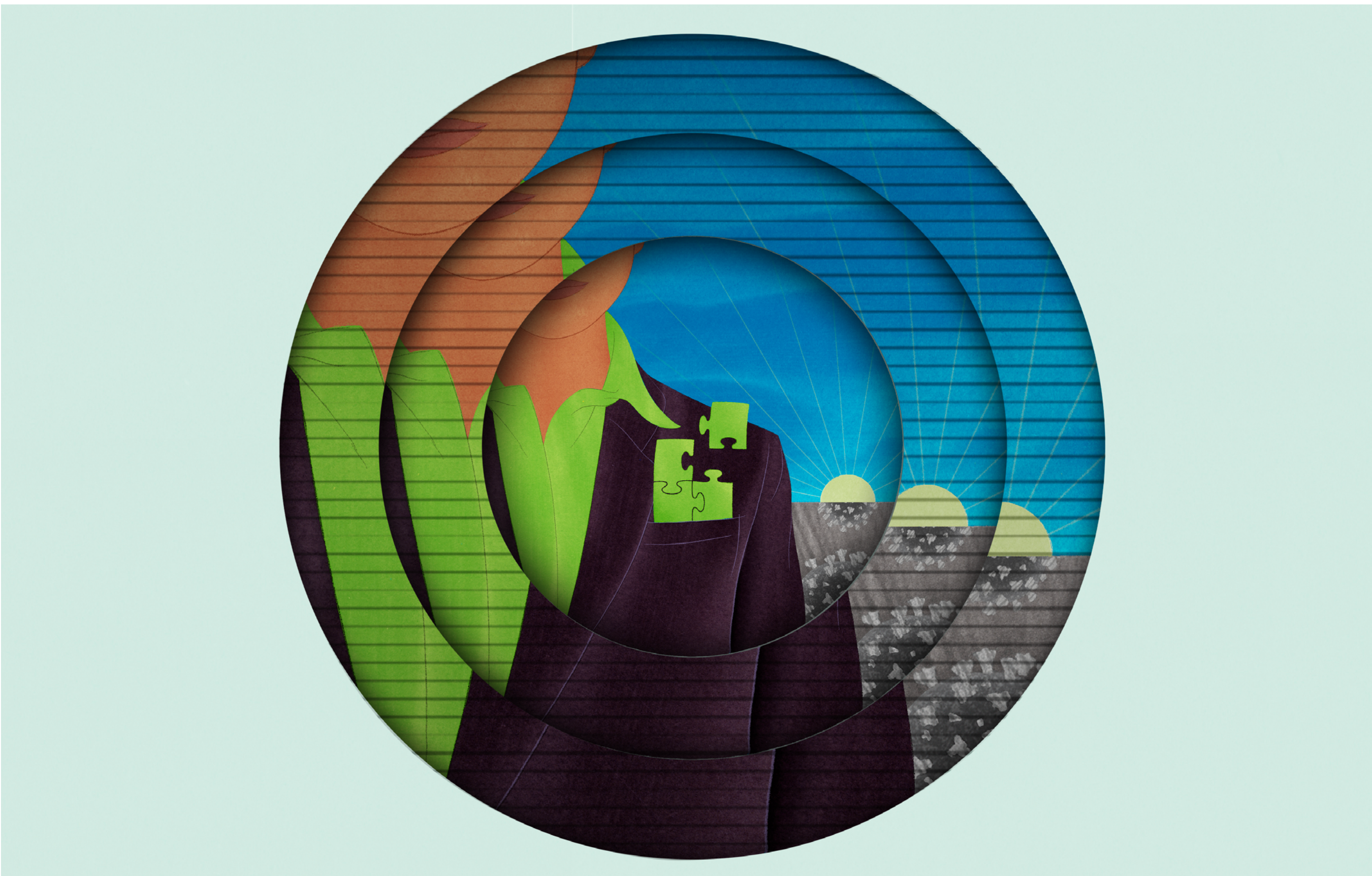

FEATURE

CEO compensation in a COVID-19 world

How should CEOs be rewarded in a time of crisis?

Dan Konigsburg and Benjamin Finzi

COVID-19 has considerably altered the dynamics around CEO compensation. How are investors, compensation committees, and CEOs themselves approaching this question in the current environment?

WITH THE COVID-19 crisis still unfolding around us, the uncertainties keep piling up: When businesses will reopen, the course the virus will take through our businesses and communities, whether consumers will feel comfortable spending again, how global supply chains will be affected … and the list goes on. But one of the very few things we can be certain of in the current environment relates to CEO compensation. Current trading conditions mean that very few CEOs will reach their performance targets this year. If this is the case, what does this mean for how pay will ultimately be awarded? How will board compensation committees react? And, ultimately, how will shareholders view any changes? Will they support CEO pay packages, and any COVID-19–induced changes, during this year's shareholder meeting season?

To get to the bottom of these questions, Deloitte interviewed a cross-section of CEOs, compensation committee chairs, and institutional investors[1] to better understand views on CEO pay from multiple angles. Certain broad patterns are discernible from these intimate, individual conversations and are highlighted below. Throughout, we have attempted to provide the actual language used by the interviewees to enable readers to develop their independent view as to the depth of this shift in mindset.

All stakeholders are starting to recognize that the dynamics around executive compensation have been considerably altered—whether due to the COVID-19 pandemic itself, or due to a move away from solely focusing on shareholder value maximization. While it is still premature to assert whether these changes are permanent, it seems that there is a need to anchor arguments related to executive pay at least in part on principles of fairness and empathy. Our discussions show an increasingly recognized link between leadership and social responsibility and how that affects the ultimate determination of fair executive compensation and appropriate return to shareholders' investments.

Organizations must balance fairness to stakeholders with fairness to CEOs

An overarching theme that surfaced among all interviewed stakeholder groups was that fairness, both perceived and actual, in determining CEO pay must be a paramount consideration. The need for fairness in how CEOs are compensated versus how workers are compensated was a recurring topic, as was the need to be fair in aligning CEO compensation with shareholder returns. At the same time, interviewees also spoke of the need to be fair to CEOs, pointing out that how they are paid now would potentially have long-term impacts on their motivation and performance in the chief executive role.

Many of the investors we spoke with expressed concerns about the perceived inconsistency and unfairness of outsized payments to CEOs at companies under stress. In particular, we heard concerns from investors about large payouts at companies that may have received government loans or other funding, or at companies that have cut dividends, halted share repurchases, or laid off or furloughed large numbers of employees. The International Corporate Governance Network (ICGN),[2] one of the largest investor-led governance organizations, published a note in April about the virus and its effect on capital. Calling out fairness as a key concern, the note suggests that the question of fairness is also important for companies that are forced to lay off staff or ask staff to operate with pay cuts. Maintaining or increasing executive pay in such cases could threaten stakeholders' trust and motivation as well as the company's social license to operate.

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Investors also stressed that CEO pay should be fair from the perspective of shareholders, many of whom have suffered precipitous losses during the pandemic. Indeed, this theme of alignment of CEO and investor interests came through in nearly every investor interview we organized. Many pointed to declining equity markets and suggested that there must be some correlation between executive pay and the judgment delivered by the markets. "For us, it's all about sharing the pain," said one governance head of a large North American government pension fund. Another investor said, referencing an argument he had heard about the virus being something that was clearly outside of all executives' control, "Yes, CEOs couldn't control the virus, but no one else could, either."

For their part, CEOs generally recognized that their compensation would likely be adjusted to be more aligned with the sacrifices made by employees and shareholders, and as a way to "share the pain" and "lead by example." One US CEO told us that her company had quickly frozen merit and salary increases, and no member of the executive team would receive new equity grants this year. Other CEOs we spoke with volunteered to have their base pay cut, bringing the proposal to their compensation committee chairs, as another way to lead by example during a difficult time. It has been publicly reported that a number of CEOs have volunteered to cut their pay this year to zero, or to US$1.00, or to otherwise drastically lower their pay.[3]

Cutting CEOs' compensation is not always the right move, however. Some CEOs spoke to us openly about retention risks: That, if CEO compensation is cut and with stock prices depressed (until recently, anyway), CEOs may begin to be approached by competitors. One CEO expected his company to go ahead with longer-term share or option grants as a retention tool. And it's the longer-term grants that CEOs recognize as the most problematic. CEOs' reactions to these will very much depend on their expectations for a post–COVID-19 recovery. If CEOs believe we are on the cusp of a V-shaped recovery, they might welcome little to no changes to outstanding grants; if they believe we are destined to experience a W- or U-shaped recovery, they might see previous grants as "lost" and seek new grants made at today's lower stock prices. No CEO we spoke with seriously entertained the possibility of option repricing, or resetting strike prices.

CEOs are also concerned about what potential decreases in pay would mean for the long term. One CEO told us that he is approaching his pay thoughtfully: He was uneasy about the long-term negative effects on his pay trajectory due to short-term COVID-19–related reductions. Another CEO said that he is approaching discussions about pay in a slightly "timid" way, given present circumstances. Both of these viewpoints reflect a sense that short-term reductions can become facts on the ground that bring a long-term reduction in pay. There is a balance here, to be sure: CEOs may wish to do the right thing in accepting lower pay this year, but they also do not want this year's pay levels to affect their future compensation trajectory.

Another worry some interviewees expressed was that lower CEO compensation may mean lower CEO effort and motivation, with harmful effects on business performance. This concern was evident among some CEOs serving as compensation committee members on the boards of other companies. These CEOs, in their position as directors, can be informed by a broader perspective—and one that can support higher levels of pay. One CEO who serves on the board of a large retailer told us, "The number-one thing I can do as a member of the board is to make sure the CEO is being supported and that he's receiving compensation for what he's put into place that's been beneficial to the company in the long term, and that he's rewarded for this, outside and apart from a crisis such as COVID."

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Behind all these considerations is the philosophical question of what pay is supposed to reward in the first place. If it is to reward effort in some way, then even a company facing zero revenue in the midst of the pandemic should reward the hours of work and wrenching decisions executives have had to make over the last few months. If, on the other hand, the purpose of pay is to align the CEO's interests with those of his or her shareholders, then the answer will be very different. If, after all, shareholders have been suffering, why should leadership be rewarded? This was characterized to us by one compensation committee chair as an "input/output problem," meaning that sometimes, even heroic efforts are not rewarded by the market.

Of course, gyrations in the market cloud this analysis further. One US compensation committee member told us: "Part of the problem is that (for me) I can't figure out what the market is doing, nor can the board. It's all great what we're seeing at the moment—but in another sense, it's certainly not reflecting the results."

Finally, it's not just *reductions* in CEO pay that were seen as problematic. The virus has not affected every business equally, or in the same way. Take the example of one compensation committee chair at a global manufacturer of, among other things, household cleaning products, whose revenues in the crisis have skyrocketed. This director, who serves on the boards of other companies that have been negatively affected by the virus, expressed equal concern about the effects on stakeholders and her CEO from pay plans paying out unusually large positive gains, as about how to pay when businesses are struggling.

Adjusting KPIs is often, though not always, frowned upon

Many interviewees spoke about the question of whether their company's key performance indicators (KPIs) should be adjusted to account for current circumstances. The decision obviously has direct implications for CEO pay: Many, if not most, CEOs are highly unlikely to reach their KPIs for this year unless the KPIs are lowered.

But with some exceptions, most of those we interviewed felt that adjusting KPIs would not be in an organization's best interests. Few of the CEOs we spoke with supported the idea of changing or easing KPIs in the middle of the year, or "midstream," as it were. Particularly for those companies that have accepted government money as part of the immediate COVID-19 response, this approach is widely understood to be an unpalatable one, and one that would have deleterious effects on the company's reputation.

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The governance head of the North American government pension fund mentioned earlier put this perspective into words. "I get that compensation is tied to performance and that this is an extraordinary event, and there may be a desire to change metrics. This might be reasonable in principle, but if these changes are disproportionate, this is a concern for us. We would have a problem if they lower targets, and then they all hit it out of the park because they've lowered the targets, and then they all get maximum bonuses. This is a particular issue if you're also laying off staff or furloughing people."

These sentiments were echoed by Amy Borrus, executive director of the US's Council of Institutional Investors (CII). She told us that, with respect to CEO goals:

> Some institutional investors are extremely skeptical of companies moving the goalposts mid-year, even in the wake of COVID-19. A senior stewardship staffer at a large public (US pension) fund told me: "Given these unprecedented times, we think it is important that there is an alignment between corporate executives, employees, and shareholders. If shareholders are feeling the pain, we feel executives should as well. In addition, we think this is the time to reinforce a focus on long-term metrics and the strategic direction of the company. I anticipate that we will review these 'revisions' with great scrutiny. There could be acceptance of revised KPIs if a company is truly changing their long-term strategy, but I think these will be rare."

A Continental European compensation committee chair identified several additional reasons that he believed performance targets should not be reset. The first was that because doing so can be distracting to management teams who should be focused instead on the safety of their people. The second was that because resetting to a wider set of targets—including a measure of sustainability, say, or taking care of colleagues—would require enormous time and effort to define. And the third was because, in any case, events with the virus are moving faster than most boards can act. That said, some companies are examining the question of COVID-19–related KPI adjustments in a broader context. As noted by the investor quoted by Amy Borrus, the COVID-19 crisis could be an opportunity to examine KPIs to make sure they truly reflect a company's long-term strategy.

These debates are occurring at a time when a CEO's compensation may be becoming less solely tied to KPIs. Some CEOs expressed a sense that KPIs themselves are changing to account for more nonfinancial measures of performance, and that COVID-19 is accelerating this. Compensation committees recognize that there is more to pay than just rewarding growth to the bottom line, and that this approach to compensation may allow discretion in how awards are made. This can reassure some CEOs.

However, some interviewees were equivocal about allowing boards discretion in setting CEO compensation. In Europe, even where compensation committees might wish to make some kind of adjustments to pay packages, corporate governance legislation is generally not supportive of committees applying discretion to pay policy. One compensation committee chair at a French-listed company told us that application of discretion by a committee is uncommon in France. At her company, she plans to introduce a specific discretion statement in the Annual Report—that the board would review executives' performance at the end of the year and that shareholders should expect the committee to apply some discretion. At the same time, the chair admitted that this was uncharted territory for the committee. "What does this mean? Who knows?" she responded.

Interestingly, one feature of the current landscape around pay seems to be a trans-Atlantic divide on compensation committees when it comes to targets. One director we interviewed, who serves on the boards of two equally large listed companies in London and New York, told us she sees a large contrast between the United States and the United Kingdom when it comes to pay. Here, an extended quote is enlightening:

> "In the US we have a CEO who said very early on in the crisis, 'Look, we're not going to hit these targets, but we need our people to continue to keep their eye on the ball. So, what we will do is, we will stop the process midyear, pay out bonuses based on half-year results, then issue new targets. Then we pay modestly for the rest of the year, in order to encourage our people to keep their eyes on the ball.' But the CEO could say this in the context of a great deal of moral authority—he's already agreed to give up 50% of his own bonus. In the UK, it's a different story. There, we knew by mid-March that these goals would not be achieved. It would have been much more logical to do what (my US company) did. But in the UK you don't change goals."

For committee members in the United Kingdom and to a lesser extent the United States, an overriding concern is securing approval from proxy advisers such as ISS and Glass Lewis, who provide voting recommendations to companies' institutional shareholders. Given the reputational impact of a "no" vote, staying on the right side of voting recommendations that can influence how more than one-third of one's shareholders might vote on a compensation issue can feel, at times, like the number-one job of a compensation committee member.

On the other side of this debate are those companies that have been buoyed by the crisis. Certain health care companies, videoconferencing technology companies, and manufacturers of personal protective equipment are just a few examples of businesses that may have experienced record growth beyond anyone's imagination. If these companies use this year's numbers as a benchmark of any kind, comparable targets may be very difficult to reach in the same quarter next year. Yet investors can be unforgiving and have short memories: Compensation committee members we spoke with at these companies harbored worries that their investors might ask later why their company is relaxing targets.

Different countries may perceive and manage CEO pay differently

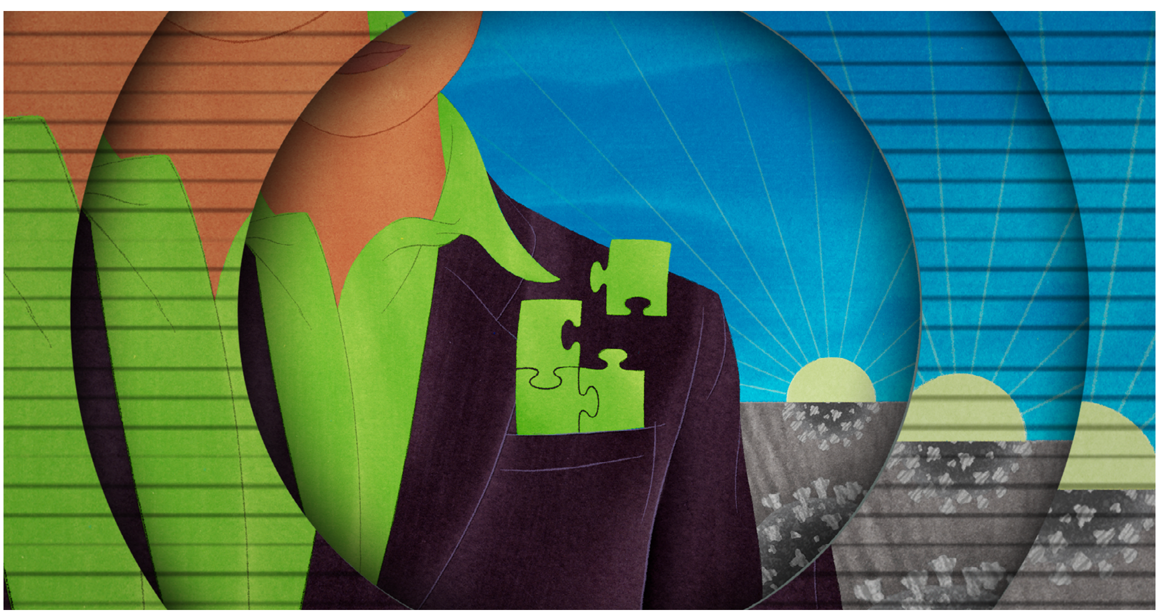
Our interviews highlighted some differences between the approach to CEO compensation in the United States and in the United Kingdom. To some extent, these differences reflect different degrees of involvement by shareholders and even the government in questions of pay, which lead to different consequences. In the United Kingdom, great attention is directed to pay levels at large, listed companies, and there is often an impatience with, and a lack of acceptance of, what is perceived to be high pay. In the United States, in contrast, high pay packages, or changes to pay plans, rarely make it to the front pages of even the business papers, nor are they often subject of government inquiry.

There are also several differences among countries in how compensation is conceived and how it is managed. For example, one UK compensation committee chair told us that they sometimes observe a conflation between compensation for the CEO, along with other top executives, and compensation for the entire organization. This can create problems: Treat everyone equally, and goals may be too strict, and the very people who should be incentivized the most end up with little to show for their effort. On the other hand, a US compensation committee chair we spoke with had little difficulty treating the CEO's pay differently.

A continuing debate in an environment of crisis

The debate about executive pay in the middle of a global pandemic was always likely to be a contentious one. The issue brings to the foreground questions of fairness, alignment with stakeholders, and the responsibility companies have to the broader society during a time like this—not to mention fundamental questions about what CEOs can and cannot control, irrespective of the effort put into it.

It is apparent that the tenor of the debate between executives on one end and boards and investors on the other has changed. Whether because of the peculiar nature of this crisis (broadly "human" vs. narrowly "economic") or because of the past two decades' secular evolution of the underlying societal paradigm to an increasingly nuanced version of capitalism, the bargaining dynamics seem different. On the surface at least, and possibly at a deeper level, an increasing number of CEOs seem willing to acknowledge the link between their social responsibilities as leaders and the implications of that link for their compensation. But despite these new and emerging dynamics—given how greatly the virus has touched and will continue to impact businesses for the foreseeable future—for CEOs, compensation committees, and investors alike, the next few months are likely to be as bumpy as the last.



Endnotes

1. Four CEOs, three compensation committee chairs (serving on six boards in the United States, the United Kingdom, and Europe), and four investors in the United States, Canada, and the United Kingdom.
2. ICGN, "COVID-19 and capital allocation," April 2020. Note that Dan Konigsburg, one of the authors, serves on the Board of Governors of the ICGN.
3. Recent reporting has indicated that for many CEOs, however, such cuts to base pay reflected a very small change to overall pay packages for the year, in some cases as little as 10%. See: Peter Eavis, "As the pandemic forced layoffs, C.E.O.s gave up little," *The New York Times*, July 29, 2020.

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