Deferring STI Awards

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CALL FOR PART OF STI AWARDS TO BE DEFERRED

A frequently expressed preference of proxy advisors and the Australian Shareholders Association (ASA) has been for part of short term incentive (STI) awards for key management personnel (KMP) to be deferred. It is a preference rather than a requirement for proxy advisors who generally consider each company's circumstances and provide voting advice on the appropriateness of the KMP remuneration arrangements to those circumstances. It should also be noted that other parties such as the Productivity Commission, the Australian Prudential Regulation Authority (APRA) and GRG have also been supportive of STI deferral. However, it is the method that GRG has seen most commonly used to implement deferral that causes concern.

This GRG Remuneration Insight examines:

- What does STI deferral involve,
- Why has the call for deferral of STI awards been made,
- How have companies implemented STI deferral,
- Has the objective been achieved, and
- What is the fundamental approach that should be applied by boards.

WHAT DOES STI DEFERRAL INVOLVE

There are several possible approaches to implementing STI deferral including:

- Splitting current levels of STI awards between cash and deferral (boards generally find this approach unacceptable for reasons mentioned below),
- Moving remuneration from salary to STI (possible but unlikely to be used),
- Moving LTI into STI (this is one GRG has observed as being most commonly used), and
- Increasing STI and the total remuneration package (generally unacceptable unless previous total remuneration package was uncompetitive).

The most commonly applied approach to deferral of STI awards is to pay a fixed proportion of an earned STI award in deferred rights which are subject to vesting conditions (vesting conditions are necessary to defer the taxing point). The deferred rights may be to cash and/or shares in the company once vesting conditions are satisfied.

The most commonly applied vesting condition has been service. Given that STI awards are generally based on performance, most boards have felt that it would be excessively onerous to apply performance vesting conditions to the deferred rights that have been earned by achieving performance goals. The service vesting periods tend to be one or two years of service or part for one year and part for 2 years of service. Counting the one year measurement period for the STI and the service vesting periods for deferred rights, key management personnel (KMP) need to wait for 2 to 3 years before they have realisable awards from deferred STI.

WHY HAS THIS CALL BEEN MADE

It appears that the original impetus for the call for part of STI awards to be deferred arose from overseas remuneration practices, particularly in the USA in the finance sector prior to the global financial crisis. These practices involved large STI cash awards for outcomes that, in many cases, were not of long term benefit to shareholders and in fact resulted in destruction of significant shareholder value. A perceived flaw in the design of these STI plans was that they did not adequately take into account risk and the time-frame for the consequences of actions to unfold.

A flow on effect has been that the Australian Prudential Regulation Authority (APRA) issued standards that apply to the executive incentive plans of regulated financial institutions. Most ASX listed companies are not regulated by APRA and various stakeholders are concerned that the STI plans of companies not regulated by APRA continue to be flawed. Whether such concerns are justified remains open to conjecture.

A means of partially addressing these perceived flaws is to defer part of STI awards and expose their value to longer term fluctuations in the value of the company's shares. This encourages KMP to consider the risks being taken when pursuing STI goals and exposing the value of STI awards they earn to the longer term consequences of such risks. However, it should be noted that this approach to deferral is likely to have less impact on KMP behaviour than one where deferred rights are further linked to the objectives set as part of the STI that gave rise to them i.e. linked to the stability of those objective achievements beyond the period of measurement. It should be noted here that clawback arguably achieves this in a much more direct manner, as it allows for recovery of incentives awarded if the actions taken by management to secure achievement of the objectives turn out to have been detrimental in the longer term. However few clawback arrangements operate in this way and instead commonly focus on material misstatements.

HOW HAS STI DEFERRAL BEEN IMPLEMENTED

Observations of market practice suggest that many companies that have responded to the call for part of STI awards to be deferred have done so by reducing the long term incentive (LTI) element and increasing the STI element of executive remuneration packages. This approach has allowed companies to:

(a) Maintain the prior level of cash STI awards – reducing cash would have caused great dissatisfaction among executives as it would have adversely affected their cash flow and reduced the value of the STI due to delay in receipt and more risk of the STI not being received due to the additional vesting factor, and

(b) Not unnecessarily increase the cost of total remuneration packages.

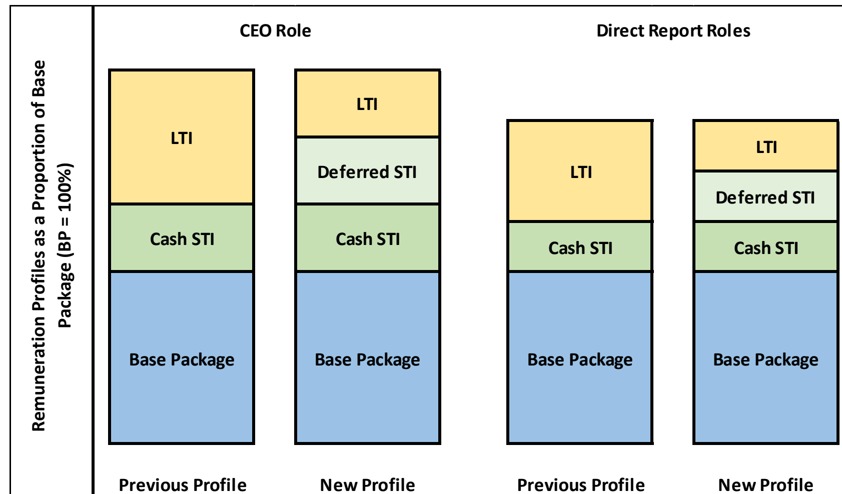
To the extent that the deferred STI has replaced cash STI, companies have also reduced cash outflow when:

i. deferred rights have been forfeited due to not meeting the vesting condition, and
ii. shares have been issued on exercise of vested deferred rights.

HAS THE OBJECTIVE BEEN ACHIEVED

The introduction of deferral of part of STI awards represents a change to remuneration profiles. In order to assess the impact of changes to executive remuneration profiles it may be helpful to use an example. The following diagram illustrates the changes in remuneration profiles that

may occur for a CEO and Direct Reports when companies introduce deferred STI through an equivalent reduction in LTI and target performance is achieved.



In the above remuneration profiles the cash STI does not change. What happens is that the vesting conditions and period for grants of deferred rights are changed in that:

a) vesting is changed from long term performance (previous LTI) to short term performance and service (new deferred STI), and

b) the measurement period reduces from typically 3 or more years for LTI to 1 and/or 2 years for deferred STI.

Rather than encouraging participants to give more consideration to both the risks associated with, and the longer term consequences of, aggressively pursuing STI goals these profile changes (above) are likely to encourage reckless pursuit of STI goals. This is because the deferred STI element will have value even if the share price has been negatively impacted and the LTI becomes relatively insignificant. Practically, the link between executive remuneration and long term shareholder benefit is then diminished relative to the arrangements that do not include STI deferral.

These changes are not consistent with the objective outlined in the foregoing. Further, such changes are likely to achieve a result that is the opposite to that which was intended.

Of course, some companies have taken a hybrid approach to implementing partial deferral of STI awards. These companies have funded the deferred component of the STI from a combination of previously cash STI and traditional LTI opportunities. The extent to which these approaches meet the objective will be influenced by the relative proportions of previous cash STI that is deferred and the previous LTI that is converted into deferred STI.

To fully meet the objective of STI deferral, deferred STI would need to be funded purely from cash STI only, with no change to the LTI proportion of the package.

FOCUSSING ON THE FUNDAMENTALS

Rather than focus on a specific narrow area of a remuneration profile such as STI deferral, it is perhaps better to revert to a consideration of the fundamentals that influence the structure of remuneration profiles.

Remuneration Committees and boards and their companies may be better served if they consider, for their company, what is the appropriate mix of:

- cash STI,
- service vesting deferred rights delivered to defer part of STI awards,

- service vesting deferred rights delivered as part of LTI grants, and
- performance vesting rights delivered as part of LTI grants.

If the reason behind the call for part of STI awards to be deferred is valid then is it best responded to by deferring part of STI awards or by increasing the LTI and decreasing the STI?

As the circumstances of companies can vary significantly it is unlikely that one type of remuneration profile will be suitable for all types of companies.

Once the most appropriate remuneration profile has been selected a transition strategy will need to be developed for its implementation.

Ultimately the criticisms of STI plans that have led to the prevailing view are related to a failure to properly design STI in high risk roles, and to manage the associated risks. In the lead-up to the financial crisis, overseas executives were paid huge short term incentives in relation to products with very long return tails that should never have been part of an STI and which would have better fit with LTI. It would appear to make little sense to then undermine the role of performance LTI in response, which is arguably the best way to mitigate short term risk taking in relation to STI (particularly when it has a higher weighting than the STI in the package).

As noted earlier, arguably a properly developed and applied clawback policy would equally or better manage the risks associated with short termism in relation to STI plans, if the clawback relates to the longer term impact of the achievement of the short term objectives.