Executive Compensation

The Time Is Right to Assess Pay Fundamentals

By Roger Brossy and Blair Jones

The coronavirus pandemic has upended executive compensation, especially the performance-based incentives that comprise the majority of executive pay. We are seeing a sharply divided corporate world: Pay plans in "essential" industries are thriving and often maxing out, while those at "nonessential" businesses offer little, if any, annual bonus along with three years of underwater performance share units or stock options.

As in any crisis, executives are working long hours and showing impressive resourcefulness. Those at the struggling companies say that results would be worse without their special efforts—and that financial recognition of those efforts deserves some consideration. Their counterparts in the winner's circle similarly say that their earlier hard work and continuing excellent execution have positioned them to overperform, so they are fully entitled to their calculated payouts.

The public, meanwhile, is naturally skeptical of companies' commitment to stakeholders and is paying close attention. Investors worry that boards will try to "make whole" executive pay losses through the use of discretionary adjustments, while boards feel pressed to ensure talent stability in the midst of trying times.

The current environment challenges key tenets of executive compensation, specifically whether it should be

- market-based, influenced by peer-group practices;
- paying for performance, with high risk for high rewards; and
- oriented to retaining key talent deemed essential to corporate success.

Boards don't need to resolve these issues immediately. Debates over these tenets may be timeless, but the current crisis should and will prompt reflections on executive pay. Here are general steps boards can take and questions directors can ask to guide that reflection.

Decide if pay should continue to be based on market results. If so, ask the following questions: Can boards of thriving companies tolerate much higher pay? Can struggling companies risk a potential brain drain to higher-paying companies? Does the definition of "market" need to expand, at least for the highest-potential talent?

Assess whether "pay for performance" needs to be redefined. What is the business's commitment to stakeholders? Before 2020, companies could count on the strong economy to absorb layoffs, but now the public is calling for improved corporate social responsibility. What is the proper balance of stakeholder concerns and awards for leaders? Will investors and customers tolerate sizable executive packages alongside employee layoffs and pay cuts, as well as (in some cases) government assistance?

Do metrics need to be broadened to fully capture all stakeholders' priorities, and if so, by how much? What does the company miss by measuring only financial and stock market performance? Or could leaders potentially lose their edge if additional measures dilute their focus? Ideally, boards could focus on both financial and stock market performance and stakeholder priorities by emphasizing a few stakeholder metrics that are strategic and lead to higher value creation. As examples, a retail company might include incentives related to sustainable sourcing, consumer packaged goods companies might focus on sustainable packaging, and energy firms could work to reduce their carbon footprint.

Determine the proper balance for retention. Rightly or wrongly, executives have come to expect a good deal of stability in their pay. Is a struggling company at risk of losing its most talented people to companies in essential industries? Can we continue to rely on the common wisdom that people leave for greater opportunity and not for pay?

If we are feeling pressure to protect our executives on the downside in the pandemic, should we correspondingly reduce the upside leverage on pay? Even before COVID-19, some investors advocated paying executives with long-vested stock and avoiding leveraged incentives. Alternatively, maybe we've seen a positive, galvanizing effect from incentives with structured leverage.

Should we clearly distinguish between the portion of compensation that is about pay delivery and the portion that is intended to vary with performance? Do investors have the patience to accept this talent equation and wait for longer-term alignment?

Boards are swamped now with more immediate concerns than the big picture of executive compensation. But as is true in other areas of business, the pandemic is an opportunity to rethink the fundamentals of pay for the new economic context.


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