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Executive pay: time for change ?

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A highly standardized process leads to yearly executive pay packages which combine salary, bonuses, stock options, restricted stock grants, performance share units, retirement benefits. The full assemblage will also include formal contracts covering change-of-control situations, termination conditions, etc. Only the quanta of the compensation package vary from firm to firm. Whenever “long-term” performance objectives are set to earn the variable compensation, “total shareholder return” (TSR) is the metric of choice (for 70% of TSX 60 companies in 2015).

It now takes some 34 pages on average to explain executive compensation. In 2000, it took all of 6 pages to describe executive compensation!

How much is our CEO worth? Well, let’s see what other CEOs of “comparable” companies are paid. Reasonable approach? Actually, no. Assembling a large number of companies from different industries, some US, some Canadian, and setting a particular CEO’s compensation at the median or the 75th percentile of these “comparable” companies’ CEOs is a recipe for ever-rising compensation. The unstated assumption, a dubious one, is that any of these “comparable” companies would recruit the CEO if he/she were not paid adequately.

Then this “competitively” set compensation is largely “at risk” so as to motivate the achievement of high performances. Right. Not really. Performance measures are set by management (or largely influenced by them) and include a broad interval giving access, commonly, to 75% to 150% of the bonus or performance shares (never or rarely 0%). Furthermore, shares have now largely replaced stock options. These shares have value even if the stock price goes down (which is not the case for stock options). Stock prices depend on many uncontrollable factors, which mean luck, good or bad, will play a significant role; actually, good luck pushes up the value of the package; bad luck pushes stock price down but the practice of yearly grant of stock options and shares will average out the effect of “bad luck”.

The compensation package, thus set, does not really please investors but they do not know what else could be done. Proxy advisory agencies, actually the fomenters of this standardized approach, will be favorable to the compensation levels if set according to their diktats. Say-on-pay voting will overwhelmingly support the pay package and the manner of its setting. (In 2016, only four companies of the TSX 60 received 20% or more of negative votes)

The ritualized process described here is indeed reassuring by virtue of the large number of firms abiding by it, but it fails to take into account the very particular character of each corporation, the specific nature of its industry, the time horizon of its strategy implementation, the drivers of its value-creation. It is prudent for a board to comply with the approach described above; any deviation risks incurring disfavor with proxy advisors, an influential lot in this matter.

Boards of directors of large publicly listed corporations are keenly aware of the limitations of the current standardized methods of setting executive pay. But it is very difficult and hazardous for any particular board to deviate from the standard approach. *Board chairs of the TSX 60 companies should get together and agree on a different way of setting compensation*. A common approach adopted by a large number of TSX 60 companies would be very effective in standing up to proxy advisors and moving forward on this seemingly intractable issue. Otherwise, this festering compensation sore will continue to erode their legitimacy and credibility with investors and the general population.

From an IGOPP policy paper ***Executive Compensation: Cutting the Gordian Knot*** *published in November 2017. Available at www.igopp.org.*