GRG Remuneration Insight 98

Are STIs Working?

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Introduction

Various articles appeared in the Press last month triggered by a survey conducted by the Australian Council of Superannuation Investors (ACSI) and comments attributed to its CEO. Unsurprisingly, the majority of commentaries fervently pointed to "high levels" of bonuses, bonuses paid for "low performance", bonuses designed and applied to "weak hurdles" and so forth. The flawed survey methodology and the way its results were disseminated added fuel to an emotive subject, and which unfortunately distracted from the commendable cause of ASCI's CEO wanting to see vested equity to make a greater portion of CEO pay.

To settle some myths related to comments in relation to short term incentive (STI) awards, GRG recently completed an analysis of remuneration disclosures from the ASX 300 2016 Remuneration Reports, the results of which may surprise many.

This GRG Remuneration Insight presents information and commentary on STI awards and reveals that the main issues identified with incentives relate to a lack of understanding by most commentators, which is made worse due to unclear communication and disclosure by some companies. Therefore, it should be relatively easy for Boards to resolve this public furore, by explaining more clearly how incentives are intended to work, and why.

ASX300 Companies

The group of companies that constitute the ASX300 regularly changes as companies move into or out of the index due to changes in market capitalisation, listing or delisting or other factors that affect qualification for inclusion. Nevertheless, it remains a solid group by which to assess the market practices of leading Australian companies.

YES! STI Awards Do Reflect Performance!

The following tables indicate the spread of **actual** STI awards paid relative to **target** policy award opportunities for companies in the ASX100, ASX200 and ASX300 that disclose this information. Please note that "policy" here is the Target Incentive opportunity and NOT the Maximum Opportunity. Also attached as Appendix A are bar charts that show the spread of actual compared to target STI awards for the ASX300.

ASX100		
Actual STI as % of Policy Target	**CEOs**	**Direct Reports**
<80%	25%	29%
80 - <100%	25%	28%
100%	6%	5%
>100% - <120%	25%	20%
>120%	19%	20%

ASX200		
Actual STI as % of Policy Target	**CEOs**	**Direct Reports**
<80%	38%	36%
80 - <100%	19%	25%
100%	3%	6%
>100% - <120%	22%	17%
>120%	18%	16%

ASX300		
Actual STI as % of Policy Target	**CEOs**	**Direct Reports**
<80%	31%	39%
80 - <100%	17%	24%
100%	2%	5%
>100% - <120%	20%	16%
>120%	30%	16%

The spread of outcomes is fairly consistent with a normal distribution and clearly shows that the often contended proposition that executives receive their STI awards irrespective of performance is demonstrably mistaken. Moreover, the fact that 10% of the companies did not pay any STI (see appendix) is consistent with the notion that STI awards need to be earned rather than being a guaranteed entitlement as some media sources seem to imply.

Based on the above, it is clear that the source of the comments evident in the media at best suggest a lack of understanding of the range of outcomes for which an incentive is intended to be awarded, and which not only includes "Stretch" (outperformance) but also Target (usually plan), Threshold (a near miss of the plan) and even nil.

Policy Targets and Stretch STI Award Opportunities

Market practice in relation to the setting of STI award opportunities between "Target" and "Stretch or Maximum" vary significantly with the following most commonly used:

- Target of 100% with stretch award of 200%,
- Target of 100% with stretch award of 150%, and
- Target of 100% with stretch award of 100% (i.e. no reward for outperformance).
- The data from the ASX300 companies indicates that stretch as a multiple of target is as follows:

Stretch STI as Multiple of Target	CEOs % of Companies	Direct Reports % of Companies
1 time	5%	6%
>1 & <1.5 times	29%	18%
1.5 times	20%	21%
>1.5 & < 2 times	16%	20%
2 times	20%	25%
>2 times	10%	10%

The definition of stretch/maximum (which is usually associated with "outperformance") also varies significantly with some considering outperformance outcomes to be extremely unlikely but highly valuable, and others as outcomes that are slightly more likely and slightly less valuable.

The above shows that any commentary on STI awards as percentages of the maximum award opportunity will be inconsequential (if not meaningless), and that really the ***Target*** incentive should be the focus of discussion.

What are STIs For?

The outdated view of STIs is that they are only intended to reward rare exceptional performance, which is way over and above expectations. However, under the current predominant executive remuneration practice the policy target levels of STI (and LTI) award opportunity are considered part of a market competitive total remuneration package for delivering challenging but reasonably achievable levels of performance.

STIs are intended to reinforce the need to achieve challenging business plans and budgets by paying target award opportunities when these plans and budgets are achieved. Furthermore, each year's plans and budgets are planned to be part of the implementation/fulfilment of a longer term strategy.

In this way the remuneration realised by executives is intended to be lower when performance is below target and higher when performance is above target, which is deliberately set to consistently flex with the experience of shareholders. This is the modern concept of variable risk-adjusted remuneration.

At times Boards are criticised for paying STI awards during years when significant write-offs have been made. If the write-offs are the result of loss of shareholder value then executives will have also lost value via their LTI plans. A purpose of the STI plan is to ensure that what needs to be done gets done. At times this can involve a decline in profitability, for example when capital is being expended to grow future income or a business unit is being sold to release capital for future redeployment into more profitable operations. In these cases STI awards need to be taken in context.

Mix of STI and LTI

For some years there has been a re-weighting of STI and LTI with STI growing and LTI declining in relative weightings. This change has been a factor in stakeholder pressure for part of STI awards to be deferred into equity. While there is no absolutely universal correct weighting of STI and LTI there seems to be a broad acceptance among stakeholders that the weighting on LTI needs to increase and executives need to have more "skin in the game" via increased levels of equity holdings. The starting point for such an outcome could be to progressively reduce policy targets for STI and increase them for LTI. To this could be added:

- extended disposal restriction on shares acquired under LTI plans,
- introduce minimum shareholding policies for executives, and
- provide salary sacrifice facility for fixed pay and STI awards to be converted into equity acquisitions via a facility made available to executives that encourages them to do so by providing attractive tax outcomes.

Conclusion

The data provided in this GRG Remuneration Insight seems to clearly indicate that STI plans are generally working as intended. However, as alluded to above, there are two main drivers for the lack of understanding of incentive outcomes in the broader community, which underpin the largely observed commentary, fuelled by poor disclosure around incentive frameworks. They are:

1. The belief that an incentive is only for outperformance or exceptional outcomes, consistent with the now antiquated concept of a "bonus", rather than the modern concept of variable risk-adjusted remuneration, whereby an executive shares the risks associated with the impact of their role with the Company and shareholders, and
2. Poorly explained and poorly shared definitions of Threshold, Target and Stretch/maximum, and often lax application of those concepts when the Board is also not clear regarding the defining of these concepts.

With regards to the latter, it is becoming increasingly common for remuneration frameworks to define and disclose to shareholders the following:

- Threshold: a "near miss" of a challenging but achievable set Target. This level of reward usually results in payment of a significantly reduced amount of the target award (typically half or even less),

- Target: a challenging but reasonably achievable objective, usually the planned/expected outcome associated with budget where there is a budget setting culture that is robust (i.e. budgets are not soft, and include challenge). The reward associated with this outcome is usually intended to deliver the target incentive under the executive remuneration policy,
- Stretch: an exceptional outperformance, with a low/rare probability of achievement, the purpose of which is to set a far-out objective to continue to incentivise performance even when a Target has already been achieved. The reward associated with this outcome is typically 150%-200% of the Target, due to the extremity and value of the outperformance required to achieve this outcome.

Given the simple steps that can be taken to resolve the problem in a short period of time we firmly believe that it is in the interests of all stakeholders to resolve this lack of clarity as quickly as possible, since it has (and continues to) caused friction and in some cases reputational damage for far too long.

GRG can assist Boards to review and develop their incentive frameworks, policies and procedures, and to communicate them to the market more effectively by drafting best-practice Remuneration Reports.

Appendix A – Actual STI Awards Compared to Policy Target Award Opportunities