



GLOBAL  
GOVERNANCE  
ADVISORS

# Compensation Policy Review



California  
Public Employee  
Retirement  
System

April 19, 20

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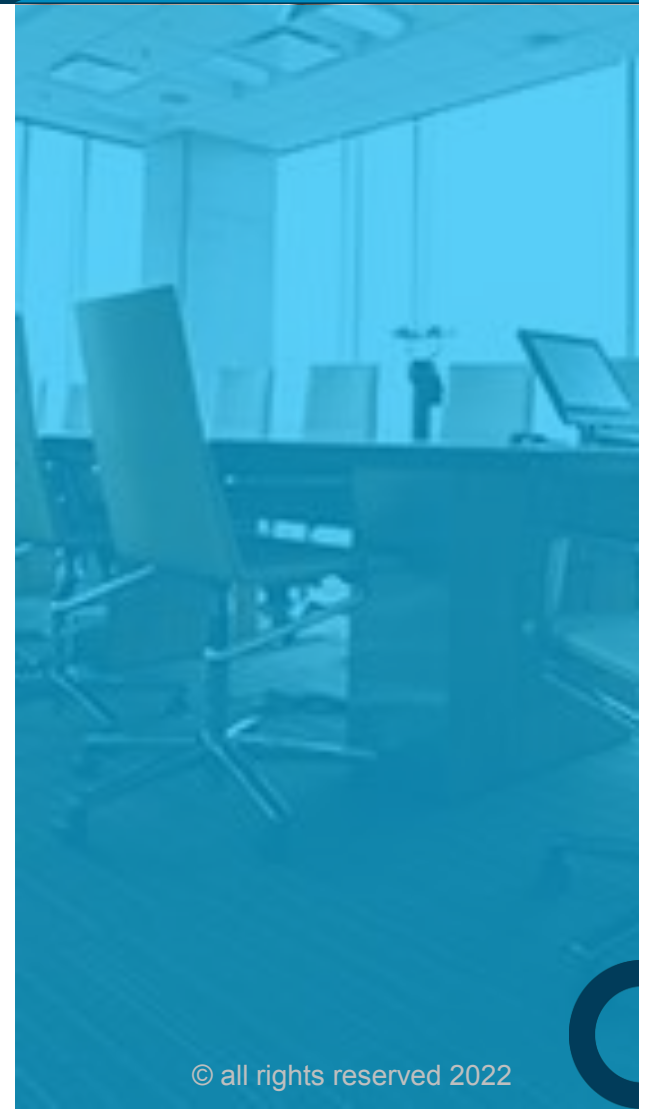
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# NEXT STEPS

# Next Steps For June Meeting

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Looking forward, **GGA recommends that the CalPERS Board:**

consider and approve the current recommendations and proposed change policy.

GGA will then work with CalPERS HR to bring back final proposed changes to the current compensation policy for the June PCTM meeting, taking into account the feedback it received on the recommendations proposed within this report.

# ITEMS FOR BOARD CONSIDERATION & APPROVAL

# Program Principles

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## MARKET ALIGNMENT:

Compensation Policies normally include a list of principles the compensation programs are based on. This list establishes a board-approved foundation for the program and includes statements on such as:

- Statements on competitiveness and equitability,
- Performance and/or retention oriented, etc.

## RECOMMENDATION:

GA will work with the members of the PCTMC and establish a list of recommended principles for reviewing committee and Board meetings as noted in the draft policy provided (see page 3 of policy).

# ing of Compensation Assessments

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## MARKET ALIGNMENT:

Compensation levels are constantly in flux due to market changes, availability of talent, and timing of peer assessments and adjustments.

The longer an organization waits to assess its compensation levels the higher the risk that it may become misaligned with the current market which could lead to:

- Higher rates of attrition, and
- Larger adjustments are sometimes required due to significant identified gaps.

## RECOMMENDATION:

In order to guard against unnecessary attrition or a requirement for significant adjustments, GGA recommends:

CalPERS conduct compensation assessment surveys every two years at a minimum.

- The inclusion of this minimum standard is proposed in the draft document provided (see pages 7 and 8 of policy).

# Private Sector Peers

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## MARKET ALIGNMENT:

The accuracy and success of compensation assessments is primarily dependent on comparing similarly sized organizations in similar and/or competing sectors.

The current maximum asset level for private sector peers is currently set at \$350B in AUM.

Comparing CalPERS (or any organization) to smaller sized organizations can result in misleading benchmarks.

## RECOMMENDATION:

To accurately compare CalPERS compensation levels, GGA recommends CalPERS:

Set the range of AUM for private sector peers to ½ - 2 times CalPERS' current size.

- The inclusion of this new level is proposed in the draft document provided (see page 7 of p



# Attachment of New Hires / Appointments

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## MARKET ALIGNMENT:

The equitable treatment of employees and new hires is always an important element of any compensation system and any subjectivity associated with the determination of compensation for a new hire or appointee is an element that can often lead to inequitable treatment of employee compensation levels, lowered employee morale, and higher attrition rates.

- Objective salary setting processes result in the most equitable treatment of new appointees whether internal or external.

Annual incentives are based on fiscal year priorities, results and budgets and therefore it is common market practice to set a minimum date by which any new hire must be employed in order to be eligible for a fiscal year's annual incentive.

- This is commonly observed as 6 months into the fiscal year.

## RECOMMENDATION:

To better align current market practices and annual performance objectives, GGA recommends the following:

Implement a “well defined and objectively-scored competency and situational framework.”

- GGA proposes to work with CalPERS HR to clearly define this framework (see page 8).

Stop the practice of paying out annual incentives to new hires that extend beyond a fiscal year performance period and set 6 months as the final date for any new hire to participate (see page 8).

# Merit Adjustments

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## MARKET ALIGNMENT:

A recent North American survey throughout all major sectors showed that the median expected increase increased to 3% for 2022.

Proper assessment ranges normally has most of the employees landing on target or “Fully Meets Performance” levels.

The following is a generally accepted standard for employee performance distribution:

Individual Performance Rating	Targeted % of Employee Population
High Performer (Far Exceeds/Exceeds Expectations)	25%-30%
Target Performer (Successfully Meets Expectations)	60%-70%
Low Performer (Partially Meets/Does Not Meet Expectations)	5%-10%

## RECOMMENDATION:

To help normalize the assessment of merit performance pay adjustments, GGA recommends CalF expand its original 4-level assessment rating to the proposed 5-level standard.

The HR team, work with GGA to establish an assessment process and standard that helps better a system with both local and national standards.

# Attachment of Pro-Rata Awards

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## MARKET ALIGNMENT:

The pro-rating of awards is a normal practice in both public and private organizations especially in special circumstances.

However, offering incentive awards that are based on less than 6 months is not a prevalent practice within today's market.

## RECOMMENDATION:

To ensure that CalPERS is aligned with normal market practice and that incentives are based on sufficient time to achieve them, GGA recommends CalPERS:

Cease the discretionary awarding of partial year awards that are based on less than the last 6 months of the fiscal year for new appointees.

Clarify conditions and eligibility requirements pertaining to board discretion under special circumstances.

- Changes to this practice are proposed in the draft document provided (see pages 18 and 19 for policy) and GGA will work with CalPERS HR and Legal Counsel to determine feasibility and potential impacts (e.g., IRC rules around deferred compensation).

# Attachment of Retirement

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## MARKET ALIGNMENT:

In many organizations, the treatment of payouts upon various termination situations could, in some instances, lead to less than favorable situations:

- i.e., Employees might mentally check out but feel that they must stay on for the full fiscal year to remain eligible for incentive payouts.

## RECOMMENDATION:

To eliminate all possibilities of employees feeling they must stay beyond their recognized retirement date and to better define the treatment of all types of termination, GGA recommends:

CalPERS clarify the treatment of special situation, pro-rated incentive payouts for all employees whose termination is the result of retirement, death, or disability. In the event of a termination associated with voluntary or “for cause” all outstanding incentives should not be paid out.

- GGA will work with CalPERS HR and Legal Counsel to determine the feasibility and impact of these recommended changes (e.g., IRC rules around deferred compensation) to the treatment of all types of terminations.

# Eliminating, Adjusting, Deferring Incentive Payouts

## MARKET ALIGNMENT:

Compensation policies need to be clear on the specific situations/circumstances when their incentive might be eliminated, adjusted, or deferred.

Higher levels of attrition is a common outcome when employees pay is altered and they feel caught off-guard, treated unfairly or perceive their employment rights were breached in some way.

## RECOMMENDATION:

In order to protect the best interests and sustainability of the System, CalPERS must retain the ability to eliminate or adjust incentive payouts under clear and extenuating circumstances, therefore GGA recommends:

This section be expanded to more clearly identify situations and/or circumstances where plan participants can anticipate payout and/or timing adjustments.

- Changes to this section are provided in the revised draft policy (see pages 18-20 of policy) and the proposed language is similar to what is currently found in CalSTRS' compensation policy which has been recently reviewed.
- GGA will work with CalPERS HR and Legal Counsel to finalize the recommended proposed changes.

# ITEMS FOR BOARD INFORMATION

# Standardization Of Performance Levels

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## MARKET ALIGNMENT:

CalPERS uses different scales at different times to assess the performance of employees when making changes to annual base pay or incentive payouts and as a result, the Board and staff are expected to use either a three-, four-, or five-point rating scale.

Simplicity is a key element that helps compensation policy administration and adherence, as well as establishes a clear understanding for all parties involved especially when performance evaluations carry with them levels of anxiety/stress and therefore it is important to always make sure processes are clear and easy for all parties to understand and follow.

Multiple scales lead to confusion, lack of clarity, and inconsistent interpretations and assessment of performance.

## RECOMMENDATION:

To streamline the definitions and rating of employee performance as well as help simplify the assessment of performance for multiple compensation elements, GGA recommends:

A modified five-point rating system based on the one currently used in CalPERS' Career Executive Assignment program be consistently applied to all performance-based compensation adjustments and incentive payouts.

- Changes to each of the rating elements are provided throughout the revised draft policy with recommended modifications to the associated adjustment or payout percentages.
- The proposed performance level definitions are provided on the following page.

# Standardization Of Performance Levels

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## PROPOSED RATING HIERARCHY:

### Performance Rating Scale and Definitions

#### 1 – Exceptional (Distinguished Performance/Leader)

Performance far exceeds expectations due to exceptionally high quality of work performed, resulting in superior quality outcomes. Responsible for major or unique contributions which have significant impact on the organization. Completion of objectives far exceed expectations for time and location.

#### Above Target – Consistently Exceeds Expectations (Superior Performance/Leader)

Performance consistently exceeds expectations, and the quality of work overall is excellent. Goals are exceeded or met under challenges which are beyond their control and required sustained extraordinary effort.

#### Fully Meets Expectations (Fully Successful Performance/Leader)

Performance consistently meets expectations, at times possibly exceeding expectations, and the quality and timeliness of work overall is very good. Employee achieves desired results, and employee demonstrates responsiveness to priorities. Completion of objectives was always on time and on budget.

#### Below Target – Occasionally Meets Expectations (Inconsistent Performance/Leader)

Performance occasionally meets expectations but is inconsistent, and/or one or more critical goals were not met. Achieved results are at significant levels. Completion of objectives may have sometimes been on time and on budget, but improvement is needed in one or more areas.

#### 4 – Does Not Meet Expectations (Unsatisfactory Performance/Leader)

Performance is consistently below expectations, and/or reasonable progress toward critical goals was not made. Responsiveness to changes in requirements. Key products are incomplete. Significant improvement is needed in many important areas.



# Reducing Subjectivity In Qualitative Elements

## MARKET ALIGNMENT:

Qualitative elements within performance management systems can often be criticized by internal and external stakeholders if they include, or are based on, unnecessary subjective assessment criteria. Subjectivity, when associated with compensation payouts, can often increase headline risk for the organization involved and/or increase the risk of some parties not defining or interpreting the performance levels in the same way.

## RECOMMENDATION:

To help protect CalPERS from unnecessary headline risk or misaligned interpretations of performance, GGA recommends:

That, to CalPERS best efforts, all performance elements be objectively based and aligned with objectives that are (SMARTER) Specific, Measurable, Attainable, Results-Based, Timebound, and Risk Weighted.

- Changes to this wording is provided throughout the revised draft policy and avoids the use of “qualitative” where appropriate and replaces it with “Individual Key Business Objectives.”
- GGA proposes to continue working with CalPERS HR to update qualitative elements and ensure that less subjectivity is included in the performance assessment process.



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