



Performance, Compensation & Talent Management Committee

Agenda Item 5c

June 15, 2022

Item Name: Annual Review: 2022-23 Incentive Metrics

Program: Administration

Item Type: Action

Recommendation

Approve incentive metrics for fiscal year 2022-23 as presented by the board's compensation consultant, Global Governance Advisors.

Executive Summary

This item presents recommendations from the Board's Primary Executive and Investment Compensation Consultant, Global Governance Advisors (GGA) for fiscal year 2022-23 incentive metrics for executive and investment management positions. Metrics include Total Fund Performance, Enterprise Operational Effectiveness, Investment Office CEM, Customer Service, and Stakeholder Engagement. Incentive metrics are reviewed annually by the Performance, Compensation, and Talent Management Committee (Committee). GGA will present their recommendations for the Committee's consideration as a follow-up to the relevant information they presented at the April 2022 meeting. Final Board-approved incentive metrics will be included in some combination on incentive plans for eligible executive and investment management positions.

Strategic Plan

This agenda item supports CalPERS' Strategic Goal to promote a high-performing and diverse workforce in the 2017-22 Strategic Plan. The Executive Compensation Program provides a means for recruiting, retaining, and empowering highly skilled executives to meet organizational priorities and strengthen the long-term sustainability of the pension fund by generating returns to pay member benefits.

Background

In August 2016, the Board approved five shared organizational metrics, including: Total Fund Performance, Investment Office CEM, Customer Service, Stakeholder Engagement, and Enterprise Operational Effectiveness. Some combination of these metrics has been included on the incentive plans of covered executive and investment management positions, as well as

other senior leadership positions since fiscal year 2016-17. As part of the initial implementation plan, it was recommended the metrics be reviewed annually and adjusted, if necessary, for the subsequent fiscal year.

For fiscal years 2018-19 and 2019-20, the Committee approved scoring threshold adjustments for the Stakeholder Engagement metric to align with Key Performance Indicator (KPI) aspirations. Also for fiscal year 2019-20, the Committee approved a change to extract Board and Third-Party Administrator Costs from the data used to calculate the outcome for the Enterprise Operational Effectiveness metric.

For fiscal year 2020-21, the Committee approved retaining the metrics from fiscal year 2019-20 and for fiscal year 2021-22, they approved slight scoring threshold changes to the Customer Service and Stakeholder Engagement metrics. At that time, GGA suggested the Committee consider potential future changes to the fund performance hurdle rates to address payout levels for performance below the relative benchmark.

Analysis

GGA reviewed the existing metrics, analyzed several years of fund performance data provided by Wilshire (the Board's investment consultant), and reviewed information available to date for the fiscal year 2022-27 CalPERS Strategic Plan. Based on their review of this information and input from the Committee at the April 2022 meeting, GGA will present their recommendations for fiscal year 2022-23 incentive metrics for executive and investment management positions. The recommendations are discussed in their Opinion Letter (Attachment 1).

For fiscal year 2022-23, GGA recommends a change for the Total Fund Performance metric. They recommend narrowing the performance expectations between threshold (minimum) and maximum performance and eliminating the potential for payouts when performance is below the benchmark. These changes align with common market practice and will help protect the long-term sustainability of the fund. GGA's detailed assessment of the Total Fund Performance metric is included in Attachment 2.

Enterprise Operational Effectiveness Metric

While GGA is not recommending changes to the other incentive metrics related to performance expectations or relevant payout ratios for fiscal year 2022-23, GGA has reviewed the correlating Enterprise Operational Effectiveness measure approved by the Board in April as part of the 2022-27 CalPERS Strategic Plan to ensure the incentive metric aligns to that strategic plan measure. Once baseline data is established for the strategic measure, GGA would support an adjustment of the performance expectations and associated payout ratios, if deemed appropriate to maintain alignment between the measure and metric.

Also related to the Enterprise Operational Effectiveness metric, GGA is recommending a modification to the cost calculation to exclude the value of leave balance payouts. The CalPERS Administrative Budget allocates expenses to the PERF and 12 affiliate funds with the purpose of matching expenses to the benefitting fund. The allocations are reported to the State Controller's Office to set the annual appropriation authority to pay CalPERS' expenses. Appropriations range from a high of \$447 million for the PERF to a low of \$77,000 for the smallest affiliate fund. Administrative expenses are assigned to these allocations utilizing unique budget codes.

When a leave balance payout occurs (e.g., upon retirement), the expense is currently allocated to specific affiliate funds based on the unit budget code where the team member was employed. This process puts CalPERS at risk of exceeding fund level appropriations when large leave balance payouts are necessary. By law, CalPERS cannot exceed its fund level appropriations. To reduce this risk in 2022-23 and beyond, CalPERS will budget and make leave balance payouts from one specific org code, thereby aligning expenses with appropriation authority. As a point of reference, leave balance payouts paid out across 28 CalPERS divisions has totaled \$3.5 million to date this fiscal year.

The outcome of the Enterprise Operational Effectiveness metric is calculated based on overhead operating costs as a percentage of total operating costs. The calculation involves sorting expenses based on budget codes assigned as either Product and Service Delivery (e.g., call center) or Overhead (e.g., information technology). Certain areas and/or expenses are excluded from the calculations such as the Investment Office (their efficiency is measured through the Investment Office CEM metric), third-party administrator fees, and board expenses. However, leave balance payments may be applicable to any of those areas, whether included in or excluded from the metric. With that in mind, CalPERS asked GGA how to treat these payments when calculating the metric. GGA's recommendation is to exclude these costs going forward.

Prior to the pandemic, one way to control the large leave payouts was to enforce the 640-hour vacation cap set through the California Code of Regulations, which CalPERS did. Based on guidance from CalHR to all state agencies, the enforcement was paused during the pandemic. Today, CalPERS again has a plan in place to enforce the cap using leave reduction programs.

Budget and Fiscal Impacts

CalPERS' 2022-23 Authorized Budget includes \$20.2 million for all incentive awards. This amount is an estimate based on budgeted salaries and the 2021-22 metric outcomes. In fiscal year 2021-22, actual incentive awards paid across all incentive programs was approximately \$11.5 million. Actual incentive payouts are subject to several factors (e.g., metric outcomes, fund performance, and individual performance) and cannot be quantified until after the end of the fiscal year.

Benefits and Risks

The incentive metrics were intended to be reviewed annually for incentive compensation purposes. The Committee's annual review of these metrics ensures incentive goals are aligned with the Board's organizational priorities for executive and investment management teams. Without a periodic and systematic review, there is a risk of misalignment with the overarching goals of the organization.

Attachments

Attachment 1 – Incentive Metrics Review for Fiscal Year 2022-23 by GGA

Attachment 2 – Investment Performance Metrics Assessment by GGA

Michelle Tucker, Chief
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