Structure Pay Practices to Develop C-Suite Talent

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In the best-run companies, CEOs and directors take considerable care in developing each leader and potential leader. They also pay leaders strategically as they progress on the talent-development ladder. Many companies, however, make the mistake of treating pay practices as an afterthought in leadership development. If boards don't object to this ad hoc approach, the companies often end up with second-rate talent development.

In the worst cases, CEOs and boards can stir up hard feelings among rising stars concerned over uneven handling of pay. They may even lose high-potential leaders to other firms, letting frustration over compensation deprive the organization of the deep bench of C-suite talent necessary for future success.

A consumer-products company with a well-established leadership-development process recently analyzed its rewards program. The CEO and board had intended the program to differentiate executives based on performance and potential. But the analysis revealed they rewarded people largely based on tenure. Veteran mediocre performers saw pay changes similar to superstars. The company was missing the opportunity to use pay to catalyze robust talent development.

To avoid sub-optimizing the performance of a talent-development system in this way, boards need to assure the systems are built from the ground up with pay in mind. The systems need to embrace consistent and continuous pay for two purposes: performance in delivering results and demonstration of potential for leadership and achievement. If compensation programs reward, motivate, and retain top performers as they move up, sideways, and take on special projects, the highest performing and the highest potential people will remain committed to the organization and become a competitive advantage.

How can CEOs and directors assure they have the right compensation practices to develop leaders who make outsized contributions to the organization? To start, CEOs and directors should ask a few questions:

- Does our pay program compensate high-potential leaders at each developmental step with pay that sets them apart?
- Does it distinguish them with meaningful awards that recognize special achievements? Does it reward the best performers appropriately as they are promoted to jobs reflecting higher plateaus of competence and experience?
- Do high-potential leaders get appropriate retention awards to keep them from prematurely looking for bigger jobs elsewhere?

When compensating the cream of the high-potential crop, CEOs and boards need to pay measurably more and use different incentives than for other individuals. They need to combine multiple pay approaches to better motivate up-and-comers. They must customize rewards and special awards so they are meaningful in size and form for recipients. And they need to use pay to give people both recognition and an incentive to stay with the company.

When used in the right order, at the right times, and in the right measure, four pay practices keep high-potential leaders ready, willing, and satisfied to stay on a fast-paced development track — and remain loyal to the firm. These practices send a message to up-and-coming leaders: "You are different, and we're giving you the highest possible reward."

Tools in the CEO and board's tool kit for rewarding sustained high performers include:

1. Differentiation in the Core Program

CEOs and boards can start to differentiate high-potential leaders by using the tools in the regular pay program. The typical program offers opportunities to differentiate base salary increases, annual incentive targets, long-term incentive targets, and individual adjustments to annual and long-term incentives — all of which can be used alone or in combination to recognize individuals.

Over time, companies should aim to put sustained high performers — particularly those who are critical to one or more succession plans — in a class by themselves. By making meaningful pay changes year over year, total compensation opportunities should rise above the median for the highest-potential leaders, ideally at the sixty-fifth or higher percentile.

A manufacturing company, for example, held back 10 percent of its regular annual incentive pool to provide adjustments of 50 percent to its highest performers. It also increased long-term incentive grants by 40 percent for the 10 percent of executives identified as having the highest potential. By receiving such adjustments, these rising stars meaningfully outpaced their peers inside and outside the company.

2. Promotional Increases

Differentiating pay through the regular program alone can make only so much difference in setting apart high-potential leaders. When succession candidates have measurably changed their value to the organization, boards can supplement regular pay with promotional increases. Promotions provide milestones at which individuals receive significant boosts in their annual bonus and the opportunity for increased long-term incentive pay. These increases visibly recognize rising stars for their progress.

A consumer products company tapped a senior human-resources generalist to head corporate human resources. In the process, it increased her total pay opportunity by over 40 percent. A healthcare company gave its CFO added responsibilities, first for information technology, then for a business unit, and finally for broader operations. The company boosted the CFO's annual bonus target by 25 percentage points and granted over 50 percent larger equity awards.

CEOs and boards sometimes move people into less prestigious, even troubled, assignments. They should then avoid penalizing leaders for taking jobs to build experience. In a marketing company, the CEO moved a leader into an ailing business unit to learn to manage a turnaround. The CEO and board gave the leader downside protection on his bonus—which was sure to otherwise fall. They guaranteed him the higher of pay based on the performance of the old or new business for the first two years.

3. Recognition Awards

Special cross-functional assignments may take high-potential leaders out of their core jobs or give them added responsibilities. Frequently, these assignments lead to high-impact results. This is where recognition awards come in, typically as cash or restricted stock. Cash awards, which are often more immediate in nature, may range up to the size of the annual bonus, or a half times salary. Stock grants, used for more significant achievements, may range from about one to three times base salary. The grants should vest over a longer period than regular equity awards, at times weighted to the back end (e.g., vesting in years 3 and 4 of a four-year vesting period).

A board seeking a recognition award for a just-elevated CFO chose cash. The CFO, faced with the difficult, stressful, and high-profile challenge of restating financials for multiple years, earned cash equal to her incentive pay. The cash vested first upon completion of the initial filing milestone and continued to vest over time as she met added filing commitments.

Another board awarded high-potential leaders charged with launching a business an immediate cash award worth one-half their salaries and restricted stock worth two to three times their salaries, provided all the key objectives for the business were met. The stock vested over five years, starting after year 3.

While serving as a financial incentive, stock strengthens high-potential leaders' sense of affiliation with the company. The greater the recognition and the larger the ownership stake, the stronger the affiliation. A company giving executives back-end-loaded restricted stock for a new venture says, in effect, "We believe in you; we want you to do what you're passionate about; and we know your work will make a difference to the company in the future."

4. Retention Grants

High-potential leaders are prime targets for poaching by other firms. To protect this talent treasure, companies can selectively issue retention incentives to help "lock in" great people. These grants are given sparingly, to make them big enough to be meaningful. This is particularly crucial after one or more leaders lose out in a horse race for a top post and the new CEO wants them to stay around.

At one company, each of three CEO candidates received a cross-functional assignment and reported directly to the board. All three also received pay at the level for CEOs at smaller companies, recognizing the candidates' appeal to head hunters. When the board named the new CEO, the passed-over executives received retention awards equal to their regular annual equity grants.

Pay is not the only way to compensate high-potential executives, of course. CEOs and directors have to consider the entire employee value proposition to advance these leaders along their leadership-development journey. The value proposition will include pay, benefits, career opportunities, job challenges, and the benefits of belonging to a great organization. But the best companies avoid raising questions over pay that might deter development. Instead, they provide explicit recognition and encouragement for top talent to go the extra mile in both developing themselves and contributing to the company.

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