POST-ELECTION INCENTIVE PAY PLANNING

Should compensation committees address the potential for regulatory changes, tariffs or geopolitical instability to impact incentive award payouts—and, if so, how?

THE ECONOMIC UNCERTAINTY that reached a fever pitch during the presidential election has given way to a new breed of uncertainty tied to the changing administration. Compensation committees now find themselves grappling with the question of whether and how to address the uncertainty posed by deregulation, tariffs and other macroeconomic shifts that may ensue as they design incentive plans for 2025 and beyond.

The overarching issue—how much should management be exposed to risks relating to events over which they have limited control?—is philosophical. "That's the big, underlying question that compensation committees have to consider," notes Rachel Gibbons, a principal at FW Cook. This question is not unique to the current environment; committees faced a similar quandary just a few years ago when navigating uncertainty surrounding Covid. "In 2020, many committees concluded that executive pay shouldn't be fully exposed to the unpredictable events that happened that year," Gibbons explains. "Consequently, we saw a good deal of backlash from shareholders and proxy advisory firms in the couple of years following the pandemic. Those external parties disapproved of companies making discretionary adjustments after the fact, thereby insulating management from events that impacted shareholder outcomes."

Heading into incentive design planning for 2025, the challenge for compensation committees will be avoiding such scrutiny from proxy advisory firms by ensuring that incentive pay remains aligned with shareholder outcomes, while also finding an approach that will motivate performance amid uncertainty. "There are a number of avenues, ranging from doing nothing to making discretionary adjustments to incentive plans after the fact, that companies can potentially pursue to address the uncertainties currently faced by committees," says Stephan Bosshard, a principal at FW Cook. "The solution that is most suitable will vary by company and by specific situation. As a result, it is important that committees consider all the possibilities and potential unintended consequences, including shareholder/proxy advisor reactions, before making any decisions."

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Some approaches compensation committees may consider are as follows:

STICKING WITH THE STATUS QUO

Perhaps the simplest option available is to take the stance that executives should have the same exposure to uncertainty as shareholders by maintaining current compensation practices. While some companies used discretion during Covid, others chose not to in order to retain alignment between management and shareholders. The latter approach could be taken here, whereby goals are set in accordance with earnings guidance and no proactive adjustments are made.

WIDENING GOAL RANGES

To the extent compensation committees wish to proactively account for potential external uncertainties, adjusting goal-setting around target is a straightforward way to do so. This approach can help compensation committees guard against the need to consider making discretionary changes after the fact.

The most common adjustment entails providing downside protection by simply widening the range of performance outcomes that earn some degree of payout. "Increasing the performance range evenly on both sides will rarely attract scrutiny," notes Bosshard. The key to avoiding external scrutiny with this approach is to ensure that the payout curve is widened equally on both sides of target, such that if the performance goal required to achieve threshold payout is lowered, then the performance goal required to hit maximum payout should be raised proportionately above target. "Another approach includes implementing a strike zone around the target," Bosshard says. "If there is significant uncertainty that prevents a company from setting an exact performance metric target, compensation committees can put a range around the target (e.g., +/-5 percent) to create a 'strike zone' that is more easily forecasted."

DELAYING GOAL-SETTING

Another way of handling uncertainty—at least in the short term—is by postponing incentive goal-setting until later in the first quarter of 2025. This approach may allow companies to gain more clarity around the new administration's plans. "At that point, compensation committees and management will likely have more information to draw from. For instance, the magnitude, timeline and potential impact of planned tariffs may be clearer, which could allow for more accurate forecasting and goal setting," says Gibbons. While goals should not be set too late in the year, there is no bright-line rule around timing, and finalizing goals later in the first quarter is unlikely to attract scrutiny.

RETHINKING THE MATH

Companies can also make formulaic ad-

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justments that can reduce uncertainty for management by mitigating the impact of factors outside of management's control. "There are ways to avoid discretionary, after-the-fact adjustments by preemptively adjusting for, say, the impact that tariffs will have on the supply chain," explains Bosshard. "However, fully shielding executives from the realities of an unpredictable external environment has the potential to create misalignment with shareholder outcomes, and therefore such adjustments may be viewed poorly externally.

"Compensation committees also have the option of reducing rather than eliminating the impact through use of 'collars' around incentive metrics," adds Bosshard. "Collars can be used to reduce the impact of items outside of management's control and prevent extreme award outcomes that are outside of management's control. This shields management to some extent, while retaining some alignment between management and shareholders. For example, applying a collar around incentive metrics would allow tariffs to impact these metrics only within a certain range, but not beyond this range. This would control volatility and acknowledge that management cannot fully hedge or mitigate the impact of tariffs while still aligning management to the shareholder outcome."

USING RELATIVE METRICS

If longer-term goal-setting is too challenging in the midst of uncertainty, a simple approach is shifting the program to using relative metrics, where company performance is measured against a custom comparator group or broader market index. "Using a relative metric, either on its own or in combination with an absolute goal-driven metric, avoids the need for goal-setting in an uncertain environment, which can be particularly helpful in long-term plans," explains Gibbons. "Ideally, a comparator group would be chosen such that all constituents are in the same situation with regard to an external factor, such as having suppliers that will be subject to tariffs."

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APPLYING DISCRETION

Regardless of which of the above options is selected, compensation committees also have the option of waiting to see how 2025 plays out and making a discretionary adjustment at the end of the performance period in the event that the impact of external factors on incentive payouts is viewed to be too extreme. This approach has the advantage of allowing compensation committees the certainty of responding to the actual impact of adverse events. However, proxy advisors have historically been critical of backward-looking adjustments—even those issued during the years the pandemic upended the economy—as such adjustments may lead to outcomes in executive pay that are not aligned with the shareholder experience. Moreover, since these adjustments take place at year-end, they also lack the motivational security that measures taken at the year's outset can provide executives.

As with any approach, companies must clearly outline the rationale for pay decisions, particularly when discretion has been applied. CD&A disclosures offer companies the opportunity to preempt criticism by telling their compensation story, complete with details around the parameters used to evaluate performance.

Ultimately, each of these approaches presents different trade-offs that compensation committees need to weigh carefully as they revisit their compensation structures to ensure they remain aligned with the shifting realities of 2025 and beyond. Clear and robust disclosure of pay practice decisions and the "why" behind them is also key. "Compensation committees need to be more agile now and more communicative than they used to be," says Bosshard. "In an operating environment where volatility, economic uncertainty and business disruptions are the norm, it is critical that committees have the ability to take a step back, consider their options, adapt to change when it's warranted and clearly articulate that decision to stakeholders."

Stephan Bosshard and Rachel Gibbons are principals at FW Cook who work with clients across a wide range of industries on executive compensation plan design.

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