Is Your Pay Plan Ready for Recession?

With the U.S. on the cusp of setting a record for the longest economic expansion ever, board compensation committee members are facing a question of increasing urgency: Should we consider adjustments to pay plan design to motivate and reward executives when and if good times turn bad?

By July, the U.S. expansion will grow to 121 months, exceeding in longevity the 1990s dot-com boom. Many experts predict the next recession will come within the next two years and some believe it will hit even sooner: “2020 is a real inflection point,” the chief economist of Moody’s warned in late 2018. “It’s going to take some real good policy making and luck to avoid a recession in 2020.”

Executives are of similar sentiment: In a survey by CFO Global Outlook at Duke University, 80 percent of CFOs said they believed recession would arrive by 2020. That is in keeping with J.P. Morgan’s real-time recession forecast model, which placed a 70 percent chance of a market downturn by 2020.

Though few expect the next economic sag to rival the 2008 rout, trade conflicts, rising interest rates, and massive debt cause many people worry.

Through it all, companies have edged closer to a period of consistency—essentially a new status quo—in executive compensation design. Practices have converged as proxy advisors and big investors like Vanguard, Fidelity, State Street, and BlackRock have voiced their preferences. One can argue that the consistency—albeit healthy in many ways—has produced a measure of complacency.

We have also accumulated ten years’ worth of new strictures to tighten pay design practices. Companies have hugely expanded their proxies’ CD&A sections in an effort to increase transparency for investors. Investors want designs to build on appropriately rigorous long-term goals, motivate better ESG performance, mitigate unnecessary risks, and neutralize the dilution caused by equity awards. Add to that the regulatory burden of the Dodd-Frank Act, which has led to, among other things, the new CEO pay ratio rule and pending clawback requirement.
While some industries have seen struggles, the current era of pay programs have not been tested by a full-scale recession. With that in mind, how will your company’s plan hold up should the economy go soft? Should your compensation committee stress test the company’s design to assure pay in 2019 responds appropriately to the potential of economic weakness?

Can today’s pay plan designs withstand a possible economic downturn? How will uniform elements like incentive rewards in the form of performance-based equity, three-year long-term incentive performance cycles, the use of total shareholder return as a primary metric of success, and limited use of discretion by boards evolve with time?

Sticking with the status quo can pose risk as times change. Now may be the right time for boards to anticipate seven challenges to pay design that a recession will almost surely prompt

1. **The volatility of equity-based compensation as an instrument will grow.** Boards can respond by shifting to more stable vehicles (e.g., full-value shares, more weight on cash). Additionally, companies can consider moving to an approach where equity grants are made multiple times throughout the year (e.g., monthly or quarterly), which will reduce the impact of volatility and the grant “timing lottery” on potential value to participants.

2. **Stock price declines will push down the value of unvested executive equity.** Boards should pressure test unvested equity levels to ensure sufficient retention power—acknowledging that other companies will experience the same dynamic in a downturn. Options might become a more attractive vehicle if valuations are “reset” (albeit hard to time to the market).

3. **Relative TSR plans will have the potential to pay out above target while absolute performance falls.** Relative TSR prevalence skyrocketed after the last recession. The measure has been a relatively effective in the rising stock price environment, but will investors tolerate above target payouts in a down market? Boards can consider deemphasizing relative TSR or use relative financial measures instead. They can also add caps to current plans that reduce payouts if absolute performance is poor.

4. **Executives will suffer a greater risk of “busted cycles.”** Boards can consider greater emphasis on nonfinancial measures to help stabilize plans and focus executives on near-term efforts that position the company for future success.

5. **Employee grants will increase dilution at lower stock prices.** Boards can confirm that the equity program targets the right population. They can also consider share-based grants or dilution “collars” where the total number of shares granted is capped, even if the grant value is lower than the previous year.

6. **Lean times will pressure executives to find creative ways to hit numbers.** Boards can take a fresh look at the risk-review process to identify pay-driven red flags. They can also consider adding or expanding clawback provisions.

7. **As the financial outlook weakens, goal setting will get more complicated.** Boards can refresh or retest the goal-setting process (see accompanying figure). They can also adjust leverage curves to ensure goals are fair and achievable—yet sensitive to the shareholder experience.

While the challenges sure to emerge as the economy slows are multi-faceted, compensation committees have a range of options to adjust pay plans both to motivate and retain executives and to offer rewards in line with outstanding executive performance. Now is the time for directors to think ahead of challenges that may come with a status quo “best-practices” pay design. No board wants to face the prospect of losing key executives whose incentive payouts do not match their efforts and achievements.
### How to Set Pay-Plan Goals in a Swooning Economy

#### Start with a Disciplined Process

Boards have made incentive-plan goal setting a major focus in recent years. More rigorous goal-setting processes have been driven by the advent of Say on Pay, increased oversight from proxy advisors, and growing demand for transparency from investors. As you come under more pressure to set goals during economic downturns or market uncertainty, bear in mind a sequence of steps.

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<tr>
<th>Continue with a holistic goal-setting framework</th>
<th>Assess the goals from multiple angles: budget or long-range plan, historical goals and results, goals compared to peers or other industry comparators, etc.</th>
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<td>Recognize that decreasing goals will get increased scrutiny</td>
<td>External advisors often view a decrease in year-over-year goals as an indication that a plan could lack rigor. In cases where a lower goal is good business strategy, ensure there is a strong narrative to explain why and how it relates to the company’s business strategy and shareholder experience.</td>
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<td>Review leverage curves relative to the business cycle</td>
<td>Different leverage curves (threshold, target, maximum) can be appropriate for different stages in a company’s business cycle or in response to shifting economic situations. For example, if the budget reflects performance that is down materially year over year, consider establishing a shallow payout curve until performance is at or above the previous year. Avoid the same performance range/curve every year without assessing the appropriateness in the current context.</td>
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<td>Gut check goal rigor with sensitivity testing</td>
<td>Target goals are typically achieved in five to six of 10 cycles, stretch goals are typically achievable one to two out of 10, and thresholds are usually attainable nine out of 10, but with a reasonable likelihood of being missed at least once in 10 years. Review scenario analysis of the business plan to ensure goals provide reasonable rigor.</td>
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<td>Pressure test the planning and budgeting process</td>
<td>Board members can ask detailed questions about how the budget and targets would be impacted by shifts in the external landscape, actions by large customers, sensitivity to market growth, cost-cutting measures, etc.</td>
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<td>Institute good governance processes for reviewing goals</td>
<td>Using a two-step process for goal-setting at the committee level is a good practice. In the first meeting, directors review the data, ask questions, contemplate the proposal and then approve in the second meeting.</td>
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