GRG Remuneration Insight 171
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Proxy Advisor Executive Remuneration Spotlight

Introduction

This GRG Remuneration Insight canvasses executive remuneration issues on which institutional investors and Proxy Advisors are shining their spotlights. These are the issues where ASX listed company boards may be exposed to receiving a "strike" (>25% of voters against the Remuneration Report) if their companies' remuneration practices are not consistent with the expectations of these groups.

If current practices are not consistent with external stakeholder expectations, then boards may wish to explain in Remuneration Reports by either:

a) explaining why their practices are appropriate for the company, even if different to Proxy Advisor expectations, or
b) outlining what changes are being implemented in the following year to align with Proxy Advisor expectations.

While important aspects that should be considered by boards are the focus of the Insight, it should be noted that these are generalisations; each Proxy Advisor and institutional investor will have their own nuances in assessing remuneration. It should also be noted that it is uncommon for a single, new issue to cause a recommendation against a resolution, or a strike; it is more usual for an accumulation of problems that have been raised and ignored over time to lead to votes against, except in egregious cases of departures from accepted market practices.

Market Competitiveness of Remuneration Packages

Proxy Advisors tend to mainly focus on data they have collected and analysed from Remuneration Reports for the S&P ASX300, as this group tends to be the main focus of institutional investors. They break up the analysis into groups of 25 or 50 companies after sorting by market capitalisation size order. These analyses generally ignore industry sectors because of the thin spread of companies in most sectors; however, at least one Proxy Advisor does also take industry sectors into account. These sector-based groups tend to be small and volatile due to the limited number of comparably sized companies in the same industry for any given business type in the ASX 300.

The Proxy Advisors tend to expect that companies will pay at the median of market practice for Fixed Pay and Maximum Total Remuneration Packages (as implied by their analysis). Companies that pay above the median of Fixed Pay or the median of Maximum Total Remuneration Packages may expect criticism and possibly a recommendation to vote against Remuneration Reports.

In order to manage the risk of remuneration falling outside of accepted or intended ranges, it would be prudent to set them using the company's executive remuneration policy, based on tailored benchmark data and advice received from a reputable independent provider. When this approach is adopted, it should be clearly explained in the Remuneration Report to inform all shareholders and Proxy Advisors. This should include disclosure of the policy, approach to benchmarking, and even the specific comparators selected. This approach should alleviate the possibility of unfair criticism of executive remuneration practices.

Balance Between STI and LTI

Proxy Advisor CGI Glass Lewis recently published an article titled "**What's Undermining the LTI? Insights from the Australian Market**" (see https://www.glasslewis.com/whats-undermining-the-lti-insights-from-the-australian-market/). In that article it was pointed out that, when vesting conditions are taken into account, many companies' practices reveal that short term incentives (STI) have a greater value than long term incentives (LTI) even when companies appear to be intending to provide an equal weighting to each of these incentive elements in executive remuneration packages.

For senior executives other than the CEO, most Proxy Advisors seem to support STI and LTI having equal weighting. For CEOs, it is arguable that they should have larger weighting on LTIs than STIs, since the CEO is considered to carry the greatest responsibility for creating long-term value for shareholders. Accordingly, in any companies where the value of the STI exceeds the value of the LTI, it should be expected that Proxy Advisors may consider recommending a vote against Remuneration Reports. This matter is exacerbated by a poor common understanding of the difference between Target and Stretch. While STI opportunities often offer Target and Stretch with objectives and rewards that are relatively close together, usually LTI has a greater Stretch value, and significantly lower chance of occurring. Therefore, setting policy/mix based on Stretch/maximum values, leads to low focus on long term sustainability and value creation.

LTI Measurement Periods

The Financial Accountability Regime which applies to the finance sector now has a mandatory 4 year deferral period for a portion of executive variable remuneration, which is leading to lengthening LTI periods in most cases. Some Proxy Advisors appear to have adopted this as the appropriate measurement period for LTIs. Since 3 year LTI measurement periods remain the vastly dominant market practice outside the finance sector, it may be expected that the Proxy Advisors will be tolerant, in the near term, of 3 year measurement periods while they push for 4 year LTI measurement periods. GRG's view is that as long as grants are annual with overlapping Measurement Periods, 3 vs 4 years makes little difference as both produce a framework for continuous, sustainable improvement, although executives will likely value the 4 year version less than the 3 year version, with LTI often already being lowly valued.

STI Deferral into Equity

Proxy Advisors tend to expect that at least 50% of STI awards will be delivered in equity and deferred. This expectation needs to be considered in the light of the company's weighting of STI and LTI award opportunities. Those with LTI award opportunities greater than the STI award opportunities are less likely to be criticised for deferring less than 50% of STI awards. However, those companies with STI award opportunities that exceed their LTI award opportunities, are likely to face strong criticism from Proxy Advisors and possibly a recommendation to vote against Remuneration Reports if STI is not deferred. This is often paired with an expectation for malus and clawback to apply, so that short term awards are subject to long term outcomes via the share price, and potentially, recovery/reduction via board discretion.

Risk, Environment, Social & Governance

Proxy Advisors and institutional investors are increasingly expecting ESG metrics, gates or modifiers to form part of variable remuneration plans. Measurement remains a problem, so ESG metrics are often viewed as "soft" or insufficiently specific if included as a single metric, commonly when the company does not have a robust quantifiable ESG or risk reporting framework in place, and may be better addressed using a multi-dimensional scorecard or as a modifier or gate. In the financial services sector, due to regulator requirements, risk and ESG are often used to determine if part or all of deferred variable remuneration is forfeited due to substandard performance in an important element of ESG and/or risk. The first step to addressing ESG and Risk, including as part of remuneration, is to develop a report identifying key organisation specific issues, and then a framework for planning and reporting on those issues on an ongoing basis. GRG can assist companies to start this journey via its AI enabled ESG platform associates.

Clawback and Malus Provisions

Clawback & Malus policies or provisions in the rules governing variable remuneration plans can be a way of addressing ESG and risk when performance is below expectations. For these provisions to operate as a penalty for, or deterrent to, poor performance it is generally necessary for significant amounts of "earned" variable remuneration to be held in a deferred form. Since LTI takes many years, if at all, to morph into vested equity it is generally necessary for significant amounts of STI awards to be deferred for Clawback & Malus Provisions to have any relevance. This aspect brings out the need for at least 50% of STI awards to be deferred for significant periods, as discussed in the foregoing.

Termination of Employment

It appears that Proxy Advisors are becoming concerned when termination of employment triggers vesting of STI and LTI award opportunities. This arises because boards generally need to exercise discretion in relation to performance, and Proxy Advisors tend to feel that boards too often exercise discretion in a favourable way towards executives when not warranted by performance.

A way of addressing this problem is to only assess performance at the end of the relevant measurement period, even if it finishes after an executive has ceased employment with the company. This approach also satisfies the preference of Proxy Advisors to retain equity well past the date of termination of employment. It also addresses termination benefit limit problems that otherwise arise.

Problems with Total Shareholder Return (TSR) Metrics

The expectation for part of executive reward to be linked to TSR is common to most external stakeholders, since it offers the strongest alignment with sustainable value creation. The use of TSR metrics in practice is one of the issues that different Proxy Advisors and institutional investors are least well aligned on i.e. there is a high degree of variability in views and preferences among these groups. This makes it challenging to achieve good support from all such groups, while having metrics that executives are engaged by.

Most institutional investors and Proxy Advisors expect TSR to be assessed on a relative basis, to remove the impact of market movements unrelated to management from reward calculations. However, in a small market like Australia, it is hard to do this in practice, noting that there are few directly comparable companies available in any given industry, and that companies of different size have different TSR expectations. It is also worth noting that due to pressure from some groups, a Threshold level of outcome was removed from the standard TSR vesting scale many years ago i.e. there is no vesting for P25 performance, only P50 at a minimum. This makes ranked TSR much more unlikely to vest, much more volatile and arguably less relevant to executive performance than other metrics, leading to low engagement from executives.

Some institutional investors and Proxy Advisors recognise this by supporting companies using fairly broad comparator groups, like "ASX 300 Financials" for example, to ensure the sample size is statistically meaningful and covers a range of relevant sized companies. However, others push for very specific comparator groups of 'cherry picked' companies and ignore the statistical and market problems that arise. Some proxy advisors will accept alternatives like Indexed TSR (which GRG generally recommends), or Absolute TSR set at levels appropriate to the Company, while others will not. Even with something like Indexed TSR, some stakeholder groups understand how a broad index calibrated against Beta provides a company-specific outcome, while others will push for comparator-driven groups, seemingly not understanding the differences between ranked and calibrated indexed TSR.

Too Soft on Safety

Some groups have identified that while companies seem quite keen to include soft, people-based metrics like customer satisfaction, employee engagement or inclusion, safety is often given only a minimal weighting in variable remuneration. This is because many companies make the mistake of using safety as its own metric, which can send confusing messages about executives being rewarded for certain injury rates or safety outcomes, especially given it usually has a much lower weighting than financial metrics. To

show that companies are generating returns responsibly, industrialised businesses should consider using safety as a gate or modifier, rather than its own metric, perhaps alongside other indicators of the "how" of outcome achievement. This sends a clearer message that if safety is not properly managed, the whole incentive will be turned off, without needing to deal with the issue of weighting it among financial and other metrics.

Managing Foreign Market Remuneration Practices

Australian companies are increasingly looking to foreign markets for opportunity, leading many to face challenges around managing the significant differences between executive remuneration markets in different locations. Ignoring the internal equity challenges, shareholders can often find the packages offered to executives in the USA, for example, surprising and excessive compared to Australian market practices. Companies managing executive remuneration across significantly different markets should have a clear policy around how they will address variations, and communicate clearly to shareholders 'when and how' market benchmarks and variations are managed. For example, paying an Australian sourced and located executive team, according to USA market rates because there is a business unit operating there, is unlikely to be well accepted. However, attracting and retaining talent within the USA market to operate businesses in the USA, will generally be accepted where it is clearly linked to strategy.

Conclusion

While most boards only come under pressure to meet institutional investor and Proxy Advisor remuneration governance expectations as they enter the ASX 300, most boards may benefit from considering such stakeholder views. It may support them to develop more mature policies and practices that ultimately benefit all stakeholders, as well as reducing change and challenges if the business matures to ASX 300 status. Most Proxy Advisors and institutional investors will publish their guidelines on their websites and offer the opportunity to meet to engage if there are matters of concern. Some will make their reports freely available to the boards of the companies being reviewed, while others will ask for a fee to access reports. Whether or not your business is ASX 300 classified, or even ASX listed, Proxy Advisors and institutional investors can provide a valuable indication of investor and community expectations that are fast evolving in a modern governance environment. How companies manage and respond to those expectations is something that GRG can assist with on a tailored basis.

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