Blue Book Version 2

INTENSIFYING PERFORMANCE MANAGEMENT

Guiding Principles

July 2005

BACKGROUND AND OBJECTIVES

"By the year 2020, Malaysia must be a comprehensively developed country, -developed economically, developed politically, developed socially and culturally, progressive and caring[1]". Improving the performance of Government-Linked Companies (GLCs) will help put Malaysia on the right track to secure this outcome.

The Government is continuing to introduce a set of initiatives towards promoting a culture of high performance in GLCs. In May 2004, the Ministry of Finance issued guidelines entitled "Implementation of Performance-Linked Compensation (PLC) in Government Linked Companies (GLCs)", also commonly referred to as the "Blue Book", which introduced the usage of Key Performance Indicators (KPIs) and PLC. In January 2005, The Putrajaya Committee on GLC High Performance (PCG) was established to catalyse the transformation of GLCs by following through on the Blue Book and other 2004 initiatives[2] and launching a series of initiatives in 2005/06.

One of the most important of these initiatives is to **intensify performance management** in all GLCs to ensure focus on the key business priorities – particularly value creation – and to attract, develop, motivate and retain outstanding talent. To inform this initiative, a detailed stock-take of the implementation of the Blue Book was completed in July 2005 (please refer to the attached document titled "Stock-take of Performance-Linked Compensation implementation"). The stock-take revealed that although many GLCs have already incorporated some form of performance management scheme in their business, there is a wide variation in implementation and, in fact, there is still significant room for further intensifying performance management across *all* GLCs.

1 YAB Prime Minister at the Nikkei International Conference on "The Future of Asia", Tokyo, 25th May 2005; as adapted from "Vision 2020 – Malaysia as a Fully Developed Country" which was presented to the Malaysian Business Council by Tun Dr. Mahathir in 1990

2 Announced in the Keynote Address by YAB Dato' Seri Abdullah Haji Ahmad Badawi, Prime Minister and Minister of Finance, at the Seminar on Culture of High Performance for GLCs, dated 14 May 2004

This book ("Blue Book Version 2") builds upon the earlier Blue Book, based on the learnings from the stock-take. Importantly, Blue Book Version 2 is completely consistent with the first version, with no variation in the original principles. Instead, Blue Book Version 2:

1. Illustrates the Guidelines with more details and best practice examples
2. Clearly pin-points the accountability for implementation
3. Includes essential aspects of performance management, namely deriving KPIs from the strategy and the value drivers of the company; conducting rigorous and differentiating reviews of performance; ensuring meaningful financial and non-financial rewards and consequence management

RESPONSIBILITIES FOR IMPLEMENTATION

The CEO and the Board have clear roles and accountability for intensifying performance management in GLCs.

The CEO is responsible for the overall design and the implementation of the performance management scheme – particularly developing the strategy; defining the KPIs and cascading them through the organisation; reviewing performance of the business, taking corrective action and reporting it to the Board; reviewing the performance of the senior management team and delivering meaningful rewards and consequences.

The Board is responsible for contributing and agreeing to the strategy; setting targets for and reviewing the performance of the company and the CEO; and following-up with meaningful rewards and consequences for the CEO.

In addition, GLCs that have not already done so should establish a "Performance Management Committee" to oversee the implementation of the guidelines in this Blue Book. The "Performance Management Committee" should be a Board sub-committee chaired by a member of the Board and should include the CEO, Head of Strategy and Head of Human Resources. The committee is likely to have a finite life of 18-24 months at least, until these guidelines are well institutionalised in the organisation's processes and senior management.

IMPLEMENTATION DEADLINE AND FOLLOW-THROUGH

All GLCs are required to intensify performance management—by fully implementing the guidelines outlined in this document—by the end of the GLC's next annual budgeting cycle (i.e. by December 2006).

GLCs should expect to be requested by their respective controlling Government Linked Investment Company (GLIC) to regularly report on the status of the implementation, starting in December 2005. In December 2005, June 2006 and December 2006, the status of the implementation will be consolidated and reported to the PCG Committee (i.e. CEO of GLC reporting status to its Performance Management Committee; GLICs receiving status through the Nominee Directors at the GLC Boards; GLICs presenting the results at PCG).

While ensuring strict compliance with good governance, GLICs may require the Boards to sign-off on implementation and may request an independent view to assess the effectiveness of the implementation.

Questions on these guidelines should be directed to PCG@treasury.gov.my

SIX CATEGORIES OF GUIDELINES

The Book sets out what is required and the general guidelines to assist GLCs in their effort to intensify performance management. It addresses six relevant areas, and is structured as such:

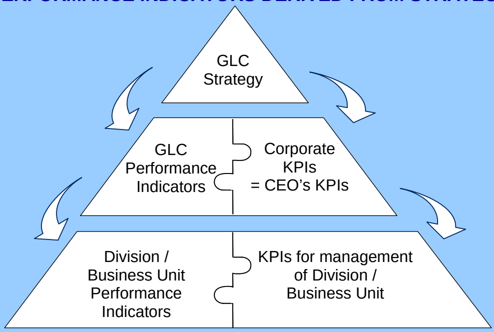
1. Establishing performance indicators and setting targets linked to strategy
2. Establishing KPIs and setting targets for senior management
3. Reviewing business performance
4. Reviewing individual performance of senior management
5. Establishing appropriate compensation framework for senior management
6. Clarifying eligibility for intensified performance management

1. ESTABLISHING PERFORMANCE INDICATORS AND SETTING TARGETS LINKED TO STRATEGY

GLC's performance indicators and targets should be tightly linked to strategy and address *all* relevant aspects of value creation within each GLC - both at the company level and also at the lower levels of the organisation such as divisions or business units. Corporate KPIs for the CEO and KPIs for managers are derived from these broader set of performance indicators (the value drivers of the company) (Figure 1)

Figure 1

CORPORATE KPIs ARE A SUBSET OF OVERALL COMPANY PERFORMANCE INDICATORS DERIVED FROM STRATEGY



DEFINITIONS

Performance Indicators:	• The complete set of measures derived from the company strategy which reflects the underlying value drivers of a company, and helps diagnose areas for action
Key Performance Indicator (KPIs):	• The most important performance indicators required to manage the business, serving as the link between performance and rewards and consequences
Corporate KPIs:	• KPIs for the company and the CEO

The specific requirements and guidelines for designing performance indicators and setting targets for the GLCs are as follows:

Guideline	Description
1.1 Design a set of relevant performance indicators directly derived from strategy (i.e. linked to the company value drivers).	• Performance indicators must be selected according to their relevance to the GLC strategy; hence, these metrics must: – Measure both direct shareholder value creation and any other concrete social/ developmental objectives set by the Board of the GLC.

Guideline	Description
	– Be balanced and holistic to address financial performance objectives as well as health (i.e. measures that support sustainable performance). Dimensions for performance indicators could include financial, customer, operations, and organisation. • Characteristics of good performance indicator are that they should: – Be *well defined*, avoiding or reducing subjectivity. For example, indices and surveys might be used to quantify subjective measures such as employee engagement. – Be both *actionable* and *measurable*. – Ideally, measure *outcomes* rather than inputs. Clear links to value should be defined when an “input metric” (e.g. employee engagement index) is selected. – Avoid damaging side-effects (e.g. while level of safety might be an important indicator for a company, it has to be defined and measured in a way that does not discourage reporting of failures). • Performance indicators should also be cascaded-down to lower levels of the organization (e.g. for each business unit or department). They should aggregate to the performance indicators at the company-level

Guideline	Description
1.2 Apply careful judgement to set targets that are stretch, yet achievable, for the performance indicators.	• Upfront in the budgeting cycle, the Board should clearly state its expectations on the targets for the company. This should be informed by advice that is independent of management. • Set stretch targets that are informed by benchmarking against industry peers. Peer companies are companies in the same industry, of similar size and subject to similar complexity and risk. The Board should approve the selection of the appropriate benchmarks. • Ensure targets are challenging, but achievable, based on bottom-up estimates from senior management, extrapolating historical performance, and an assessment of internal capabilities. • Targets should be agreed upon by the Board and CEO as part of the GLC's business cycle before the beginning of the financial year. • Be explicit about critical assumptions behind the targets (e.g. oil prices, GDP growth).
1.3 Selectively allow revision of targets for cases where the external environment has fundamentally changed.	• Targets can only be revised during the year if – Performance has deviated from targets because factors outside management control *significantly* changed the assumptions behind the targets; and – Management was and is unable to take corrective action. • Board approval or instruction is required to revise targets during the year.

2. ESTABLISHING KPIs AND SETTING TARGETS FOR SENIOR MANAGEMENT

The performance of individuals in the company is monitored through KPIs. KPIs are also used as a basis for individual performance assessment and delivery of meaningful rewards and consequences. When properly designed they align management's desired behaviours and performance with business objectives.

The specific requirements and guidelines for establishing KPIs and setting targets for senior management are as follows:

Guidelines	Description
2.1 Design a balanced and holistic set of KPIs linked to strategy.	• Corporate KPIs for the CEO are the most relevant performance indicators for the company. Similarly, KPIs for other senior management are a subset the performance indicators for their respective divisions, business units or departments. • Best practices suggest that for clarity and focus, each senior manager should have no more than five to eight KPIs. • Corporate KPIs and KPIs for other senior management may also include major milestones with measurable outcomes (e.g. cost, time and impact of successfully installing a major IT system). • KPIs for senior management other than the CEO, may also include overall company performance • KPIs must be appropriately weighted based on their importance to the business objectives and the person's control over the KPIs

Guidelines	Description
2.2 Ensure senior management formally agree to KPIs and targets.	• The CEO should agree formally with the Board on Corporate KPIs and targets and the Chairman should sign-off this agreement with the CEO. • For other senior management, apply a similar process where the respective superior signs-off. • KPIs and targets should be agreed and signed-off by the first month of the financial year
2.3 Demonstrate clear link upfront between targets and performance ratings.	• The methodology to link KPIs to individual performance ratings should be clearly announced at the beginning of the year e.g. – Performance against KPIs determines ratings, rewards and consequences (commonly known as "Absolute Rating"). – Performance against peers determines rating, rewards and consequences (commonly known as "Relative Rating").
2.4 Report headline performance indicators.	• GLC CEOs should report to investors their objectives, headline performance indicators and priorities, without revealing strategic actions or conflicting with laws or regulations. • These headline performance indicators are a subset of the broader performance indicators. Headline performance indicators should, where possible, include economic profit and at least the main drivers of value creation (e.g. revenue growth, EBITDA, etc.).

Guidelines	Description
	• Headline performance indicators can also be a powerful tool to rally all levels of employees, by providing a common reference point to chart progress. This is especially potent where staff rewards across all levels are linked to the headline performance indicators. • Headline performance indicators should be announced at least annually with the year-end results, and progress against them should be included in the quarterly reports of results.

3. REVIEWING BUSINESS PERFORMANCE

The performance of the company and each division, business unit or department, must be reviewed on a regular basis to ensure early identification of issues and opportunities, as well as to maintain focus on business priorities in order to drive overall performance improvement for the GLC.

The specific requirements and guidelines for reviewing business performance are as follows:

Guidelines	Description
3.1 Conduct Board review of company performance.	• The full Board should conduct detailed reviews of performance against Corporate KPIs in the form of at least one half-day meeting held every quarter. • The output of the meeting should be an action plan that addresses major variances. This action plan should be codified and form the basis for measuring progress at the next review.
3.2 Establish regular performance reviews for all divisions, business units and departments.	• The CEO should review the Corporate KPIs and then each Division's performance indicators with the relevant senior manager or team. • Performance review meetings should take one half-day or a full-day, and be held at least once every quarter. Frequency and duration should be adjusted according to importance and complexity of the business area. • The output of the meeting should be an action plan that addresses specific gaps and opportunities. This action plan should be codified and form the basis for measuring progress at the next review.

4. REVIEWING INDIVIDUAL PERFORMANCE OF SENIOR MANAGEMENT

KPIs for the CEO and other senior management are meaningless without the follow-through of a rigorous individual performance review process.

The specific requirements and guidelines for reviewing individual performance are as follows:

Guidelines	Description
4.1 Put in place a rigorous process for reviewing individual performance.	• Even though there should be a clear link between the performance of a business and the review of individual leading that business area, business performance reviews should be followed by a separate review of individual performance. • The Board should review on a semi-annual basis the actual results of the CEO as well as identify any issues and recommend remedial action if required. • Superiors should review senior management periodically (ideally once every 6 months, but at least annually). • The performance review can be done by the direct superior or, preferably, an evaluation committee. A committee comprised of the superiors' peers will ensure sufficient calibration of reviews across the organisation (e.g. Board reviews CEO and top management; CEO and top management review management in the second level).

Guidelines	Description
	• If competencies, attitudes, values and/or behaviours are included as part of the evaluation, a 360-degree review system may be useful (i.e. feedback received from superiors, peers and subordinates – all with relevant exposure to the person being evaluated). • All reviews should be followed by an extensive and open feedback discussion with the person evaluated. This discussion should cover performance against KPIs, strengths, development actions and overall performance rating.
4.2 Ensure evaluations show real differentiation in terms of overall rating.	• The individual's performance rating should clearly link to their performance against KPIs. • The evaluation process should rate people on a sufficiently broad scale so that a wide distribution of ratings can be achieved. • It is important that the performance rating shows true dispersion across each level in the organisation (e.g. 5 to 10 percent rated at the lowest level of the scale and 5 to 10 percent rated at the top level of the scale, with the remaining employees distributed across several additional ratings).

Guidelines	Description
4.3 Follow up performance rating with meaningful rewards and consequences.	• There has to be a strong link between a person's performance rating and any subsequent monetary incentives (bonus, salary increases, etc.) and non-monetary incentive (e.g. promotion, public recognition, etc.). The Board should monitor this correlation. • Low performers should be initially coached to improve and/or moved to a new job where their capabilities are better matched. Consistently low performers (e.g. those whose last two reviews have resulted in low overall rating) should be considered for termination.

5. ESTABLISHING APPROPRIATE COMPENSATION FRAMEWORK FOR SENIOR MANAGEMENT

The Government encourages GLCs to review the compensation required to attract and retain the right talent while ensuring that the business remains financially sustainable. As well as base pay compensation, GLCs can use cash and/or shares as performance bonuses to motivate senior management behaviour and performance towards the company's overarching strategy and objectives.

The specific requirements and guidelines for establishing an appropriate compensation framework are as follows:

Guidelines	Description
5.1 Ensure that base pay is competitive in the market.	• In general, the base pay of senior management should be set around the 50th percentile of peer companies' base compensation. • The Board can set higher compensation levels to attract the best talent to the organisation if/when required (e.g. for scarce technical talent).
5.2 Ensure that base pay increments reflect individual performance.	• All increments in base pay must reflect the overall rating of the individual and show true dispersion between high performers and low performers.
5.3 Link bonus and total compensation to rating.	• There should be a minimum performance threshold measured against the KPIs that has to be met before entitling the employee to the performance bonus or an increment in base pay. This minimum threshold should be set by the Board. However, the threshold should not be less than 50%. • There should be high variability in total compensation that is strongly linked to an employee's rating.

Guidelines	Description
5.4 Ensure that total compensation is competitive in the market.	• The Board should set the level of its company's performance bonuses and overall total compensation commensurate with the company's performance and competition for talent. The Board reserves the right to determine the final performance bonus payout. • Benchmarking of performance bonuses and total compensation can be done against both domestic and, where applicable, international peers to ensure competitiveness: – For line positions, peer companies from the same industry should be used (ideally these peers should be the companies selected to set the targets). – For other technical / support positions, peer companies might not be from the same industry, as the talent pool is cross-sector (e.g. finance department). • The variable part of the compensation should be significant: – For companies that give a "company bonus" (i.e. standard compensation for all employees irrespective of performance), Boards should gradually reduce company bonus and increase the performance bonus, to make variable compensation tied to performance more relevant. – The performance bonus should recognise the targets achieved and so total compensation may match or exceed the market average.

Guidelines	Description
5.5 Use cash rewards	• Cash or a combination of cash and shares may be used to align short-term incentives. • A GLC's ability to afford a cash payout must be built into the reward calculation and the payout system needs to ensure that both short- and long-term performance is considered. • Performance bonuses should be self-funded, (i.e., for senior management, the GLC needs to achieve minimum financial targets before bonus payout is made, to ensure that bonus payout is a fair fraction of value created).
5.6 Use share based rewards.	• Where GLCs are in a position to do so, long-term incentives can be based on shares (share options, share-appreciation rights or other forms of share-based instruments). • The shares awarded should be spread over an adequate vesting period to ensure adequate linkage to long-term value creation and retention of key personnel (e.g. 5 years). • The option price offered should be based on market price on the date of award without any discount.

6. CLARIFYING ELIGIBILITY FOR INTENSIFIED PERFORMANCE MANAGEMENT

It is important that GLCs—and their people—are clear about who is eligible for intensified performance management.

The specific requirements and guidelines for clarifying eligibility are as follows:

Guidelines	Description
6.1 Ensure senior management participate.	• Senior management is defined as the CEO and two to three levels below (to be determined by the Board). • Where appropriate, senior management should be offered employment contracts with explicit compensation linked to KPIs. Employment contracts should have defined termination clauses stating how, why and when the contract can be terminated if targets for KPIs are not met. • At the end of the contract period, or in the event of position vacancy, there should be open competition for senior management positions. Executive search firms may be used to locate external talent. Internal and external talent should be benchmarked. • In situations where the contract is terminated prematurely, adequate compensation can be considered (commonly referred to as the "golden parachute" or "golden handshake") and determined by the Board.

Guidelines	Description
6.2 Ensure that other employees are subject to the principles of performance management.	• GLCs should have most employees on a performance management scheme to further instil a performance culture in the company. • Although these guidelines apply to the CEO and other senior management, the principles of linking rewards (financial and other forms) with performance should be applied at other levels of the organisation through ESOS schemes, bonuses and promotions. • Certain elements applied to senior management might not be applicable to other employees (e.g. employment contracts).
6.3 Ensure Non-Executive Directors do not participate in variable performance-linked incentive schemes.	• Non-Executive Directors are not eligible to participate in variable performance-linked incentive schemes, due to the need to maintain appropriate check and balance, and avoid short-term actions. • However, Non-Executive Directors' total compensation should be set at least around the 50th percentile of Non-Executive Directors' compensation in peer companies.