Executive remuneration in Australia

– is it irretrievably broken?

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2018 – a perfect storm

2018 has been a tumultuous AGM season for corporate Australia, with executive remuneration taking centre stage. The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry and the findings of APRA's Prudential Inquiry into CBA have highlighted remuneration as a key driver in encouraging the pursuit of short-term financial gain at the expense of the long term interests of key stakeholders, good corporate culture and health of business. Remuneration at both executive level and sales based incentives for customer facing staff have taken the heat (being identified as the root cause of unethical behaviour), with some questioning the need and appropriateness of incentives altogether.

Underpinning it all are three key issues:

- **Quantum**: the sheer size of some remuneration outcomes has reverberated badly with the community, fed by the financial media;
- **Alignment**: the lack of alignment of some remuneration outcomes with shareholder experience has incurred the wrath of investors – most notably Telstra, Tabcorp, Westpac and NAB; and
- **Trust**: an underlying distrust in Boards of our major companies to do the right thing.

Boards have been grappling with executive remuneration frameworks and outcomes, and how to ensure alignment with company performance and shareholder experience, for a number of years. However, now a new layer of complexity has emerged. Government, regulators and the community are demanding Boards ensure results are achieved in the 'right way' and not at the expense of customer or community standards. While this should be a 'given', history tells us it is not. There is mounting pressure on companies (particularly Boards) to focus on their 'social licence to operate', as part of a broader campaign to rebuild trust in corporate Australia.

As we look back on 2018, it is clear the mood has shifted. The key trends, outlined below, have been underpinned by a deep scepticism of the role of incentives and a distinct lack of trust in Boards to do the right thing.

Key trends

- ***The overall quantum of executive remuneration is too high for the public – and corporate Australia is listening and acting, albeit too slowly for some.*** The public and financial media continue to express their outrage at the sheer quantum of remuneration, and investors and proxy advisers at remuneration that is disproportionate to company performance (or shareholder experience). In 2018 we saw some leading Board members publicly recognise that executive remuneration is out of hand.

  Companies have responded to community and shareholder criticism by 'rebasing' CEO pay levels upon a new appointment. In FY18, new ASX100 CEOs have, on average, commenced on fixed remuneration 19% lower than their predecessor, and a number of companies have rebased other incoming KMP to maintain appropriate ratios with the CEO.

  For continuing CEOs, we have seen restraint in fixed pay increases, with over one third of CEOs in the ASX100 receiving no fixed pay increase in FY18.

  This is also filtering down to executives. The 'small' CPI increase often given as a minimum in the past has been withdrawn, as Boards realise that for a CEO on near $2m a year this increase can often come close to the average worker's wage.

  Whilst not a solution, it is a step in the right direction.

- ***Outcry where bonuses have been paid in circumstances where companies have performed poorly.*** Shareholders (and proxy advisors) continue to be particularly critical of incentive payouts where there has been a fall in shareholder value and/or stubborn underperformance (e.g. Telstra), performance that has not met expectations (e.g. QBE) or payments against 'soft' targets / vague non-financial measures which are not clearly quantifiable (or no targets at all in relation to Tabcorp's Tatts transaction bonus).

  In addition, there has long been a divergence in view of the role of short-term incentives or 'bonuses'. Many investors and commentators believe these should only be given for outperformance – while many management teams consider these annual bonuses to be 'normal' remuneration, at risk only in cases of underperformance.

  This compounds the trust issue where two of the key players have completely different expectations around STIs and companies are not clear and transparent in their communications.

- ***The tension between financial and non-financial measures as the basis for incentive payments has escalated.*** The findings from the Royal Commission and APRA have been particularly critical of the emphasis of short term financial measures in scorecards.

They are calling for more focus on non-financial measures in the financial services industry such as customer, behaviour, risk and culture. The intention is to shift the focus to include 'how' an employee does their job rather than just the focus being 'what' the outcome was. APRA's recently released remuneration standard proposes that financial measures must not comprise more than 50% of performance criteria for variable remuneration outcomes.

Previous attempts to introduce strategic or non-financial measures into remuneration frameworks were often attacked by shareholders and proxy advisers as introducing 'soft' targets so the Board can 'hand money out' or targets that can produce payouts even when financial results are below expectations.

Much of the initial backlash to strategic / non-financial measures was down to poor communication of the targets. In order to regain the trust and confidence of stakeholders, these measures need to be quantifiable and clearly linked to the achievement of a company's strategic objectives and shareholder value creation. Engagement with external stakeholders will be even more critical than ever.

– ***Recognising one size definitely does not fit all, companies are introducing bespoke remuneration arrangements in an effort to align reward frameworks more closely with company strategy and shareholder experience.***

The trend towards incorporating strategic measures into the LTI has continued as a way to better align rewards with company strategy – not just annual profit (eg CBA, Incitec Pivot and Caltex).

A number of companies have also moved to collapse STI and LTI structures into a single incentive plan. These plans link rewards to a scorecard tested annually and deliver a large proportion of the reward in shares that are restricted for a period (eg QBE, JB Hi Fi, NAB). A variant of this plan incorporates an additional performance test at the end of the performance period on at least some of the equity (eg Wesfarmers, Telstra, and now Perpetual for its CEO).

The rationale for these plans is compelling – to reduce complexity, enhance the value executives place on these structures by improving line of sight while also allowing for long-term alignment with shareholder through granting restricted shares (which also allows Boards greater opportunity to clawback or forfeit awards). However, they are not appropriate for all companies or industries.

Stakeholder reaction to variable incentive plans during the 2018 AGM season has been very mixed. There has been a high degree of shareholder cynicism that these plans are only being introduced to boost executive pay packets by companies that have not enjoyed LTI vesting. A few have received strikes (e.g. NAB, AMP, Telstra, QBE) and there have been a few near misses (e.g. JB Hi-fi, Regis Healthcare).

The negative market reaction has been most violent where there have been healthy payouts following poor company performance, opaque scorecards or perceived short termism (because of the annual scorecard) or other contextual factors which are not directly linked to the remuneration structure or outcomes under the variable plan (such as the Royal Commission, strategic direction and consistent underperformance).

– ***While shareholders continue to distrust boards to do the right things, we have seen, more than ever, the use of Board discretion to reduce awards.*** However, even where Boards are exercising discretion, this is often perceived to be 'too little' (eg Telstra, Westpac and NAB).

Boards are increasingly calling for more information to allow it to consider the quality (not just quantity) of financial results in awarding incentives. This has been facilitated by using contra or supplementary indicators to assess if results have been achieved in the 'right way'. This takes in consideration of behaviours, culture, risk, customer, employees, suppliers and the broader community in which companies operate.

– **Culture, governance and remuneration are inextricably intertwined** – The role of remuneration in supporting (or undermining) culture is in the spotlight and has been reinforced by the findings of the Final Report. As highlighted by Commissioner Hayne, 'remuneration tells staff what the entity values'. Commissioner Hayne asks companies to form a view of its culture, identify problems, develop and implement a plan to deal with them and then determine whether changes have been effective. With culture, and its link to governance and remuneration, now squarely on the agenda, the questions for companies are how will culture be measured internally? How will culture be reflected in the reward framework? How will it be reported to RemCo/Board? And how will companies respond to problems identified?

Looking forward

Where does this leave us? We are at a cross roads.

Remuneration will undoubtedly continue to be a contentious issue in 2019 and beyond. The findings of the Royal Commission were released in early February and their reach will be felt by companies outside of the financial services industry.

APRA and ASIC have had a big stick taken to them in the Royal Commission and will need to flex their regulatory muscles in response. APRA has recently released its updated prudential standard in July 2019 for public consultation until end October.

The Final Report of the Royal Commission has tasked APRA with setting limits to the use of financial metrics in connection with long term measures in the financial services industry. This has been reflected in APRA's draft standard released in July 2019. There have been calls for more simple frameworks by some of the leading Chairman in corporate Australia (ie cash and grants of shares).

We will continue to see restraint in quantum and a greater willingness of Boards to exercise discretion in light of corporate and shareholder outcomes.

As financial services companies are tasked to review the effectiveness of their remuneration frameworks. Boards will need to undertake annual reviews to understand whether their frameworks encourage 'sound management of non-financial risks' and have been 'working as intended'. The quality and type of information that boards will demand will have a greater emphasis on misconduct, risk and culture.

We will also see a greater emphasis on accountability and consequence management, including the more regular consideration and exercise of clawback policies when issues are identified.

However, whether this can rebuild trust between Boards and investors, is unclear. The sins of the past hang heavy.

We will, however, see greater transparency and more emphasis on communication – with shareholders, the community, and management teams.

Two things are clear – there are no easy answers. And rebuilding trust will be a journey that takes time

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