Charting the course

How performance metrics and incentives are shaping executive retention and behaviours

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In the dynamic landscape of modern business, aligning executive performance with the strategic objectives of organisations has never been more important. With traditional approaches to executive compensation undergoing significant reassessment, companies are keenly focusing on structured frameworks to evaluate executive contributions effectively. The performance matrix emerges as a pivotal tool, ensuring that executives' actions are in harmony with the long-term goals of the organisation.

Executive evaluation

Emerging challenges and trends

While the narrative on executive remuneration is still evolving, emphasising on a framework that covers individual contributions beyond simple peer comparisons can help build buy in with the executives and stakeholders alike. This framework covers a spectrum of factors including work quality, strategic impact, and stakeholder management, all aligned with board objectives. However, concerns loom large over the ramifications of executive dissatisfaction with compensation, or worse, the potential for CEOs to depart even when compensation meets their expectations. This scenario poses a stark narrative that can backfire, particularly in sectors plagued by talent shortages.

In this article, we'll delve into structuring performance matrices for executives and how those metrics can influence their incentives and payouts. This framework can help boards looking to align executive performance with the company's long-term objectives, all while ensuring accountability.

While emerging trends highlight the need for comprehensive executive evaluation, there remains a strong case for focusing on concrete metrics such as budgets, targets, and key result areas (KRAs), especially over shorter evaluation cycles. Many organisations prioritise short- to medium-term performance goals, with increments every six months offering actionable insights for stakeholders. Although ESOPs and long-term share value play a role in senior leadership's incentives, shorter-term achievements aligned with strategic goals should remain prominent in executive assessments. This focus on measurable outcomes can complement, rather than replace, a more nuanced view that also considers qualitative factors beyond the numbers.

Looking beyond the numbers

Executives are expected to not only deliver financial results but also to guide the organisation through both opportunities and challenges that extend beyond just revenue and profit targets. To gauge executive impact, multiple factors need to be considered:

1. **Strategic leadership:** Executives are responsible for setting, refreshing, and executing the company's strategy. Directors need to assess whether the leadership team has effectively aligned the company's short- and long-term goals with its operational capabilities and ambitions. Metrics in this area could include the success rate of strategic initiatives, market share expansion, and competitive positioning.
2. **Operational efficiency:** Evaluating how well the C-suite optimises resources, manages costs, and drives productivity is key. Metrics such as cost-to-revenue ratios, operational expense reductions, and return on invested capital can reflect the executive's ability to ensure operational efficiency.

3. **Risk management:** In an environment filled with regulatory pressures, technological disruption, and market volatility, risk management is non-negotiable. Boards can measure executives on how well they anticipate, mitigate, and manage risks, including financial risks, cybersecurity threats, and compliance issues. Specific risk-adjusted return measures or risk management performance relative to industry benchmarks can be useful here.
4. **Cultural impact:** The C-suite shapes company culture, which in turn impacts employee engagement, innovation, and retention. Factors such as executive effectiveness in promoting diversity, attrition, inclusion, and a positive work culture can be part of the evaluation. Key indicators could include employee turnover rates, engagement scores, and the effectiveness of internal leadership pipelines.
5. **Stakeholder relations:** Executives are not only responsible for managing internal operations but also for building strong relationships with external stakeholders such as investors, customers, and regulators. Stakeholder satisfaction metrics, customer retention rates, and regulatory compliance can provide valuable insights into the executive's ability to build trust and foster strong, long-term relationships.
6. **Sustainability and ESG performance:** Increasingly, executives are expected to drive Environmental, Social, and Governance (ESG) initiatives. Their leadership in areas like reducing the company's carbon footprint, improving community relations, or advancing governance practices can be a key part of the evaluation process. Metrics here can include the achievement of specific ESG targets, external sustainability ratings, and community engagement outcomes.

Linking performance to incentives

With a well-structured performance matrix, the next step is to align these metrics with executive incentives. Incentives should not only reward short-term performance but also reinforce behaviours that contribute to the company's long-term stability and growth. Here's how boards can link performance to compensation:

Short-term incentives (STIs): These are typically annual bonuses tied to immediate results. While revenue and profit targets are common STI metrics, boards can also consider to factor in non-financial achievements such as the completion of critical strategic initiatives, improvements in customer satisfaction, or risk mitigation.

Long-term incentives (LTIs): Long-term incentives encourage executives to make decisions that benefit the company over a multi-year horizon. Equity-based compensation (e.g., stock options, restricted stock units) tied to long-term performance indicators such as sustained EPS growth, share price appreciation, or successful market expansion ensures that executives are personally invested in the company's future success.

Risk-adjusted pay: Introducing a risk-adjusted component into incentives is essential. A portion of the incentive payout can be subject to clawback provisions if excessive risk-taking is discovered after the fact, or if earnings that led to bonuses are subsequently found to be unsustainable.

Non-financial incentives: These could include leadership development opportunities, a more influential role in shaping corporate strategy, or recognition in the form of industry awards. Such incentives are often just as valuable in motivating top-tier executives as financial rewards.

Ensuring accountability:

To strengthen executive retention and accountability, it may be beneficial to ensure that performance evaluations and incentives are aligned consistently across comparable roles. While unique talents should be recognised, maintaining equitable rewards based on measurable deliverables can help mitigate potential perceptions of disparity, fostering a more cohesive environment.

To support leadership continuity, organisations may consider narrowing substantial compensation differentials between the CEO and the next tier of executives. Addressing these gaps can help mitigate potential discontent and the likelihood of key leaders seeking roles elsewhere, fostering greater cohesion and stability within the top leadership team.

Additionally, in an era of increasing scrutiny on corporate governance, it is essential that incentive structures also include mechanisms to ensure accountability. Boards can consider integrating the following:

Clawback provisions: These provisions allow the company to recoup incentive payments if later audits reveal that the executive's performance was overstated, or if ethical breaches occurred during the performance period.

Deferral mechanisms: A portion of executive compensation can be deferred to ensure that incentives are tied to long-term performance. This aligns the executive's interests with the company's sustained success.

The path ahead

As the narrative around executive compensation and performance metrics unfolds, the imperative for strategic alignment, equitable reward distribution, and effective succession planning cannot be overstated. Organisations are poised at a crossroads, where fostering innovation, encouraging strategic risk-taking, and ensuring operational continuity will define their trajectory in the competitive business landscape. Empowering executives while ensuring alignment with the broader organisational goals stands as the cornerstone of sustainable growth and success.

Lastly, as organisations refine executive evaluation and compensation policies, it's essential to acknowledge that success and setbacks are collective outcomes. Rather than attributing achievements solely to a few key individuals, a balanced approach should recognise the contributions of the wider team. Integrating a greater share of overall company performance into evaluation processes can foster a sense of shared accountability, reinforcing the idea that sustainable success is built on collaborative effort.

We would like to thank our nomination and remuneration committee council members for their time in providing us with their valuable insights and perspectives that have contributed to building this point of view document.

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