

2019 AGM Review

- Focused on directors' remuneration cap

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- ▶ Looked at the local practice of “Say-on-Pay,” the problems associated with it, and possible solutions based on a review of the proposals on directors' remuneration cap put to vote at the Q1 2019 AGMs and the recommendations issued by KCGS.
- ▶ From the legal and corporate governance perspective, shareholders have a valid right to say on directors' remuneration. It is necessary to empower shareholders to have a practical authority on the directors' remuneration cap.
- ▶ The results show that firms set an excessively high cap in comparison with the actual pay. The remuneration is not tied to performance in many cases. All raise questions about why they set a remuneration cap in the first place.
- ▶ A detailed breakdown of remuneration and the performance measurement methods need to be disclosed prior to the general meeting of shareholders. In the future, Korea should also adopt an advanced institution such as Say-on-Pay and Directors' Remuneration Report.

Directors' Remuneration - definition and significance

When someone refers to directors' remuneration, it means all kinds of compensation bundled in a package which is paid to a director for his/her service at the company. It generally includes monthly salary, bonus, severance pay, and the like. In Korea, as per Article 388 of the Commercial Act, the remuneration paid to a director should be approved by the annual general meeting unless a specific value is specified in the firm's articles of incorporation.

In practice, however, shareholders only get to approve the total compensation at the company level. Payment breakdown for each director is decided by the board of directors or a committee delegated to do so. The Commercial Act requires that a general meeting of shareholders approve directors' remuneration for two main reasons: to prevent a potential loss that may be incurred to the company by the directors deciding their remuneration themselves and to protect shareholders, creditors, and

employees of the company¹⁾ based on the principle of capital protection.

From a governance perspective, by asking shareholders to approve director pay, a company can align shareholder interest with that of company management and consequently mitigate the agency problem. It also serves as a disciplinary tool to encourage management to make the best possible efforts for the enhancement of shareholder interest.²⁾

Issues with local practice of putting director remuneration cap to vote

In light of corporate governance theories and the Commercial Act, it is desirable that shareholders take part in the decision-making of directors' remuneration. Under the current practice, however, the cap, not the actual value, is approved. In this sense, it is hard to say that shareholders have the necessary tools to oversee and keep in check the decision-making around directors' remuneration.

Until the annual general meeting, shareholders are not informed of detailed data on director pay. It means that they have difficulty assessing whether the proposed remuneration cap is appropriate or not.³⁾ Even if the remuneration cap is approved by the general meeting, the voting decisions are not made based on adequate information.

From the companies' perspective, since they need the approval of the total sum only, it is not uncommon that firms propose a cap that is excessively high relative to the actual payment. Due to this practice, shareholders face difficulty every year in making a reasonable projection of the actual remuneration level based on the proposed cap.

Against this practice, foreign investors including the British Columbia Investment Management Corporation(BCI) and the State Board of Administration of Florida(SBA Floria) voted against the director remuneration caps proposed by domestic firms in their respective annual general meetings of 2019, citing inadequate disclosure.⁴⁾

1) Dong Yoon Chung (principal editor), 2014, "Comments on Commercial Act (Company 3)", Korean Association for Judicial Administration, pp.238

2) Jensen and Murphy, 1990, "Performance Pay and Top-Management Incentives", Journal of Political Economy, Vol.98, No.2, pp.225-264

3) KCGS, Feb. 12, 2019, "Preview of 2019 Annual General Meetings"

KCGS’s views on proposals of director remuneration cap

As described above, local firms seek shareholders’ approval of the director remuneration cap as a total value at the entire firm level. In order for shareholders to fully exercise their shareholder rights, first, the gap between the remuneration cap and the actually paid amount needs to be reduced. Otherwise, firms must demonstrate a well-established alignment between performance and compensation and provide a rationale for a high cap relative to historically low actual payment rates.

Against this backdrop and based on the 「KCGS Proxy Voting Guidelines」, the Korea Corporate Governance Service(KCGS) conducted proxy analysis on the proposals submitted to 300 annual general meetings held in Q1 2019.⁵⁾ The Guidelines were updated in early 2019 and advise that shareholders look at the level of alignment between the director compensation and performance and the actual payment relative to the total cap.

[Table 1] KCGS Proxy Voting Guidelines – Director Remuneration Cap

Before update	After update
We recommend voting FOR the approval of a remuneration cap on directors, unless the proposed limit on directors remuneration is excessive considering <u>the size and business performance of the company.</u>	We recommend voting FOR proposals of approving a remuneration cap on directors, as long as the proposed remuneration limit is not excessive considering <u>the size of the company and the board, business performance, linkage with performance, actual payment rate, etc.</u>

Out of 299 proposals seeking approval of a cap on directors’ remuneration, KCGS issued negative voting recommendations against 81 of them. Following the aforementioned revision of the Guidelines, the ratio of the adverse voting recommendations jumped to 27.1% from 2.1% in the previous year. The updated Guidelines recommend that shareholders look at the actual payment value compared to the remuneration cap and cast a negative vote if the actually paid amount stays

4) <http://vip.cgs.or.kr/>

5) KCGS press release, April 4, 2019, “Proxy Review of Q1 2019 Annual General Meetings”

under a certain level against the cap and if an excessively high cap was set without any specific reason or rationale being provided.

Remuneration cap and actual payment trends

Out of the 299 firms mentioned above, a separate review was carried out on 244 companies whose remuneration data were available for a minimum four years back. On average⁶⁾, the companies actually paid⁷⁾ around 49.46% of the remuneration cap.

[Table 2] Actual Payment Rates of the Firms

Actual Payment Rates	# of firms	%
0~10%	1	0.41
10~20%	9	3.69
20~30%	17	6.97
30~40%	46	18.85
40~50%	53	21.72
50~60%	57	23.36
60~70%	37	15.16
70~80%	18	7.38
80~90%	4	1.64
90~100%	2	0.82
Average	-	49.46*
Total	244	100.0

* Arithmetic average of actual payment ratios collected from 244 firms

An averaged actual payment rate of around 50% means that companies have a tendency to set a cap at twice the amount they actually pay. About 30 companies actually paid around 30% of the cap. It means that the cap is three times higher than the actual payments and the very purpose of seeking shareholders' approval of the remuneration does not carry much significance.

As per the provisions of the Financial Investment Services and Capital Markets Act,⁸⁾ some firms provide information that they pay out performance pay in reflective of quantitative indicators representing the company's business performance and qualitative

6) Max 10 years of data (2008~2017)

7) A ratio of the actual payments paid to inside directors relative to the total remuneration cap. The actual payments for inside directors were calculated by subtracting the total remuneration paid to outside directors and audit committee members, which are disclosed in the annual reports, from the total remuneration cap approved by the annual general meeting.

8) Article 159(2) of the Financial Investment Services and Capital Markets Act

indicators such as a director's contribution.

KCGS also conducted a review of the top variable pay rates.⁹⁾ Most of the companies did not disclose the breakdown of the variable pay or the share of the variable pay was not sufficiently high, failing to provide an explanation on the disparity between the cap and the actual payment. Another significant number of firms paid performance pay but did not disclose the computation breakdown or did not pay performance pay for a long time. These firms made us wonder why they introduced a pay structure containing variable pay in the first place.

[Table 3] Top variable pay range of the firms

Variable pay range cap	# of firms	%
0~10%	6	4.48
10~20%	15	11.19
20~30%	17	12.69
30~40%	22	16.42
40~50%	22	16.42
50~60%	18	13.43
60~70%	17	12.69
70~80%	11	8.21
80~90%	5	3.73
90~100%	1	0.75
Average	-	44.06*
Total	134	100.0

*Arithmetic average of variable pay ranges collected from 134 firms

As mentioned above, the pay structure was not disclosed sufficiently enough in most cases. Thus, a set of widely-used performance indicators were selected to see whether pay was tied to performance. Seven performance indicators, including sales, O/P, and ROE, were selected. The results showed that the majority of the companies reviewed had fewer than three performance indicators tied to remuneration. Of the 16 firms showing alignment in five performance indicators, none of them paid a base salary only. 11 of them had disclosed variable pay, and the top ratio reached around 48.66% on average.

9) KCGS looked at the individual director remuneration data appearing on the previous year's annual reports. For every firm, individual directors' variable pay ratios were calculated out of the total remuneration minus miscellaneous income (severance pay and holiday bonus) and the highest ratio was taken for this report's purpose.

[Table 4] # of performance indicators tied to pay

# of performance indicators tied to remuneration	# of firms	%
0	54	22.13
1	54	22.13
2	54	22.13
3	37	15.16
4	29	11.89
5	10	4.10
6	5	2.05
7	1	0.41
Total	244	100.0

* Arithmetic average of the number of performance indicators confirmed to have ties with pay.

As illustrated above, most listed firms proposed a high remuneration cap relative to their actual payment rates. It is not deemed that the linkage between performance and pay structure or size is clear, either. In conclusion, the local practice of setting a high remuneration cap is not compelling enough.

Case Studies

This section takes a look at companies' disclosure about the actual payment rates and the ties with performance. These are important parameters for investors to look at in their evaluation of the appropriateness of the remuneration cap. In some firms, actual payment almost reached the cap value and there was a pay plan tied to performance in place. Many, however, proposed an excessive remuneration cap relative to the actual payment value without demonstrating any tie to performance.

In the below cases, the companies had a high actual payment ratio relative to the disclosed remuneration cap. They also disclosed a detailed computation method of the variable pay. This information helped shareholders make an informed decision on the remuneration cap.

[Case 1] Both actual payment and variable pay ratios are high.

- Company A is a KOSPI-listed firm operating in the steel industry.
 - For 2019 business year, the firm presented KRW10 billion for remuneration cap.
 - The actual payment rate over the 10 years stands at 87% and the variable pay accounts for 57.9% of the total remuneration.
 - The variable pay (CEO) is computed based on a mix of short-term performance indicators (O/P, EPS, operating cash flow, and sales), long-term performance indicators (share price fluctuation(%) against KOSPI and competitors, ROE fluctuation(%), and Debt/EBITDA fluctuation(%)), and non-financial indicators (efforts for enhancing long-term competitiveness in the areas of investment, technology and people)
 - The above constitutes adequate evidence for setting a cap worth KRW10 billion.
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Some of the companies distributed additional papers at the general meeting detailing their agenda items. The papers had a detailed explanation of why they proposed a certain level of remuneration cap.

[Case 2] A firm that provided a rationale for its remuneration cap

- Company B is a KOSPI-listed firm manufacturing home appliances.
 - For 2019 business year, the firm presented KRW9 billion for remuneration cap.
 - The actual payment rate over the 10 years stands at 55% and the variable pay accounts for 37% of the total remuneration.
 - This company filed a separate explanation of the agenda detailing the execution of the previous business year (2018). It said that the cap was set at KRW9 billion taking into account the max simulated value of the directors' salary and bonus and the variability of the remuneration.
 - The company provided additional information for shareholders' decision-making including the previous business year's actual payments and the rationale of the proposed remuneration cap.
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Other companies, however, posted a very low actual payment level despite a high proportion of the variable pay, raising questions on the level of the remuneration cap. In the below case, the variable pay takes up more than 60% of the total pay while the actual payment has remained at the 10% level over the past ten years.

[Case 3] High share of variable pay vs. very low actual payment rate

- Company C is a KOSPI-listed firm operating in the securities industry.
 - For 2019 business year, the firm presented KRW3.9 billion for remuneration cap.
 - The actual payment rate over the 10 years stands at 18.46% and the variable pay accounts for 60.6% of the total remuneration.
 - The company's variable pay ratio is fairly high. Still, the remuneration cap was set at more than five times the actual pay rate, and this raises a concern over the relevance of the remuneration cap.
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Even worse, the variable pay ratio and the actual payment rate are both low. There is no confirmed tie between pay and performance indicators, either.

[Case 4] Both actual payment and variable pay rates are low. No confirmed tie with performance

- Company D is a KOSPI-listed firm operating in the food industry.
 - For 2019 business year, the firm presented KRW6.8 billion for remuneration cap.
 - The actual payment rate over the 10 years stands at 42.4% and 11.4% of the CEO remuneration is variable pay.
 - Director remunerations had no ties to performance indicators such as sales and O/P.
 - Although the cap is almost double the actual payment value, there is no confirmed tie between pay and performance both in the pay structure and actual practice. Thus, a high remuneration cap is not supported.
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Closing

Shareholders are given the authority to approve directors' remuneration. The intended purposes include making shareholders' interest aligned with that of company management and encouraging management to work for the enhancement of shareholder value. The local practice in Korea where only the total sum is approved, however, does not work to that end. In most cases, companies set a cap at more than twice the actual payment negating the very reason why the laws require shareholders' approval. Others did not disclose detailed breakdown or criteria of individual directors' remuneration, denying shareholders adequate information they need before giving consent. In recognition of this problem, the Financial Services Commission and the Ministry of Justice are pursuing shifts in the institutional framework. There is a notice out on the amendment of the relevant rule so that remuneration information is disclosed prior to the general meeting of shareholders.¹⁰⁾

Under the current laws and practice, shareholders get to vote on the remuneration cap only. They are not exercising their shareholder rights in a genuine sense. As a long-term solution, it is advised that Korea work to expand the scope of shareholders' rights both in the spirit and the letter. In the process, the Say-on-Pay and the Directors Remuneration Report would work as good reference for Korea. The former refers to shareholders' advisory voting on directors' remuneration which has been widely adopted in the advanced capital markets. The latter is a UK regulation requiring shareholders approval of directors' remuneration.

On top of the institutional efforts, companies also have a lot to do. Some are already providing extra information through a variety of channels to help shareholders assess the appropriateness of the remuneration level. Others should also follow the lead and make efforts to provide detailed information on the pay structure including breakdowns and how performance is measured.

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10) Press release from the Financial Services Commission, April 24, 2019, “ 「Measures to Improve Effectiveness of AGMs of the Listed Companies, etc.」 ”