Compensation reform to empower businesses thrive amid adversity

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Since 2024, the global economy has experienced a relatively robust growth with easing inflationary pressure, however, the recovery road is still bumpy given the geopolitical uncertainties, fierce trade frictions and rising global debt levels. Meanwhile, China's economy has been affected by multiple factors, such as the insufficient domestic demand, diverse economic development, hidden challenges and risks in major areas and frictions and temporary pains amid the transition from old to new driving forces, which all constrained the pace of business development.

To maintain competitiveness and foster sustainable development in current economic environment, businesses are increasingly engaged in the organizational, workforce and compensation system reform driven by cost reduction and efficiency improvement, striving to adapt to the complex and changing landscape. Some businesses may make changes focusing on the number of employees, including adjusting recruitment plans, upgrading organizational structures and optimizing staffing, while a growing number of businesses are conducting total compensation reform, including slowing down the growth of compensation expense or optimizing total compensation package. In this article, EY team will discuss how to introduce total compensation and rewards mechanism to navigate the economic cycle and support enable businesses' sustainable innovation and growth.

Cutting costs and increasing efficiency with multi-pronged measures – Actions taken by current businesses to navigate the economic headwinds

Overall, the compensation reform remains focused on cutting costs and increasing efficiency, industries such as banking and financial services, internet and automotive sectors are facing significant waves of compensation reform and workforce optimization.

- Banking and financial services sector: The sector, which once boasted high compensation package, has experienced an adjustment in recent years due to the changing economic environment and regulatory policies. By the end of 2023, 53% among the 51 A-share listed securities brokers we researched had experienced salary reductions, with a significant decline by around 6% in renumeration per capita[1] compared to the end of 2022, and 5 brokers' employees even saw decrease in renumeration per capita by over 10%. In a leading securities broker, the renumeration per capita dropped sharply from over RMB1,000,000 in 2021 to RMB700,000 by the end of 2023.

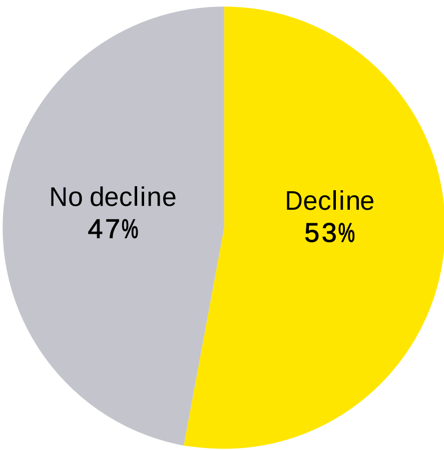

Figure 1: Renumeration per capita changes in 2023 among A-share listed securities brokers

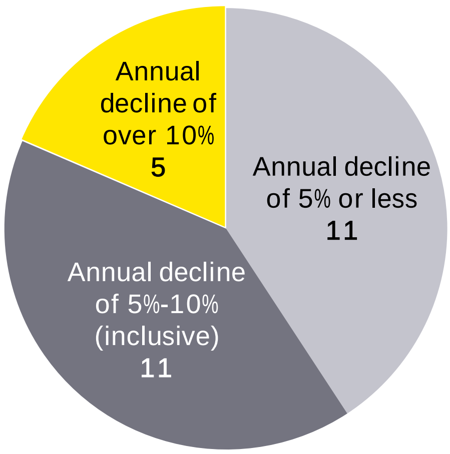

Figure 2: Renumeration per capita declines in 2023 among A-share listed securities brokers

1. Renumeration per capita = (Cash paid to and on behalf of employees + Accrued employee compensation at the end of the period - Accrued employee compensation at the beginning of the period) / ((Number of employees at the beginning of the period + Number of employees at the end of the period) / 2)

Following the pay cuts, there was a subsequent reduction in the workforce as securities brokers and investment banks starting to initiate layoffs. Among the 51 securities brokers listed on the A-share market, 37% had experienced layoffs by the end of 2023, with an average annual workforce reduction rate of nearly 3.5%. In certain instances, the rate soared to approximately 10%[2].

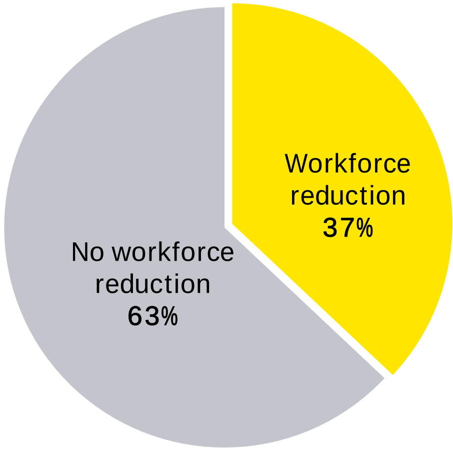

Figure 3: Layoffs among A-share listed securities brokers in 2023

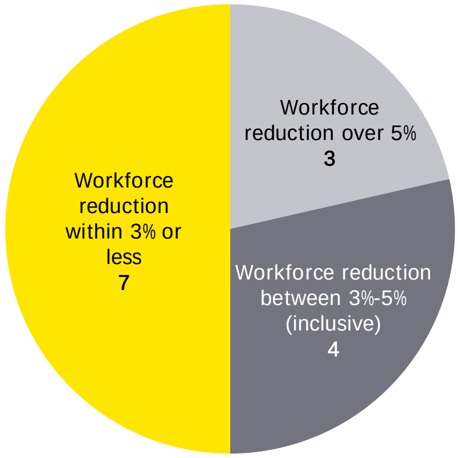

Figure 4: Layoff cases by percentage

- Internet sector: In this highly competitive and rapidly evolving sector, some leading internet technology companies are taking proactive approaches to cut compensation package to reduce labor costs in response to dynamic market demands and profit fluctuations. For example:
  - Rank-based reform: Indirect pay cuts by slashing nearly half of ranks
  - Workload extension: Disguised pay cuts by increasing and extending workload
  - Rigorous performance evaluations: Pay cuts in a justified manner by discounting compensation paid based on performance score

Meanwhile, employees in certain non-core business functions and under-performing functions or those ranking at the bottom in performance evaluations are facing dismissal. According to the public information by leading internet technology companies[3], EY team found that the layoff ratios ranged from 10% to 15% as of the first half of 2024.

- Automotive sector: With the market shrinking gasoline-powered vehicle and acceleration of electric vehicles (EV), the automotive sector is undergoing a profound production and organizational transformation. Due to a sharp profit drop, cutting costs and increasing efficiency have become an important survival strategy for most automotive companies. Since 2024, multinational automotive giants have announced their plans on personnel optimization to address challenges brought by market contraction and transformation. The sector is experiencing a rapid reduction in labor costs encompassing traditional automakers and EV manufacturers including original equipment manufacturer (OEM) and parts suppliers. They have managed to optimize cost structure to address declining profitability by curtailing production capacity, closing factories and shutting down production lines and attrition.

Implementing various measures with portfolio innovation – Total compensation reform to empower businesses' high-quality growth

Based on our extensive experience in total compensation practices, the EY team observed that businesses are increasingly adopting diverse and innovative long-term incentive mechanisms for compensation adjustment and supplement, by adapting to market dynamics and their specific situations and aligning with the evolving trends and needs for compensation and incentive reform. These measures can help businesses accommodate the need to reduce labor costs and empower them to act toward high-quality growth. There are four major trends identified as below:

2. Eastmoney Choice, iFinD
3. Analysis based on the public annual reports

- The ratio of variable pay is expanding. The compensation structure is being reshaped and optimized with a focus on increasing the ratio of variable pay based on posts and ranks by taking into account multiple factors including roles and responsibilities, value creation and market competitiveness. Taking the structure of total compensation packages for executives as an example, the EY team found that the ratio of variable pay has increased to 50% or even higher from 30%-40%. Typically, the higher the strategic importance of a position, the higher the rank and the more direct the value contribution and impact, the greater the ratio of variable pay will be. Especially for the key position within an organization, total compensation package is becoming a normalized practice that includes fixed pay, short-term and long-term incentives. For example, there is a trend for the total compensation package of executives where fixed pay, short-term incentives and long-term incentives are distributed on an equal basis. In doing so, businesses are introducing a mixed portfolio of incentives with diverse types and time horizons while increasing the ratio of variable pay. In addition, a growing number of businesses are considering shifting fixed and variable pay toward long-term incentives as a part of the portfolio to retain key employees.

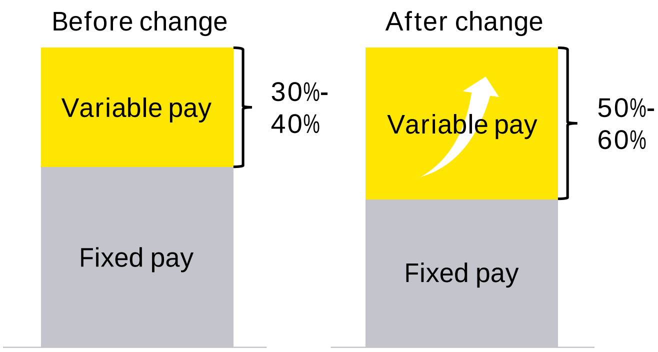

Figure 5: Changes in the ratio of variable pay among executives

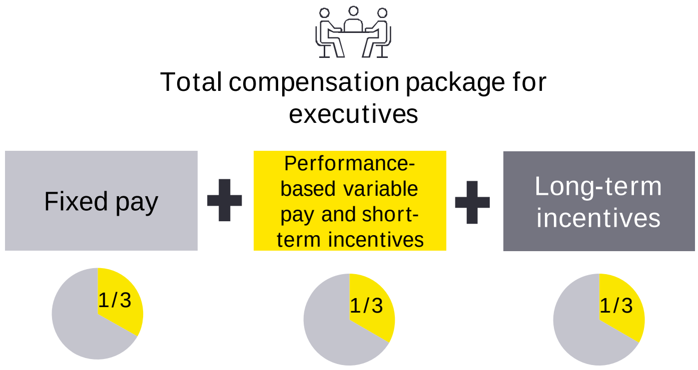

Figure 6: Typical structure of total compensation package for executives

- The total compensation package comprises various components. With special incentives and long-term incentives being integrated into the variable pay portfolio in the component of total compensation. Special incentives are rewards to employees who have fulfilled their targets or made special contributions and used in recognition of additional achievement and value created to motivate sales, research and development and innovation. These incentives often include performance commission, project bonus, patent or technology-related rewards, excess withdrawal, deferred payment and bonus pool, which can be used to motivate high potential employees with long-serving willingness or outstanding teams.

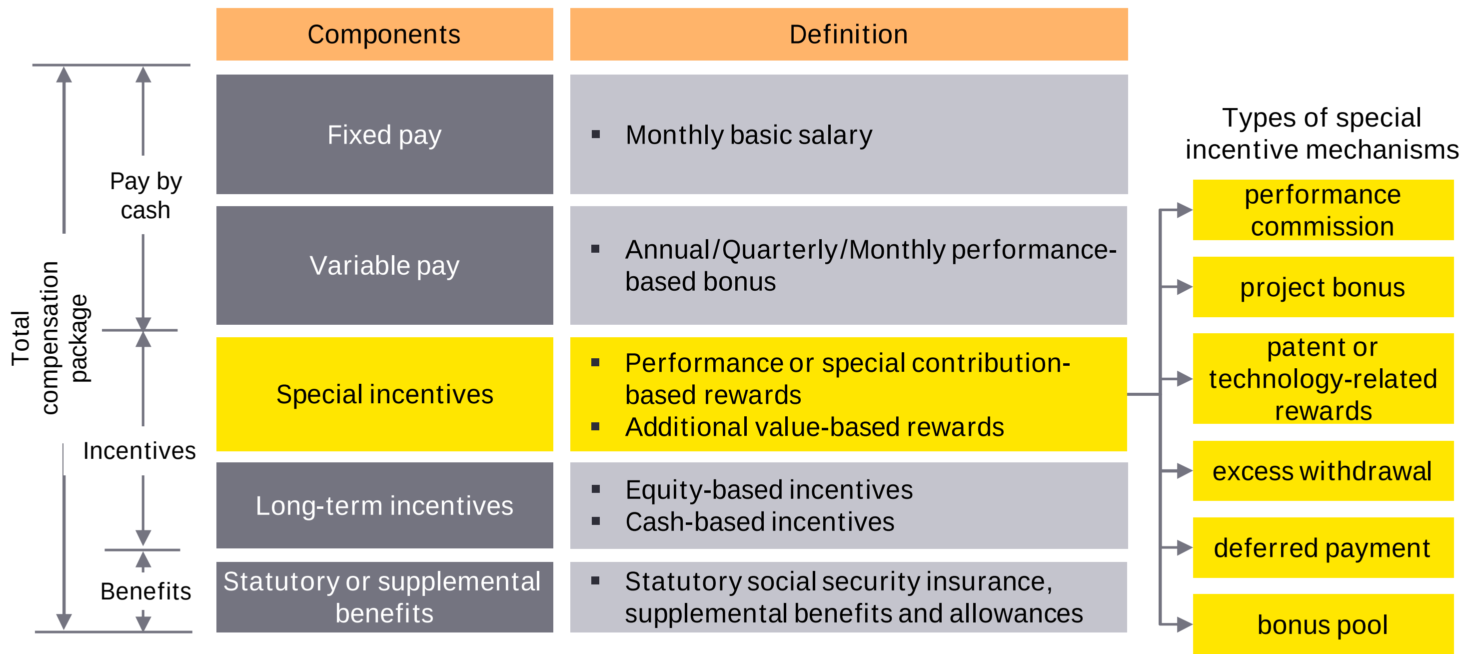

Figure 7: Diversified total compensation component

- Strengthening the performance-based payment mechanism. The payout of incentives is becoming more performance driven. With the increasing ratio of variable pay, individual income fluctuations intensify, aiming to motivate employees to meet and exceed targets. The performance-based payment is structured through multi-level incentive mechanisms. Specifically, long-term incentives often aligned with the overall business performance, which can be moderately differentiated by responsibilities and contributions, for example, varying by business sectors (including the development stages, strategic positions and economic benefits) and department functions. However, short-term incentives are often closely aligned with the fulfilment by functions, teams or individuals, aiming to encourage efforts to deliver specific targets or milestones. To motivate business line leaders and their teams, performance targets can be developed at multiple levels (e.g. baseline target, operational target, challenging target and sprint target) and pay can be varied by performance.

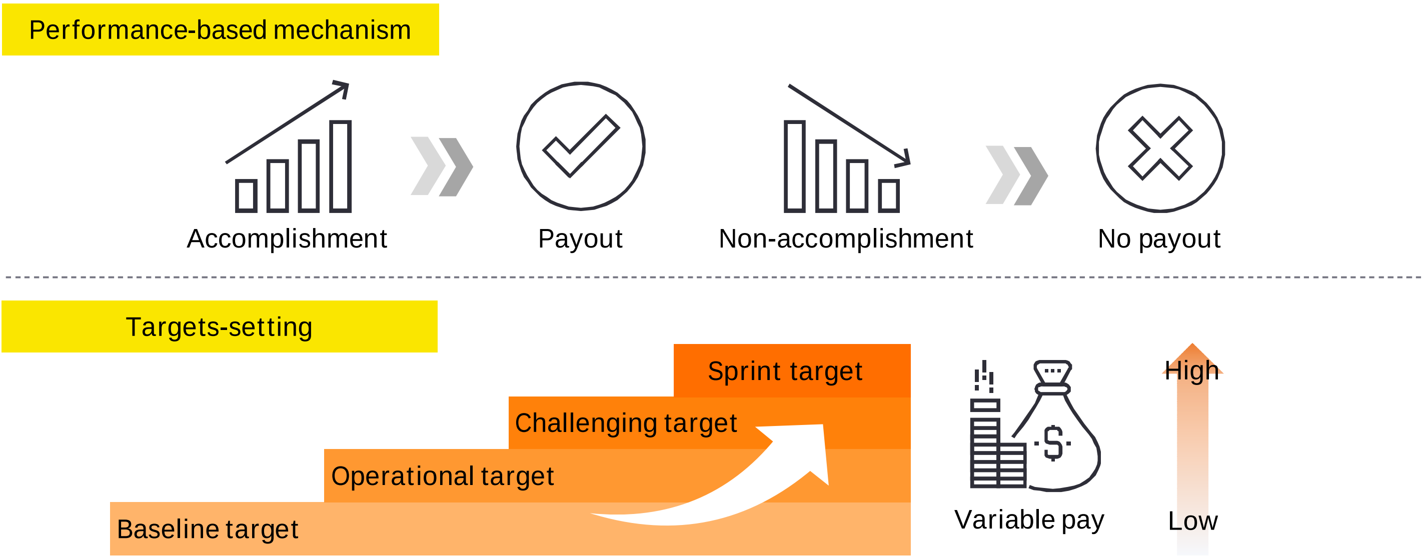

Figure 8: Performance-based payment mechanisms

- Extending the payout cycle. Businesses can align the payout of variable pay with the frequency of performance assessment. For example, the deferred payment scheme may be introduced in a justified manner for a moderate mitigation of cash flow pressure in a challenging environment while encouraging employees to maintain high levels of productivity and shifting the focus of executives and staff from short-term behaviors to sustainability in line with business strategy. Alternatively, on top of cash, businesses can offer flexible and diverse payout options, including realizing by equity, which forges a strong connection between employee benefits and corporate performance. These options also provide a mechanism for payout as corporate value increases.

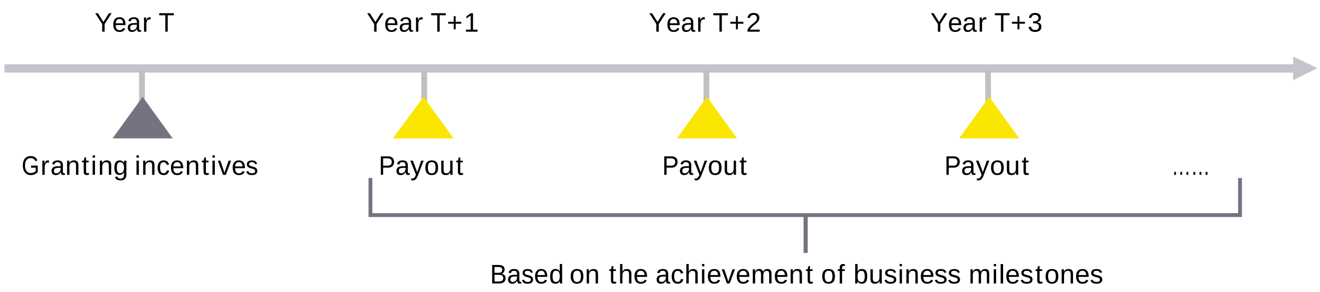

Figure 9: Extended payout cycle

Implementation is the key with effective communication - Key takeaways for total compensation reform

The key to a successful reform relies on designing a plan and bringing it to life. With our extensive experience, the EY team has identified four key takeaways for total compensation reform in current economic landscape.

- Starting the mechanism design with a scientific approach. The total compensation optimization and reform needs to be underpinned by a standardized and justified position and ranking system. This starts with streamlining and defining the existing position and rank system to clarify qualification standards and career development paths. Subsequently, we aim to develop a promising career trajectory complemented by a competitive compensation package that aligns with corporate development. Meanwhile, a performance management mechanism with scientific approach is equally important, supported by a well-articulated performance management policy. This will not only facilitate the reform process but also strengthen the correlation between performance and compensation.
- Effective communication is the key. Great emphasize should be placed on communicating with employees thoroughly on the compensation reform to foster consensus, which serves as a cornerstone for enhancing operational performance improvement.

  (1) Communication process: The communication can follow a step-by-step approach from preliminary interviews and surveys, pre-communication to formal communication. Firstly, communications and interviews are conducted with core management and function leaders to understand the appeal from core stakeholders and communicate the core concepts of reform effectively. Then, a top-down approach is used to communicate these concepts and build a foundation of trust to reach a broad consensus.

  (2) Communication strategy: To address the challenges of internal communication within an organization, it is necessary to develop a communication strategy specific to the organization based on risks identified earlier and the actual situations of employees. By delving into the communication strategy and anticipating potential issues, businesses can identify solutions and communication pathways in advance to reduce the pressure on instant response while minimizing misunderstandings and contradictions, thus overcoming communication barriers to improve effectiveness and satisfaction.

  (3) Communication and implementing approach: External resources can be utilized. Given that compensation reform is associated with individual benefits and is relatively sensitive, a third-party consulting organization can be deeply involved in the planning and entire communication process in addition to the firm support from core management, aiming to garner employee acceptance, balance the interests of all parties and facilitate fair agreement on the compensation reform.
- Choosing the right timing is crucial. To effectively implement the compensation reform, it is crucial to choose the right timing by considering factors such as market dynamics, development stage, financial cycle, organizational changes and position and ranking adjustment. By doing so, the impact on business operations can be minimized and broader acceptance among employees can be achieved. For those business units, functions or groups where the reform is expected to be particularly challenging, a pilot or step-by-step approach prior to full implementation is suggested to avoid process rushing or any negative effects on team stability and the effectiveness of the reform.
- Standardized reform practices are necessary. Compliance is paramount in every aspect of a total compensation reform to forestall collective incidents, labor disputes and legal repercussions stemming from non-compliance, thereby mitigating the potential legal risks and financial losses. When adjusting the ratio of variable pay, it is necessary to keep the adjusted fixed pay at or above the local minimum wage standard. Amid the adjustment, factors such as the type and duration of employment contract and compensation provisions must be carefully considered. The reform must be compliant with laws and regulations by adhering to the principles of fairness, justice and rationality, following democratic consultation procedures and/or communicating and negotiating with employees on changes to employment contract, thus maintaining a good business image and providing an underpinning for long-term business development.

Boosting confidence and deepening commitment – What EY team can do

China is at a critical stage to transform economic development patterns, optimize its economic structure and shift the growth engines, where all sectors need to adapt to the changes. This requires businesses to deepen the reform of their internal management mechanisms, especially the organizational structure, talent management, compensation and incentive system, thus improving the organizational and talent effectiveness. Also, it is necessary for businesses to build a more flexible total compensation system and high-performing team through incentive and constraint measures as well as common development of individuals and businesses. By doing so, businesses can adapt to the changing environment and tide over difficulties. Regards to total compensation system, the EY team provides “one-stop” services related to compensation optimization and implementation support tailored to specific needs and business development stages, including optimizing talent structure, supporting total compensation strategy, optimizing and innovating diverse incentive mechanisms and developing options for long-term incentive mechanism. This ensures alignment among the organizational structure, talent development system and performance management system with business strategy, thereby providing a solid foundation for businesses to achieve sustainable and high-quality development.

EY team provides “one-stop” total compensation services tailored to diverse needs across the entire business lifecycle

	Phase 1: Diagnosis and research	Phase 2: Optimization and improvement	Phase 3: Implementation support
1 Talent structure optimization and total compensation transformation	▪ Total compensation diagnosis and assessment ▪ Market research on executive compensation ▪ Post and rank system sort out ▪ Executive and core talent review	▪ Post and rank system optimization ▪ Talent structure optimization ▪ Executive compensation design ▪ Compensation system optimization (including strategy, level and structure) ▪ Compensation management policy and process improvement	▪ Rank placement and alignment support ▪ Compensation alignment implementation, management and maintenance ▪ Compensation negotiation and communication support
2 Optimization and innovation of diverse mechanisms	▪ Diagnosis and assessment of the effectiveness of incentive mechanisms ▪ Market practices of diverse mechanisms research	▪ Top-level framework design and diverse incentive portfolios plan ▪ Incentive model design and innovation for diverse business segments and multi-level groups ▪ Performance-based mechanism design for special incentives ▪ Simulated analysis of incentive costs and benefits	▪ Dynamic management of incentive mechanisms ▪ Employee empowerment training
3 Long-term incentive plans design	▪ Long-term incentives research on global capital markets ▪ Research on industry-specific leading practices ▪ Established incentive plan review	▪ Long-term incentive plans design and adjustment (across development stages from start-up, fund-raising, Pre-IPO and Post-IPO) ▪ Long-term incentive models innovation in specific scenarios (e.g., spin-offs, equity swap, etc.) ▪ Equity structure optimization and shareholding structure design for domestic/foreign companies ▪ Long-term incentive costs/share-based payment costs estimation and assessment	▪ Communication and implementation support ▪ Annualization management for long-term incentives ▪ Compliance management and tax structuring for local and expat residents

Figure 10: EY team’s “one-stop” total compensation services

The EY compliance team can provide practical integrated options tailored for optimization with legal expertise and extensive experience when an organization intends to simultaneously optimize organizational structure and adjusting personnel assignment amid its total compensation reform. These options can assist organizations in complying with laws and regulations and balancing the interests of business and its employees. Moreover, the EY team can assist businesses with effective implementation of optimization plans, democratic management procedures to minimize the impact on existing operations while preventing controversy and mitigating potential risks to help businesses navigate unexpected events with agility, facilitating a smooth and stable transition toward total compensation reform.

Courage and perseverance are truly manifested only in times of adversity and a piece of jade can only become finer through polishing. The EY team is always ready to work together with businesses and bring knowledge to life, which will empower the businesses' thrive by shifting mindset and improving the capability of the management team.

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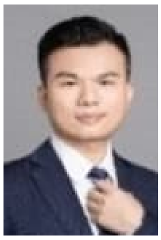

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