Pay for Results

Aligning Executive Compensation with Business Performance

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The corporate governance environment is changing dramatically. Shareholders are demanding that pay be commensurate with outcomes, in a way that is transparent and tangible. In many countries including US, UK, Canada, Hong Kong and Australia, the disclosure rules for publicly traded companies require that performance measures be disclosed in most cases and that companies explain how their pay programs relate to organizational performance. The market has continued to focus on this issue, prompted in part by the global economic crisis and the excesses in some companies and geographies. Whilst Asia has generally avoided the excesses, the focus on executive pay governance is happening globally.

In our previous article, we focused on the roles Shareholders, Directors and Management should have on designing and implementing Long-Term compensation plans for their Executives. We ended that article on the notion that the right Performance Metrics are the key to successfully implementing responsible Executive Pay. The present article focuses on how to achieve this.

Performance Measurement As The Key To Good Governance

There are many factors that influence how smoothly the system of governance functions in an organization. You must have clarity of roles and effective division of labor. There must be an appropriate investment of time and resources and a well - rounded and flexible process for decision making. Directors and executives must exhibit leadership, while at the same time be able to work as team members when collaboration is called for. They must also possess deep knowledge of the business and have a thorough understanding of the factors influencing the market in which they operate. When it comes to executive remuneration governance, all of these things are important, but a solid performance measurement system is, perhaps, the single strongest determinant of whether or not stakeholder interests will be met.

Performance measurement serves as the basis on which decisions are made and judged and provides a common language for communicating the goals of the organization so as to align everyone behind shared objectives. This helps position the company for long-term, sustainable value creation; not surprisingly, high performing companies tend to have fewer problems in the governance arena.

Performance measurement is important to shareholders, directors, and executives alike. Each of these stakeholders has different priorities when it comes to monitoring and rewarding results, and the most effective measurement systems will be responsive to a wide range of interests (See below).

What Investors, The Board And Management Want

- Alignment with the particular business strategy and other organizational processes (no cookie-cutter metrics).
- Strong line of sight to individual behavior.
- Reasonable, defensible pay and performance outcomes.
- Simplicity and ease of communication.
- Motivational goals that contain the right amount of "stretch."
- Flexibility to address both retention and measurement challenges as they arise.
- Meaningful and fair calibration between results and payouts (no free rides).
- Direct linkage to shareholder value creation.
- Appropriate management of risks
- Clear and transparent disclosure of performance standards and compensation decisions.

When it comes to Executive Compensation, the goal of compensation committees, senior leaders, and human resources professionals is to develop a balanced and defensible approach to performance measurement — one that fairly and accurately captures results so that companies can more confidently reward executive contributions.

Change Is In The Air

Besides the shifting governance paradigm, there have been many other developments that have shaped the executive remuneration environment over the past decade. While these vary from region to region, they encompass such things as converging accounting practices, enhanced disclosure, heightened attention on executive perquisites, benefits, and severance arrangements and, lately, increased regulatory interest.

New executive compensation disclosure rules abroad, as well as likely here in the country, will continue to put the spotlight on pay and performance alignment, equity and pension values, and termination and change-of-control benefits. In addition, the continued say-on-pay activism we've seen in Australia, the UK and other countries may impact board decision-making processes and compensation program design. Even non-binding votes on executive pay in other jurisdictions has increased transparency and allowed shareholders to express their views, while leaving final decision making in the hands of the board.

The impact of these changes has been widespread. While trends have played out differently in different regions, some common themes have emerged:

- Increased focus on variable remuneration.
- Shift from stock options to full value shares.
- Greater use of performance-based equity.
- Elimination of egregious perquisites and benefits.
- Imposed limits on non-performance based pay, including severance and change-in-control benefits, supplemental executive retirement, and deferred compensation.
- Greater diversity in remuneration packages.
- Dual performance hurdles for long-term incentives are becoming more common (e.g., relative TSR coupled with strategic goals in areas like customer service and risk management).

These developments are moving executive remuneration practices in the right direction. Around the globe companies are taking a more comprehensive approach to executive remuneration design and making strides to improve the link between pay and performance. From increasing the use of variable pay to attaching performance conditions to long-term incentives, executive remuneration programs are becoming more balanced and more responsible.

To get a better sense for how these trends are playing out in the marketplace, let us review current practices in mature and developing markets, and contrast that with what we typically see in Singapore.

Pay Mix

In mature markets, executive remuneration is delivered primarily through variable pay. This means a significant portion of the remuneration opportunity is at risk and is contingent upon achieving positive performance results. Both short - term incentives (typically an annual cash bonus plan) and long-term incentives (generally some form of equity) are prevalent in the market place, with a greater emphasis on long-term remuneration at most organizations (particularly in the US, the UK, Canada and Australia where companies continue to rely heavily on equity - based remuneration).

Companies in developing countries, such as those in Latin America and some in Asia, tend to rely more heavily on fixed remuneration, such as base salary and executive benefits, although the use of both cash and equity incentives continues to grow. Singapore tends to follow this latter model, where base pay typically makes up 60-70 % of top Executive pay, although the larger companies are likely to have base pay at 50% or less.

Short - Term Incentive Remuneration

Short - term incentives are highly leveraged in mature markets. In the United States, annual executive bonus opportunities typically range from 50 to 200 percent of salary, sometimes reaching upward of 300 percent of base salary at maximum. In the United Kingdom and other mature markets, maximum annual bonus levels have traditionally been lower but are now trending upward. Short - term bonuses are also relatively common in emerging markets. However, such opportunities typically represent a smaller portion of the total pay package. Economic uncertainty or high inflation in these regions can make it difficult to set goals even one year out, so shorter performance periods (quarterly, semiannual) are sometimes used. In Singapore, most of the bonus schemes pay out on an annual basis and represent around on average 3-4 months of top management's pay, ranging up to 7-12 months of pay for exceptional performance. Across Asia there is evidence of increasing target levels of bonus.

There is significant variety in short-term performance measurement practices from company to company in Singapore, but some common themes emerge:

- Profitability metrics are the most common measures of short-term performance in the country, as well as around the world.
- Most companies use more than one metric to measure performance in their annual incentive plans. Most companies include individual achievement against KPI's and many use some degree of discretion in assigning bonus payout amounts.
- Strategic objectives are sometimes, but not always, used in combination with financial metrics.
- Measuring results against absolute goals is more common than relative performance measurement.

Long - Term Incentive Remuneration

The use of multiple equity vehicles to deliver long-term incentive remuneration has become commonplace in mature markets, although the long - term incentive mix varies by region. For example, time-vested stock options continue to be prevalent in the US and Canada, but are declining in use in the UK and Australia, despite a recent uptick in ESOS usage driven by current low share prices. In Singapore, it is not common to see more than one plan in any given company, and many plans currently follow a plain-vanilla retention based approach.

A portfolio style approach is beneficial to both executives and shareholders because it adds balance to the overall remuneration program design and increases the likelihood that remuneration outcomes will be fair and reasonable in light of performance. Long-term performance measurement practices also tend to fall along regional lines. Companies in North America have significant flexibility in designing long-term incentive programs, and metrics include everything from revenue to economic profit to share price goals. In the United Kingdom and Australia, there is more consistency in practice as a result of institutional shareholder guidance. Companies in these regions tend to vest performance shares or options based on the achievement of earnings per share goals or relative total shareholder return measured against industry peers. The use of long-term incentives has been much less prevalent in emerging markets. In some countries in Asia regulatory restrictions or other implications make it difficult to implement equity programs. In other regions, market volatility has hindered the motivational value of equity, while unstable economic conditions have historically made long-term goal setting a challenge. In Singapore, as mentioned earlier, the trend has been to use Options with early progressive vesting and no performance

criteria attached. The tides are turning, however, and a growing number of companies in the region are looking to add a performance based long-term component to the total executive remuneration package, following the example of large, local companies. Singapore has tended to be a leader in the use of a performance condition where restricted share plans are adopted.

The Verdict

How successful have the design changes outlined here been in improving the link between pay and results? Research on the relationship between pay and performance among large and mid size companies in the United States suggests that there continues to be room for improvement. Overall, year-over-year changes in total direct remuneration (base salary plus actual bonus payouts plus expected long-term incentive values) appear to be reasonably well aligned with performance. However, remuneration levels were up for more than half of the "bottom" performers, suggesting that companies could better balance upside opportunity with more meaningful downside risk. The bottom line is that companies are on the right track, but in order for programmatic changes — like adopting performance-based equity — to really enhance the pay for performance relationship, companies need to get performance measurement right.

Bringing Defensibility To Executive Remuneration

Without a sound performance measurement system, it is impossible to assess the reasonableness of executive remuneration programs and payouts. You must know whether or not the company is creating shareholder value and the degree to which that value creation (or destruction) can be attributed to executive performance.

The objective is to bring your measurement practices and, by extension, your executive remuneration programs to a new level.

To develop sound Performance Metrics Remuneration Committees need to focus on the following:

- Abandon the guesswork and start making informed decisions based on solid research, in-depth quantitative analysis, and intelligent discussion.
- Review the potentially weak link between compensation and performance due to heavy reliance on base pay. Scarce use of equity or other long-term incentives focuses management resources on short-term, rather than long-term results.
- top working backward by agreeing on a definition of value for your organization up front — and then identifying those factors that have the greatest impact on its creation.
- Use the business strategy as the basis for selecting performance metrics, rather than relying heavily on what competitors or analysts tell you to measure.
- se both internal planning and external trends and economic data to set performance targets that will motivate your executive team to shine — and let your shareholders sleep at night.
- Test the relationship between award and performance levels thoroughly to make sure that pay outcomes will be reasonable under all performance scenarios — both strong and weak.
- Make your measurement system a high -impact one by anticipating problems before they happen and investing the necessary time and resources in implementation.
- Greater focus on succession planning and leadership development is likely, as it is becoming imperative to develop executive talent from within. Measuring this risk is a key role for the Boards of Asian Companies. Balancing paying for performance with the need to attract and retain top-flight talent continues to be a challenge in light of increased scrutiny.

Change is in the air, and companies must meet the challenge of performance measurement head-on to ensure that their remuneration programs are reasonable and defensible to all stakeholders. Further disclosure and regulation of executive pay are being discussed but would result in additional complexities and constraints on boards' ability to set remuneration policy in line with company structure and business strategy.

When times are good, it is less critical to have a perfect measurement system, but during more volatile times, the stakes are bigger and given recent moves to regulate markets and give shareholders an even stronger voice, companies simply cannot afford to be wrong. Directors and management need to partner together to make pay for performance a reality before shareholders take matters into their own hands. ■