Key Watchwords in Long Term Incentive Compensation: Efficiency, Diversification and Performance

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Summary: As the U.S. economic recovery gathers steam, executive retention will again be a key issue for Compensation Committees, even in the midst of increasing scrutiny over executive pay. In this environment, a powerful opportunity exists for companies to rethink their philosophies regarding significant portions of their total rewards packages. In so doing, they should have in mind three key watchwords in Long-Term Incentive (LTI) compensation: Efficiency, Diversification and Performance.

Quick Look:

- The return of a more robust and competitive U.S. business environment--in the midst of increased scrutiny over executive pay--creates a powerful opportunity for companies to rethink their philosophies regarding significant portions of their total rewards packages.

- To maintain LTI compensation as a competitive tool, companies have eliminated or replaced stock options or moved to 100-percent restricted stock or a mixture of options, restricted stock and cash.
- In the area of retirement income accumulation, many companies are opting for performance-earned awards to a defined contribution supplemental executive retirement plan (SERP).

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These forces can be summed up simply: improved American business conditions have created a much more competitive marketplace for senior executive talent; *retention* objectives will drive the design of executive compensation in the coming months like at no time since the start of the Great Recession. With shareholders putting increased pressure on compensation committees to tone down total executive pay packages, the timing couldn't be more significant. The confluence of these two trends challenges the design of all aspects of executive pay, particularly the mix of wealth accumulation tools used in the long-term incentive sphere, creating the perfect opportunity to review how plans fit into current compensation philosophy.

Critical Question

Now is the time for companies to ask a simple question, "Do we know how to make our LTI compensation plan as strategic, efficient and competitive as possible?"

By measuring the efficiency of various elements of LTI in terms of cost to a company versus value to executive, much is revealed.

FIGURE 1: EFFICIENCY OF STOCK OPTIONS COMPARED WITH RESTRICTED STOCK

	Stock Options	Restricted Stock
Value of Grant/ Award	$100,000	$40,000
Corporate Expense	$40,000	$40,000
Value to Executive at Grant/Award	$-0-	$40,000

Assumes a 40 percent Black-Scholes valuation: actual valuation may be higher or lower.

Consider Figure 1. If the executive received a $100,000 option grant/award, the company stock's value would have to increase 40 percent for the executive to realize the same $40,000 value the company expensed at grant. Were this to occur, the $40,000 in restricted stock would be worth $56,000.

Clearly, stock option plans are not as efficient as they once were due to SFAS 123(R) and its expensing requirement. As a result, many companies are backing away from full reliance on stock options as long-term awards.

So what can companies do today to maintain LTI compensation as a strategic, efficient and competitive tool?

In my experience, a number of companies have either eliminated and replaced stock options, or moved to 100-percent restricted stock, or to a mixture of options, restricted stock and cash.

Company Contribution Awards

While the efficiency of restricted stock awards versus stock-option awards is clear, there is another element being introduced into LTI compensation packages—the use of company contribution awards to nonqualified deferred compensation plans (DCPs). DCPs typically are implemented because highly compensated executives are limited in what they can save for retirement through 401(k) plans (2014 maximum pre-tax contribution of $17,500 and a limit on company contributions to $260,000 of considered total compensation).

FIGURE 2: Efficiency of Stock Options Compared with Restricted Stock and Company Contributions			
	Stock Options	Restricted Stock	Company Contribution to DCP
Value of Grant/Award	$100,000	$40,000	$40,000
Corporate Expense	$40,000	$40,000	$40,000
Value to Executive at Grant/Award	$-0-	$40,000	$40,000

Existing DCPs can be amended to permit *discretionary* company contributions, generally with investment choices in the hands of the executive and can thus be used to receive LTI awards. Assuming a $1,000 award, if a company decides to go to "100-percent efficiency," it would issue $1,000 in restricted stock instead of stock options. An alternative approach with the same 100-percent efficiency would be to issue a portion of this LTI award in the form of a company contribution to the DCP, for example 20 percent, or $200. In this case, 20 percent of the LTI would be deferred and invested in a diversified portfolio of investments directed by the executive and the 80 percent balance would be in restricted stock.

Now consider Figure 2. While the line of thinking in shown here stresses efficiency, some companies may want to include a higher share of ownership for more performance incentive. In that case, a consulting firm may design the LTI plan with a smaller amount in options, a larger amount in restricted stock and a lesser amount in company contributions.

Diversify for Effectiveness

Ultimately, effectiveness is the key to successful LTI plans because it can lead a company to introduce the power of diversification. Quite simply, diversification increases the stability and potentially, long-term effectiveness of the plan.

During the Great Recession, this point was proven and should be engraved in executive memory: ***a single company's stock has far greater volatility than a diversified portfolio.*** Consequently, when a company introduces diversification into its LTI awards, to the extent that the executive has less volatility in his or her portfolio, the overall executive compensation program has greater stability. Thus, the use of company contributions to a DCP with investment choices (just as efficient as restricted stock) adds effectiveness through diversification.

An Additional Direction

Each public company, as part of its "Compensation Discussion and Analysis" proxy disclosure, is required to explain its philosophy of executive compensation and executive benefits. Most companies have a well-developed philosophy of salary, short-term and long-term incentive pay. However, few have focused on a philosophy for the benefits side and many are silent.

When a Committee applies a goal of "competitiveness" to the area of retirement income accumulation (including nonqualified benefits), a growing percentage of companies opt for performance-earned awards to a defined contribution supplemental executive retirement plan (SERP). The board sets performance criteria, which are often similar to the annual incentive plan; that is, high, medium and low achievement produces scaled awards. Vesting varies, depending upon objectives (retention, attraction, reward).

This move can measurably improve the competitive standing of the overall benefits program. In one instance, a company opted for a defined contribution SERP with a combination of 50 percent award toward a goal of a competitive retirement benefit and 50 percent performance based and, therefore, variable. If the performance goals are met on the average during an executive's career, he or she will end up with a competitive retirement benefit. Higher performance will produce an above-average benefit. In another example, a company moved totally to a 100-percent performance-based award, also targeting a competitive retirement benefit if performance goals are met. These bold actions are not surprising given that corporations are again operating today under the white-hot light of competition for talent.

Time for a Change

The increased competition for executive talent is causing companies to rethink their entire approach to executive benefits and retirement philosophy. Companies that are not already deep into reviewing their philosophy may want to move quickly.

About the Author:

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