

GRG Remuneration Insight 105

Variable Pay – Victim or Villain

Author: Denis Godfrey | June 2018

Contributors: James Bouchier, Nida Khoury & Peter Godfrey

Introduction

Revelations from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry resulted in much adverse commentary about the role of variable pay in influencing Non-executive Directors (NEDs), senior executives and other employees to behave unethically, and in some cases even criminally. This GRG Remuneration Insight seeks to examine the veracity of such commentary in relation to key management personnel (senior executives and non-executive directors) and explore related issues.

Non - executive Director Remuneration

Remuneration of NED roles in Australia does not usually include any variable pay as NED remuneration is typically composed of fixed amounts of board fees, committee fees and superannuation contributions.

In some cases, part of the remuneration package is composed of grants of options (usually in start-up companies; particularly exploration and research companies) or equity/share grants which are in lieu of fees (usually on a voluntary fee sacrifice basis). In the limited circumstances where options are provided they are generally seen as aligning shareholder and NED interests and sharing the risk of success in situations where risk is high. However, options have not been regarded as an appropriate form of remuneration for NEDs of most companies as they could provide an incentive to expose the company to excessive risk or as the life of the option approaches its end, to short termism. Hence, they are not widely used in Australia, and external stakeholder groups, institutional investors and governance advisors tend to see options as compromising the independence of NEDs.

Equity grants in lieu of fees are best delivered as rights which are exercised into shares subject to disposal restrictions. Such disposal restrictions should be until the earlier of the 15th anniversary of the grant or cessation of being a NED of the company. A practical implication of the disposal restrictions is to ensure that NEDs do not sell shares while they remain NEDs and therefore have the same interest in longer term value preservation and growth as other shareholders. This is generally taken to be positive alignment and may even be seen to support risk management through ensuring NEDs have “skin in the game”.

In view of the foregoing, it is clear that the remuneration structures used for NEDs in Australia do not provide any incentive to behave unethically or criminally; and if such behaviours have been exhibited by some NEDs it would not have been because of NED remuneration practices. Moreover, given the relatively low incidence of the types of rights plans we have described here, it could be argued that a rational change would be to increase their use.

Senior Executive Remuneration

Senior executive remuneration is typically composed of three elements being: Fixed Pay (salary, superannuation, cash allowances, fringe benefits and fringe benefits tax), short term incentive (STI) and long term incentive (LTI).

Fixed Pay

Changes to Fixed Pay tend to be driven by a combination of factors including: change in the size of the company (larger companies pay more than smaller companies for the same role title), the performance of the individual relative to role requirements and relativity of the actual pay to the market rate for the role which does change due to market movements. The area where there may be seen to be an incentive, is when performance reviews and ratings are linked to fixed pay increases, such as via a “merit matrix”. However, the value of merit-based increases tends to be negligible compared to the range of value available under incentives. However, this does raise a key issue, which is the role of the performance management framework, including role performance assessment (as opposed to incentive performance assessment). This is discussed further, below.

Long Term Incentive

The most commonly used form of LTI is grants of Rights (entitlements on exercise after vesting to a Share in the company or a payment equal to the value of a Share). Thus, there is value for participants if the Rights vest irrespective of whether or not the share price has increased, although the value will be greater if the share price has increased. Because of the lesser leverage and lack of a “cliff share price” involved in this arrangement compared to options, the behavioural risk associated with them is generally lesser.

Grants of Rights are usually made annually and vesting is typically based on performance measured over a period of three or more years. This combination of the annual grants and the overlapping 3+ year measurement period ensures that the focus is on longer term sustainable growth in shareholder value, irrespective of which combination of performance metrics are used to determine the extent of vesting. This is because each point in time will be the beginning, middle and end of different sets of grants, making it hard for the outcomes to be gamed.

Using AMP Limited as an example; their LTI plan uses Rights subject to a 3 year measurement period with performance being assessed by reference to total shareholder return (TSR) and return on equity (RoE) metrics. AMP’s 2017 Annual Report indicated that none of the 2014 grants vested and the likelihood was that none of the 2015 grants would vest. Given the experience of shareholders (as evident from the share price graph below), the LTI outcomes are appropriate and the LTI has operated as most stakeholders would have expected. It is also hard to argue that the behaviour of executives was driven by these long term measures, since the outcomes of their behaviour have reduced the probability of vesting, not increased it. Where they may have had an advantage would be in respect of future grants (due to a start from a low base), though few of the responsible executives may remain following the current review.

The chart below tracks AMP’s share price movement and compares it to the All Ordinaries Index over the last 5 years. For about 95% (4 years and 9 months) of the time AMP’s share price largely tracked the All Ordinaries Index indicating that inappropriate business practices did not produce above average returns for shareholders or expected vesting for executives. However, for about 5% (3 months) of the period when inappropriate business practices were brought to light the share price tanked and destroyed significant shareholder value. As executives did not deliver sustainable growth in shareholder value the LTI worked appropriately and delivered nil value for executives. The salient question then becomes if this outcome would have still arisen were it not for the current inquiry, or would the LTI have vested if only at low levels, propped up by the inappropriate conduct? This points to the issue of how the performance management and risk management frameworks function in these types of organisations if such behaviour was not being detected and addressed by the Board prior to the inquiry.

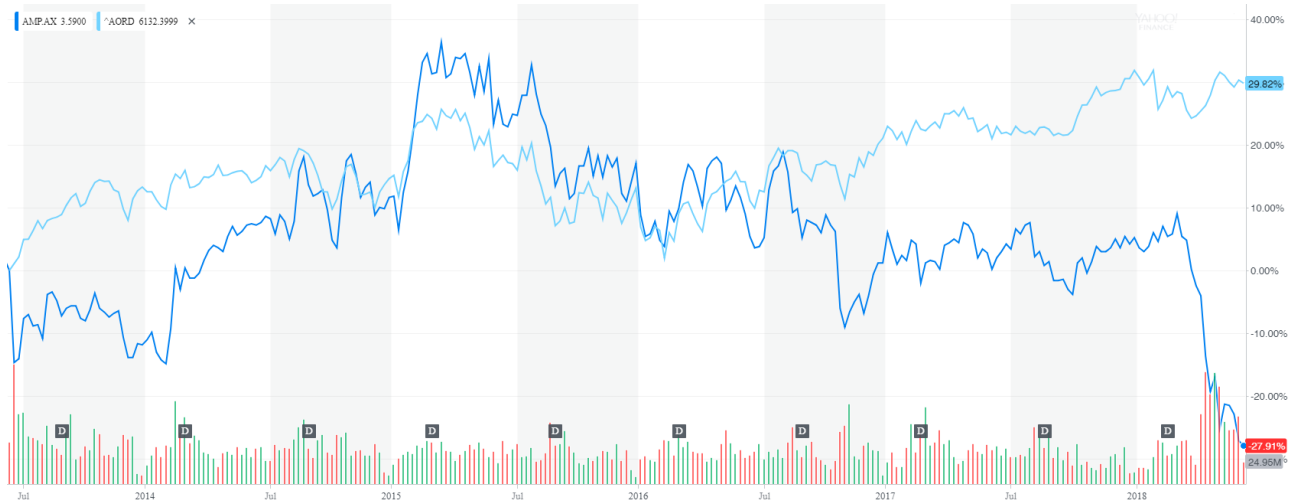


Chart Source: Yahoo Finance

Short Term Incentive

STIs generally measure performance for a year by reference to key performance indicators (KPIs) and performance standards derived from business plans and budgets largely created by management. The way that STIs are constructed produce a conflict of interest for senior executives as they are aware that their awards will be judged by reference to the parameters contained in business plans and budgets that they largely set. Even though the business plans and budgets are subject to Board review and approval, it is almost certain that they are not excessively challenging as senior executives of most large ASX listed companies receive STI awards that average close to the target STI award opportunity.

Returning to the AMP example, the 2017 Annual Report indicated that the CEO received 90% of his target STI award opportunity. Other senior executives received between 56% and 69% of opportunity although it is unclear as to whether the opportunity referred to was the target or stretch/maximum. Therefore, during a period when overall company performance did not deliver value for shareholders, executives were still well rewarded via the STI plan. This is an area of clear misalignment with shareholders and high risk which can be expected of a reward element that focusses on short termism and the influence that executives have on internal planning/reporting.

STI Deferral

Due to the clear risks and potential for misalignment attached to STI, it is common practice among larger ASX listed companies for part of STI awards to be deferred into equity. The logic being is that such deferral will expose executives to the same value variances as experienced by other shareholders. Unfortunately, however, this logic is flawed as executives are not buying the shares, they “earn” them by maximising their STI awards.

STI award opportunities often range from 50% (at threshold) to 200% (at stretch) of the target award opportunity. The example in the following table illustrates that senior executives are not in the same position as shareholders (the simulation is based on STI target award of \$100,000, with 50% deferred into equity when the share was \$10.00 and it either fell by 30% or grew by 30%).

STI Performance	STI Award	Cash Award	Value of Deferral (\$7.00 Share Price)	Value of Deferral (\$10.00 Share Price)	Value of Deferral (\$13.00 Share Price)	Total STI Award (\$7.00 Share Price)	Total STI Award (\$10.00 Share Price)	Total STI Award (\$13.00 Share Price)
50% of Target	\$50,000	\$25,000	\$17,500	\$25,000	\$32,500	\$42,500	\$50,000	\$57,500
Target	\$100,000	\$50,000	\$35,000	\$50,000	\$65,000	\$85,000	\$100,000	\$115,000
200% of Target	\$200,000	\$100,000	\$70,000	\$100,000	\$130,000	\$170,000	\$200,000	\$230,000

The important point to note here is that once the STI award has been determined there is relatively not much variance in the value of the STI award realised even if the share price varies significantly (70% to

130% in the example). Where the executives do realise significantly greater benefit is by maximising the STI award itself (50% to 200% range in the example).

Reverting to the AMP example, even though the share price has tanked the value slump is only around 30% from a +10% growth over 4.75 years to a -22% fall at the end of the 5 year period. Thus, the penalty for engaging in inappropriate business practices that may have enabled inappropriately high STI awards to be earned has been minimal and merely represents a slap on the wrist at worst. The executives are still better off having maximised their STI by taking short term risks, compared to the deferred amount having been offered as genuine, market tested LTI in the first place.

Conclusion

If some variable remuneration practices may have been partly to blame for unethical behaviour, then it is STI that is the main cause and deferral of STI has done little, if anything, to mitigate it. The emerging “single incentive plans” will obviously exacerbate this risk. On the other hand, LTI plans with a high weighting on market metrics deliver outcomes more consistent with stakeholder expectations.

However, the underlying problem of undesirable behaviour, risk-taking and misconduct cannot be addressed and managed by incentives, with managed being the operative word. Too often Boards rely on incentives to fulfil the role of a performance management framework and assume that measures can be identified that do not need to be risk managed.

The truth is that most performance indicators have strengths, weaknesses and behavioural risks associated with them, and incentives are intended to reward outcomes; not efforts or inputs. Here, it is the efforts and inputs leading to problematic outcomes and no incentive plan will ever be able to measure, monitor or provide remedial action in relation to inputs. This is the domain of the performance management and risk management frameworks, both of which should work to oversee the incentive framework, monitor behaviours that may impact incentivised outcomes and where problems are identified they are managed before incentives are blindly paid out; and ideally before the behaviour becomes an ingrained cultural issue.

It is GRG's view that:

- a) Boards should consider reducing the quantum of STI award opportunities and possibly eliminating them altogether,
- b) If STI plans are used the award opportunities should be small and be paid in cash as deferral has little, if any, useful impact,
- c) The degree of performance and risk management framework oversight in relation to incentives need to be continuously evaluated and Boards need to get deep feedback on how outcomes are achieved, not just whether they are achieved,
- d) Variable pay should be fully or predominantly via LTI plans, however the design features of LTI plans need to be reviewed to:
 - i. ensure that measurement periods are longer and better aligned with the planning cycles,
 - ii. holdings of LTI grants continue beyond cessation of employment unless circumstances warrant forfeiture,
 - iii. Boards retain and apply discretion to vary LTI vesting to ensure it is consistent with the experience of shareholders, and
 - iv. Shares acquired when LTI grants are exercised following vesting are retained by executives during their tenure and beyond, subject to sales being permitted to meet taxation obligations (such obligations should not arise before the earlier of cessation of employment and the 15th anniversary of the LTI grant).

As a final comment, we find AMP's announcement in their 2017 Annual Report that it is going to eliminate the LTI plan and create a massive STI plan with deferral bewildering. At least AMP should not be at risk of losing senior executives as they will most likely do very well out of such a new plan even if shareholder value is destroyed even further!