

# Effect of the Economy on Executive Compensation Programs

## View from Asia's boardrooms and 2009 survey report on executive pay in Hong Kong

### At a Glance

**Most independent directors** at Asian companies believe executive pay programs need to change.

**CEO bonuses in Hong Kong declined in 2008:** Performance continues to drive total cash compensation. CEOs at higher performing companies earned more than their lower performing counterparts.

**Boards are factoring risk as well as succession assessments** into their deliberations on setting pay, and are adjusting long-term incentive pay opportunities based on performance and risk.

### About the Survey

In May 2009, Watson Wyatt conducted a survey among independent directors of listed companies in Asia. They shared their view on where executive pay is heading in Asia, and the effect the economy is having on executive pay programs at the companies on the boards of which they serve.

We then examined these boardroom viewpoints against actual market practice at 65 companies in the Hong Kong Composite Index (HKCI), based on annual reports published as of 31 March 2009.

### The Board View

#### Executive summary

A majority of independent directors believe that companies need to change their executive compensation programs in order to respond to pressures from the financial crisis and new regulations affecting executive pay.

Directors are unanimous in their belief that the executive pay opportunities will decline over the next two years. Close to 60 per cent believe that executive pay-for-performance will improve to a significant or at least a moderate extent as a result of public pressures.

## Key Findings

- More than 40 per cent have already reduced bonuses, and all these companies expect further reductions in bonuses for 2009.
- Most companies have already adjusted the pay mix between fixed and variable pay or are considering doing so over the next few months.
- In fact, more than half the companies are expecting to add a formal risk assessment process in the next twelve months or are considering doing so.
- Approximately a quarter of the directors report that they now are requiring mandatory deferrals of cash incentive payouts, or are considering such a change.
- Two-thirds of the companies are making changes to the metrics in their incentive plans, especially in the annual bonus programs.
- Yet, directors are not advocating lowering performance goals for 2009, with close to 90 per cent saying that there should be either no change in the goals or at least an improvement over last year's performance.

In spite of the downturn and the soft labor market, two-thirds of the directors remain either significantly or moderately concerned about the retention of their high-performing senior executives. This might explain why a sizeable number of directors think it is appropriate to take action on underwater stock options.

The director survey also shows that directors of companies in Asia are struggling, and coming to grips with increased disclosure requirements, impending shareholder 'say-on-pay' provisions, claw backs, and caps being placed on base pay in some jurisdictions.

## Conclusion

Directors serving on boards of companies in Asia are concerned about both the risk inherent in executive pay programs and their ability to retain top-performing executives. They are seeking ways to make pay more sensitive to risk outcomes, adjusting the mix of pay, reducing annual bonus amounts, and deferring annual incentives. At the same time they are concerned that legislative changes relating to initiatives such as caps on base pay and bonuses, moratoria on stock plans in China, deferred compensation limits, shareholder say-on-pay and increased disclosure, might hinder their ability to retain their top performing executives.

## 2009 Survey Report on Executive Pay in Hong Kong

We then examined whether actual market practice reflects the opinions of Hong Kong's directors. Watson Wyatt reviewed disclosures of executive director pay at sixty-five (65) constituent companies of the Hong Kong Composite Index (HKCI) that published their annual reports prior to 31 March 2009. Median revenue for the sample is approximately HK\$11.3 billion.<sup>1</sup>

### Key Findings

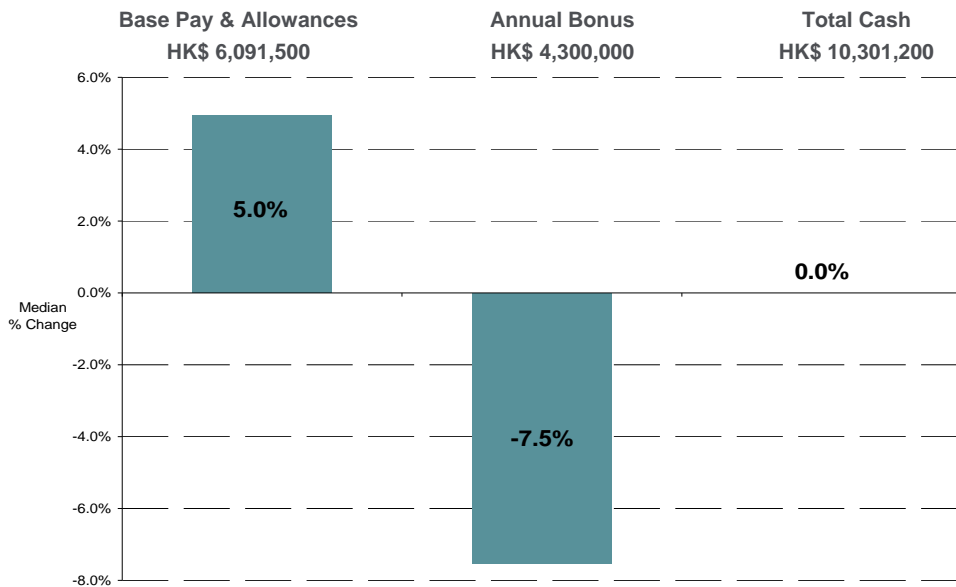
- For the first time in many years, total cash compensation remained just about unchanged, with bonus payments showing significant declines.
- The mix of pay is shifting, with an increase in the long-term component and a decline in the annual bonus.
- Performance drives realizable pay, with Chief Executive Officers (CEOs) at higher performing companies earning more than their low performing counter parts.
- Boards are awarding larger Long Term Incentive (LTI) opportunities to better Total Shareholder Return (TSR) performing companies.
- Boards are adjusting the LTI opportunities in the form of share options upwards in consideration of the risk of option awards.
- Approximately 20 per cent of all executive directors on the Boards of HKCI companies retired or terminated (either voluntarily or involuntarily) over the last two years, thereby revealing possible continuity and succession issues in the executive suite.



<sup>1</sup> The reporting dates were: 31 December 2008: 48 companies; 30 September 2008: 1 company; 30 June 22008: 10 companies; 31 March 2008: 6 companies.

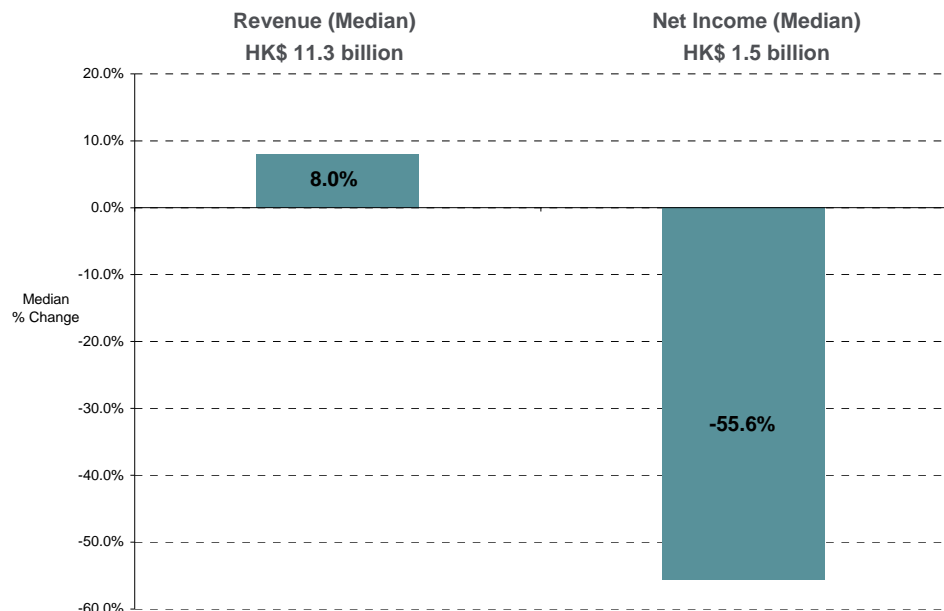
## CEO bonuses decline substantially

Total cash compensation for the CEOs of HKCI companies basically held steady over the reporting period. While guaranteed cash compensation (base pay and allowances) increased by 5 per cent (HK\$6.1 million at the median), annual bonus pay-outs declined by 7.5 per cent to HK\$4.3 million, resulting in a total cash compensation that was almost flat at HK\$10.3 million.



When we analyzed variations at individual company level, bonuses fluctuated much more than base pay and allowances.

Reductions in bonuses followed declining profits, although not as closely as would be expected. We suspect that by removing the differences in fiscal year end dates, bonus declines would have in fact been more drastic. The chart below shows that while revenues within the sample still grew at approximately 8 per cent, net income declined by whopping 55.6 per cent.



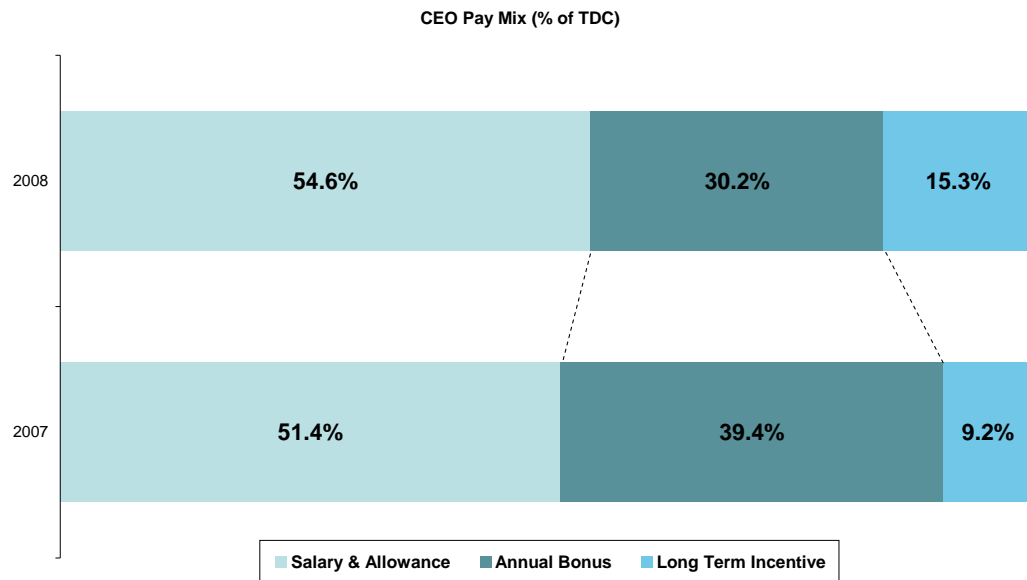
## Significant changes in mix of pay

CEO pay at Hong Kong companies has also undergone a significant change in terms of the mix between guaranteed and variable compensation, either in the form of annual bonuses or through long-term incentive awards.

Our analysis shows that Hong Kong Boards are in fact providing higher pay opportunities in the form of long-term incentive awards than in the prior year. The grant value (viz. pay opportunity) of long-term incentive awards increased by two thirds (67 per cent), from 9.2 per cent to 15.3 per cent of total package <sup>2</sup>.

Realized annual bonuses decreased from 39.4 per cent to 30.2 per cent of the total package, a proportional decrease of more than 23 per cent.

Fixed compensation, on the other hand, increased from 51.1 per cent to 54.6 per cent a proportional increase of a little more than 6 per cent.



<sup>2</sup> Total Direct Compensation = base pay and allowances, annual bonus, and the grant value of the long-term incentive awards.

## Performance drives CEO total cash compensation

The table below illustrates that for the period 2006-2008, the median cumulative bonuses received by CEOs at higher performing companies, whether in terms of cumulative net income, revenue or total shareholder return (TSR) change for the 2006-2008 time period is substantially more than those received by their low performing counterparts. Boards are awarding higher bonuses to CEOs at higher performing companies. Hence, there is a strong relationship between pay and performance. Boards are adjusting the bonus awards to a significant extent based on company performance.

2006-2008	Cumulative Net Income Change	Cumulative Bonus (HK\$M)	Cumulative Revenue Change	Cumulative Bonus (HK\$M)	Cumulative TSR	Cumulative Bonus (HK\$M)
High Performers	30.0%	\$13.4	61.1%	\$16.5	13.2%	\$15.2
Low Performers	-73.8%	\$10.5	11.3%	\$8.5	-11.1%	\$10.0
All Companies (n=65)	-14.1%	\$13.0	29.1%	\$13.0	0.3%	\$13.0

All numbers and percentages are medians; high and low performers are defined as the top and bottom half of the companies

## CEOs at better TSR performing companies receive larger LTI opportunities

Boards are also awarding larger LTI grants to companies that have a better track record in terms of TSR performance. The table below shows that there is a marked difference between the LTI opportunities, primarily in the form of share option awards, granted to CEOs at high TSR performing companies and those that are granted to their low performing counterparts. Likewise, the total direct compensation (TDC) pay opportunity at high performing companies is higher than the TDC opportunity at low performing companies.

2006-2008	Cumulative TSR	Cumulative LTI Opportunity (HK\$M)	Cumulative TDC (HK\$M)
High Performers	21.4%	\$12.5	\$55.4
Low Performers	-10.3%	\$9.3	\$52.2
All Companies (n=26)	0.3%	\$10.6	\$53.8

All numbers and percentages are medians; high and low performers are defined as the top and bottom half of the companies

## Boards are adjusting LTI opportunities upwards in consideration of the risk in option awards

Share options are by far the most prevalent long-term incentive vehicle in Hong Kong. In the absence of other equity incentive vehicles, Hong Kong's boards appear to be factoring in the degree of compensation risk when they establish the level of pay opportunity. Since options have a substantially greater risk than other equity incentive programs - such as restricted share ownership programs - it is not surprising that boards are adjusting for this risk by giving larger stock option values. Hence, risk assessments are being factored in to the deliberations of remuneration committees in setting executive pay.

Watson Wyatt's recommendation is that all companies consider the relative risk in their compensation programs as compared with their peers. But companies need the helping hand of the regulator, and a broader array of equity incentive programs. Hong Kong's company law and stock exchange listing rules need to be amended to facilitate a wider selection of equity incentive vehicles, such as restricted shares, performance shares, and employee savings and ownership programs. With only one tool (viz. employee share options), Boards can only adjust the LTI opportunity in one way, namely by giving even more options to adjust for the high degree of risk in their companies' option awards.

This observation may be counter-intuitive. But there appears to be convincing evidence that Boards are adjusting riskier compensation opportunities upwards, and less risky compensation downward.

The table below shows that in spite of the substantial drop in their companies' share prices, Boards granted not just more options to equate the grant value of the prior year, but in fact they granted even more options so that the total grant value substantially exceeded that of 2007.

	2007	Number of Shares Required for Same Grant Value	Same Number of Shares	Actual 2008
Number of Shares Granted (M)	193.2	220.5	193.2	345.5
Grant Value (HK\$M)	9,489.2	9,489.2	7,045.3	11,705.7

### Retention concerns are justified

Approximately, one-fifth (20%) of the executive directors on the Boards of HKCI companies were either retired or terminated, whether voluntarily or involuntarily over the last two years – this is a significant figure. Performance is not the only objective of a company. Attraction, retention and the long-term sustainability of the corporation are important as well. It is relatively easy to let executives go, but much more difficult to replace people in the right position. The figures below raise questions about the succession of top executives at Hong Kong's largest corporations.

Title / Position	2007	2008	Total
Chief Executive Officer	9.2%	12.3%	21.5%
Chief Financial Officer	10.8%	13.8%	24.6%
Executive Directors	10.5%	10.3%	20.8%

### Conclusion

Clearly, remuneration committees and Boards are tasked with a difficult assignment in structuring executive compensation arrangements. Directors are entrusted with billions of shareholder dollars, and even with more in terms of bank deposits and savings if they serve on banks and financial institutions. They need to protect the corporations on the boards of which they serve, providing for continuity as well as innovation, and creating total compensation packages for their executives that enable these executives to fulfill their role and high office even better.

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**For more information** on improving your executive programs, contact Dr. Hans Kothuis, Director Executive Compensation Asia Pacific on +852 2820 8224 or [hans.kothuis@watsonwyatt.com](mailto:hans.kothuis@watsonwyatt.com) or visit <http://www.watsonwyatt.com/asia-pacific/ec>