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Center for Board Effectiveness

On the board's agenda | US
The complex role of the board in setting executive compensation

In conjunction with Deloitte's Chief Executive Program, this edition of On the board's agenda reviews recent developments in how boards set executive compensation, outlines challenges related to market volatility, and illustrates how variations across countries may impact compensation strategy. Much has happened since the last time we discussed this topic in September 2019. In the intervening period, boards and executives have contended with a global pandemic, the Great Resignation, a return to business normalcy marked by not-so-normal historic inflation, geopolitical conflict, and sundry other challenges. For directors, the current state of the executive compensation landscape might be characterized as a mix of the familiar and altogether different.

Why it matters

The pay of both CEOs and others in the C-suite is a recurring subject of interest for a company's shareholders, employees, the media, and government regulators. Perhaps in part due to this high visibility, the complexity of compensation governance has continued to increase over time. Ideally, an executive compensation strategy provides incentives to management that drive performance, aligns pay levels with shareholder returns, encourages long-term decision making, and is congruent with the goals of other board stakeholders. When crafting a strategy for this area of governance, a few developments in recent years could be important to keep in mind.[a]

> Expanded purview
The rise of DEI and ESG as C-suite concerns continues to shape pay dialogues.[a]

> Geopolitics matters
Executive strategy on compensation varies greatly across different countries.

> Open dialogues
Consider the interests and voices of shareholders *and* other stakeholders.

[a] DEI refers to diversity, equity, and inclusion; ESG means environmental, social, and governance.

Compensation structure, metrics, and incentives

Executive compensation has four primary dimensions: (1) base salary, (2) benefits, (3) bonus plans tied to short-term (typically annual) performance, and (4) long-term incentives to align the interests of executives with shareholders and other stakeholders. The process of benchmarking executive compensation has become more standardized over time, but the details for each plan may vary widely by role, industry, geography, and company culture.[1]

Finding congruence between short-term executive actions and long-term company goals may be difficult. Because in executive compensation strategy decisions, as in many areas of corporate governance, the push and pull between short-term and long-term concerns is a constant undercurrent.[2] Business history is full of tales of cost-cutting initiatives that raise short-term profits but yield long-term losses (or result in other negative developments like talent churn and lost market opportunities).[3] This may be one reason why, at least since the early 2000s, executive compensation has tilted toward equity-based awards with longer time horizons.[4]

Executive compensation dimensions[5]

> Pay structure
This may include a mix of cash and equity tied to metrics and goals with short- and long-term timelines.

> Balancing act
Alignment between shareholder expectations and need to attract/retain top-tier executive talent.

> Volatility management
In a shifting macro-economic environment, balance between challenging but attainable goals may be beneficial.

The universe of options to select from may change across short-term and long-term incentives. As an example, broadly speaking, short-term metrics have two main categories. First, *financial metrics* are measures of company performance, such as revenue, profit, and cashflow. Second, *strategic* (or non-financial) metrics encompass a variety of items that may be harder to quantify but may nonetheless be important for performance. In recent years, this latter category has expanded to include items reflecting corporate values under the banner of purpose, sustainability, and social responsibility.[6]

Example of short-term executive compensation metrics

Financial[7]	Strategic (non-financial)	
	Business objectives[8]	Corporate values[9]
Revenue	Individual performance	Bolstering employee DEI
Profit	Customer satisfaction	Meeting ESG goals
Cashflow	Growing market share	Community engagement

Deloitte's research has noted values-oriented performance metrics require an iterative process to define, which may make them challenging to incorporate into a broader strategy.[10] As such, at least for now, DEI and ESG metrics are usually included as part of shorter-term incentive strategies.[11] According to Conference Board research, 73% of the S&P 500 have executive compensation plans that incorporate some type of ESG metric.[12] The reasons for growth in this category are complex. But some data[b] suggests promoting corporate values accountability through compensation metrics may highlight the strength of the company's commitments to a broader range of stakeholders.[13]

[b] Research suggests companies that prioritize corporate social responsibility as an outcome metric, including tying it to executive compensation, tend to financially outperform their peers. See Isabel-María García-Sánchez and Jennifer Martínez-Ferrero, "Chief executive officer ability, corporate social responsibility, and financial performance: The moderating role of the environment," *Business Strategy and the Environment* 28, no. 4 (May 2019): pp. 542–55.

When it comes to long-term incentives, a 2023 Deloitte survey on US equity compensation trends found that public companies have increased their use and weighting of performance restricted stock units (RSUs) in incentive portfolios. Concurrently, respondents also indicated they were decreasing the weighting of (or eliminating) time-based stock options.[14] These changes reflect a growing trend of companies seeking to "de-risk" executive compensation strategy. In other words, such developments may reflect a shift toward prioritizing executive retention via increasing payout certainty.

Say on pay (SOP) votes

By now SOP votes may not be new for corporate governance, but they remain an important consideration for several reasons.[15] First, increased requirements around disclosures of executive compensation may bring more opportunity for public scrutiny. Second, while SOP votes are non-binding in the United States, they still may serve as strong signaling mechanisms with both practical and symbolic importance. For instance, one proxy advisory firm considers passing votes of less than 70% or less to be unsatisfactory.[16] In some cases, companies that receive unsatisfactory ratings may need to provide explanations of their action plan to address shareholder concerns. If a company's response to such inquiries is later deemed inadequate, it could cause proxy advisors to recommend future "against" SOP votes.

SOP considerations and developments[17]

> SOP vote failures
Failed votes across the S&P 500 have slowly increased from 8 in 2011 to 22 in 2022.

> Geographic considerations
The structure and effect of SOP votes may vary greatly across different nations.

> Future trends
Recent economic volatility could mean SOP failure rates may trend higher.

Geographic variations in executive pay strategy

Importantly, the "portfolio" (mix of time- and performance-based vehicles) of long-term incentives may vary across geography. This could have implications for the global executive talent market. Due to varying investor and proxy advisor expectations, companies seeking to craft a consistent global strategy may face difficulties.

In Europe, for example, executive compensation packages have long tended to eschew time-based restricted stock in favor of performance-linked RSUs.[18] Yet this type of geographic variation is increasingly a topic of debate and dialogue. For example, London Stock Exchange officials recently called for a discussion on executive compensation, noting the UK's approach may be hampering its ability to attract talent and listings in a global marketplace.[19]

Variation in common long-term RSU features for CEOs[c]

United States	European Nations
50% time-based 50% performance	100% performance

[c] This table is designed to highlight country-based variations in compensation structures. These are not actual compensation plans, and they do not imply that companies should or should not offer any listed item. See Katie Kenny and Ian Dawson, "Incentivizing leadership in a global talent market," presentation at the GEO Virtual Conference, June 13, 2023.

Shareholder and stakeholder input on pay may also vary by geography. In the United States, a non-binding SOP vote has been required by regulation for over a decade. Existing data suggest US-based SOP initiatives have elevated the voice of advisory firms (and the investors they represent), though it remains unclear if SOP vote outcomes meaningfully alter board strategy and future executive pay structures.[20] Concurrently, other research suggests the United Kingdom's binding triannual votes on pay policy[d] may have had a notable effect on the structure of future executive compensation plans.[21]

Executive compensation data trends

Increasingly large amounts of data about executive pay are being collected, and the information available is trending toward greater granularity. More datapoints recently became available via new SEC regulations implementing portions of the Dodd-Frank Act. The new rules, approved in September 2022, mandate reporting on some aspects of pay versus performance.[22] Beginning in December 2022, SEC-registered companies started reporting on these metrics for the past three years. What the data shows on this topic, of course, depends on the lens used and the subset of companies assessed:

US executive compensation data highlights

CEO to worker pay ratio 399 to 1
In 2021,[e] the gap between the salary of CEOs and non-manager workers across large companies reached a historic high.[23]

Mean pay package value declined 1% YoY[f]
As calculated via the SEC's compensation actually paid formula, S&P 500 executive pay declined slightly between 2021 and 2022.[24]

Race and gender equity compensation parity[g]
Some research suggests chief executive pay by gender and race are reaching parity, though results vary greatly by industry.[25]

To be sure, the impacts of more detailed compensation reporting may not be known for some time. But if past trends are an indication, stakeholders seem to be very much aware of executive compensation data. And for many of them, it is an important issue.[26]

For example, while it varies by industry, some consumers are more likely to express negative sentiments and change purchasing patterns when they perceive pay ratios as "high."[27] Similarly, in a series of hypothetical randomized experiments, employee negative perceptions of pay ratios were linked to lower morale.[28]

Conclusions and discussion questions

The complexity of setting pay may be magnified when it involves groups with varying and perhaps conflicting short-term and long-term interests. It may be difficult to find the balance between these varied stakeholders with different time frames. Ultimately, though, and regardless of the number and volume of other voices,[29] decisions on this matter fall to the board and its compensation committee.[30] When thinking about executive compensation, possible questions for boardroom discussion might include:

- Is there clear alignment between the company's overall strategy and individual compensation metrics? How are metrics, individually and collectively, tied to overall strategy goals?
- Do the company's executive compensation philosophy and implementation plan balance the need to be competitive, risk management concerns, and longer-term strategic objectives?
- Should commitments to stewardship, DEI, and ESG be incorporated into executive compensation plans? If so, are the metrics applicable and reflective of the company's current strategic priorities in this area?
- Has the board or the committee analyzed executive compensation for both internal and external equity? Should (or have) the results of those equity assessments be shared with stakeholders?
- Under what circumstances can (or should) the board or compensation committee update pay strategy in response to feedback from shareholders and other stakeholders?
- How much input should executives have into the process of setting pay metrics? Does the current process allow for a sufficient level of input to check for values congruence between the board and management?

[d] In the United Kingdom, annual votes on say on company remuneration reports are advisory.

[e] Methodologies for CEO to worker pay ratios vary widely based on geography and inclusion criteria. For analyses that look at the largest public companies, the most recent data vintage is 2021. See Steven A. Bank and George S. Georgiev, "Securities disclosure as soundbite: The case of CEO pay ratios," *Boston College Law Review* 60 (2019): p. 1123.

[f] The unit of analysis is critical when examining trend data on executive compensation. While S&P 500 executive compensation declined slightly between 2021 and 2022, a study of the highest-paid 100 CEOs during the same period shows an increase of 7.7%. See Amit Batish, "Equilar 100: The 100 highest-paid U.S. CEOs," Equilar Insight, May 3, 2023.

[g] Importantly, though, this is an area of research with a great deal of confounding variables. CEO pay equity (and lack thereof) seems to be strongly shaped by geography as well as variations in norms that sometimes disproportionately discriminate against executives from certain underrepresented racial and ethnic groups. See Atif Ellahie, Ahmed Tahoun, and İrem Tuna, "Do common inherited beliefs and values influence CEO pay?," *Journal of Accounting and Economics* 64, nos. 2–3 (2017): pp. 346–67.

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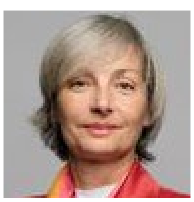

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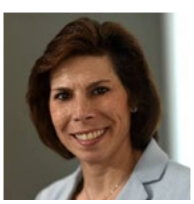

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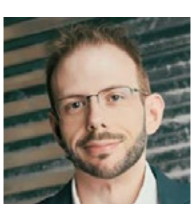

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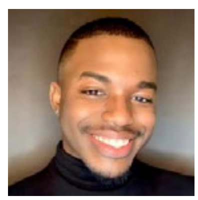

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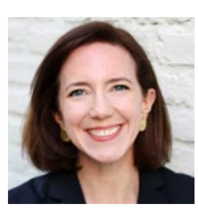

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