GRG Remuneration Insight 104

BEAR: Concerns With Variable Pay Deferral

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Introduction

Following is a copy of a letter sent to Mr. Wayne Byres, Chairman of the Australian Prudential Regulatory Authority expressing concern over the variable pay deferral aspects of the BEAR legislation. The content should be self-explanatory, however, if any aspect is not clear then please feel free to contact a GRG consultant.

Text of Letter

The purpose of this letter is to draw your attention to several aspects of the draft Bill dealing with the Banking Executive Accountability Regime (BEAR) in so far as it relates to deferral of variable remuneration. The issues raised are of a serious and crucial nature, which may require amendments to the legislation or which may be able to be dealt with under the powers conferred on APRA by legislation. The terms of the draft legislation lack clarity that at best may lead to confusion and inconsistency in application or at worst may lead to manipulation. Accordingly, it is requested that APRA intervene at an early stage to provide clarity to those organisations affected by BEAR.

It is first noted that the legislation makes a fundamental assumption underpinning all other consequences, which is that appropriately qualified persons understand what is meant by variable remuneration and when it has been paid (as outlined in the Explanatory Memorandum). Godfrey Remuneration Group wishes to raise concerns regarding this fundamental assumption, based on our deep experience as a leading executive remuneration advisor.

ASSUMED KNOWLEDGE REGARDING VARIABLE REMUNERATION

Variable remuneration is generally seen as taking the form of a short term incentive (STI) or a long term incentive (LTI). With an STI, an opportunity is offered and accepted (much like a contract) early in the financial year or immediately prior, and performance is measured over a financial year. Following the end of the financial year (i.e. not during the year of performance or offer) the performance is assessed and the amount of STI earned is determined by the Board and it is paid either in cash or a combination of cash and an award of equity which may be subject to vesting conditions and/or disposal restrictions for a period of months or years. Therefore, there is typically around a one year delay between the contract being entered into, and an award being determined. STI is generally considered to be "paid" when the award has been determined and a cash amount transferred and either when equity is granted or when any at-risk conditions cease to apply to deferred components. Some would argue it is not paid until disposal restrictions cease.

LTI is usually effected as a grant of equity part way through a financial year, and is granted in respect of remuneration for that financial year (when grants are being made annually), which is then subject to performance and often service vesting conditions over a measurement period of 3 years. There is typically a short period between the LTI contract being entered into, and the grant being made, and then a long period between the grant being made and the determination of vesting outcomes. LTI is generally considered to be "paid" either when the grant is made regardless of vesting in the future or when at-risk conditions cease to apply, though views vary widely in this regard.

This outline of what is commonly understood and accepted by remuneration professionals forms important context for the consequences and discussion that follow, and for the calculation of how much remuneration has been paid, which is critical for compliance.

BEAR VARIABLE REMUNERATION DEFERRAL REQUIREMENT

When variable remuneration is $50,000 or more the minimum deferral requirement under BEAR is for the lesser of:

(a) 60% or 40% of the accountable person's variable remuneration for the financial year (the ***relevant financial year***) in which the decision was made granting the variable remuneration; or

(b) 40%, 20% or 10% of the accountable person's total remuneration for the relevant financial year.

MULTIPLE POSSIBLE DATES FOR REMUNERATION DECISIONS

The phrase "the decision was made granting the variable remuneration" seems to be critical in understanding the intended operation of the variable remuneration deferral provision of the draft BEAR legislation. This phrase seems to impact both when remuneration arises and when the deferral period commences.

This phrase could be viewed as applying to many dates including:

a. when a new or revised employment contract is agreed,
b. in relation to STI
    i. when an STI offer terms for a financial year are decided by the Board,
    ii. when the STI offer is accepted by the employee i.e. employee decides to accept,
    iii. when the Board decides the actual amount of an STI award following the end of a financial year,
    iv. when the immediately payable cash STI award is paid,
    v. when the immediately payable STI award is delivered in equity,
    vi. when it is decided that equity paid STI awards will vest,
    vii. when equity paid STI awards vest,
    viii. when disposal restrictions on vested equity paid STI awards are released,
c. in relation to LTI:
    i. when the LTI offer terms for a financial year are decided by the Board,
    ii. when the LTI offer is accepted by the employee i.e. employee decides to accept,
    iii. when the Board decides to grant the LTI,
    iv. when it is decided that the LTI will vest,
    v. when the LTI vests, or
    vi. when disposal restrictions on vested LTI are released.

Given the interpretation appears to allow for many possible dates regarding both when remuneration has been paid or becomes payable, and when the deferral period commences, it would be helpful for clarity to be provided as to the approach intended to be applied.

EXPECTED INTENDED APPROACH

The Approach

In relation to STI and LTI it seems likely that the intended approach is that the decision to grant is taken to occur:

a) for STI when the decision is made as to the quantum and form of the STI award based on performance over the prior financial year (i.e. subsequent to performance conditions being tested), and
b) for LTI when the decision is made granting the equity including the vesting conditions attached to that equity (i.e. prior to performance conditions being tested).

This view leads to consistency of treatment of STI and LTI as remuneration arises when enforceable entitlements arise through decisions of the Board. Also, in both of these situations a remuneration quantum can be determined and employees have enforceable entitlements.

Aspects Requiring Clarification or Confirmation

Value of Equity Grants

What value should be applied to equity grants for the purposes of calculating the amount of remuneration paid during a period? The accounting standard (AASB2) recognises four categories of equity grants (those with market related vesting conditions, those with non-market related vesting conditions, those with non-vesting conditions and those with no conditions) which can have different values and different approaches to amortising those values in company accounts, despite having identical values from a remuneration perspective. Using AASB2 values would result in inconsistent application of the deferral provisions, because AASB2 was never intended, and is not used, for the purposes of calculating how much equity to grant. The approach to be used to calculate the value of equity grants needs to be clarified, and should ensure consistent treatment of similar remuneration instruments.

Inconsistent Treatment of Parts of STI Awards

According to BEAR, variable remuneration is that which:

"*is so much of the accountable person's total remuneration as:*

(a) *is conditional on the achievement of objectives; or*
(b) *is a retention bonus (however described)*". (underlining inserted)

This definition requires a determination at the time the remuneration is paid or becomes payable as to whether or not there is a performance or service condition attached. If there is a performance or service condition then the remuneration is classified as variable, otherwise it is not variable remuneration. In this regard, it is important to note that it is becoming increasingly common for service conditions to be removed from STI and LTI conditions.

Under generally accepted remuneration practice variable remuneration applies to:

a) STI award opportunities where the amount to be paid is variable depending upon performance, or
b) LTI which is typically provided as unvested equity grants that may vest depending upon performance and/or service.

That STI which was variable is no longer variable (applying the above) when the decision to grant is made, which seems to morph its character from variable to not variable due to the requirement for it to be variable when it becomes payable. This seems to be a strange approach or perhaps an unintended consequence of the way the draft legislation has been expressed.

The following table reflects the main possible elements of total remuneration and classifies them as variable or not variable under this approach:

Total Remuneration Element	Variable or Not Variable Remuneration
a) Salary paid during the year	Not Variable
b) Benefits provided during the year	Not Variable
c) LTI grants made during the year which are subject to performance and/or service vesting conditions	Variable
d) Cash STI awards paid during the year but excluding any amount previously recognised as remuneration when it became payable	Not Variable

Total Remuneration Element	Variable or Not Variable Remuneration
e) Unvested equity paid STI awards subject to performance or service conditions	Variable
f) Vested equity paid STI awards not subject to performance or service conditions (possibly subject to disposal restrictions)	Not Variable
g) Cash STI awards earned but not paid as they are deferred and subject to performance or service conditions	Variable
h) Cash STI awards earned but not paid as they are deferred and not subject to performance or service conditions	Not Variable

The foregoing table makes it clear that while all LTI grants would be considered to variable remuneration only a small sub category of STI awards will be classified as variable remuneration, with the balance instead contributing to not variable remuneration. The classification of STI awards seems to be a possible anomaly in the current draft legislation.

ALTERNATIVE APPROACH

Alternative Approach

An alternative interpretation of the intended approach could be that the decision granting the variable remuneration occurs when the decision is made to make an offer. This would mean:

a) For STI that it will be recognised as remuneration in the year prior to or early in the financial year when STI performance is measured, and
b) For LTI that it will be recognised as remuneration in the year prior to or during the financial year for which the LTI grant was intended to form part of the employee's remuneration.

It would also mean that the full value of STI and LTI opportunities will meet the definition of variable remuneration irrespective of whether they are paid in cash or equity.

Aspects Requiring Clarification or Confirmation

Value of Equity Grants

The same comments made earlier apply to the alternative approach.

Value of STI Remuneration

This approach raises concerns as to what STI value should be used for remuneration. Should it be:

- Actual STI which may not be known in the financial year of the decision particularly if the decision were made prior to the financial year of the STI i.e. 2 financial years prior to the STI award being determined,
- Stretch or maximum STI award opportunity which is unlikely to be earned, and which may be up to double the expected outcome,
- Target STI which should be the most likely outcome, or
- Some other STI value.

Conclusion

It is trusted that the foregoing has brought out the lack of clarity in the draft BEAR legislation and the need for it to be amended or clarified via APRA determinations. To assist affected organisations, such an APRA determination should be released as soon as possible.