THE ROAD AHEAD FOR EXECUTIVE PAY

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Introduction

In the recent financial crisis, the main sources of criticism were the exercise of poor risk controls, mega bonus payouts, the excessive leverage and the deliberate blindness to the bubble-like conditions in the housing market. Those were the fundamental causes for the crisis along with a rise in unemployment, liquidity issues, inflation and high commodity prices.

However, behind the economic causes, one could easily detect a heap of unethical behaviour. For example, some of the CEOs of well established firms that collapsed overnight such as Lehman Brothers, Bear Stearns and AIG were compensated with enormous payouts ($34m, $38m and $14m respectively) practically for ruining their companies, while their employees lost their jobs and customers their money. Many of them in effect sacrificed their soul for greed.

This happened because the financial industry got disconnected from its ethical base and firms focused on their short-term interests without considering the long-term impact on their customers and employees. The outcry to halt excessive executive compensation in countries like America and Europe forced the governments to intervene to bring about some order.

For example, US treasury secretary Tim Geithner said the government would not impose restrictions such as caps on pay, nor would it meddle with compensation packages. Instead, it wanted companies to adopt a series of broad principles on pay to make it easier for shareholders to understand and approve.

This approach infuriated those who were hoping the Obama administration would impose regulatory mechanisms to curb excessive corporate pay after an outcry over hefty bonuses being dished out by firms rescued with the taxpayers' cash. Geithner, however warned that such an approach would ultimately be counterproductive, and in practice, only firms that were bailed out had to face stiff restrictions on bonuses and other forms of pay. Some were asked to submit their Senior Managers' compensation packages for review. Most companies escaped such restrictions, but the government wanted firms to take a fresh look at the way they rewarded their top management.

Reward Strategy

Therefore Companies need to avoid plans that offer big rewards for short-term risk-taking and should reconsider the rationale for all the “golden parachute” schemes floating around in their companies. Also firms need to be more open with investors about the logic behind their decisions on executive pay.

The process of linking pay to performance works reasonably well in many Asian countries. The large number of bosses whose remuneration plummeted during the recession is solid example how well a robust pay for performance scheme works in practice. Nevertheless, several executives have made a lot of money even though their firms’ track records have been on the decline. This is either because the CEOs have packed the firms’ remuneration committees with their board pals who are friendly to their cause or they are totally ignorant. To address this issue, the US government is pushing for legislation to give the Securities and Exchange Commission (SEC) powers to ensure that compensation committees are truly independent of the management. It also wants the SEC to ensure that consultants who advise such committees on pay are independent as well. For example, the Sarbanes-Oxley Act, which significantly restricted auditors’ ability to cross-sell other services in order to bolster their independence. However, fixing executive pay from now on will require more than just a few regulatory tweaks, in addition companies would need to have boards that have the competence to review a pay proposal and influence pay deals before they are inked.

Executive Compensation

A survey done after the economic crisis by Cornucopia HR on market trends in Executive Compensation in South Asia, highlighted the increasing shift from massive Short Term Incentives (STI) like mega bonuses and incentives to Long-term incentives (LTI) (employee stock options, ghost options, stock appreciation rights) to recognize company performance, typically over several years.

The objective of such LTI plans is to provide incentives for staff to improve the overall performance of the organization by linking the employees’ long-term rewards to the organization’s long- term goals.

Long-term incentive plans reward employees for attaining results over a long-term often more than two years, and typically between three to five years. The reward from a long-term incentive plan is normally cash or shares. The employer would choose one or the other depending on the declared goals of the LTI plans and the risk appetite of the recipients. Cash-based LTI plans are found to be effective in rewarding employees, teams, departments and SBUs for meeting or exceeding performance milestones that span more than three years.

Cash-based plans allow companies to target long-term goals. One of the benefits to the employer of using a cash-based plan is that the plan and its rewards can be specifically tailored to

suit a senior employee who is critical for the business, for example, if the goal of the company is to introduce two new product lines over the next 3 years and achieve a declared sales volume, the company can work out a long-term cash incentive plan to match that goal.

Cash-based plans are very effective when the company is private or shareholder dilution is a big concern. A Differed Bonus plan is also another very popular cash based LTI vehicle used by companies to get key talent to focus on the long-term success of a firm.

Employee Share Plans

The most common form of LTI is the Share based plan and the employee share option plan which are perhaps the single most common form of LTI in use in most companies.

Employee Share plans are easy to comprehend because they provide a reward based on a market price of a share. The issue, however, is that the current value of the share is generally the only determinant of the value of the award. This means that if the company goal is to improve overall productivity and not market cap alone, the LTI will not be perfectly aligned with the stated goal.

A second difficulty with an employee share option plan is determining the value of the award to the employee at the time of the award. This value problem poses as the most difficult problem for valuation because they have no real value at the date of grant, but can have extraordinarily high or low values at the time of exercising the option. Employee share option plans can be very effective when, the company wants to create a strong link between the company's share performance and the employee performance, when there is limited cash available for cash type LTIs.

Often, Employee Stock Plans are very popular among business startups as cash flow is poor and the fact that equity has its high risk/high reward characteristics, it helps employees to feel and act like owners and that helps new companies to attract talent on the fast track looking for a quick buck. Furthermore, Retention also becomes far easier if the stock price has appreciated significantly. Employee Share-based plans can take two forms: appreciation or entire value. However the key difference is that one share plan provides full value of the share whereas the other only gives the appreciation in value of the same share measured from the share value on the day of the original grant.

Each has its strengths and weaknesses, and depending mostly on the life cycle of the organization and the talent challenges facing the business. Plans with awards based on share appreciation are seen to be stronger only when the goal is to reward future performance and business expansion. Plans with awards based on entire value provide a far more stable payment plan, allowing awards to be paid if the share value drops below its current level. These plans provide more stability in payments and typically less volatile for risk averse talent.

Ghost options, which are becoming very popular among many Asian organizations, have the characteristics of both equity-based and cash-based because the value of the plan is based on share performance and the payment is only in cash.

The two most popular examples are Phantom Stock and Stock Appreciation Rights (SARs). This type of hybrid LTI plans are normally used when equity is not available or shareholders do not want any further dilution and desperately want to attract, retain and motivate their key talent who are critical for the business.

Conclusion

In conclusion, our research suggests that Long Term Incentives are becoming popular once again, forming an integral part of total executive pay (Total cost to company) in many markets especially in light of the global downturn and businesses being increasingly challenged by shareholders to align employee goals with the long-term success of the organization.