

The Immediate Future of **Executive Compensation**

Implications of the Global Financial Downturn

By Dr. Hans Kothuis, Brian J. Lane and Alex Forrest





THE RECENT downturn of the economy, particularly afflicting the financial services sector, has given companies the unique opportunity and impetus to consider some key questions pertaining to executive compensation programs. Whether participating in a government bailout program or experiencing record losses and severe stock price declines, the changing economy and industry flux are affecting most financial service firms, public and private. In this bulletin, we introduce several considerations for these companies during these turbulent times.

I. Can we better assess the risk inherent in our compensation programs?

Recent economic events have shown that the world is a far riskier place than originally believed. Risk was undervalued and sold from party to party ending in our current situation. In the compensation arena, for years we have remunerated executives via annual- and long-term incentive awards with much of the incentive driven by short-term performance. We underestimated the risk inherent in the short-term focus of some of these awards and the behavior they incited which may have factored into the current crisis in the financial sector.

Hence, it comes as no surprise that country leadership is now prohibiting companies from providing incentives to senior executives that “take unnecessary and excessive risks that threaten the value of financial institutions” (cf. US Congress “Emergency Economic Stabilization Act of 2008”) or encouraging companies to “use measures that take proper account of a range of risks including liquidity risk” in measuring performance in the calculation of bonuses (cf. UK Financial Services Authority “Letter to CEOs re: Remuneration policies” 13 October 2008).

What can companies do in dealing with the hazards of low predictability and high volatility? How can they be at least approximately right rather than totally wrong in their executive pay decisions? How can they fluctuate pay and still provide bonuses for good performance without sinking the whole ship? How can they improve on the quality of their pay decisions? The observations below provide our perspective on recent events. Of course, every company will need its own analysis on the risk inherent in compensation programs, their pay and performance linkages, and their recognition awards that aim to re-motivate key employees in these challenging times.

II. What actions are necessary to contain costs while retaining key employees?

Most companies operate in a fairly narrow range of performance, and in difficult times often resort quickly to lay-offs to achieve immediate improvements in bottom-line performance.

However, studies have shown (including those dealing with the 1930s) that rather than resorting to large scale, drastic lay-offs companies are better off in the long-term if they reduce compensation in a flexible manner with the objective of retaining key associates.

Any compensation reduction will require careful company-wide communication and separation of the good from the mediocre performers. Keeping your best and most experienced people will enhance the long-term value of your company.

III. How should we handle 2009 base salary increase?

Many companies have begun to consider decreasing their budgeted base salary increases or even freezing salaries for 2009.

The cost-savings associated with a move like this are immediate and could be substantial. It can also send a message to investors that the Company recognizes that action needs to be taken.

Given the softening of the executive labor market, we expect there to be substantial downward pressure on total compensation with the bulk of the adjustment coming from lower short- and long-term incentives. However, companies that traditionally employ heavily-leveraged compensation structures (i.e., high proportion in incentives) may still consider salary increases commensurate with 2008 to maintain the competitiveness of the guaranteed package.

IV. Are changes necessary in the performance metrics measured under incentive plans?

We expect a reduction in the use of incentives that are contingent upon share price. In the current environment, many question whether share price movement in fact reflects performance. Increasingly, Boards and Shareholders realize that performance management can not be outsourced to the market.

Instead, we expect an increase in underlying operational and financial measures coupled with an emphasis on strategic measures.

Additionally, given the newfound difficulty in goal setting and low visibility, companies are likely to increase the use of discretion on incentive payments, reserving

the right to use after-the-fact qualitative assessments to adjust actual payouts.

Boards will likely conduct a robust review of how performance should be assessed under incentive plans, with greater emphasis on strategic initiatives, sustainability, balance and maintenance of trust. Solid underlying operating performance will be more valuable than financial performance delivered through risk, hedging, and excessive leverage.

Finally, we expect the pay versus performance correlation to be flatter and less leveraged in the years to come.

V. How can we ensure that the focus of incentive awards is long term?

We give below a number of devices that can be used to hold pay to a later date.

- Deliver a portion of the annual bonus in restricted shares, subject to additional vesting.
- Defer a portion of annual bonus to be paid over time subject to additional, future financial performance criteria.
- Parlay part of the annual bonus in a long-term incentive award, tied to, for example, three year cumulative performance.
- Require top executives to hold all their shares until after retirement or voluntary termination.

Additionally, we anticipate many companies will be reviewing their approach to determining the size of share awards, given the drop in the share price. **W**

Watson Wyatt's Executive Rewards Survey (ERS)

Annually, Watson Wyatt's Hong Kong Executive Compensation Team conducts the Executive Rewards Survey (ERS). Since 2006, the ERS team has accurately surveyed compensation levels, policies, and practices at leading insurance- and banking-industry companies in the Asia-Pacific region.

In addition to robust, position-specific compensation data for regional and country level executives, this year's survey highlighted many important trends for executive compensation in the financial services sector, such as: differences in local and expatriate compensation, actual and budgeted compensation increases, the changing practices of incentive compensation, and the prevalence of different types of performance metrics.

The Watson Wyatt's ERS team is eager to begin the 2009 installment as many of the much talked-about compensation program changes due to the current global macroeconomic environment will have been implemented. Through the ERS suite we are able to keep track of the evolving face of executive compensation in the region.

Survey results are open to participants and committed future participants. HR and compensation professionals may contact Shawn Li at shawn.li@watsonwyatt.com with interest.



Dr. Hans Kothuis
Director Executive
Compensation,
Asia Pacific

hans.kothuis@watsonwyatt.com



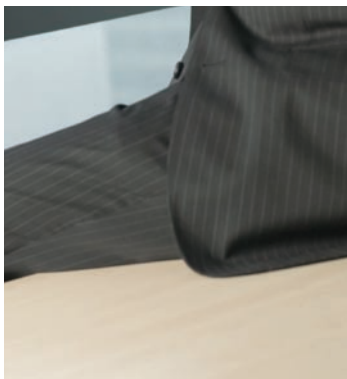
Brian J. Lane
Compensation
Consultant,
Hong Kong

brian.lane@watsonwyatt.com



Alex Forrest
Manager,
Executive
Compensation,
Hong Kong

alex.forrest@watsonwyatt.com



Executive and Director Remuneration & Corporate Governance Report

An Analysis of Hong Kong and Mainland China Companies Listed in Hong Kong

2008/2009

Boards and Remuneration Committees of listed companies in Hong Kong and Mainland China have an increasing need to gain further insight into the field of Executive Compensation. Shareholders, especially large institutional investors, continue to demand executive pay for performance to drive long term growth. In addition, Board and Committee Governance and Structure have become important topics of discussion as well as the rewards for Independent Directors.

In this, our 7th year of publishing the report, we have amended the report name to better reflect the extensive information in our database. In the report, we provide you with an essential tool for reviewing and structuring your executive's pay from Base Salary to Annual Bonuses and Long Term Incentives to Retirement. Moreover, the report contains two in-depth sections regarding Stock Incentives and Corporate Governance including analysis on Director Fees and Board Committee Structure.

- Essential survey report for Hong Kong Remuneration Committee and HR Professionals
- *New* Classification of companies based on market capitalization segments
- Includes:
 - Compensation analysis of over 4,000 Executives and Directors and 650 Senior Managers in more than 300 companies across 11 major Industries in Hong Kong and China
 - Analysis of China A-Shares and Hong Kong Growth Enterprise Market companies in addition to Hong Kong Main Board companies
 - Detailed pay and incentive mix analysis for CEOs, CFOs, as well as Named Executive Directors and Senior Managers
 - Latest development on stock incentive trends and grant values
 - In-depth analysis of director fees, board and committee structure
- Chinese text included in major sections (主要部份均附有中文注译)

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