GRG Remuneration Insight 102

KMP Remuneration Issues for 2018

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Introduction

2018 is shaping up to be a year of change in relation to key management personnel (KMP) remuneration. This GRG Remuneration Insight seeks to identify and comment on areas where change is underway or likely to occur in the next 12 months or so.

Fixed Pay

There has been much discussion of late, among economists, politicians, unions and others, regarding the long period of record low wage growth becoming a threat to the stability of the economy, despite generally positive corporate performances. Signs of consequences for financial risk are starting to emerge, in particular for retail spending, with the government proposing corporate tax cuts to support wage increases, and the opposition proposing more direct measures. Sydneysiders would be painfully aware of the impact of this issue coming to the fore, upon public transport, with some unions starting to take a tougher stance on this issue. While it seems that it may be some time before increases are observed in market data, there appears to be an emerging expectation that wages will need to rise faster in the next 12-24 months. These matters are bound to put further spotlight on any KMP remuneration increases.

Short Term Incentive

There has been some recent movement in the market to increase the weighting on short term incentive (STI) and reduce the weighting on long term incentive (LTI). The reasons for this change are not obvious as STIs are often subject to criticism including:

a) STI awards are unjustified when company performance is poor,

b) Key performance indicators (KPIs) and the performance ranges set for them are influenced by executives who, as STI participants, have a conflict of interest,

c) KPIs often have little, if any, relationship to growing shareholder value,

d) Cash STI awards are generally not subject to clawback if performance during the STI year does not lead to sustainable growth in shareholder value; or even worse when it leads to longer term destruction of shareholder value,

e) Part STI deferral into equity does little to drive the pursuit of growth in shareholder value – STI deferred into equity has much less motivational impact than an LTI in relation to growing long term sustainable growth in shareholder value,

f) Stretch performance goals and award opportunities can lead to a short-term perspective with immediate goals being pursued at the expense of longer term performance, and

g) One of the most common criticisms of annual reports by external stakeholders is the lack of transparency regarding STI objectives, and outcome calculations i.e. STI is generally seen as opaque and poorly correlated with performance.

Due to these factors GRG would not be surprised to see re-weighting to give more prominence to LTI than to STI, and which will be accompanied in most cases by lower target STI awards in the remuneration mix. Consequently, Stretch STI award opportunity will also come under pressure from 150% (and in some cases up to 200%) of the target STI award opportunities. With lower STI Targets, it is possible that STI deferral will be reduced or eliminated as it becomes unnecessary when LTIs have an appropriate weighting in the mix of variable pay.

Long Term Incentive

The design features of many LTI plans remain stuck in outdated paradigms, which mean that they continue to be poorly regarded by executives and fail to meet their primary objective of aligning executive remuneration with the success achieved in growing shareholder value. Many designs can be improved as indicated below:

a) When companies make annual LTI grants it is clear that each grant represents remuneration for the year in which the grant occurs. This is despite the fact that vesting conditions are based on the assessment of several years of performance, and typically several years of "service testing", usually being the year of grant and two subsequent years (3 year measurement period). This service testing approach results in many LTI grants being forfeited on termination of employment despite having been earned by having completed the year of work to which the grant related. Taxation and perceived retention effects influenced the now outdated practice of LTI grants either lapsing or vesting on termination of employment. The taxation problem does not arise in modern LTI plans and the retention effect has been recognised as weak or non-existent. For these reasons the application of service vesting conditions in parallel with a performance conditions is being reconsidered by leading Boards, with the removal of the service aspect of the vesting condition which significantly improves the perceived value of LTI.

b) Retention of unvested LTI grants following termination of employment (vesting continues to be subject to performance testing in relation to performance vesting conditions) is generally seen as desirable as it can lead to executives paying appropriate attention to succession planning, ensuring their performance is maximised up to the time of departure and not harming the company following departure. New style grants can achieve this without leaving the executive exposed to a tax liability in respect of the value of unvested rights held at the date of the termination of employment.

c) The two most commonly used LTI performance metrics, ranked total shareholder return (rTSR) and earnings per share (EPS) growth, are finally now both recognised as being less than ideal. While a small number of Boards have almost moved away from LTI altogether, others are improving efficacy via improved vesting conditions, and other metrics are starting to rise in prominence. Some of the more interesting new performance metric approaches are being floated by professional experts in company performance management rather than remuneration consultants or internal HR staff – see GRG Remuneration Insight 103. These new approaches are certainly worthy of consideration so that Boards may select those that fit their organisation's needs and circumstances.

d) Takeover provisions of many LTI plan rules leave executives with total uncertainty as to their entitlements up until the point of time that the Board makes a decision to vest or lapse some or all of the LTI grants they hold. Modern plans provide executives with a base vesting entitlement and leaves the Board with discretion to increase the number that vest, if considered justified.

e) Many companies are applying simplistic formulae to calculate the number of rights or options to be granted as LTIs. These formulae tend to assume that the target level of vesting will be 50% and that a vesting scale applies to each tranche of LTI. When these assumptions vary the formulae can give rise to inappropriate numbers of rights or options being granted. A more flexible formula is available and will ensure that when Boards change the vesting conditions or vesting scales, the executives continue to receive the correct numbers of rights or options.

Other Incentive Issues

There are a number of current issues that potentially relate to incentives more broadly, and which will need to be watched closely during 2018, including:

a) The rise of the single incentive plan is coming under increased scrutiny and criticism from external stakeholder groups, proxy advisors and institutional investors because it conflates short and long term performance, reduces transparency, and undermines long-term performance alignment,

b) The tax deductibility of transactions with employee share trusts (ESTs) in relation to equity-based remuneration (which is not otherwise tax deductible). While the first draft of the tax ruling (TR 2014/D1) cast doubt on the sustainability of such tax deductions, and a number of groups remain concerned about this issue, the more recent draft ruling (TR 2017/D5) indicates that such deductions are not under attack (assuming the EST is being operated in accordance with its intent),

c) The basis of allocations of equity grants remains contentious, although the use of accounting standards to determine grant numbers has all but disappeared, as it should, since AASB2 was never intended for this purpose. The remaining issues are related to whether or not equity values should be discounted for dividend entitlement loss (they should, otherwise employees of non-dividend paying companies are advantaged compared to dividend paying peers, though this practice is often criticised for reasons that remain dubious) and whether Target or Stretch incentive opportunities are used in the calculation (which should be based on Stretch, to be calculated using the Target vesting % drawn from the vesting scale - otherwise Target becomes the Stretch i.e. grants will be too low).

d) GRG has observed for some time an issue that appears to be finally coming to the fore; which is that one of the main reasons that the efficacy of incentives may be undermined is a lack of understanding by management regarding how to influence the levers related to incentives, and lack of support for professional development to improve such an understanding. In that sense, too often incentive plans are still relied upon to act as a performance management framework, instead of an outcome of that framework, which is a function that incentives cannot properly fulfil. The issues related to "soft" non-financial targets have illustrated this point clearly as not all subjects of performance management are suitable as the subjects of incentives. It is not reasonable that either such targets are ignored, or that incentives are compromised by the inclusion of inappropriate measures, and instead two distinct processes need to run side by side (performance management, and incentives).

Salary Sacrifice Equity Plans

A strongly held and increasingly popular view is that executives and non-executive directors should, within a short period after taking on a KMP role, have significant "skin in the game" via holdings of equity in the companies for which they work. New style fee/salary sacrifice plans facilitate this and can be particularly important when deferred STI and vested LTI do not achieve the expected levels of equity holding. Key aspects of the new salary sacrifice equity plans include;

a) No limit on the amount that may be sacrificed (i.e. $1,000/$5,000 limits do not apply),

b) Participants can choose when to withdraw plan shares which triggers the taxing point – no need to set a defined period of disposal restriction prior to salary sacrifice which makes the plan highly flexible,

c) Dividends can be reinvested on a pre-tax basis, which through compounding leads to enhanced benefit outcomes, and

d) Down side risk protection can be provided at no additional cost to the company or shareholders, thereby ensuring that the amount salary sacrificed will not be lost or discounted even when the company's share price falls – this is an optional feature that may not be seen as appropriate for some KMP roles.

For non-executive directors, a recent trend has been the development and implementation of holding requirements, however many Companies have made the mistake of requiring non-executive directors to acquire such holdings on-market. It is far less onerous and the right outcomes are achieved far quicker, if an appropriately designed pre-tax share acquisition plan is implemented.

Remuneration Committee Calendar

Given the scale and complexity of the cycle of tasks that Remuneration Committees are now faced with, a recent and effective trend has been for Boards to develop a more complete/detailed Remuneration Committee Calendar. GRG has helped a range of clients to develop such calendars in relation to their particular circumstances and approaches to remuneration governance, and as a result, we have been able to compile a typical calendar of considerations. As part of this Remuneration Insight, we are offering a free flexible template which you may use as a starting point to develop your own such calendar. Email us at info@grg.consulting and opt-in to email based Remuneration Insights to obtain your copy. The following provides a preview, and we would of course be happy to assist in customising the template for clients, should customisation be required (noting that different incentive plans can require different approaches/timing for example):

Aspect/ Timing	Exec Base Package/Total Remuneration Package Levels	STI	LTI	NED MBPs	Other
Jul	1. 1 July implement new packages (or backdate to this date if this date is not met)	2. Make STI offers close to the start of the new financial year, acceptances due by month end. 3. Undertake vesting procedures for equity deferred STI that has vested (assuming service test ends 30 June).	4. Communicate LTI vesting conditions for the new financial year close to the start of the measurement period – 1 July (set expectations about offer parameters but no offers to be made pre-AGM)	5. Undertake equity vesting procedures if there is any NED equity subject to service testing ending 30 June (note: no plan currently in place)	6. Begin drafting remuneration report. 7. Notify ASX of change in director's interest, related to deferred STI vesting for the MD or NED equity vesting if applicable - via Appendix 3Y
Aug		8. Determine (approve/resolve) incentive outcomes (including value of deferral) for the most recently completed financial year following completion of Audit, and engage payroll noting superannuation implications for those on high income. 9. Determine whether Board discretion should apply to modify award/vesting outcomes. This may require procurement of external data or advice to support modifications by the Board. 10. Consider whether clawback or malus policies/procedures need to be activated. 11. Communicate incentive outcomes for the previous year, and undertake vesting procedures if applicable. 12. For already departed good leavers, notify them or their beneficiaries of vesting/awards.			13. It is assumed audit is completed and full year results are released to market mid-month. 14. Calculate VWAP for the 14 days following the 24 hours after the release of full year financial results, to be used in equity grant number calculations following this date and prior to the half year results announcement. 15. Notify ASX of new issue in Appendix 3B for exercised equity. 16. Notify ASX of change in director's interest if applicable, Appendix 3Y for exercised equity
		18. Calculate number of deferred STI Rights (in relation to previous year STI outcomes), LTI Rights to grant (for current year), and NED equity to grant (for current year), based on the appropriate VWAP, ahead of seeking			

(continued, contact us for your flexible copy)