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What Boards Need To Know About Compensation Management In The Post-Global Financial Crisis Environment

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With the Singapore economy growing at double-digit rates and business activities buzzing, talent attraction and retention has again become a priority issue for companies. Business cycles, however, continue to be highly volatile. Keeping compensation variable (i.e., pay at risk), and thus as a flexible business cost, continues to be the right strategy, but it needs to be done not only with talent's rising expectations in mind but also the lessons learned from the recent global financial crisis.

The regulatory changes in response to the global financial crisis are reshaping compensation practices. The G20 endorsed the Financial Stability Forum's Principles for Sound Compensation Practices (FSF Principles) issued on 2 April 2009. Many countries in the Asia Pacific have taken steps to implement these Principles into their legislative framework. Although most people are well-aware that these regulations apply directly to "significant financial institutions," few are aware that the regulations also apply to "large, systemically important firms." On top of that, we think that the Principles will over time permeate into mid- and small-market segments as well via converging corporate governance standards and best-practice proliferation.

It is thus important for board's remuneration committees, management and the HR practitioners to take heed of the "things to come", which we summarize as six themes in this article.

1. The board of directors should be responsible for the compensation systems' design and functioning.

Without the continuing attention from the board, the functioning of any well-designed compensation systems may change in ways that are inconsistent with the original intent of the systems.

Case in Point: A mid-size company hired a new CEO to turnaround the business. Compensation was benchmarked with similar market-capitalized companies at the 50th percentile level. Two years later, the CEO had done well by streamlining the business, divesting non-core assets and achieving expected profitability. The second round of benchmarking showed that the CEO's compensation was above the similar market-capitalized companies. Further analysis showed that because the company was in a turnaround situation, it did not benefit from the general market's rising tide over the last two years. The original peer group did and went on to much larger market capitalization, leaving another group to move up to the comparable size level with this company. The newer group's average CEO compensation level was much lower than this CEO. With that understanding, the remuneration committee did not reduce the CEO's compensation. Another two years passed. The company was poised to grow. A significant portion of the CEO's compensation was then put into long-term incentives to support growth targets.

The case underscores the point that while industry comparison may be relevant in setting compensation, it should not override the need for independent decisions that are based on the company's financial situation and strategic objectives.

Guidance: The remuneration committee should conduct reviews of the compensation systems annually or once every 2-3 years by. The review should extend to persons at all levels who receive material performance-based incentives, as lower-level employees with material incentives can take actions that are individually insignificant but collectively detrimental.

2. Employees engaged in financial and risk control should be managed in a way that is independent of the business that they oversee.

The board should ensure that senior risk management executives are involved in the compensation process, and compensation for employees in risk management (or equivalent) functions should be determined independent of the business areas.

Case in Point: A company included the Chief Risk Officer (CRO) in reviewing its new incentive plan, together with HR and Finance. The CRO was asked specifically to look at whether it would encourage excessive risk taking and if the performance measures and timing take into account all significant risks. This perspective complemented the HR's talent and Finance's funding viewpoints.

Guidance: Risk and compliance functions should have performance measures based on the achievement of their specific objectives. For senior executives in these roles, an appropriate compensation arrangement is likely to feature a higher proportion of fixed salary to performance-based incentive than would be the case for employees with profit centre responsibility.

3. As there is a cost to taking risk, incentive compensation should be adjusted for the risk taken.

Measuring performance only in terms of revenue or market share may provide an incentive for employees to disregard the quality of the business. Measuring performance by profits or earnings may be appropriate in many cases but calculations should adjust for risks, including future risks not adequately captured by accounting profits. Boards 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.

Case in Point: While there are sophisticated ways to allocate capital through an economic capital model in order to recognize the risks associated with any business, a small company in Singapore simply used profit after tax and capital charges as a funding mechanism for its incentive pool.

Guidance: The results of risk-adjustment are not foolproof, and remuneration committees should apply judgment and common sense in the final decision about incentive pay. Poor performance in non-financial measures such as risk management or behaviors contrary to the company's values can pose significant risks and should override achievement of financial performance

4. Incentives as a part of total compensation should not be so large that employees are encouraged to take excessive risk beyond the company's risk appetite.

Employees should be compensated with sufficient fixed pay so that they have an appropriate level of income security.

Case in Point: A consumer durable goods company moderated its sales incentive plan by increasing the base salaries in order to hire better quality staff, and then invested in them via intensive on-the-job training.

Guidance: While industry benchmarking would provide information on what is generally the proportion between base and incentive compensation, it may not always be the right answer. The company needs to look at its own business model and its strategic imperatives. Some good questions to ask are: How do we sell successfully in this business? Are the results achieved by the sole effort of the recipient of the incentive? Are there other contributing or mitigating factors?

5. Incentives should have a payout schedule that is aligned to the time horizon of risks.

The incentive should be deferred with a minimum vesting period if the incentive is a significant proportion of total compensation. The proportion and the vesting period of the deferred element should be appropriate to the nature of the business and its risks.

The deferred incentive can be given in company shares on the assumption that the future impact of today's action will be reflected in future share price movements. The deferral can also be given in cash with a deduction feature to account for poor performance in the future.

Case in Point: An owner-managed company paid the CEO a profit-sharing annual incentive. There was no share-based compensation because the CEO's deemed interest, comprising his and his family's ownership, was already substantial. The nature of the business, however, led to periodic large transactions and profit-taking in these transactions, resulting in large incentive payments in certain years. To deal with the "spikes" in incentive payments, the company implemented a deferred incentive plan that accrued payments until they were vested upon actual profit realization.

Guidance: The recipients are likely to discount the value of the incentive if a portion is deferred to the future. Thus it works better if the incentive amount is substantial. On the other hand, when there is a potential risk that the results funding the incentive may actually turn out to be not as expected, it makes sense to defer. Most business results or cycles do not fit nicely into a single financial year.

6. Incentives should have both an annual and a long-term component

The long-term incentive must, to the extent possible, offer payout profiles that reflect the payout profiles to ordinary shareholders. A common plan, such as share options, tends to represent a one-sided incentive that can generate very high payments to executives in a bull market. On the other hand, when share prices fall and the option value becomes zero, shareholders may suffer losses whereas the executive granted options may have no further downside risk.

Case in Point: A company replaced its share option plan with a performance share plan that awards shares to the executives upon pre-defined performance conditions. The decision was made based on three advantages of the performance share plan over the share option plan: better alignment with shareholders' interest; the explicit performance conditions; and less dilutive in delivering the same value to the executives.

Guidance: If an incentive plan pays out based on the achievement of future earnings-per-share (EPS), for example, management could very well devise strategies to boost EPS during the life of the plan, to the detriment of the longer-term health of the company. For example, increasing leverage is a technique which can be used to boost EPS. Boards should take account of these potential issues when developing an incentive plan.

Conclusion

As seen from the six themes, compensation management involves a number of serious considerations and, if done right, it could play a key role in supporting the business. Put the money where the mouth is, so to speak. Apart from its strategic value, compensation is also the largest cost component in most businesses. It certainly warrants the highest level of attention—at the board level.