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Driven by an array of forces and influences, organizations have been transforming their executive remuneration programs in recent years. This article discusses the Minimum Analytical Standards companies should adopt to reach the final frontier in responsible executive remuneration.

Effective decision making: The final frontier of responsible executive remuneration

By Diane Doubleday and Bruce Greenblatt

All businesses, public and private alike, feel pressure – whether from the media, regulatory agencies, shareholders or those concerned about internal pay equity – to ensure that their executive compensation programs are responsible and defensible.

Over the years, companies have responded by making changes to their programs and processes. For example, several years ago the tally sheet gained prominence as a way to carefully examine the full array of executive rewards. As a result, companies took a more thoughtful look at their total compensation values, including benefits and perquisites. Recently, the Securities and Exchange Commission (SEC) disclosure rules in the US called for more transparency from publicly traded companies; the process of preparing the disclosure strengthened communication between finance, human resources and legal departments. In effect, the "what" and the "who" of executive compensation design have undergone change, but little has been said about "how" effective decisions are made and evaluated.

To that end, Mercer has developed a set of Minimum Analytical Standards that we advocate in our work with companies and boards. These standards form the baseline to support effective decision making and evaluation that lead to appropriate, effective outcomes. In this article, we describe the Minimum Analytical Standards and their application. These standards are *minimum* requirements; context demands that each situation be looked at to assess the most appropriate approach for boards and their advisers to consider the issues at hand.

1. Peer group development

Peer group reference data often forms the basis for establishing what constitutes the "market" for compensation levels and pay practices. Peer group development has come under scrutiny as contributing to the "ratcheting up" of executive compensation. As we reported in "Responsible peer group selection: A guide for identifying appropriate peers for assessing executive pay" (*Executive Remuneration Perspective* #61, April 2007; visit www.mercer.com/perspective), Mercer has articulated best practices for peer group development. When we advise our clients, our view is that:

- Peer groups should be developed prior to evaluating compensation or performance levels.
- The peer companies should reflect the multiple markets in which the organization competes – including markets for executive talent, customers and capital.
- Ideally, a peer group should consist of at least 10 to 15 peers, to balance fair market representation with manageable size.

- Where a peer group falls below eight organizations, outliers can influence the overall information. In those cases, a secondary broader group, such as an industry sector or general industry reference, should be used to provide a balanced view of the market.
- Peer groups should be sized appropriately, so that the median scope measure (revenue or assets, as appropriate) approximates the company's size. Where that is not feasible, consideration should be given to regressing the data to size it appropriately.
- Performance should not be used as a criterion for selecting peers – there can be significant volatility from year to year. Instead, the company's performance relative to that of its peers should be evaluated *against* the selected peers to test for pay and performance alignment (see item 5 on the next page).
- Typically, a consistent peer group should be used for executive, director and pay/performance alignment analyses.
- Unless there has been a significant shift in the business character of the company or peers, peer group composition should be revisited only periodically (every two to three years) to test for fit, not annually.

2. Use proxy compensation data responsibly

Proxy statements report compensation data for the CEO, CFO and the next three highest-paid executives. (In some limited cases, companies are required to disclose additional executives.) That disclosed data should be used as a reference for comparable positions in the company. Ideally, proxy data should be used as a competitive compensation reference only for the proxy officers in the company – limited to five individuals. The proxy data should be used to assess functional matches, if possible, although they can also be used to evaluate compensation based on pay rank within the organization. In the case of newly hired or promoted executives, caution should be exercised to ensure that reported compensation levels represent ongoing annual practices. Finally, proxy data should be used as one reference point; broader survey data should be used in the evaluation to round out an assessment of the competitive labor market.

3. Look at the full range of market data

When compensation statistics are reviewed, we believe that the full range of the market data should be assessed. Companies have come under criticism for referencing the 75th percentile of the market, which has a potential effect of accelerating pay increases. When reviewing market data, the full range of statistics should be evaluated – 25th percentile, median and 75th percentile.

4. Evaluate benefits and perquisites to understand total remuneration

Executive benefits and perquisites, particularly retirement benefits, are often a significant part of the total remuneration program. These programs carry potential headline risk as recent accounts of substantial retirement payments illustrate. From the company's perspective, these programs often provide substantial economic value to the executive that may not be fully captured in pay disclosures.

A company should periodically assess the competitiveness of its retirement and other benefit/perquisite programs to ensure that they have a holistic view of total compensation delivery. This review, at a minimum, should include an assessment of overall program structure and should incorporate a valuation of the program versus the market. The value of these programs is often "hidden" and a full understanding of them helps inform more effective decision making for other pay components, including incentives, equity and severance.

5. Regularly test the alignment of pay outcomes with performance

The appropriateness of pay program outcomes cannot be fully understood in a vacuum. A robust assessment of the performance that generated the pay delivery is essential to fully appreciate whether the executive compensation program is effective. Our minimum standards call for an assessment of pay actions in light of performance. We believe that an *external* perspective is important to capture the viewpoint of shareholders. This assessment includes a review of a company's relative performance against its peers on a short-term (for example, one-year) and longer-term (for example, three-year) basis. Performance measures should be broad, including a range of growth, profitability, return and shareholder metrics. This external perspective can be supplemented with an *internal* view of performance, including performance versus plan, the achievement of strategic initiatives and other viewpoints. This assessment helps ground an evaluation of pay outcomes to determine their appropriateness and defensibility.

6. Assess annual run rate and share dilution

The competitiveness of pay delivery should be evaluated from multiple viewpoints. In addition to ensuring that the dollar levels of pay are market-competitive, the aggregate use of equity should be considered against what shareholders will tolerate. Share usage should be evaluated in two respects. First, the number of *shares* granted offers context for the proportion of common shares outstanding that are granted. However, that approach by itself does not recognize that the type of vehicle used for equity delivery has different economic impact on shareholders. Therefore, a second *economic* approach is critical as well. Since companies increasingly use full value shares in their programs, this assessment recognizes that the

value of full shares and options differs. "Economic Run Rate" should be considered – this captures the proportion of a company's *market capitalization* that is shared with participants using the face value of stock and the grant-date present value of options (using Black-Scholes or binomial). Taken together, these two tests provide insight into whether the level of equity usage is appropriate relative to peers and shareholder expectations. Because many companies use irregular grant patterns for different equity vehicles, companies should look at both annual and three-year average practices.

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7. Consider the executive compensation program holistically

Reviews of executive remuneration program design and pay actions should consider the full range of implications for programs. Understanding the competitiveness of pay levels and practices is an important but not sufficient part of the review. There are four factors that should be evaluated as part of the decision-making process:

- **Remuneration** – Understanding the competitive marketplace for pay levels and practices in order to develop a program that will support the attraction and retention of executives.
- **Performance** – Evaluating how the program reinforces the performance of the company. This includes reviewing the extent to which the program supports key performance priorities, whether performance measures are defined appropriately and goals calibrated for an appropriate degree of stretch, and testing the alignment of pay outcomes with levels of performance achievement.
- **Governance** – Understanding the perspective of institutional shareholders, proxy advisory firms and others as it relates to executive compensation policy decisions and pay actions.
- **Regulatory** – Incorporating the implications of regulatory requirements on the program, including accounting, tax law, corporate law and securities law. These perspectives should be evaluated to ensure that the form and magnitude of payout appropriately comply with these issues.

By taking a holistic view, a company can make more informed decisions regarding the compensation elements, their mix and the target market position. Additionally, the company can better articulate its overall total compensation philosophy, which can serve as a guideline for compensation decisions on an ongoing basis.

Conclusion

Effective decision making for pay determinations is a critical step to ensuring responsible executive remuneration. Committees and companies need to avail themselves of a wide range of information – tally sheets, accumulated worth and others, as appropriate – to ensure that their programs are designed well. These Minimum Analytical Standards offer a starting point for making certain that committees rely on sound analytics when making their decisions. And that should serve committees, companies and shareholders well.

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Mercer is a leading global provider of consulting, outsourcing and investment services, with more than 25,000 clients worldwide. Mercer consultants help clients design and manage health, retirement and other benefits and optimize human capital. The firm also provides customized administration, technology and total benefit outsourcing solutions. Mercer's investment services include global leadership in investment consulting and multi-manager investment management.

Mercer's global network of 17,000 employees, based in more than 40 countries, ensures integrated, worldwide solutions. Our consultants work with clients to develop solutions that address global and country-specific challenges and opportunities. Mercer is experienced in assisting both major and growing, mid-size companies.

Mercer's human capital business helps organizations globally to optimize their performance by meeting their most critical needs in three related areas:

- Managing, rewarding and engaging talent to drive business performance
- Ensuring responsible executive remuneration
- Enhancing HR effectiveness

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