

Navigating the Current Talent Environment

Top Priorities for Compensation Committees in the Year Ahead

January February March April May June July August September October November December

2022 has been a dynamic year for executive compensation. Market volatility, the war for talent, inflation pressures and the increasing focus on ESG issues have led compensation committees to reevaluate the effectiveness of their executive compensation programs in the current environment.

To gain a clearer view of the key issues boards and their compensation committees have faced in 2022, *Corporate Board Member* and Compensation Advisory Partners (CAP) surveyed more than 200 public company directors. In this report, we present our findings and share our views on how these issues may continue to impact executive compensation programs well into the year ahead.

KEY FINDINGS



71 percent of directors surveyed believe the current market for CEO and senior executive talent is intensely competitive, though there is a divide between those who believe its intensely competitive for all roles and those who believe it is intensely competitive for niche roles.



Common approaches to attract and retain CEO and senior executive talent in the current environment include enhanced salary increases and the use of special equity awards.



Inflation and supply chain issues are the two biggest sources of uncertainty for directors surveyed.



A little more than half of the directors surveyed said their companies use ESG factors to determine compensation for the CEO and senior executives. This aligns with emerging market practice among large companies based on CAP's research.



The most common ESG metric among those who use these considerations in their compensation planning is diversity, equity and inclusion.



93 percent of directors surveyed believe that TSR has a place in long-term performance plans, unchanged from when we last conducted this survey in 2019, though the degree to which they use it continues to vary significantly.

War for Talent: Attracting and Retaining Leaders

In the early days of the Covid-19 pandemic, companies eliminated jobs to cut costs, and candidates had limited opportunities. In 2021 and 2022, the market shifted significantly. Amid the “Great Resignation” and the evolving state of hybrid and remote work, companies have faced challenges attracting and retaining top talent at all levels of the organization.

Nearly three-quarters of respondents said they believe the current market is intensely competitive, though there is a divide between those who believe it is intensely competitive for all roles and those who believe it is intensely competitive for niche roles.

The competition for top talent in certain pockets of businesses such as data analytics and digital has been intense in recent years, as companies across industries have increasingly focused on transforming their organizations to better leverage technology. Because talent in these areas is valuable in all industries, companies are not just competing with peers for top candidates. As a result, some companies are taking action outside of their annual compensation process to enhance the retentive value of executive packages, though specific approaches vary.

Thirty-nine percent and 51 percent of survey respondents granted special equity awards to attract or retain the CEO and other senior executives, respectively. Far fewer companies used cash retention bonuses at the CEO and senior executive level. Equity awards achieve the objectives of conserving cash and linking executives’ interests to those of shareholders. Companies typically use cash retention bonuses deeper in the organization, where employees may not be eligible for equity.

Practice is split between performance-vesting and time-vesting awards. Time-vesting awards are a powerful retention tool because they are not “at risk” in the same way as performance-vesting awards. However, proxy advisory firms and shareholders prefer performance-vested awards that still require executives to deliver results to earn value.

CAP has found that boards that use special awards for the most senior executives spend time weighing the business case for granting such awards with the potential cost and external reaction. Proxy advisory firms and shareholders tend to criticize special awards granted to the CEO. For instance, shareholders pushed back on JPMorgan’s special award granted to the CEO in 2021 through the Say-on-Pay vote where only 31 percent of shareholders voted in favor of the program, versus 91 percent in the prior year. As a result, companies often address retention concerns for the CEO through the core compensation program to avoid doing something outside the norm.

How would you characterize the current market for CEO and senior executive talent?

Intensely competitive across the board **40%**

Intensely competitive for niche roles **31%**

Competitive but not out of the ordinary **24%**

Business as usual **3%**

A buyer’s market for executive talent **1%**

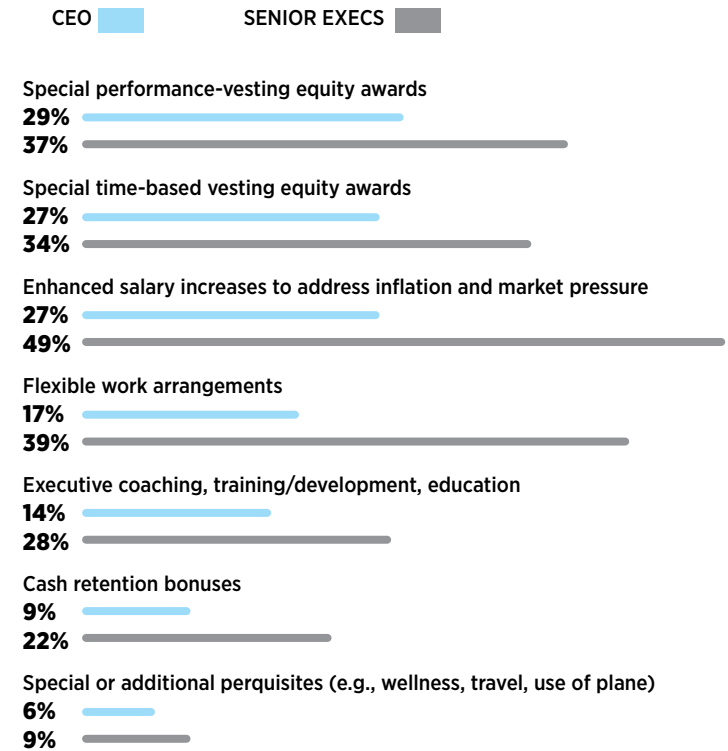
Enhanced salary increases were also common among respondents this year: 27 percent said their company provided enhanced salary increases to the CEO, and 49 percent provided them to other senior executives. Salary increases directly address issues like inflation and market pressure because they provide present day value to executives. Some companies may have been hesitant to provide enhanced salary increases at the most senior levels because they build significant fixed cost into the compensation program. Companies may view incentives, which are a variable cost, as a better way to address short-term retention concerns.

Other benefits like additional perquisites and flexible work arrangements that many companies provided to address retention concerns deeper in the organization were less common at the executive level. In many cases, executives may have already received these types of benefits, such as wellness and travel benefits.

EXPERT FORECAST: CAP expects talent retention to continue to be a major focus of compensation committees. Salary budgets in 2023 are again projected to be above the historical norm of 3%, and we anticipate companies will continue to use special one-time equity awards, though they may be more targeted at retaining current leaders than attracting new ones in 2023.

We do believe, however, that the prevalence of compensation actions and the rate of compensation increases that companies made to address challenges in 2021 and part of 2022 may start to stabilize. In addition to providing competitive compensation, companies will need to ensure they offer a meaningful value proposition to employees, including training and development opportunities, flexible work arrangements and wellness and other benefits to support retention.

Has your board taken any of the following actions to attract or retain CEO and senior executive talent in the current environment?



**Respondents were asked to select all that apply.*

Market Outlook: Volatility and Its Impact on Compensation Programs

Following the economic challenges of 2020 and a faster-than-expected economic recovery in 2021, the economic story of 2022 has been one of great uncertainty. High inflation, rising interest rates, a war in Ukraine and continued supply chain challenges have created an uncertain environment and led to significant market volatility. Some of these factors, like inflation, have directly impacted the performance outlook for many companies across industries, while others, like continued supply chain issues, have had a greater impact in certain sectors.

Nearly three-quarters of directors participating in the survey cited inflation as one of the top two sources of uncertainty for their business. Unsurprisingly, inflation was consistently a top response for respondents across industries.

Supply chain issues are also a major source of uncertainty. But while 51 percent of respondents cited it among their top two, companies in industries like Industrials, Consumer Discretionary, Consumer Staples and Materials are especially impacted by the disruption.

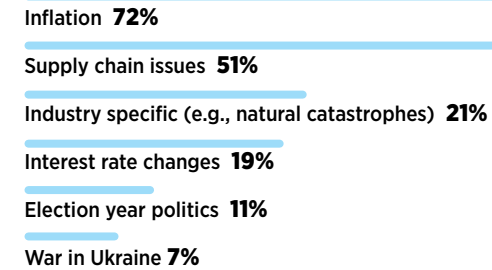
Only 19 percent of respondents cited rising interest rates as a top source of uncertainty, though when looking at the data by industry, we found that to vary greatly. For instance, 42 percent of financial services companies and 64 percent of real estate companies and REITs reported interest rate changes as a major source of uncertainty for their businesses.

The majority of respondents said they are not considering changes to their short-term and long-term incentive plans to address specific sources of economic uncertainty, but 77 percent said they are doing so to mitigate overall market volatility. The most common changes considered include allowing for greater use of discretion (47 percent), changing the goal-setting approach (34 percent), greater use of time-based restricted stock (32 percent) and the use of committee authority to adjust incentives (32 percent).

EXPERT FORECAST: The impact of economic uncertainty on financial results is becoming clear. As we enter 2023, we may see compensation committees and boards exercise discretion to adjust payouts to recognize factors that were outside of management's control and align with their view of performance, though likely not to the extent they did to recognize the impact of Covid-19 in 2020.

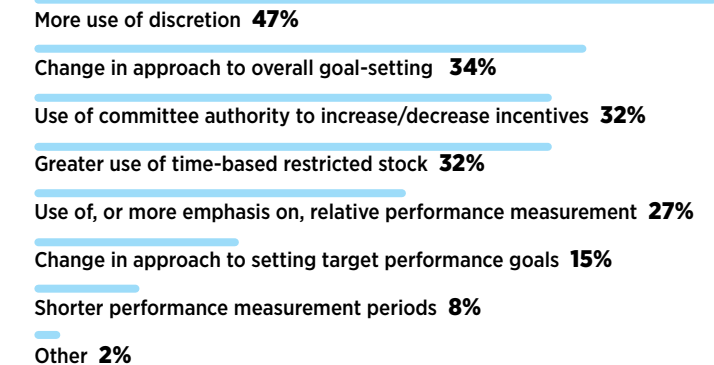
When making adjustments to compensation plans, companies will need to clearly disclose the rationale to shareholders to tell the pay-for-performance story, as adjustments and the use of discretion may be viewed negatively externally, particularly multiple years in a row. Boards will need to balance these external perspectives with the need to reward for performance and retain top talent in a competitive market. Companies will also need to consider current economic factors in setting their business plans and incentive plan goals, for 2023.

Which of the following aspects of the current economic environment are the biggest sources of uncertainty for your board?



**Respondents were asked to select the top 2.*

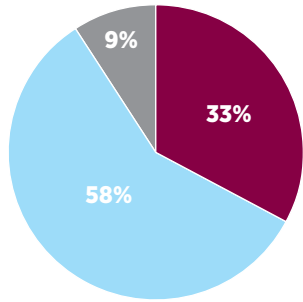
Which of the following adjustments have been made to the company's incentive programs to specifically address overall market/environmental volatility?



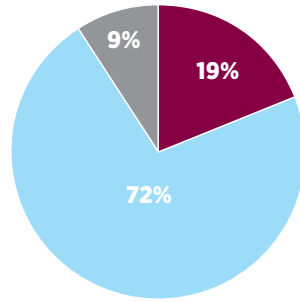
**Only among those who made adjustments (77 percent of the respondents); Respondents were asked to select all that apply.*

Are you considering making adjustments to your short-term or long-term incentive plan to mitigate the impact of any of the following factors?

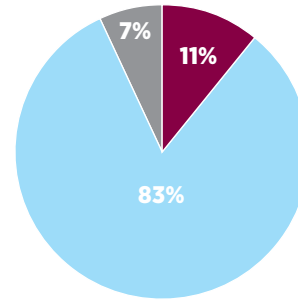
YES NO NOT SURE



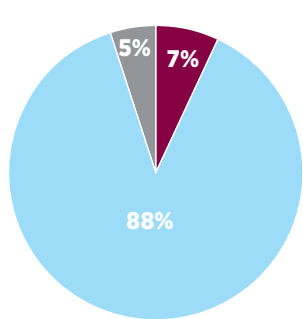
Inflation



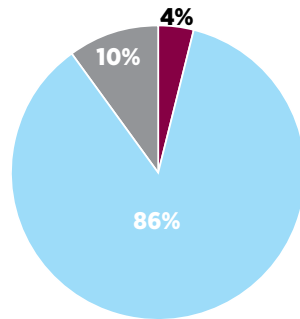
Supply chain issues



Interest rate changes



War in Ukraine



Natural catastrophes

The Role of ESG in Executive Incentive Plans

In recent years, shareholders, regulators and other stakeholders have increasingly pushed companies to disclose information on their ESG strategies, policies and progress. As a result, companies and their boards have spent a great deal of time and energy defining their ESG strategies and determining how best to ensure their executive teams pursue such goals. Increasingly, companies are doing this by incorporating ESG measures into the compensation decision-making process for executives. A little more than half of the directors participating in our survey said they use ESG measures to determine compensation. This aligns with what we see among large companies.

Our findings show that companies that incorporate ESG measures into their compensation programs do so in a variety of ways, though most said they consider ESG as part of an overall assessment of company or individual performance in the annual incentive plan. More than a quarter reported using ESG metrics as a weighted performance metric, and 13 percent said they use ESG as a modifier in the annual incentive plan.

CAP has found that discrete ESG award components typically have weights of 5 to 10 percent, and ESG modifiers can typically modify payouts up or down by 5 to 10 percent. As a rule of thumb, including ESG as a weighted metric or a modifier clearly signals to plan participants and shareholders that progress on ESG issues is important to the company, while limiting its impact to 5 to 10 percent of the total payout keeps the primary focus on financial results.

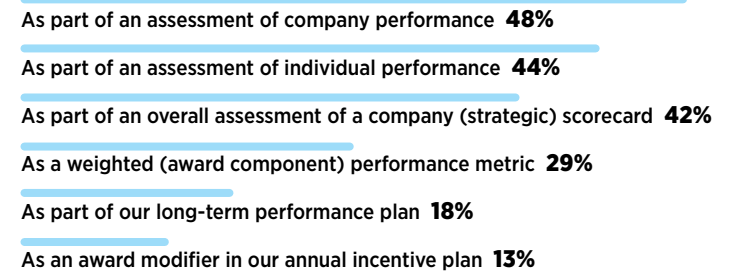
Most directors participating in the research reported evaluating ESG results on both a quantitative and qualitative basis. However, one third of respondents who use ESG metrics as a weighted component or modifier report evaluating ESG metrics on a purely quantitative basis. In CAP's experience, companies that include ESG measures as a defined part of the plan formula are more likely to use and define specific quantitative criteria, allowing them to clearly communicate criteria and results to participants and shareholders.

Eighteen percent of respondents said their company uses ESG metrics in the long-term performance plan. Long-term performance plans tend to payout based on achievement relative to quantitative multi-year goals. Though ESG objectives tend to be longer-term in nature, many companies are still defining and evolving their ESG strategies. As a result, companies may not be ready to set three-year quantitative goals for ESG metrics. We've also found that companies tend

Does your company use ESG measures to determine compensation for the CEO and/or leadership team?



How does your company use ESG measures to determine compensation for the CEO and/or leadership team?



**Among respondents who answered their companies use ESG measures to determine pay for the CEO and/or senior executives. Respondents were asked to select all that apply.*

to prefer quantitative measures for equity-based long-term performance plans to preserve the favorable accounting treatment allowed for equity awards.

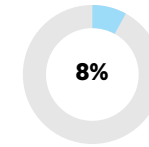
Ninety-two percent of respondents who said they consider ESG in making compensation decisions do so for all senior executives or senior executives and other management, while 8 percent said they only apply ESG considerations to the CEO's compensation. This speaks to the fundamental belief that all members of a leadership team are responsible for working toward and impacting companies' ESG strategies.

As one would expect, the specific ESG metrics included in incentive plans typically focus on the "E" and "S" of ESG and vary by industry and company. While our survey found human capital metrics such as DE&I and employee engagement to be the most common metrics across industries, some ESG metrics are common only in certain industries. For example, our data shows that employee safety, sustainability and other environmental metrics are more common in the Industrials, Energy and Materials sectors, and corporate contributions to the community are more prevalent among financial services firms. In our view, this demonstrates that companies are selecting the ESG metrics that are most important to their unique circumstances, stakeholders and long-term business strategy.

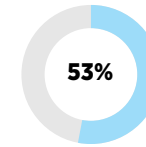
EXPERT FORECAST: Numerous research show that the prevalence of ESG measures in incentive plans continues to climb, but how do directors know if an ESG measure is "right" for their company's incentive plans? CAP believes that companies should have a compelling business case for adopting ESG measures. Like other incentive measures, ESG measures should be tied to the long-term business strategy and, ultimately, the objective of creating value for shareholders. Companies considering adding an ESG measure to their incentive plans should understand "where they are now" on the issue, define "where they want to be", and have a credible and meaningful game plan for "how to get there."

We may see more companies add ESG measures as part of a modifier in the annual incentive plan to signal the importance to their business strategy while focusing primarily on financial performance. To align with the common view that ESG strategies are longer-term in nature, we may also see more companies incorporate ESG measures into the long-term plan. We expect practices around ESG measures in incentive plans to evolve as companies continue to define how their ESG strategies fit into their overall business strategies.

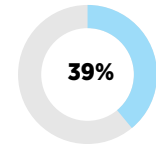
Is the use of ESG metrics in determining compensation for the CEO or for all members of the leadership team?



For the CEO only

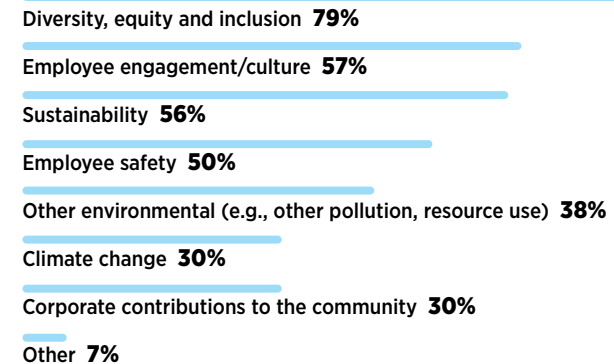


For the CEO and senior executives



For the CEO, senior executives and other management

Which of the following ESG factors are included as a measure in the performance assessment?



**Respondents were asked to select all that apply.*

Use of Total Shareholder Return in Establishing the Link Between Pay and Performance

Views on including relative TSR in long-term performance plans have only changed around the margins from 2019 to 2022.

Ninety-three percent of the directors surveyed said relative TSR should be included in the long-term plan—unchanged from the last time we asked this question in 2019. The percentage of respondents who believe it should be a weighted measure decreased slightly from 67 percent in 2019 to 63 percent in 2022, and at the same time, the percentage of respondents who said relative TSR should be a modifier increased from 11 percent to 16 percent.

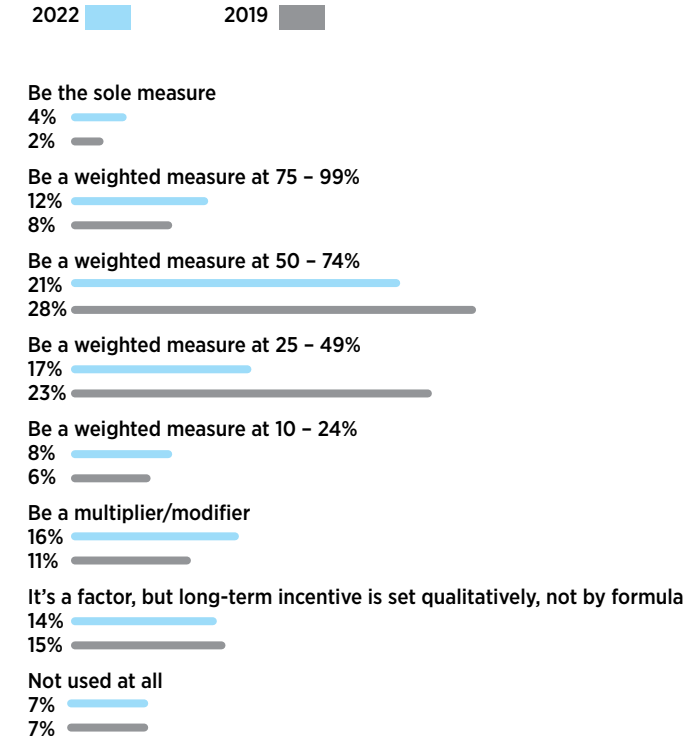
These survey results are consistent with market practice. TSR continues to be the most prevalent metric in long-term performance plans, though we have seen its weight decrease. Most companies that use relative TSR as a metric weigh it 50 percent or less or use it as a modifier.

One of the main drawbacks of using relative TSR as a metric is that it is more of an outcome than a result that executives can drive toward. Executives have greater line-of-sight to performance results on financial metrics. Using relative TSR as a modifier allows preliminary payouts to be based on financial performance to which executives have line-of-sight but adjusts final payouts for TSR outperformance or underperformance to link final payouts to performance.

EXPERT FORECAST: Our perspective is that companies should balance relative TSR—which directly aligns with the shareholder experience—and financial metrics, over which executives have greater control. To achieve this, CAP believes weighting relative TSR between 25 and 50 percent or using it as a modifier is appropriate.

Additionally, the SEC’s recently finalized rules on mandatory pay versus performance disclosure include a comparison of a company’s TSR to the compensation paid to its executives and the TSR of a comparator group. The requirement to disclose the link between TSR and compensation could, in theory, cause companies to adopt relative TSR as a metric or increase its weight. However, in practice, we do not expect the new disclosure rules to cause companies to seriously reconsider or change how they use relative TSR given many companies already use it in their long-term performance plans.

What role should total shareholder return play in a long-term performance plan?



Conclusion

The dynamics of 2022 have pulled the attention of public company directors in multiple directions. Going into 2023, many compensation committees are evaluating executive compensation programs to assess whether they continue to be competitive and effective in the current environment. Though compensation committees may need to take discrete action to attract or retain executives for specific roles, there may be more hesitance than in the past couple of years to make wholesale changes to core compensation programs to address short-term issues.

Companies are likely to reserve more significant changes, like adopting or evolving ESG measures in their incentive plans, to align with shifts in business strategy. As companies evaluate their businesses amid the tight labor market and uncertain economic environment, any changes in strategic direction, organizational structure or leadership will necessitate a critical review of pay programs and HR practices to ensure they support the overall enterprise.



Demographics

Board Function

Outside director	51%
Committee chair	33%
Executive director	21%
Board chair	16%
Lead director	8%

Market Capitalization

Emerging	7%
Small	34%
Mid	36%
Large	23%

Sector (GICS)

Healthcare	17%
Industrials	16%
Financials	15%
Consumer Discretionary	13%
Information Technology	12%
Energy	8%
Real estate/REIT	7%
Materials	4%
Consumer Staples	3%
Telecommunications	3%
Utilities	2%

Public Company Board Tenure

Less than 2 years	8%
3 – 5 years	21%
6 – 10 years	28%
More than 10 years	44%

Committee Representation

Compensation	70%
Audit	61%
Nom/Gov	52%
Risk	18%
Other (please specify)	17%
Innovation	6%
Ethics	3%

CORPORATE BOARD MEMBER®

Corporate Board Member, a division of Chief Executive Group, has been the market leader in board education for 20 years. The quarterly publication provides public company board members, CEOs, general counsel and corporate secretaries decision-making tools to address the wide range of corporate governance, risk oversight and shareholder engagement issues facing their boards. *Corporate Board Member* further extends its thought leadership through online resources, webinars, timely research, conferences and peer-driven roundtables. The company maintains the most comprehensive database of directors and officers of publicly traded companies listed with NYSE, NYSE Amex and Nasdaq. Learn more at BoardMember.com.

Chief Executive Group

Chief Executive Group exists to improve the performance of C-Suite members and corporate directors, helping them grow their companies, build their communities and strengthen society. Through our membership-based peer networks (CEO Network, CFO Leadership Council, Corporate Board Member Network and American College of Corporate Directors), live events, proprietary research and flagship *Chief Executive* and *Corporate Board Member* publications, we connect the leaders of nearly every sizable company in the United States, enabling them to share experiences, insights and hard-won wisdom to mutually benefit each other.



Compensation Advisory Partners (CAP) is a leading independent consulting firm specializing in executive and director compensation and related corporate governance matters. Our consultants have served as independent advisors to boards and senior management at many leading companies in the areas of compensation strategy and program design, promoting sound corporate governance principles.