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5 Principles for Successful Executive Pay Benchmarking

Using the five principles described in this article can prevent ratcheting up of executive pay.

Commentators on executive pay have for years pointed to factors that drive up compensation levels. Some of these factors, such as paying more to take account of unprecedented challenges and global competition, raise no eyebrows. But others, namely peculiarities in the compensation system unrelated to the functioning of executives, come in for fair criticism.

Leading pundits and governance groups have taken aim at benchmarking as a primary cause. Their argument is that "competitive" benchmarks are artificially precise and thus flawed. More important, repeatedly targeting a specific percentile, often the median, frequently leads to unnecessary pay increases. These criticisms have triggered a backlash against using benchmarking data.

However, the culprit in pay increases is not so much benchmarking but overreliance on an exact percentile as a standard for adjusting pay. Many companies and compensation committees toe the line of the median rather than risk not paying competitively and appropriately. In effect, they give benchmarking data too much weight. But benchmark figures can offer a valuable input to the process and a resource for more thoughtful decision making without being an absolute standard.

The Criticisms of Benchmarking

To understand how to use benchmarking appropriately, it is important to first take stock of three potential criticisms.

Criticism No. 1: The median causes ratcheting

Because most companies position target pay at or above 50th percentile, they create perpetually increasing pay.

By Greg Arnold, Semler Brossy

Avoid false precision in arriving at competitive pay levels, as the benchmark numbers don't perfectly reflect reality.

This is an accurate criticism. Ratcheting happens when companies regularly adjust individual pay upward if it falls below the 50th percentile (or whatever the desired positioning), but rarely adjust it downward if above the 50th percentile. When undertaken year in and year out, such adjustments create a mathematical certainty that pay will rise for all executives. As illustrated in Figure 1, this ranks as the most powerful of the unintended consequences. It stems from compensation committees feeling compelled to raise sub-median pay and hesitating to lower pay exceeding the median.

Criticism No. 2: Market benchmarks are not magic

Because the supply side of the market for executive talent is not perfectly competitive, raising all compensation to the median is not necessary.

Employees, particularly executives, do not jump from one company to the next simply to earn a small raise. Movement is governed by many factors, including role, career development, culture and workplace environment. In other words, financial signals do not alone determine where an executive will work. Moving pay incrementally to the "competitive market median" thus may be unnecessary to retain talent. Appropriate pay also depends on numerous factors specific to the individual, including sustained individual performance, company knowledge, experience and skills. As a result, pay adjustments should be based on individual factors and not just data-driven averages.

Criticism No. 3: Peer groups may boost the benchmark

Because the competitive market, particularly peer groups, rarely reflects an exact match with a company, manipulation of the groups can drive up pay.

Peer group selection is often criticized for two reasons: First, management has input into peer groups and may influence the selection of higher-paying peers. Second, the inclusion of significantly larger and/or higher paying "aspirational" peers can increase pay benchmarks. If companies routinely include either higher-paying or aspirational peers, the use of median data will again automatically ratchet up target pay levels.

Five Principles for Thoughtful Use of Competitive Data

None of these criticisms should stop companies and compensation committees from using competitive data. If committees follow five principles in using benchmarks to help to set pay, they will better inform and improve their decision-making process, mitigate the ratcheting effect, and reinforce their role in executing pay decisions that motivate and reward executives.

Principle No. 1: Use judgment

Adjust pay using common sense and sound judgment rather than strictly adhering to benchmarks.

The primary tenet of a thoughtful approach is using market data as a guidepost to a decision and not the definitive standard. Too often, committees and management teams default to matching the median, as if pay levels should be the result of an equation. While this is easy, it may encourage the company to take its eye off the big picture. The most effective pay adjustments take numerous factors into account — an individual's performance, role and responsibility, internal equity and positioning, past pay increases, current equity holdings and indirect pay elements (perquisites, retirement programs, etc.).

For instance, newly promoted executives are often initially positioned below the benchmark with the intention to transition them to market levels over time. In other cases, an individual's impact in helping the company realize its specific value proposition may exceed or fall short of that for executives in comparable peer roles (e.g., the chief of compliance and quality in a medical-device company), suggesting that deviating from the market benchmark is appropriate.

Principle No. 2: Avoid false precision by using a range

Avoid false precision in arriving at competitive pay levels, as the benchmark numbers don't perfectly reflect reality.

Market data are imperfect. Executive turnover, changes to survey participants, one-time awards outside regular programs, customized programs developed to fit unique circumstances — these all complicate the translation of competitive data into valid input in pay decisions.

Owing to a margin of error, a more effective approach is to view market data as providing a range in which the pay should fall and still be considered competitive (e.g., +/– 10% or 15% from the benchmarked number). By not limiting guidance to a specific number, companies can slow the inevitability of ratcheting while better reflecting reality.

One way to avoid false precision is to group executives into tiers, based on a combination of market data and their roles within the organization. This approach, shown in Figure 2, has a number of advantages. First, it facilitates the application of judgment to pay decisions. Second, considering pay in aggregate and by tier, rather than on a position-by-position basis, provides an overview of the competitiveness of the entire program rather than overly emphasizing position-by-position pay levels. Third, the company can evaluate pay levels on a total cost basis to assure that executives are fairly sharing in gains with shareholders and keeping total compensation costs reasonable. Finally, averaging data over a larger sample mitigates the inevitable year-to-year fluctuations that exacerbate the ratcheting effect in Figure 1.

Principle No. 3: Choose peers rigorously

Use a robust process to develop your peer group and refine the group as needed.

Developing the peer group remains critical in deriving data that serve effective decision making. The best approach combines quantitative and qualitative screens to identify appropriate peers. For companies without a natural peer group or market definition, reviewing for unintended biases in the data (e.g., differences in pay across industries) is crucial.

For example, a company in low-margin retailing business uses a peer group with direct competitors in its industry segment as well as retail and consumer-oriented companies that have higher margins. To ensure that market data from the combined group do not overstate the appropriate market pay levels for that company, the company tests the impact on competitive pay levels of including companies with higher profitability (after controlling for

Smart Benchmarking

Here are some key questions to evaluate whether your company uses pay benchmarking as effectively as possible:

1. Do you quickly adjust pay for all executives to the median regardless of individual or business circumstances?
2. Are market data presented as a singular value rather than as a range?
3. Have you tested your peer group for pay biases that stem from including companies that are larger or have different business models?
4. Are all executives routinely positioned at or above median once they have sufficient tenure?
5. Is senior executive pay routinely increased every year, especially at rates that exceed the broader employee population?

Figure 1 | **Perpetual Pay Increases Driven by Adjustments to the Median ($000s)**

Year 1

Company C is at the median with pay of $3,500

Company E is below the median.

Company	CEO Pay
Company A	$7,000
Company B	$4,500
Company C	$3,500
Company D	$3,000
Company E	$2,800
Median	**$3,500**

Year 2

Company E increases pay by ~30% in order to be in line with market

The median of this group is now $3,600

Company C , which was at the median in Year 1, is now below the median.

Company	CEO Pay
Company A	$7,000
Company B	$4,500
Company E	$3,600
Company C	$3,500
Company D	$3,000
Median	**$3,600**

Year 3

Company C increases pay slightlyly (less than 10%) to return to the median

Median pay for this group is now $3,750.

Company	CEO Pay
Company A	$7,000
Company B	$4,500
Company C	$3,750
Company E	$3,600
Company D	$3,000
Median	**$3,750**

company size). Because there is no systematic bias, the expanded group provides helpful insights.

Principle No. 4: Maintain year-to-year consistency

Maintain the incentive pay structure unless market data shift significantly.

Make it clear to employees that target bonus and long-term incentive opportunities will remain constant until the market presents a strong rationale for adjustments. Year-to-year consistency does not preclude annual merit increases or adjustments. It simply frees the company from adhering strictly to market data in maintaining annual and long-term incentive targets. Significant deviations from market pay and/or a change to the business — such as merger-and-acquisition activity or changes in roles — still call for adjustments.

Maintaining the structure avoids an annual scramble to chase fluctuating market rates, which move around erratically if for no other reason than the makeup of peer groups, survey participants and incumbents naturally changing from year to year. In one company, the compensation committee decided to hold the executive incentive structure flat and only make adjustments every two or three years. The annual bonus and long-term incentives have so far remained the same for three years and within market bounds. This approach requires the right culture and communication to implement effectively.

Principle No. 5: Pay below the median when warranted

Be comfortable positioning some executives below market, given that some jobs are smaller or less strategic than others.

A company's comfort with positioning some employees below median remains key, although difficult, in thoughtfully using market data. In many cases, a person may be new to a role or have different responsibilities than peers at similar companies. Lower pay is then perfectly appropriate. Being comfortable with the company's internal decision making, as well as recognizing that market data are imperfect, can reassure management and compensation committees that pay should fall below the median in such cases.

Figure 2 | **An Example of Using Ranges Instead of Medians**

Salary Benchmarking by Market Range ($000s)

Tier	Title	Company	Position Median	Market Midpoint	Market Range (midpoint +/–10%)	Assessment
1	CEO	$950	$1,000	$1,000	$900 to $1,100	Within range
2	COO	$650	$625	$600	$540 to $660	Within range
	CFO	$580	$575			Within range
3	BU Head	$575	$550	$517	$465 to $570	**Above range**
	BU Head	$500	$500			Within range
	BU Head	$460	$500			**Below range**
4	SVP	$415	$425	$418	$375 to $460	Within range
	SVP	$410	$440			Within range
	SVP	$400	$390			Within range
5	VP	$385	$400	$344	$310 to $380	**Above range**
	VP	$350	$333			Within range
	VP	$325	$300			Within range
6	VP	$290	$310	$285	$255 to $315	Within range
	VP	$285	$295			Within range
	VP	$240	$250			**Below range**
Total		**$6,815**		**$6,893**	**$6,205 to $7,580**	**Within range**

Thinking Smart

Market data remain an important input to decision making. But as with decisions in most corporate matters, data need to be used thoughtfully. Defaulting to using the market benchmark as the exclusive, or even primary, input to the annual pay adjustment process risks getting caught in an inexorable upward ratcheting of pay that will increase costs and frustrate shareholders and proxy advisers. Following the five principles outlined above will lead to more effectively setting pay levels that both properly reward executives and pass muster with company outsiders. ws

Greg Arnold is principal in the Los Angeles office of Semler Brossy. He can be reached at garnold@semlerbrossy.com.

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