GRG Remuneration Review

Does STI Practice Need to Change?

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INTRODUCTION

The aspect of executive remuneration that has received the most commentary in relation to the global financial crisis has been short term incentives (STIs). This article seeks to comment on STI practice in Australia and provide guidance on those aspects where improvement may be needed.

The STI is a component of total remuneration packages and part of the wider terms of engagement of an executive. Before discussing STI plans it may be helpful to provide brief comments on some of the broader aspects of executive employment.

ASPECT	COMMENTS
Base Package (TFR or TEC or FAR)	The quantum of Base Packages is mainly driven by the size of the executive role which is a function of the size of the company and specific role accountabilities. Its level is largely unrelated to individual performance as poor performers do not retain their jobs and performance is mainly recognised via incentive payments. Also see later comments in relation to total remuneration packages.
STI	This component will be discussed in detail later in this article.
Long Term Incentive (LTI)	Australian LTI practice has evolved along different lines to practices in other parts of the world particularly, the USA and would generally be considered to be soundly based and well aligned with total shareholder returns. Typical Australian practice is along the following lines. • Shares and rights are the types of equity units offered (less leverage and less incentive to take excessive risks than would apply to options), • Annual grants (spreads focus from single period performance to multiple overlapping performance periods), • Grant sizes are reasonable in size (avoidance of mega grants takes focus on share price away from a single point in time), • Vesting is subject to performance as measured over a period of around 3 years after the grants (longer overlapping measurement periods turn focus to sustainable performance improvement), • Performance is measured by reference to relative total shareholder return (TSR) (relative performance seeks to neutralise the effects of market cycles and TSR aligns executive and shareholder interests). Also see later comments in relation to total remuneration packages.

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ASPECT	COMMENTS
Total Remuneration Package (TRP)	TRPs are composed of Base Package, STI and LTI. The quantum of TRP for target performance i.e. the expected payout for the expect level of performance, needs to take account of several factors including: • Competition for executive talent – if the company is seeking to attract and retain high calibre executives then it may need to adopt a higher market positioning than a company that is targeting solid but not outstanding talent, • The expected company performance level – companies seeking to be among the top business performers in their sector may need to target TRPs that are commensurate with the targeted levels of performance whereas those expecting to be middle of the road may set middle of the road TRP targets. The mix of the components should be appropriate to the company's circumstances and contain appropriate mixes of: • fixed and variable remuneration, • STI and LTI, and • immediate cash and deferred STI awards. Restructuring remuneration packages such that in relative terms Base Packages are reduced and incentives are increased needs to be approached with caution. Base Packages that are too low may place too much emphasis on incentive payouts and encourage excessive risk taking and/or poor practices. The limit on deductibility of the salary component of Base Packages in the USA had the effect of restraining levels of Base Packages and increasing the amounts available via incentives. The resultant excessive focus on incentives may have contributed to those practices that have been partly blamed for the global financial crisis. Thus, pressure to hold Base Packages at current levels and to provide remuneration increases via larger incentive opportunities needs to be resisted and carefully considered given the overall circumstances of the company. All executives should build an equity stake in their company via deferred STI awards but only CEOs, Direct Reports and select key executives should participate in LTI plans. In many Australian companies LTIs extend too deep into the executive ranks, therefore programs need to be developed to redress this situation.
Severance Payments	The quantum of payments in Australia is typically no more than one year's Base Package for a Managing Director and less for lower executives. This quantum has evolved following considerable input from various stakeholders and would generally be viewed as reasonable. Often a severance payment arises when the company initiates the termination for other than cause. A rationale for the company making a severance payment in these circumstances is that by undertaking to make such a payment the company can help maintain a stable executive team during unsettled periods when executives may be inclined to seek alternative employment with less risk of termination. Severance payments provide executives with a safety net in the form of funds to tide them over until they find replacement employment and thereby avoid financial disadvantage in the event of termination by the company. It can be difficult to find cause for termination that can be attributed directly to an executive even when a company's performance has been poor. Thus, some terminations qualify for severance payments even though there may be questions as to whether the circumstances fall squarely within those intended to be covered. More precision may be required in relation to circumstances when severance payments will not be made or will be reduced.

	Such circumstances could include: a) When shareholder value has reduced by more than say 25% between the commencement of the employment agreement and the date of termination, b) the company has been bailed out by government or an industry body, c) the company has entered into a scheme of arrangement with its creditors, d) the company is or is about to lose a contract, licence or other arrangement which will significantly adversely affect future earnings, and e) the company is seeking to merge with another company to avoid a) to d) above.

TYPICAL EXECUTIVE STI PLAN

The following table presents the design elements of a typical executive STI plan and then provides commentary.

DESIGN ELEMENT	COMMENTS
Measurement Period	One year being the company's financial year is typical practice.
Award Opportunity	Usually expressed as a percentage of the Base Package. Often there is a maximum award opportunity which removes or moderates the incentive to take excessive risks in order to achieve large payouts. Often the additional awards that may be earned by exceeding the target level of performance represent a small uplift from the award for delivering target performance. Again removing or moderating the incentive to take excessive risks in order to achieve larger payouts.
Key Performance Indicators (KPIs)	It is usual for there to be a mix of corporate, business unit and individual KPIs. This mix is designed to encourage teamwork and cooperation. It also aims to recognise that individuals and business units are part of a larger company and that it is the health and prosperity of the total company that needs be the priority. The KPI approach allows adherence to corporate values to be included were it is an important consideration. The mix of KPIs seeks to mitigate against individual pursuit of personal goals irrespective of their implications for others and on the company as a whole. Care needs to be exercised when selecting KPIs so as to ensure that unintended consequences do not follow. It should be noted that rule 10.17 of the ASX Listing Rule prohibits executive director remuneration from including a commission on, or percentage of, operating revenue. This prohibition should also act as a warning as to the risks involved in aligning any employee's remuneration with revenue, as opposed to say realised profit contribution. An example of a poorly selected KPI is production volume from a mine as it ignores the costs of the production, whether it can be sold and if so at what price.
Weighting	The weighting applied to each KPI is intended to reflect its relative importance and priority.

DESIGN ELEMENT	COMMENTS
Performance Ranges	For each KPI a range of performance outcomes needs to be set. The range is from : • threshold being the level for which some amount of STI will be payable but below which no STI is payable, up to • stretch being the level that will attract the maximum amount of STI payout. Within this range it is typical to set a target level which is determined by reference to the business plans. Depending upon the budgeting approach the target may be at or above the budgeted level. The spread between threshold and target and between target and stretch is generally related to the elasticity of potential performance levels. However, account also needs to be had to the degree of risk to which the company may become exposed in seeking to achieve higher performance levels particularly between target and stretch. It would generally be expected that the target level would reflect the company's risk appetite.
Performance Aggregations	Dominant practice has been for each KPI to be treated as a separate component such that if performance in relation to one component is sub-standard it will have no impact on the incentive payout applicable to another KPI. An alternative that is widely used is to aggregate the results in relation to all the KPIs and to then calculate the STI payout based on the aggregated result. Under this approach a sub-standard performance in relation to one KPI will reduce the payouts applicable to other KPIs. The aggregated approach has been used in circumstances when it is seen as important for at least threshold levels of performance to be achieved for all KPIs. However, it may also be relevant in circumstances when a single KPI has a significant weighting and high upside potential which may encourage a single minded approach to the KPI without regard to the implications of practices on other parts of the company.
Payouts	Payouts have traditionally been made in cash soon after the annual results have been certified, STI awards calculated and payment approved. Bonus sacrifice is widely offered with bonuses being paid as additional superannuation contributions or tax deferred share acquisitions. In some cases part of STI payouts have been deferred for 6 to 24 month with payment being dependent upon continued employment. Deferred payments were generally not subject to further performance criteria and have been paid in cash. Consideration should be given to a significant proportion of STI awards being deferred for such periods as will allow the implications of activities during the STI measurement period to flow through and impact subsequent performance. This is discussed below.

PAYOUTS IN THE FORM OF VESTING SHARES

Mechanism

Deferred STI payouts in vesting company shares are generally put into effect by the company contributing funds to a Plan Administrator which then acquires the shares by on-market purchase or subscription to a new issue. This approach ensures that the cost of the shares qualifies as a tax deduction as would a cash STI payment. However, the company can choose between market purchases and new issues depending upon considerations as to cash flow and dilution of current shareholders.

Broad Exposure to Total Shareholder Return (TSR) Changes

Vesting Approach

Vesting of the shares can be made dependent upon service and/or performance conditions. Service will itself ensure that the executive is exposed via share price movements and dividends, to the medium to longer term implications of activities during the period when the STI award was earned. As TSR is an outcome of share price movements and dividends assuming that they are reinvested into the company's shares, the simple conversion of part of the STI payout into an investment in company shares that must be held for a lengthy time period will expose executives to changes in TSR that accrue from activities and decisions taken when the STI was earned.

Dealing Restrictions Approach

An alternative that achieves the exposure to future TSR implications but does not expose executives to forfeiture of the shares is to simply place dealing restrictions on the shares. For example the shares could be restricted from sale for up to 10 years (maximum tax deferral period). As executives would receive dividends they would receive some benefit from the shareholding during the dealing restriction period.

If employment ceased during the restriction period then the dealing restrictions would need to be relaxed for at least say 50% of the shares so as to enable sufficient shares to be sold to fund the tax liability that arises on termination of employment.

Specific Exposure to Implications of Work During the STI Measurement Period

However, if a more specific linkage is required to performance during the STI measurement period then a vesting condition could be related to specific aspects of performance being enduring. In sales roles it would be feasible but perhaps complex to track the implications of sales over the term of the product or service that was sold. However, in most executive roles the tracking of specific aspects of performance is generally not possible. Therefore, the wider implications for the company or a business unit need to be considered. Hence, the deferral into shares will often represent a reasonable approach to exposing STI earnings to future performance implications.

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GRG Contacts

GRG is well positioned to assist boards in reviewing their company's remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies are among our substantial client base.

GRG maintains databases on director and executive remuneration. We capture all the aspects required to be covered in Remuneration Reports and therefore provide an authoritative source of advice in relation to market practices and emerging trends.

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