THE BUSINESS TIMES BTINVEST

Published on Monday, 11 December 2017

SID SINGAPORE INSTITUTE OF DIRECTORS | BOARDROOM MATTERS

Has Pay-For-Performance Differentiation Worked?

By Shai Ganu

Conventional executive compensation models are built on certain universally accepted principles. For example, a large portion of pay should be at risk, leveraged incentives drive executives to perform better; and performance-based long-term incentives (LTI) help retain key talent.

While these pay-for-performance principles are quite robust and defensible to shareholders, we should ask if they have achieved the desired objectives of driving performance and productivity improvements, differentiating reward outcomes amongst executives, and motivating and retaining key executives.

Are we paying more for less?

Pay-for-performance models should, theoretically, result in improved performance over time. Yet macro data in Singapore seems to suggest otherwise.

Over the past five years, employee wages have increased by more than 20 per cent. However, productivity measures, such as return on equity, return on capital, profit per employee, saw a considerable decrease.

According to analysis conducted by Willis Towers Watson, for the top 70 SGX listed companies, fixed pay levels for CEOs and senior executives have, on average, increased by approximately two per cent each year; yet total compensation levels have stayed generally flat over the past five years.

One could argue that, in this regard, the pay-for-performance model has served its purpose – variable pay levels have decreased commensurate to muted financial performance. However, notwithstanding the tougher market conditions, the model seems to have failed the test of productivity: we are paying executives the same, or more, for lower returns.

Is variable pay truly variable?

Another expectation from pay-for-performance models is that they should significantly differentiate compensation outcomes between executives.

However, the analysis of the 70 SGX listed companies shows that, among executives within the same job grade (or same job size), total compensation varies only by eight to 10 per cent.

Although the practice is gradually changing, companies conventionally have awarded: common inflation-linked fixed pay increases to all executives; LTI compensation within a narrow range for each job grade; and economic-profit sharing percentages that are fixed by job grades, where applicable.

The only reward element subject to individual differentiation has been the annual performance bonus, which is linked to individual executives' balanced scorecards.

However, among the larger companies, the annual bonus constitutes less than 10 per cent of total compensation. Executive roles are quite complex and they are often responsible for leading and aggregating teams' performances. Consequently, companies do not find it easy to attribute company successes or failures to individual executive's actions.

Executive motivation: convention versus perception

Conventional models suggest that leveraged incentive plans (i.e. the carrot and stick) motivate executives to perform better, and to work harder. This also implies that executives are driven by high risk-high reward outcomes.

However, research based on approximately 200 directors and executives in Singapore revealed that their perceptions of current compensation were quite the contrary.

When asked to choose between receiving $1 million today, or receiving a guaranteed pay-out of $1.5 million after 24 months, nearly two-thirds chose the

$1 million today. While this was not the economically rational option, it suggests that executives discount heavily for time.

Similarly, when asked to choose between a guaranteed bonus of $1.2 million and a 50 per cent probability of receiving a $3 million bonus, four out of five opted for the guaranteed bonus even though its economic value was lower. This suggests that executives may actually prefer low-risk options even if they yield low reward.

Finally, when asked what motivates them to perform their best, doing meaningful work, building a successful team, and leaving a legacy were far more important drivers than compensation and incentives.

Strengthening pay-for-performance

In order to strengthen the link between pay and performance, the board should first define which performance measures matter.

Progressive boards are implementing executive scorecards with fewer, yet individually-oriented, performance measures. Company performance determines the size of the bonus pool, but each person's individual performance determines his/her pay-outs.

This requires a change in mindset to move away from egalitarian bonus distributions, to truly differentiated outcomes. For example, top performing executives may get double the bonus of average performers.

In addition to annual bonuses, any fixed pay increases, profit sharing rates, or LTI awards should also be linked to individual performances. Some remuneration committees have also introduced additional multipliers – to dial up or down incentive outcomes – based on qualitative assessments by the board of each executive's contribution.

When applied appropriately, these enhancements to compensation models could result in 20 to 25 per cent differentiation in total compensation.

Boards should also recognise that different reward elements serve different purposes. For example, if the main purpose of an LTI plan is to retain executives, then companies could consider time-based restricted shares, or restricted shares linked to operational measures. If the LTI is intended to drive future performance, then companies could link LTI award values to leadership attributes and the assessment of each executive's potential.

Successful executive compensation models must balance the economic arguments and pay-for-performance principles with executives' emotional responses and perceptions regarding compensation. Only such balanced programmes will help attract, retain, and motivate top talent.

Shai Ganu is a member of the Professional Development Committee of the Singapore Institute of Directors.