Beyond Pay: Compensation Committees And Human Capital

by Ryan Resch and Ruby Tewani

As boards grow more active and involved in their companies, the scope of their responsibilities is also expanding. Compensation committees are at the leading edge of this evolution, growing beyond their traditional top executive paysetting role to take on talent development, company culture, and how well the firm is meeting its human capital responsibilities.

Today, environmental, social and governance (ESG) issues, and more specifically human capital (a key part of the "S") are under increasing scrutiny. This heightened attention is well deserved. Companies with strong ESG practices deliver more sustainable returns, including higher levels of value creation and lower risk.

There are several drivers of this evolution (some might even call it a "revolution"). These include shareholder activism on ESG, a greater watchfulness among institutional investors, legislative and regulatory changes in many global jurisdictions, and the groundbreaking Business Roundtable statement shifting primacy from shareholders to a commitment to all stakeholders. Customers, employees, communities, suppliers and others are all pressuring companies to demonstrate strong ESG practices.

Board members face compelling new questions and the need to thoughtfully consider how these changes will alter their role. They are also challenged to action by taking critical steps.

Each element of ESG bonds a company to different and indispensable communities with unique sustainability-related issues. Environmental, for instance, ties corporate goals and vision to the physical world, the challenge of good stewardship and the use of the world's natural resources with a focus on a company's carbon footprint.

Social reinforces the importance of how a company respects and manages its own work force in a way that draws and energizes talent. Not only is the power of "S" critically important to talent attraction and retention, but it also engages institutional investors, who recognize the solid business reasons for pursuing sound human capital management (HCM) practices.

Governance ties to the regulatory community as an opportunity to strengthen the company rather than simple check-box compliance.

The need for broader disclosure of human capital is likely to continue given that a number of ESG frameworks require disclosure of various metrics.

While ESG started as a way for investors to practice socially conscious beliefs when they invested, it has now gained traction with the broader investment community to embrace the practice, given the solid business reasons.

Institutional investors usually align their approach to ESG with their investment strategies. "Active" investors, with specific views on organizational strategy and operations, typically file shareholder proposals to get public companies to disclose information on topics such as workforce diversity and pay equity.

"Passive" investors use ESG to support sustainable value creation over the very long term, and stronger performance supports their asset management businesses. For instance, BlackRock's investment stewardship priorities focus on HCM while State Street links culture (an intangible value driver) and strategy.

Proxy advisory firms, Institutional Shareholder Services and Glass Lewis, are starting to address HCM with an initial focus on board diversity. Both firms

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will generally recommend voting against nominating committee chairs (and potentially other directors) at companies with no female directors. Glass Lewis has gone further to specifically address California legislation on board gender diversity.

For the 2020 proxy season, if a company headquartered in California does not have at least one woman on its board, Glass Lewis will generally recommend voting against the nominating committee chair unless the company discloses a clear plan to address this issue.

The Securities and Exchange Commission's investor advisory committee has outlined the need for HCM disclosures to better address the inherent value of human capital. This was seen as an imperative given the lack of disclosure on human capital practices and the increasing importance of human capital to a company's financial performance and market value.

What must be disclosed is debated, but the need for broader disclosure of human capital is likely to continue given that a number of ESG frameworks require disclosure of various metrics across a number of different human capital dimensions. These include the International Organization for Standardization, Embankment Project of Inclusive Capitalism and the World Economic Forum.

The reach of these issues extends beyond investors, as the Business Roundtable's pronouncement suggests. In fact, the consideration of all stakeholder interests to ensure business success is not a new concept. Key stakeholders, including employees and customers, have increasingly advocated for change within companies and sought more sustainable business practices that are in the best interest of all stakeholders and their communities.

The number of human capital proxy proposals in 2018 and 2019 increased year over year relative to the total number of shareholder proposals filed.

Transparency and accountability are commonly advocated themes that directly impact how board members provide oversight. The heightened focus on ESG and human capital places reputational risk squarely in the category of legitimate business risk.

Shareholder proposals for 2018 and 2019 demonstrate market focus on ESG issues, specifically as they relate to human capital governance. Willis Towers Watson analyzed shareholder proposals filed in 2018 and 2019 for Russell 3000 companies. The number of human capital governance proposals (i.e. board diversity, workforce diversity and pay disparity) increased year over year in absolute numbers, as well as relative to the total number of shareholder proposals filed. Some of these proposals have been challenged by issuers, but the SEC has rejected these challenges, allowing the proposals to go to vote.

Among these proposals is a call to report on board diversity. While the issuer (or company) is primarily responsible for responding, nominating and governance committee members are also impacted as they make their recommendations on board refreshment.

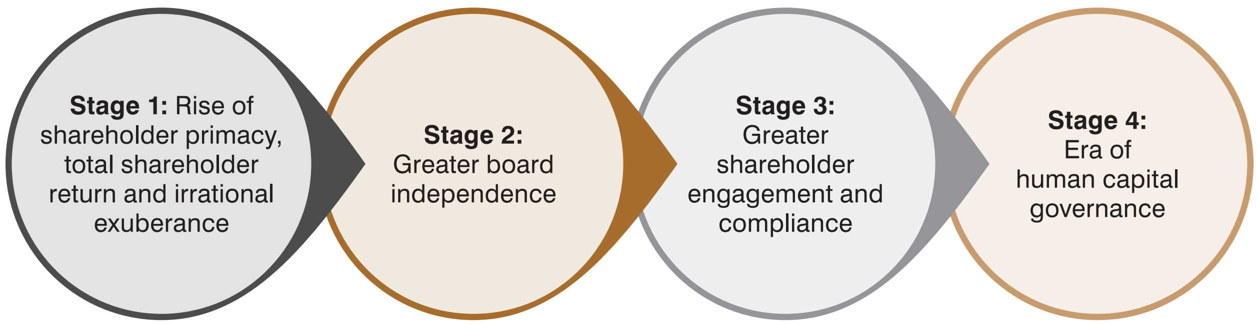
Also rising is the number of shareholder proposals on environmental issues such as carbon footprint, plastic pellet spills and sustainability reports including greenhouse gas emissions. Again, while the responsibility for responding to these lies with the issuer, it raises concerns for board members who have a fiduciary responsibility to shareholders on managing business risk, reputational risk and oversight of business operations.

Over the last 40 years, we find four distinct stages in corporate governance evolution which align with the board's role overseeing executive compensation.

How are these factors changing governance? If we look back at corporate governance's historical arc of change over the last 40 years, we find four distinct stages in this evolution which align with the board's role in overseeing executive compensation. Greater scrutiny and complexity in the design and execution of executive pay programs have resulted. These challenges are not disappearing, but the board's role is broadening to examine human capital more broadly throughout the organization.

Evolution Of Boards And Human Capital

Four Stages For Compensation Committees



☐ ***Stage One: Rise of shareholder primacy, total shareholder return and irrational exuberance.*** In the late 1980s and 1990s, there was an increased focus on creating shareholder value and driving total shareholder return. Leveraged and management buyouts elevated the role of the manager, and helped owners transform companies and unleash shareholder value. With strong academic backing, boards decided they needed to more directly align the interests of senior management with shareholders, and this was done through increasing levels of stock and stock options.

At this time, boards were still dominated by the CEO and management, but the focus shifted significantly to the interests of shareholders, and that interest was often fairly short term. The composition of boards was still largely homogenous, including the current and former CEOs, and with the CEO chairing the board and all committees.

This stage peaked and crashed in 2001 to 2002 with the Enron and WorldCom debacles and the bursting of the dot-com tech bubble. At this point, many people in many countries started to see the need for better corporate oversight and more independent governance.

☐ ***Stage Two: Era of increasing independence.*** Perhaps the most significant change in U.S. governance came about as a result of the Sarbanes-Oxley Act in 2002. This sweeping legislation required, among many other things, that boards of public companies be vastly more independent. The CEO became the only executive on the board. No longer could the CEO chair or even be a member of the compensation, audit or nominating and governance committees.

Compensation committees now had the ability to make decisions independent of the CEO and management. They could hire their own advisors without having to go through management.

The composition of boards gradually began to change and include younger board members from more diverse backgrounds, particularly financial expertise. Boards became more data oriented and asked tougher questions about company performance and its alignment with pay. They also became smaller and more independent, and accountability—along with the commensurate risk—increased.

Committees and management became much more transparent, communicating far more with shareholders.

☐ ***Stage Three: Era of compliance and shareholder engagement.*** The regulation of governance and especially executive pay has increased, and the role of the compensation committee has become more prescribed and compliance-oriented. The Dodd-Frank Act created the say-on-pay vote. This made the compensation committee focus on plans that align with market and perceived shareholder interests in order to secure a higher say-on-pay vote result. Proxy advisors gained in prominence and through black-box rating methods encouraged companies to adopt pay programs that aligned with their perceived best practices.

At the same time, committees and management became much more transparent, communicating far more with shareholders, both through direct outreach and through better written proxy statements and other communications. Most companies made a serious effort to engage directly with their major shareholders.

Shareholders went from an amorphous body of millions of ever-changing individuals, to a handful of powerful players with ownership positions that require the serious attention of the board and management. This included large index and institutional investors (such as BlackRock, Vanguard and State Street) and more activist shareholders that advocate for corporate change, ranging from specific areas of interest to broader corporate performance and structure.

Board diversity continued to increase with greater female representation and broader skills sought to provide balance and expertise in specific areas of the business.

Compensation committees will now need to review human capital outcomes similar to the way an audit committee reviews financial statements.

☐ ***Stage Four—Era of human capital governance.*** We believe that we are on the cusp of the next era in corporate governance. Boards will be pushed to consider multiple stakeholder interests (beyond shareholders) to address the growing importance of sustainability and the various stakeholders that are impacted by the company.

They will likely be asked to better articulate their social purpose and long-term value proposition so that they can better adapt to rapid changes in risk mitigation and valuation. This includes a greater focus on overseeing human capital throughout the company similar to how companies oversee and value financial capital.

The compensation committee will need to review human capital outcomes through a statement of human capital metrics, with supplemental notes on top issues and drivers behind the metrics. This is akin to the way an audit committee reviews financial statements which include the outcomes of financial performance, along with details on the various drivers that contributed to financial results.

There may be some tension between boards and management similar to when boards took greater responsibility for reviewing financial performance. However, this can be a productive discussion to articulate human resource strategies and their effectiveness while ensuring that management remains responsible for the development and execution of the strategy, and the board oversees and asks the right questions.

As with prior changes in the board's role, this set of changes will require adaptation, new data, processes, different decisions and decision rights, and possibly different skills. Yet boards have adapted to major change in the past and with good planning can adapt to these changes as well. As with many prior changes, we believe the net result will be an improvement in the quality and effectiveness of board oversight and company performance.

Board compensation committees must satisfy top-down scrutiny by investors as well as bottom-up pressures from their workforces.

What can compensation committees do differently? Companies today face both top-down scrutiny by investors and bottom-up pressures from their workforces. Their compensation committees are pivotal to satisfying both these constituencies. It is imperative that management and boards assess whether their companies are creating well-considered policies that reflect a commitment to issues like fair pay and diversity, and also how they rate against peers.

These policies are critical to sustainable human capital and to succession plans that help make sustainable value creation more likely. Companies also need to think about the value of human capital and how it should be managed in terms of value creation and risk mitigation, similar to how physical and financial capital is managed. So, as companies take more responsibility for their entire workforces, their boards, through their compensation committees, should take these steps:

☐ ***Step 1: Strategy.*** Compensation committees need to clearly understand the organization's talent and human capital strategies and how they align with the broader business strategy. As the pace of change intensifies, these strategies need to be forward-oriented. They must reflect real-time changes in how work gets done and how human capital programs will need to evolve so that companies can actively manage these changes.

Truly effective strategies need to consider the company's current and desired cultures, and how underlying behaviors, motivations and actions could affect the successful execution of the strategy. They also need to reflect how the impact of broader stakeholder considerations and the interplay among stakeholders are being addressed, including the company's human capital strategies.

This process can clarify the specific human capital practices and programs that need to be better understood, and more importantly, how it may shift human capital and the organization's long-term value creation.

Research suggests that the value of intangible assets (human capital primary among them) has increased five-fold over the past 40 years, and represents most of a company's market value. While two companies may have similar plants and equipment, the difference in value creation will more than likely be due to how human capital is being used to drive higher returns with less risk.

Expanded human capital oversight must become a regular, institutionalized part of the board's responsibilities.

☐ ***Step 2: Governance.*** Many compensation committees operate through generic charter statements about human resource philosophy or oversight. These statements will need to be expanded with specific charges if committees are to take a meaningful, comprehensive approach to human capital management that oversees the interests of the entire workforce and not just leadership and senior management.

A change to the compensation committee charter needs to be proposed to the full board. This reassessment should include revised decision rights, and define new reports, data and discussions from management. All of this needs to be built into the committee calendar to schedule reviews over the course of the year. In this way, expanded oversight becomes a regular, institutionalized part of the board's responsibilities.

It will be important to maintain the right balance between board oversight and management's responsibility for the development, design and execution of its human capital programs. While there is general agreement that the compensation committee should have broader oversight, this balance must be carefully managed to ensure that both parties are working in the company's best interests.

Willis Towers Watson research has found 50 percent of S&P 100 compensation committees have names that indicate expanded responsibilities, and that 10 percent changed those names within the past 10 years. The most common names include succession planning/talent, leadership development and human resources/people. Of these committees, the additional roles include succession planning, evaluation of compensation risk, broad-based pay and benefit programs, diversity/inclusion and culture/engagement.

☐ ***Step 3: Monitoring.*** Companies will need to tell a compelling story that explains actions and plans and reflects positive outcomes across a variety of human capital programs and practices. Regular, data-driven, compensation committee reviews should measure the progress of HCM. Show the connection to improved performance and the overall health of the company for significant, sustainable change to occur. We see committees looking at human capital in a similar way to how boards already review and assess financial capital. This will be more data-driven, analytical and long-term focused.

As an example, companies are likely to develop high quality HCM dashboards. These should pro-

The Human Factor

Core Human Capital Metrics

Labor profile	Total rewards	Attraction & retention	Productivity	Well-being	Culture
Diversity (gender and other)	**Gender/fair pay ratios**	**Turnover** (including high performers and high potentials)	**Training and development** (costs and hours)	**Financial**	**Employee experience and engagement**
Employment mode (e.g. full-time, part-time, contractors)	**Pay and benefits by level**	**Acceptance and time to fill rates**	**Labor cost/performance & alignment with individual performance**	**Social**	**Leadership effectiveness and alignment**
Skill availability (including critical skill employees)	**Competitive programs**	**Tenure, time in role, and promotion rates**	**Employee health and safety**	**Emotional**	**Human capital risk** (e.g., workforce policies)
				Physical	

vide the board with a quick view on the company's labor profile, total rewards programs, attraction and retention, productivity, wellbeing and culture. One example is shown above.

☐ ***Step 4: Reporting.*** There will need to be a discussion about accountability, and how an expanded role will affect what is reported to the full board, employees, shareholders and the public. For example, as the compensation committee tries to establish both its own diversity story and the broader company narrative, members need to use data provided by management to understand if diversity demographics are improving and what kinds of people, skills and backgrounds will ensure a broad approach to business challenges and opportunities.

There will also need to be a discussion on changes that need to be made to external disclosure reports, including respective legal considerations. The board might also want to rethink its shareholder engagement strategy to more proactively tell the company story.

What is next? If these critical steps are taken, compensation committees will evolve into a greater role in overseeing the employee engagement, culture talent management and development processes of the organization. This will support greater diversity, deeper bench strength and competitive program designs. The committee will support sustainable value creation through optimized human capital, which contributes to the sustainable, long-term growth demanded by institutional investors. ■

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