

Point of View

Time for a Fresh Look at Executive Incentive Plans

From the current morass of executive pay controversy and complexity, there is a simpler way forward for many companies.

Executive pay is under unprecedented scrutiny from many quarters, especially in the wake of the global financial crisis and related governance inquiries and guidelines. Among the major criticisms of executive pay are its perceived lack of transparency and of long-term alignment to shareholder interests.

Short-Term Incentive Challenges

Short-term incentives have been characterised as promoting an excessive focus on short-term results, with inadequate regard for judicious risk management and sustainability. There is now a strong push to defer a significant portion of short-term incentive payments and tie the deferred value to the company's ongoing performance. Many companies are already deferring part of their annual executive bonuses into shares and many others are expected to join them over the next year or so.

Long-Term Incentive Challenges

At the same time, hardly anyone seems to be happy with long-term incentives. Investors are mystified by the tendency of many companies

to award similar share or option values, year after year, no matter how the company has been performing. Shareholder representative groups and proxy advisers have reacted by imposing very blunt vesting conditions on these awards, which tend to deliver 'feast or famine' vesting outcomes from one year to another.

Many executives treat this highly volatile pattern of equity reward vesting as a game of chance, largely unrelated to their effort and operating performance. In general, executives attach low prospective value to these awards, relative to their accounting cost to the company.

If companies were to show a clearer connection between long-term incentive award size and prior performance, shareholders should be prepared to accept less extreme performance vesting conditions, since the award will have already passed a performance test at the time of grant. Further, instead of imposing 'one-size-fits-all' vesting criteria (e.g., relative total shareholder return), shareholders should be more comfortable with vesting being linked directly to the company's distinct long-term strategic goals or milestones.

Convergence of Short-Term and Long-Term Plan Features?

This is painting a picture in which short-time incentives will be more medium-term and even longer-term in pay-out timing, while more effective long-term incentives should converge towards having some features similar to short-term incentives, i.e., greater reference to prior performance, balanced by a more reasonable, more graduated and customised approach to the pay-out vesting scale. A few companies have headed in this direction already.

In the new environment, many companies may find it more meaningful and administratively simpler to morph their former short-term and long-term incentive systems into a single incentive award for each executive each year, which:

- Reflects a sound blend of short-term and long-term goals;

- Draws on an appropriate balance of absolute and relative performance metrics; and
- Has a pay-out stream delivered in the form of some cash immediately, followed by staggered delivery of equity over a considerable period.

If shareholders can see a clearer line of sight to sustainable results, and if executives feel their equity award vesting is less of a lottery, a well thought out single incentive plan may be more effective for all concerned and less contentious than the present array of executive incentive plans.

If you would like to discuss the content of this paper with one of our lead executive remuneration consultants, please contact Peter Ryan or Alan Jackson on +61 2 9247 8066 or email peter.ryan@hewitt.com or alan.jackson@hewitt.com.

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