PAY FOR RESULTS:

The Changing Roles Of Boards And Company Executives In Pay Decisions

Fermin Diez, Worldwide Partner & Lee Voon Keong, Consultant
Mercer (Singapore) Pte Ltd

Overview

Aligning pay with performance is no longer just important, it is now essential to a responsible executive remuneration program. Companies where pay appears disconnected from results are roundly denounced and their directors find themselves subject to withhold or no vote campaigns in, for example, the United States, or to removal in the United Kingdom and other countries that give shareholders such a right. Decision makers, whether board members or CEOs may find themselves ousted over failing to align pay with results. In Singapore, the regulations have not reached these levels, but it is possible that we will follow the lead from other countries.

Compensation should be focused on results, rather than performance. This isn't just semantics; we want to emphasize that while you can get a pat on the back for effort (which many equate with performance), you should get paid for delivering results – results that over the long term deliver increased value to shareholders and are evaluated in the context of the market and the company's business strategy.

Paying for results necessarily means that a one size remuneration strategy will not fit all. Designing short - or long - term incentive plans to align with results has to be customized to the specific organization, whether corporate entity, business unit or a division. Too often we see companies migrating to "plain vanilla" measures such as total shareholder return or earnings per share. These are end measures, they do not reflect the drivers of long-term value nor do they communicate to participants the company's strategic or tactical priorities. As a result, we believe that boards or executives were not adequately linking reward outcomes to sustainable performance results.

Executive Remuneration Governance

The corporate governance paradigm is shifting dramatically when it comes to executive remuneration. In the past, investors had an insufficient voice in what or how executives were paid. In reality, if shareholders were unhappy with executive pay, they had little recourse other than to sell their shares in the company.

Boards of directors did not have much influence either. The stability of boards often led to a strong sense of trust and comfort with the company's management team and the compensation programs used to reward their contributions. Pay recommendations put forth annually by management would be reviewed for reasonableness and approved by the compensation committee of the board with little independent review of such matters as the peer companies used to evaluate the competitiveness of pay or the inputs used to calibrate performance targets, to the extent targets were even used.

Management tended to take the lead in recommending pay increases, negotiating new employee contracts, and designing new incentive programs. Human resources would collect and analyze benchmark data from published surveys or the proxy statements of peers to assess the competitiveness of the current pay program and develop recommendations for the upcoming year. Finance would be responsible for identifying the performance measures that would fund incentive programs and for calibrating awards with various performance levels based on the internal budget. The bulk of the work was performed in advance of the compensation committee meeting with little direct involvement from directors. As a result, the board's blessing was often viewed as a necessary formality.

The picture today is strikingly different. Investors around the globe want significant influence and clamor for more say over executive pay matters. Boards face increased scrutiny from shareholders, the media, and regulators as they struggle to balance the interests of investors and management. Management will be asked to take a back seat in a process they previously led, and are gradually redefining their role as one of collaboration and consultation.

Investor Role

Governance developments vary by region, but we are experiencing a definite increase in shareholder influence on executive remuneration issues from Europe to North America to Asia Pacific and beyond. There is little doubt this trend will continue as shareholders react to the widespread share price declines that have resulted from the economic downturn, which in turn was partly caused by risky incentive programs.

Board Role

Stemming from a more activist shareholder base and heightened media attention, the board role is in the midst of transition. We are seeing a shift in the board's accountability from high-level oversight of the business – including executive remuneration matters – to independent review and verification of corporate strategy and more direct involvement in day-to-day decision making.

This increase in responsibility means a greater time commitment for compensation committee members. Committees are upping the number of times they meet each year and asking directors to spend larger amounts of time preparing for meetings, reviewing materials, or participating in preliminary discussions. Because the regulatory environment will more complex, directors will have to invest additional time in training on executive remuneration matters – both up-front (upon appointment to the committee) and ongoing, in order to keep up with the constantly changing rules and regulations. The role of the committee chair is also expanding to fill the need for greater collaboration with outside advisors, as well as with management.

Greater scrutiny of the board role (along with a few visible shareholder lawsuits following major corporate scandals abroad) has increased the perceived liability associated with the director position. This is pushing many boards to adopt a risk-management mentality in managing their fiduciary responsibilities. Directors must constantly weigh how their decisions impact the business and how they appear to shareholders. It is no longer simply a matter of showing that compensation levels are reasonable; boards today must be able to rationalize why the compensation package looks the way it does. They must defend why one equity vehicle was selected over another, explain how performance metrics support shareholder value creation, point out the specific inputs that went into the annual target setting process, and prove why selected peers are valid comparators for compensation benchmarking.

Boards have to balance the pressure on pay from shareholders with the need to attract and retain top executive talent. This has become harder than ever. Merger and acquisition activity as well as the expansion to global markets by local companies has resulted in larger and larger organizations, and few individuals have the skills and experience to run businesses of this size and scope.

Globalization is also having a profound affect on the ability of companies to attract and retain executive talent. Executives are increasingly willing to move across borders to greener pastures, so companies must often compete not only within their home country, but also against foreign competitors for talent. Meanwhile, firms expanding into new markets sometimes find it difficult to recruit executives in the local market because what is status quo to shareholders in the home country might not be competitive or attractive in other regions. For example, family-owned companies in Singapore which typically do not have a long-term incentive compensation component can find it difficult to recruit talent from the multinational companies, where long-term incentives are fairly common.

While some boards may welcome the growing power of shareholders over compensation matters as a counterpoint to management influence, there is no doubt that it makes the process more complex and sensitive. Given the range of interests that must be attended to, many boards may struggle to balance what shareholders want to see with the practical needs of the business.

Management Role

Mirroring the growing influence of shareholders, management control over executive remuneration programs has begun to decline. This is not to say that senior leaders will no longer have input into compensation decisions, but long gone are the days where executives called the shots. As boards respond to shareholder concerns by becoming more actively involved in both executive remuneration strategy and implementation, philosophical questions arise as to whether executive remuneration falls under the realm of management or is primarily a governance concern.

Where the pendulum will settle is difficult to predict. Many CEOs may find themselves playing "defense" when it comes to executive remuneration matters and be forced to invest greater amounts of time and resources into building the business case behind pay decisions. This development can be troubling to senior leadership because it is their responsibility to achieve positive business results, and they know more than anyone that the right executive talent can make or break a company's best efforts.

While executive talent can be one of the most important investments a company can make, the line between competitive and excessive remuneration can be a difficult one to walk — especially if remuneration decisions can be criticized as self-serving. In this regard, the additional pressure on management to demonstrate that compensation programs are reasonable and defensible should bring more accountability to the process.

However, executives must retain the flexibility to make timely decisions that are responsive to both internal and external developments impacting the company's talent strategy. Executives need the ability to respond quickly and decisively to retention concerns. Directors, who are not involved in day-to-day business operations, are usually not in the best position to spot emerging retention issues, and obviously this is information that shareholders would not be privy to until it is too late.

Another potential danger is the tendency to fall back on the status quo when designing incentive plans. Shareholders usually like simple, conventional approaches to incentive compensation because it allows them to more easily compare outcomes across companies. Widely accepted program designs often seem like a safer bet to directors as well, since they pose fewer challenges when it comes to shareholder communication than a customized plan that has been designed to reflect a company's unique business context. In fact, we have already seen this move to standardize programs take Singapore, the United Kingdom, and Australia, where institutional investors have pushed companies to link the vesting of long - term equity awards to performance as measured by just a few generic metrics — namely absolute total shareholder return, relative total shareholder return measured against peers or an index, or earnings per share.

Incentive compensation can be an invaluable tool for aligning executive efforts with the strategic priorities of the business. While an easily understood plan that allows for more direct comparisons against peers might be welcomed by shareholders, it can be problematic for the CEO who wants to rally his or her team behind a new revenue or return goal in support of the company's business strategy. Gains from streamlining the measurement and reward processes across companies must be balanced against the ability of companies to tailor measurement and reward processes to their specific needs.

Achieving The Right Balance Of Interests

The balance of power in the realm of executive remuneration matters is undergoing a historic shift away from management and toward shareholders. It will be interesting to witness the full consequences of this transition. Some correction of the power imbalance was clearly necessary and should lead to positive reforms, but, as with all transformations, we must be wary of unintended consequences.

Let us start with the positive. We can expect more dialogue with key investors (particularly the institutional shareholder base) as companies seek to incorporate their views and objectives into their governance and compensation policies and practices. We can also expect more collaborative executive remuneration programs, which reflect innovative practices drawing on investor input and experience and a greater focus on calibrated pay-for-performance plans and arrangements. Other likely developments include more transparent disclosure, the curbing of nonperformance-based executive benefits programs and large severance guarantees, and more meaningful performance conditions being attached to incentive compensation.

On the flip side, greater involvement on the part of shareholders could become a bureaucratic nightmare if not kept in check. Lengthy proxy battles over director nominees or executive remuneration matters can ensue, and may actually be counterproductive to the objective of shareholder value creation. Potential dissent in the boardroom could also increase the cost of governance and may hamper a company's ability to respond to developments quickly and nimbly. Under the worst-case scenario, governance headaches may usher in a new age of privatization, as companies look for ways to free up resources and streamline decision-making processes.

To maintain the right balance in control over executive remuneration matters, shareholders, directors, and management must have clearly delineated objectives, roles, and responsibilities:

- Shareholders must find the right balance between holding the board accountable and trying to seize control. They need to be vocal in demanding alignment between shareholder value and executive pay, but should avoid unnecessarily hamstringing the organization. For example, in the United Kingdom and Australia, shareholder activism has severely limited the flexibility companies have to design customized rewards programs and has led to an overreliance on cookie-cutter incentive plans that provide little connection to company-specific business strategy.
- The board must carefully balance shareholder concerns with the strategic and operating needs of the business. Directors must consistently demonstrate proper due diligence and exercise thoughtful and defensible decision-making. They must make a real commitment to clear and transparent disclosure and promote open lines of communication with both executives and shareholders.

  Boards also need to find the right balance between oversight and micromanagement when dealing with the executive team. They should independently verify incentive plan payouts, ask tough questions about plan design, and provide objective input and guidance on compensation matters based on their knowledge and experience. Yet, the board may not always be in the best position to spearhead design work or facilitate plan administration, and must be willing to turn over the reins to the executive team when it makes the most sense to do so.
- Management must find the right balance between ownership and collaboration. Executives have on-the-ground knowledge and should be actively involved in driving remuneration decisions, but they must also be open to independent review and critique. They must also exhibit a strong focus on shareholder interests by aligning executive remuneration programs with value creation and rewarding sustainable, long-term results instead of short-term spikes in performance.

Greater shareholder involvement will no doubt be a powerful force in shaping executive remuneration, but it is not a panacea. Remuneration continues to rise in countries where say-on-pay policies have been adopted because the fact remains that an effective management team is critical to business success and there are far too few talented executives to go around. Executive pay is an art, not a science, and it is impossible to agree upon a perfect definition. The best companies can do is to make reasonable decisions based on thorough analysis and meaningful collaboration among stakeholders. Performance measurement is the key to making this a reality. We will address this last point in an upcoming article. ■