

# Addressing Remuneration Matters As Set Forth In The New Code of Corporate Governance

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In today's global environment of heightened investor, activist, regulator and media attention (not helped by the high profile corporate scandals that kept popping up just when you think you saw the last of it), the pressure is increasingly placed on the Remuneration Committee ("RC") to exercise due diligence and sound decision making, to uphold good corporate governance process and generate shareholder returns. The demands are made the more difficult with the increasing complexity of the business and talent markets.

In line with these changes, Singapore also revised its Code of Corporate Governance, which will take effect from 1st November 2012 for financial statements issued from that date.

Based on our consulting experience in Singapore and globally, and our research on shareholder advisory and regulatory groups, we would like to present our views on how best to meet the new requirements relating to remuneration matters (Principles 7, 8 and 9 in the Code), not just in form but in a substantive way.

Let's start by reviewing what the new requirements are, along with our suggestions.

## Principle 7

In Guideline 7.1, there is an intention to strengthen governance via the RC. RC should have a "written terms of reference which clearly set out its authority and duties...and disclose in the company's Annual Report...the key terms of reference..."

While most RCs currently have a charter or terms of reference, the quality of such

varies widely. Authority and duties of the RC should include most if not all of the following:

- Development of a compensation philosophy for the executive management, which serves as a basis to cascade down to the rest of the organization.
- Identification of the company's key strategic, financial and operating objectives which can be used as a basis to incentivize the executives.
- Development of compensation

In Guideline 7.2, the new Code added “share-based incentives and awards” to share options. This is a clear recognition of the increasing use of alternative share plans since the early 2000s, especially plans with performance linkage. Whichever form it takes, the underlying concern is that plan recipients do not benefit merely by the extraneous market movements. In the same vein, they should not be disadvantaged by the mere fact that markets are down.

practices, which utilize the different compensation components of base, annual and long-term incentives, perks and benefits, to meet the following objectives:

- Attraction and retention of executives,
  - Alignment to shareholders' interests;
  - Maintenance of internal equities;
  - Appropriate mix between fixed pay versus variable pay based on the desired risk profile and time horizon;
  - Balanced focus on the annual business performance and long-term sustainability;
  - Reinforcement of the company's desired culture;
  - Avoidance of shareholder and media criticism;
  - Efficiency and compliance with tax, accounting, and securities laws; and
  - Protection of executives in corporate development events (for example, change-in-control, retention or severance provisions), yet, not setting barriers to value-enhancing corporate transactions.
- Initiation of compensation program review, and the recommendations to the board on changes.

- Review and approve CEO base pay increase and variable incentive awards.
- Ratify compensation decisions for the other key executives.
- Oversee all aspects of incentive pay programs, especially for jobs where incumbents as a group is undertaking material risk for the company. Examples are front-office jobs where incumbents are involved in sales and product development activities.
- Hiring and contracting with key executives, and protecting proprietary information from future competition through executive employment agreement and non-compete covenant.
- Make decisions regarding severance pay of key executive when needed.

- Review director compensation.
- Approve the draft RC report to be inserted in the annual report.
- To deliver on these duties, RC should have a pre-determined year-round agenda, maintain proper documentation of the context, design considerations, eventual decisions and the rationale.

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In Guideline 7.3, in addition to encouraging the RC to use internal and external experts, the new Code underscores the importance of the “Independence and objectivity of the remuneration consultants” and to make the appropriate disclosure in the annual report.

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Selection and working with an advisor cannot be delegated totally to the management although the advisor should work with the management in understanding the business context and executive viewpoints. Each RC should be able to answer this question if it is posed by the shareholders: “Please explain the basis for your characterization of the RC’s advisor as independent.” If you can’t give a reasonable, good faith answer to that question, then you must either change the circumstances or change the advisor.

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Thus RC should ensure that they have advisors who are willing to take a stand in writing, reputable and acknowledged thought leaders who are knowledgeable about the company’s business and industry, in full command of the data and facts as well as the emerging trends in executive compensation, and most importantly, has the best interest of the organization at heart and the process skills to drive the RC discussions towards a common understanding and decision.

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## Principle 8

The new Code calls for the design of the remuneration structure to be aligned with “the long-term interest and risk policies of the company”. Specifically, Guideline 8.1 states that remuneration design should “promote the long-term success of the company... symmetric with risk outcomes and be sensitive to the time horizon of risks”, and Guideline 8.4 encourages the use of “contractual provisions” to “reclaim incentive components...in exceptional circumstances”.

Our suggestions to addressing these requirements are as follows:

- Firstly, determine the appropriate performance measures for incentive plans. Include an accurate “price” of risks in all profitability calculations by using risk-adjusted measures. RCs should recognize that profits are most usefully measured relative to a referenced return on the amount of capital supporting the business. The amount of capital should reflect the risks associated with the business.
- Measure performance at the company level and avoid having individual businesses taking a first call on “their” profits unless they are autonomous units bearing their full funding costs.
- Decide on the time frame to measure performance. While the short term

should remain to be one year to coincide with the budgeting cycle, the time frame for the long-term incentives is less clear as it needs to parallel the business cycle.

- Use deferred bonus and clawback provisions in the plans. The former refers to bonus plans that do not pay out fully at the end of the financial year but defer a portion to the next 2-3 years. The latter refers to clauses that stipulate that the incentives could be taken back in future years under certain circumstances.

The new Code has suggested the following for clawback provision:

- Positions: “executive directors and key management personnel”
- Acts: “misstatement of financial results, or of misconduct resulting in financial loss to the company”
- Means: “contractual provisions”

Assuming that a RC finds these definitions suitable for its situation, that leaves the RC to define the time period for the right to clawback and any due process considerations.

- Decide on the weights to be given to the short vs. long-term incentives. Traditionally, the long-term incentives have been weighted one to two times the amount of the short-term incentives. This may increase as the emphasis over long-term results takes prominence.
- Lastly, and perhaps the most difficult part, create a “partnership” mindset and mechanisms in the company, going beyond stock ownership and withholding requirements. Compensation is only one of the levers in shaping executive behaviors. Leadership values and beliefs, and role models convey strong messages and confer intangible rewards. Leadership, together with performance and compensation, are the three priorities for the governing boards in terms of managing executive behaviors. Having this multi-dimensional

consideration requires the RC to retain a certain hindsight and discretion as opposed to strict adherence to pre-set formulae.

In fact, many of the leading companies in Singapore are already using risk-adjusted measures, deferred shares, bonus banks, performance shares and other incentive plans that are paying for long-term shareholder value creation, which adhere to many of these good design principles.

## Principle 9

In our view, the most impactful change in the new Code lies here by calling for enhanced disclosure in a number of areas. In the absence of prescriptive measures, investors would need to rely on disclosed information in order to review and judge for themselves if the plans adopted by the companies are reasonable, fair and in good faith. We would encourage companies to strive for greater transparency in key executive compensation in order to demonstrate accountability to the public market.

We highlight a couple of notable areas below:

Guideline 9.1, other than the remuneration levels, remuneration report should include “aggregate amount of any termination, retirement and post-employment benefits” granted to directors and top executives. These benefits generally are not an issue in Singapore companies, unlike the controversy of “golden handshakes” in other markets.

Most importantly, Guideline 9.6 points to the need to provide “more information on the link between remuneration ... and performance”. While disclosing

the actual remuneration levels and mix provides a view on how much is paid, it is what you are paying for that is more informative. Disclosure is an effective shareholder communication tool, if done well, to elucidate the figures disclosed.

To take on the challenges looming ahead, RCs should consider taking the following preparatory steps towards disclosure:

- Understand your shareholder base and if you think shareholders may be critical of certain areas of your program, consider explaining the rationale for these program features and why they continue to make business sense for your company.
- Ensure that RC members and committee advisors are not only independent in thinking but follow a due process to safeguard their independence.
- Assemble a team (internal and external) early, and coordinate efforts among Finance, HR, compensation advisor, management reviewers, and RC reviewers that can challenge many of the assumptions that underlie the current program.
- Ensure that pay levels meet business and talent objectives while considering internal pay relationships (e.g., between the CEO and next-level), and external benchmarks such as those of a peer group.
- Demonstrate how the compensation plans align with financial performance and stock price, and support other business objectives that create shareholder value. This can be done by assessing incentive-pay measures and goals as well as incentive-pay

mix (i.e., short-term and long-term incentives, and cash versus equity).

- Determine whether a quantitative analysis of historical pay-versus-performance makes sense with incentives as granted and as vested for the corresponding performance periods.
- Use shareholder-friendly mechanisms such as stock ownership guidelines, stock withholding requirements, deferrals and clawback provisions.

Most importantly, you must be able to answer affirmatively to the following questions:

- Are your compensation plans performance-based and aligned with shareholders/long-term value creation?
- Are your compensation plans related to the business strategy and tailored based on size, industry, performance and competitive position?
- Does the plan articulate a coherent compensation philosophy appropriate to the company and clearly understood by all directors?

## Conclusion

In summary, the new Code asks for greater accountability on the part of the RC to ensure good remuneration design and disclosure to the public. Well-managed companies have this opportunity to blaze the trail and demonstrate that they indeed have a robust remuneration system in place and, more importantly, a governance process that is not unduly influenced by management but is actually supported by the management.