Minding the Executive Compensation Gap

By Jennifer Wagner Shenker and Gregg Passin

The unintended—but predictable—consequences of the Dodd-Frank Act’s efforts to curb executive pay are becoming apparent. In just over three years, compensation committees are approaching critical decisions through a narrow lens focused on satisfying proxy advisors’ criteria for earning a “yes” say-on-pay vote by closely following industry trends and so-called best practices.

The result? Companies seem to be seeking safety in following the herd, implementing plans that look remarkably alike. Sadly, unique business priorities and talent requirements have become secondary considerations. Even worse, critical decisions are being made in a siloed fashion, without input from key stakeholders, leading to misalignments that undermine the execution of the company’s strategic vision.

Cookie-cutter executive compensation programs that fail to recognize the complexities of the business do little to support real, long-term shareholder value creation. Boards need to adopt a more collaborative, evidence-based, and business-centric executive compensation process.

1. **Reorient to the global talent market.** If you run a global business and your executive compensation decision-making process never looks beyond U.S. practices, you are doomed to lose the global war for talent. Boards and executive teams are increasingly diverse in terms of nationalities and home countries—a trend that requires thinking differently about managing executive pay.

   Decision makers must understand global differences in tax, social welfare, and regulatory requirements in order to optimize delivery from a cost and retention perspective. They also must be able to draw comparisons across dissimilar packages to identify and mitigate internal equity concerns.

   More systematic and rigorous international mobility practices should also be on the agenda as a strategy to address business imperatives (e.g., refocusing efforts in a growth region), promote leadership development, and develop managerial talent that can work successfully across geographic and cultural boundaries. Mercer’s research shows that the requirements for successful global leaders are different than those for successful domestic leaders; international assignments are a powerful way to develop these competencies.

2. **Integrate executive talent planning and rewards decision making.** Executive talent planning and rewards management are intricately connected, particularly from a risk perspective. Externally hired CEOs are paid, on average, more than one-third more than CEOs promoted from within, and it is generally accepted that senior executives without a strong bench have more power in negotiating their own pay. On the other hand, executive reward programs can inadvertently stymie talent objectives (such as when innovation is hampered by too much focus on short-term profits in the incentive plan).

   Mercer’s research shows that an increasing number of companies combine responsibility for executive rewards and talent decision making. Seventeen of the 30 Dow Jones Industrials include at least one non-compensation-related activity among the duties of the compensation committee, and 12 engage in multiple non-compensation tasks. The most common of these activities are succession planning (12 companies) and leadership development (10 companies). Four companies include management selection, and an equal number mention broader workforce management. This expansive mandate may even be reflected in the name of the committee, with the words “human resources” or...
“development” included in 11 companies. Regardless of structure, boards should consider how talent information (like leadership potential) and rewards information (like retention value of equity holdings) are best managed in an integrated manner when reviewing their annual agenda, calendar, and processes.

3. Understand total career compensation. Few compensation committees consider realizable pay over an executive’s full tenure, and many gloss over the value of benefits in evaluating competitiveness against peers. This can distort the true value of compensation, and may result in a total rewards package that is markedly off from the intended market positioning.

Neglecting to directly address career compensation can also have unintended consequences. With employers scaling back on retirement programs and the value of investment portfolios in flux, more executives are delaying retirement for financial reasons. These leaders may be less likely to drive major change efforts due to the time and complexity involved, while clogged pipelines can decrease motivation and increase turnover among ambitious younger executives.

Analyzing the value of all elements of compensation is essential to understand the full impact of compensation programs. Proactive and frank discussions with executives about career and retirement goals can drive tangible savings and transition plans that support succession planning efforts.

4. Harness the power of data. Leading companies are investing heavily in their people and pioneering new ways of monitoring and managing the return on these investments. Yet, according to Mercer research, compensation professionals continue to rely primarily on benchmarking to guide their decisions, as opposed to including more sophisticated analytical techniques such as projections, simulations, and predictive modeling used by other HR functional areas. This failure to jump on the “big data” bandwagon is not for lack of opportunities; whether isolating the impact of leaders on sales or profitability results or identifying the impact of pay decisions on engagement and productivity, workforce analytics represents a powerful tool for managing rewards at all levels.

More in-depth analyses enable companies to make evidence-based decisions that recognize a business’s unique ecosystem, rather than blindly following the herd. It also enables them to more easily justify decisions to stakeholders. Failure to do so creates risks that companies should seek to mitigate. As a first step, compensation committees should regularly review a dashboard of human-capital metrics that provide objective, data-driven insights into organizational threats and opportunities. Companies may also consider ways to tie executive pay to human capital results.

5. Embrace multiple stakeholder collaboration. Investors indicate they are having more detailed conversations with companies earlier in the executive compensation process, and this is a positive development. Collaboration, however, should not be limited to shareholders. Proactively seeking input from a broad range of stakeholders—including management, outside advisors, HR, finance, and legal—ensures a balance of perspectives and avoids systemic biases, including those that can arise from focusing too narrowly on shareholder feedback.

Committees should consider whether current processes provide an appropriate degree of collaboration and if a wide enough range of stakeholders are included in the process. Annual agendas should be paced so that information and opinions can be shared, discussed and reflected upon before important decisions must be made, and stakeholders should have multiple opportunities to provide input and identify potential problems leading up to each meeting. It is generally both inefficient and ineffective for outside advisors or management to prepare recommendations in a bubble without cross-pollination of information and perspectives.

Boards should consider talent and rewards information in an integrated manner.

Bridging the Gap
Organizations must be willing to challenge the status quo to bridge the gap between the complexities associated with managing executive talent and pay in global entities and the pressures to conform to industry norms and proxy advisory standards. Managing executive talent to achieve sustainable business results demands holistic thinking, a long-term orientation toward value creation, and iterative processes that engage stakeholders early and often.

This shift means the difference between managing executive pay solely as a risk and managing executive talent as both a risk and a business driver. Companies can best reflect an organization’s unique business needs by considering a wide range of inputs and analytics that can lead to defensible, evidenced-based judgments. Executing on this shift also requires access to advisors who are willing and able to work collaboratively, broaden the conversation and bring new perspectives to light.

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