GRG Remuneration Insight 148

Tips for KMP Remuneration Benchmarking in 2023

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Introduction

This is the time of year when most Boards and Remuneration Committees turn their attention to reviewing the quantum and composition of remuneration for key management personnel (KMP) which covers senior executives and non-executive director roles. Key components of such reviews are for information on market practices to be accessed and for recommendations to be received from independent remuneration consultants (ERCs).

Market practice information is needed so the directors can be well informed about the environment in which competition for talent occurs. Recommendations are also sought by prudent directors who understand that market data is only the first step in determining appropriate remuneration, and/or who wish to ensure that they can, if required, establish that they have acted reasonably (see sections 208 to 211 of the Corporations Act) when setting the remuneration packages of both executive and non-executive directors. This GRG Remuneration Insight discusses matters that may need to be considered when undertaking KMP remuneration reviews.

Inflation is Driving Increases in Remuneration for All Levels of Employees

As is evident from press coverage, there is considerable pressure for significant increases in remuneration, from the minimum wage case to various large employee groups such as teachers, health professionals, transport workers etc. With inflation having risen to a 30 year high of around 8%, before recently dipping, and inflationary pressure continuing via cost-of-living stresses being driven by steep rises in mortgage interest rates, energy costs, food costs etc., it seems that demands for remuneration increases will continue for the foreseeable future. The current State and Federal Governments seem to be supportive of increases in remuneration as they seek to at least maintain living standards and preferably to improve such standards for those less well off in our community. The combination of these factors makes it almost inevitable that remuneration will increase materially and across the community over coming months and years.

History indicates that KMP remuneration tends to increase at a higher rate than the rate of increase for lower levels of employees. Even at this early stage of the inflationary cycle there is evidence that executive remuneration has started to increase at rates higher than general community rates. While some may be sceptical of the need to increase KMP remuneration due to inflationary pressure, on the basis that this group is not as sensitive to cost of living pressures as others, Boards need to monitor the remuneration market and be prepared to act swiftly to avoid loss of key talent. Regardless of the social debate, market benchmarks will inevitably increase materially and quickly in the coming periods.

Non-executive Director Remuneration

During the Covid lockdown period when many businesses were adversely affected, a large number of Boards chose to reduce or freeze Non-executive Director (NED) fee levels in the interests of shareholders. Although these practices have been discontinued it seems evident that NED fee levels have not fully returned to those that would have applied had Covid not intervened. Hence, there may be a need for catch-up to preserve the real value of NED fees. Of course, any increases in NED fees will need to fall within the shareholder approved aggregate fee limit (AFL or fees cap).

GRG is already observing faster than usual market movements in NED remuneration, and what appears to be an emerging trend of more frequent review. Thus, consideration may need to be given to seeking shareholder approval for an increase to the AFL before fee increases may be implemented.

With Corporate Governance pressure for Boards to have minimum shareholding guidelines for NEDs, consideration should also be given to the form in which increases are delivered. If NEDs have low shareholdings, it may be preferable for increases to be delivered in the form of equity. Such approaches are tax efficient and enable desired shareholding levels to be achieved quicker. It should also be noted that shareholder approved equity grants to NEDs are not counted towards the AFL, and this can therefore be an effective way to increase NED remuneration without breaching approved fee limits (but will require shareholder approval of the grants). Further, even in cases where NEDs already hold the required level of equity, for those NEDs that back themselves and the Company, ongoing settlement of board fees in the form of equity offers a compelling investment opportunity and a supplement to superannuation; pre-tax fees can be sacrificed into an Employee Share Scheme (ESS) that produces an outcome equivalent to 100%Capital Gains Tax (CGT) discount (compared to investing in the market from post-tax income). For dividend paying companies, it also produces a doubling of the dividend stream.

NED benchmarking tends to be more straight-forward than for executives, however, determining how to mix and settle NED remuneration remains challenging for many boards. The most common issues to arise relate to:

1. strategic review and implementation of NED remuneration framework activities, as planned for by the board in relation to NED benchmarking,
2. review and setting NED remuneration policies in relation to usual committee fee multiples and board chair multiples,
3. understanding how to design an equity plan that preserves NED independence,
4. how to deal with changing superannuation rates and various limits that could apply:
    a. there are two limits of which boards need to be aware being the superannuation guarantee contribution (SGC) limit ($25,292 in FY23 & $27,399 in FY24) and the concessional contributions limit ($27,500 in FY23 & FY24), which means that there is little scope for tax effective fee sacrifice contributions ($1,708 in FY23 & $101 in FY24, if not amended),
    b. fees policies should be set as inclusive of superannuation and superannuation contributions should be at the required SGC rate unless the NED has received an exemption from SGC contributions due to having high income and multiple employers,
    c. where boards pay superannuation in addition to board fees, committee fees often become problematic where most of the SGC limit is reached through board fees, while NEDs are participating in different committees in different capacities and reach their cap at various points in the model, thus producing unwanted variation in the remuneration paid to different NEDs despite equivalent contributions to the work of the Board, and
    d. it is important to remember that superannuation is remuneration, that is deferred by law to the extent required. Remuneration should not be less because the required deferral amount has been reached.

GRG's comprehensive NED remuneration database of over 1,000 companies can be cut into comparator groups for benchmarking. Accordingly, reports and recommendations can be prepared promptly. Our team can help you unpack basic benchmarks into actionable advice taking into account all the stakeholder, legal, tax and analysis issues that may otherwise be challenging for the board to navigate.

Senior Executive Remuneration and Special Considerations

Competition for senior executive talent is intense making it imperative for Boards to ensure that they are offering total remuneration packages that are competitive, structured to reward performance, produce alignment with stakeholders' interests and retain key talent. Market movements for executives are already above the levels we have seen in many prior years, indicating that executive remuneration benchmarks are going to move strongly through the next few remuneration reviews.

The SGC cap and the concessional contributions limit also need to be considered when dealing with executive remuneration.

A key issue in the market at present is the rising prevalence of service tested equity, which emerged when borders closed and cash flows tightened: from fixed pay, to deferred short term awards, single incentive plans, sign-on awards, retention grants, and in a very few cases long term awards, appear to be the focus of tensions between various stakeholder groups.

The other salient issue for this remuneration season is the use of non-financial, ESG and risk metrics as discrete metrics driving executive remuneration. An ongoing debate between stakeholder groups continues to rage about whether such factors are "part of the day job" and should be used as a gate or modifier, vs those that see such metrics as core to the business strategy and excellent indications of value creation or outperformance of expectations. APRA's requirements for financial entities virtually requires that part of executive pay is driven by metrics related to fulfillment of the basics of an executive role, which is likely to become a trend that spreads to others. Given that many of these metrics appear to be "hygiene factors" GRG generally views such metrics as better placed in a performance management framework that can be applied as a gate or modifier to executive remuneration outcomes.

GRG has comprehensive data on all KMP roles and has various tools to enable recommendations to be made on quantum and structure for roles where data is limited. Being able to make recommendations in relation to roles where limited data is available is a distinguishing feature that sets GRG apart from other ERCs. With the number and type of KMP roles being disclosed by listed companies reducing year on year, being able to benchmark all direct reports to the executive team is becoming increasingly challenging for many boards that rely on basic title matching market statistics. While GRG has for many years offered methodologies that address this problem, including organisation and job design-based approaches, advanced statistical analysis and non-comparator-group based approaches that rely on the largest data sets in Australia, we are now taking the next logical step.

GRG is responding to clients' needs for remuneration data in relation to senior executive roles that are not classified as KMP by developing a database that will integrate both publicly disclosed data and data collected directly from clients ("private survey"). Not only will this database cover the quantum of each element of remuneration but will delve into the performance metrics used for performance related remuneration. If you would like to be part of this database and thereby gain access to more comprehensive information, please contact Kylee Davidson or Chris Godfrey on (02) 8923 5700.

Doing Something Different to Gain a Competitive Advantage

Retention Grants

Service tested equity grants are generally not well regarded externally when part of long term variable remuneration, as a sign-on or retention grant, but are usually well accepted as part of single incentive plans, fixed pay exchanges and short term award settlements. Noting the current competition for talent, some boards in hot-spots have found it necessary to offer sign-on and retention grants to secure the talent they require and are prepared to accept the risk of external stakeholder criticism.

Although Retention Grants of Rights (Rights that vest with service only) often represent a high risk of negative feedback from proxy advisors, they could be considered by boards as part of long term variable remuneration (LTVR) if retention of senior executive talent is a matter of concern and external stakeholder views are of lesser concern. This approach involves no additional cost yet can be more highly valued by executives than Rights that are subject to performance vesting conditions. Of course, fewer Retention Rights than Performance Rights would be granted to deliver the same LTVR value at grant.

However, there are ways to configure and communicate service-tested equity that represent high risk, while others are low risk, and boards considering this kind of remuneration should seek expert advice, particularly in relation to sign-on arrangements. There has been a notable number of sign-on arrangements that have resulted in misalignment and inappropriate outcomes in recent years, with executives walking away with sign-on awards despite short tenure and destruction of shareholder value. There are many ways the need for a sign-on bonus can be addressed, and finding right the balance between stakeholder requirements involves understanding all of the alternatives, and the strengths and weaknesses of each. It is possible to design sign-on remuneration that is attractive while limiting the risk of misalignment. When sign-on is intended to address foregone variable remuneration offered by a previous employer, it may be important to recognise the at-risk nature of the foregone remuneration in "replacement" arrangements, otherwise changing employer becomes an effective way to de-risk

remuneration, and this is arguably driving the trend we see of executive tenure falling to typically around 4 years.

Dividend Equivalents

Companies should consider paying dividends equivalent on fully vested Rights to encourage long term retention of Rights. Such payments provide executives with additional cash flow and reduce financial pressures to exercise Rights and sell shares. They do not involve additional cost to the company compared to paying dividends on shares acquired by exercising Rights. This practice reduces pressure to exercise equity to access dividends, triggering tax and sales into the markets, and instead supports long-term tax deferral and holding of equity. This would appear to be in the interest of all stakeholders, although the reporting of dividends as part of statutory remuneration tables needs to be carefully managed. It may require holding policies and guidelines to be amended to include fully vested rights that are equivalent to a share but supports the faster achievement of holding policies due to a lack of tax related outflows.

Tax Advantaged Salary Sacrifice Equity Acquisitions

The ESS taxing provisions allow employees to salary sacrifice and receive equity interests that are equivalent to shares. Tax on these interests is deferred until exercise and then the CGT provisions apply (50% can be tax free) to the growth in value between grant and exercise. A small shortfall interest charge may apply but will, in most cases, be far exceeded by the CGT savings. For executives wishing to accelerate their equity holding in the company this is a very attractive benefit that may be offered by the company.

Conclusion

As the end of the financial year approaches boards need to review remuneration for NEDs and senior executives. The 2024 reporting period which is being decided upon in coming months is shaping up to be a critical one to get right, with plenty of economic risk, talent turnover risk and competing stakeholder tensions to be managed. This review should involve accessing market practice data and advice on approaches that may be implemented to improve the attractiveness of remuneration packages, and tailored advice should be sought to assist the board to identify and manage risks, while balancing stakeholder preferences according to current circumstances.