

Boardroom Questions

Executive Remuneration



Executive remuneration in the spotlight



Following the regulatory developments and external stakeholder feedback over the last 12 months, below is **four key themes** and **'where to next'** in the executive remuneration landscape.

Four themes from the current executive remuneration landscape

1 Link between pay-and-risk-management

Driven by the regulatory developments in the financial services sector, there is a **growing community expectation that executive pay should be linked to the management of non-financial (as well as financial) risk in the Company**. The February 2019 findings from the Royal Commission into the Banking sector discovered that **financial risks have been historically well-managed by companies, whilst non-financial risks, less so**. APRA's recently released remuneration standard has proposed that financial performance measures must not comprise more than 50% of performance criteria for variable remuneration outcomes.

2 Pressure on the high quantum of CEO pay

The quantum of executive pay has received attention from external stakeholders, with **CEO pay being the primary focus**. Whilst the US and the UK have mandated the disclosure of the CEO pay ratio, to ensure transparency over the relativity of CEO pay to the average employee at the company, no equivalent mandate has taken place in Australia. However, it has been observed that in 2018 financial year (FY18), **over one third of CEOs in the ASX100 had their fixed pay frozen in FY18**. Separately, newly appointed CEOs in FY18 **commenced on fixed pay levels that were 19% lower than their predecessor**.

3 Criticism of bespoke variable remuneration arrangements

Over the past two years, there has **been increasing popularity in the introduction of the combined variable plan**, which collapses the short-term incentive (STI) and long-term incentive (LTI) plan into an all-in-one approach, for simplicity. Since the announcement of combined variable plans by 10 companies in the ASX200, at least **two companies have decided to revert to a traditional STI and LTI structure**, following shareholder backlash.

4 Alignment to shareholder interests

Partly driven by the regulatory developments in the financial services sector, the **emphasis on shareholder alignment in executive pay structures is stronger than ever**. In particular, this includes a focus on the holding periods of LTI plans and the quantum of executives' shareholdings. Whilst non-executive directors (NEDs) typically do not receive performance-related pay, it is generally good practice for these individuals to maintain a substantial shareholding in the company, to ensure an alignment of interests with shareholders.

Board considerations - what's next on the remuneration front?



1 Further regulatory developments in Australia

Following recommendations from the Royal Commission's Final Report, it is likely that the BEAR remuneration deferral requirements will be extended to all APRA-regulated companies (which will capture most financial services companies) and clawback (the ability to recoup vested and paid remuneration) will be mandated. APRA has released its draft prudential standard for public consultation until end October, which includes a proposed 50% limit on the use of financial performance measures to determine variable remuneration outcomes. APRA has stated that prudential standard will release the final standard before the end of 2019, and effective in 2021.

2 Pay increases at the executive level

Given the focus on high levels of executive pay (especially at the CEO level) and current low levels of wage growth in Australia (with Consumer Price Index growth at 1.3% in 2019), any pay increases at the executive level need to be considered carefully.

3 Bespoke variable remuneration arrangements – is there still a place for them?

With combined variable plans receiving criticism from external stakeholders throughout FY18, it is likely that their prevalence will not increase in the ASX200, in the next two years. Whilst the external saleability of an incentive plan is an important consideration, this should not be the driving factor in implementing a new remuneration framework.

4 Great(er) expectations on ensuring alignment to shareholder interests

Whilst the majority of ASX companies provide executives with some form of equity remuneration already, there may be increasingly stringent external stakeholder expectations to ensure long-term alignment between shareholders and executives/NEDs. APRA's proposed standards look to lengthening deferral periods up to 7 years.

Boardroom Questions



1 Regulation Developments

- What needs to be changed in the company's remuneration framework to 'get on the front ahead of APRA's release of the final standard?
- For those which operate in the non-financial service sectors, what flow-on effect will APRA's prudential standard have on my company?

2 Pay increases to executives

- How will the increased quantum be justified to external stakeholders, and is this correlated to company performance and share price performance over the past 12 months?
- Do current levels of remuneration enable the company to attract and retain individuals with the required skills and experience to achieve the company's strategy?

3 Variable remuneration arrangements

- Is the company's current incentive plan (variable plan or traditional STI and LTI plan) fit-purpose for the company, even though all stakeholders' may not necessarily agree with design?
- Does the company's current incentive plan meet its remuneration principles and enable it to motivate its executives to meet the company strategy?

4 Alignment to shareholder interests

- Does the company have minimum shareholding requirements to ensure executives and NEDs maintain a substantial shareholding in the company? Have these been reviewed recently to ensure they continue to be appropriate and tax efficient?
- Is the length of the holding period of the incentive 'long enough', given the current regulatory climate and international trends?

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