensation committees, do you include individual performance assessments in determining annual set of awards?

Richard: Peter, we do. In fact, the way we structure our short-term incentive plan is that 70% of it is tied to a financial metric, but 30% relates to these nonfinancial metrics that you mentioned. And in fact, those are the basis of the goals and objectives that we set for our CEO in his performance assessment at the end of the year. He in turn takes those and rolls them down to his top 50 executives so that we have from top to bottom, everyone on the same page in terms of what they need to do, and it's not always formulaic, you can't always tie it to some financial metric. Many of these relate to things like strategy, diversity, talent identification, some business restructuring, and other things that are less precise and less measurable. But nonetheless, they're important to the board, they're important to our shareholders, and we want to try and find ways that we can create plans that incentivize management to proper behaviors, but also that they can understand and react to. If they don't understand how it works, if it's just a black box, it's really not going to work for anyone.

Pete: So in this case, we have the 30% carved out for individual goals. Does that 30% carve out part of your whole senior leadership team, or is it a little bit more discretionary than that?

Richard: It's a little bit more discretionary as you go down the line. It is true for the NEOs who are the top five, and then of course it's a function of their cash compensation as it's a short-term metric.

Pete: Okay. All right. Let's dovetail and take that example to how the outside world looks at that. And I'm thinking of shareholders and the proxy advisory firms. In your world, and the question is, are your compensation committees comfortable with exercising discretion on bonus plans?

Richard: Well, you put your finger on the word: discretion. And when the day's done, it's about applying judgment. And what's the most important thing any director brings to the equation, it's their judgment. That's why you should be bringing them on board. And so, we don't have a problem with exercising it. It is the essence of any director's responsibility. And in fact, it's embedded in the business judgment rule. It's not to say that you do it randomly, but you are trying to look at those facts and circumstances and … I always harken back to the Supreme Court decision when we're talking about obscenity. You know it when you see it.

If the company's performing well, and they're moving in the right direction, the board gets it, and they know that it's time to and set the management appropriately. And if it's not moving in the right direction, that's also the same tool to send a signal because just because of the financial metrics are good, there may be very important things that are missing in the equation that you need to send a message out as well. So that gives you that flexibility to appropriately incent management and let them know that you're serious about these other issues.

Pete: Yeah, and I liked the way you phrased that. When I think about financial metrics versus nonfinancial metrics, I think about lag indicators and leading indicators. I always think about the bucket of financials, which are growth returns and profitability. I think of those as lag outcomes. So you say, here are our goals. What did you do? We will pay you for that. Very important, clearly. What I like about the individual assessment, whether it be individual assessments or just broader nonfinancial goals, is it sets the tone for where you want to go with the company, which supports the outcome, and it sounds like that's how you think about it as well.

Richard: Sure, because there are some things that take time and particularly when you're talking about strategy, you're not going to get there overnight. Right? And so that-

Pete: …takes years sometimes.

Richard: Correct. And so the kinds of things you're talking about that lead to an outcome may require patience. And that's part of it. Not everything is totally measurable in a dollar and cent and you need to be able to have a forward vision and be able to think a few steps ahead to be able to move the company in the direction you need it to go. That's why you have to have this flexibility. There's no one size that fits all and all of these things. Every industry's different. Every management team has different chemistry, and some industries are more regulated than others. And in the end, the whole point is to incent management. It's not to punish them, it’s to incent them. And if they can't understand it, if they don't know how it works to their favor and the board needs to understand that it can't be gained, it's got to be measurable-

Pete: Can't be gained, right.

Richard: … and they have to understand how it's measured, then it works for everyone. But you have to create a paradigm that's going to be very balanced.

Pete: Let's talk about the long-term incentive plan. Let me just set you up for this question. When I think about how often nonfinancial goals are in long-term incentive plans, I wouldn't say it's rare. I have seen some examples, and you certainly can relate to this. If you're looking at say a life sciences company, a new public company, they're going through a lot of regulatory hurdles to get maybe a drug or product out to market, you have different stages of regulatory approval, I've seen some interesting designs ... And usually these plans are more creative than the Fortune 500 plans where you might see part vesting triggered, and part on regulatory approvals, so I've seen that. I see examples of how nonfinancial metrics could apply to long-term plans.

In your world, which is very different of course, do you see any discussion around applying nonfinancial metrics to long-term incentive plans?

Richard: I don't see as much. Certainly in the companies I'm involved with it's really much more tied to a-

Pete: Traditional...

Richard: ... a traditional financial metric. And, when you're talking about long term, you're typically talking about strategy because that's three to five years out. But again, when I go back to other examples that, particularly when you're dealing with a significant regulatory oversight, there are numerous metrics that might not make sense in the US, but you might see overseas because of the different philosophy they may have about capitalism and what the norms are, and therefore management compensation. Because you could look at any of the proxies in the US and try to compare them to counterparts in different countries and you're dealing in totally different-

Pete: Absolutely.

Richard: ... almost three different zeros at the end in kind of compensation, so it's a different world.

Pete: Well, Dick, I want to thank you for your time today. It was a terrific discussion.

Richard: Thank you for having me.

Pete: I also want to thank the NACD for allowing us to discuss what I think is a very important topic for all boards to consider.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.