Executive Pay in China: By No Means Simple

By Wells Tian, Head, Aon Consulting Beijing

Recently, the US media has focused its attention on “sky-high” bonuses for bankers, at a time when the country is reporting double-digit unemployment. Goldman Sachs, Morgan Stanley, and JPMorgan’s investment bank (all of which last year took and then repaid US government bailout funds) have informed their shareholders that they will set aside US$36.4 billion for compensation in 2009, up 27% from the same period a year earlier. The announcement has led to a public outcry and increased political pressure to put a lid on bonus payouts. As part of his oversight of bailed-out companies, Kenneth Feinberg, the US Treasury’s Special Master for Compensation, recently ordered pay cuts averaging 50 percent for the top 25 executives at seven companies that took US bailout money.

In China, the high compensation of executives in state-owned enterprise also has become the subject of hot debate in the media. Employers are caught in a dilemma — they have to ensure equitable compensation as well as reward star performers to retain talent. Shareholders may not be happy about the high rewards. There does not seem to be a quick solution to this quandary.

From a pure design point of view, the procedures and compliance of executive compensation programs among listed companies seem to be a fairly straightforward exercise. After all, executive compensation is a matter decided by the Board, based on relevant market benchmarking and internal compensation philosophy.

Under normal market conditions, a performance-based compensation philosophy would ensure executives are rewarded with salary levels that are pegged to the market’s average. However, current poor economic condition has caused a setback in terms of rewards for executives.

What is equitable compensation for executives?

What is reasonable or equitable pay is a matter of opinion. Compensation theories espouse that appropriate levels of compensation will attract the right kind of executives. More importantly, they will motivate star employees to vigorously raise the company's performance, which will ultimately help create greater value for the shareholders. The majority of China’s listed companies are beginning to face the challenge of finding the “right level” of compensation, and to identify performance measures that are aligned with their long-term goals.

A key feature of executive compensation design is to focus on creating incentive-based compensation for executives who have fiduciary responsibilities. There are, however, three key areas that need to be addressed in designing executive compensation. They are:

> Ensuring transparency: How does one monitor the transparency of key management practices, and the effectiveness of the compensation mechanisms put in place?

> Finding proper measures and standards: What are reasonable performance targets and performance standards?

> Managing risk: How does management avoid major risks in their decision-making?

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The first question is about the transparency of corporate governance, the second issue relates to the company's set performance goals, and the third relates to the company's risk control.

Transparency of corporate governance

Despite copious amounts written on corporate governance in the marketplace, many organizations have yet to come to terms with putting in place boardroom practices that ensure executive decisions can be accounted for and are transparent.

Following the major fallouts of US companies and the onset of the Sarbanes-Oxley Act on disclosure and internal control provisions in 2006, companies have been forced to re-integrate financial and personnel-related reports, including information on the remuneration of key executives.

In some markets in Asia, including China, the government has made it mandatory for companies to disclose executive compensation data. However, shareholders and investors doubt the integrity and authenticity of the data provided.

Compensation awards are usually under the tight control of a small number of board-level directors and executives. Transparency is hard to achieve as the members making the decision often have discretion regarding which benchmarks to use in measuring the performance of the target group.

As an example, when faced with five companies used in the comparative measure, it makes a very big difference whether to choose the median or mean salary as the benchmark. Even when the decision has been made to use the median, results will vary depending on whether the target receives fixed salary, comprehensive cash or full pay. Thus, it is not difficult to see why executives’ pay, and performance, could very quickly far outpace the actual value they have created for the company.

In China, complex salary composition and poor disclosure further complicate the opaque nature of compensation systems. It is quite common for executives with a state-owned enterprise to receive pay from several different posts and positions. In this context, it is easy to understand the public’s negative reaction to news of astronomical salaries of these executives.

Achieving compensation transparency is a tough task. Even in a country such as Singapore, with high corporate governance standards, listed companies are only required to disclose the combined remuneration of the top five executives.

Outside of China, securities law has been tightened to ensure proper disclosures of financial data, including directors’ and executives’ compensation. For example, in the United States, false disclosure can lead to fines of US$1 million and a prison term of 20 years, not to mention the potential for further civil action by the company’s shareholders.

Setting performance goals

Often, the largest portion of an executive’s salary is not the cash, but the long-term incentive elements represented by stock options and shares. These can account for 60% to 80% or more of the total compensation package. Recent studies have shown that companies often introduce long-term incentives by granting stock options with no strings attached. Later on, they gradually transition to incentives where performance targets are linked to the stock plan. This trend leads to two questions:

1. What is a good performance indicator?
2. How should companies measure the level of performance?

Performance measurement has always been the Achilles heel of corporate governance. In the governance of many companies in Asia, the company's management develops the business strategy and only high-level financial information is provided to external or independent directors. This results in top executives having a larger role in determining what constitutes good performance. Board discussions on performance are often superficial and difficult due to the lack of information and the Board's limited role in determining performance measures. That is why in many executive pay design processes, the board invites external consultants to provide a more objective view of the managers' performance.

The performance measurement process usually begins with goal setting. In determining the target, if we adopt a single financial goal, such as a return on investment or shareholder's return, it is simpler to build a link to the objectives of the shareholders. In setting performance targets, it is easy sometimes to overlook indicators of internal operational efficiency and the long-term core competency-related goals.

Another difficulty with performance target setting is the reliance on a single financial indicator. Financial data can be easily manipulated in financial reports. Managers who have an interest might have an incentive to massage the data.

Performance indicators have their inherent complexities. If a company decides to use return on investments (ROI) in the next three years as the key performance indicator for executives' performance, it is difficult to determine whether to use the rate of return on investment every year during the three years, or to base it on three cumulative years of return on investment. These two methods appear to be the same, but the former puts pressure on the executive to show results in each respective year during the period measured while the latter provides a certain level of flexibility by enabling three years of performance to be collectively measured. The latter also gives more scope for executives to plan long-term-oriented strategic initiatives.

When it comes to goal setting, it is also questionable whether companies should use relative or absolute indicators. Relative indicators depend on the company's market position or its historical performance, while absolute indicators depend on how the company has set its plan and budget.

Goal setting and process of performance evaluation can be equally tricky exercises. Under normal circumstances, whether the target is achieved (i.e. the "absolute" performance) can be calculated objectively. However, when the board evaluates performance, it may adjust its ratings based on the changes in the external market environment (i.e. the "relative" performance). Executives can point to their relative performance as the basis for arguing that high salaries should be retained. It can be hard for a board of directors faced with a challenging external operating environment, to decide if a drop in performance should be attributed to poor management decision-making or external factors outside of management's control.

Using a combination of relative and absolute indices can be an effective way to measure how a company has performed; however, the exercise is often complex. Consequently, management can argue that the performance indicators selected are not relevant and should not be used as a reference.

Managing risks
The implosion of the global financial market and the subsequent economic downturn has uncovered weaknesses in corporate risk control. The financial impact unleashed by the sub-prime mortgage
crisis was unexpected and unprecedented. What the financial crisis has uncovered is the poor implementation of risk management mechanisms in relation to key executives' risk-taking appetite and subsequent linkage to how they are compensated.

From the perspective of compensation management, performance incentives need to take into account a desire to limit or constrain on unhealthy risks. Management does not need their hands tied when making decisions on investments or personnel. At the same time, however, boards of directors need to limit their executives' incentive to take actions that result in undue exposure to risks that could ultimately destroy a firm's value.

There is an increasing need to tie performance incentives for key executives to the risks to which they may expose a company. Boards of directors shaping compensation policy need to consider the aftermath of the company's exposure to risks. They may even need to consider recovering previously paid compensation or recalculating the total compensation based on zero-based budgeting. In the US, such action may be forced on companies receiving US-government bailout money. The US Treasury through Kenneth Feinberg is said to be considering efforts to retrieve monies from overpaid executives working at companies receiving government assistance. Clearly, the public around the world is ready for change in the compensation of top executives.

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