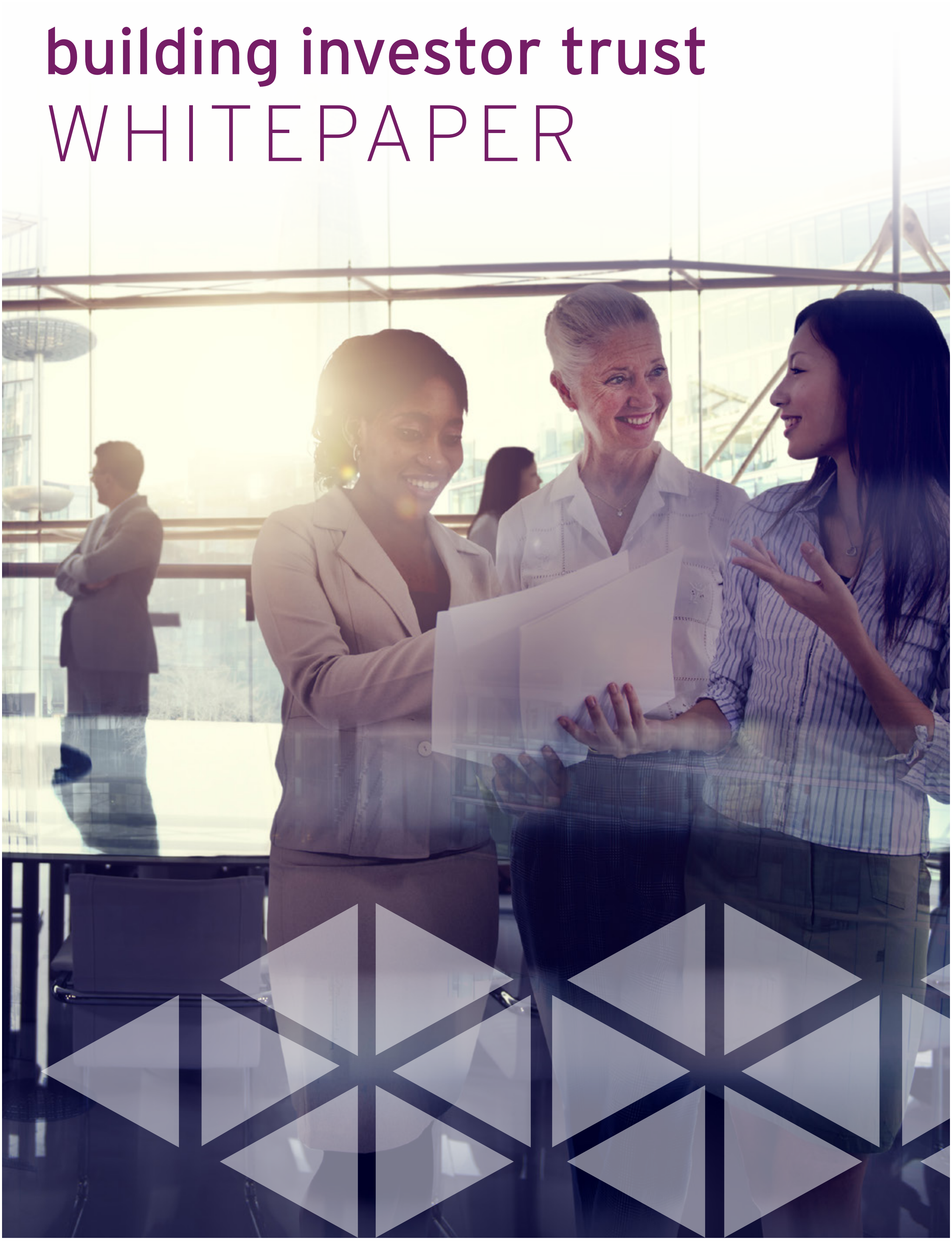
Executive remuneration and building investor trust

WHITEPAPER



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Introduction

The focus on executive remuneration, and especially the perception of excessive remuneration, has not dissipated in the past year. The community, and the federal government, are outraged by large CEO and executive salaries and bonuses, especially in the financial services industry, following the findings of the Hayne Royal Commission. The 2018 annual general meeting season saw a record number of listed companies receive a first strike on their remuneration report.

In this environment, boards need to take the lead and management teams must support them, ensuring they are able to clearly explain the performance that resulted in specific outcomes this year

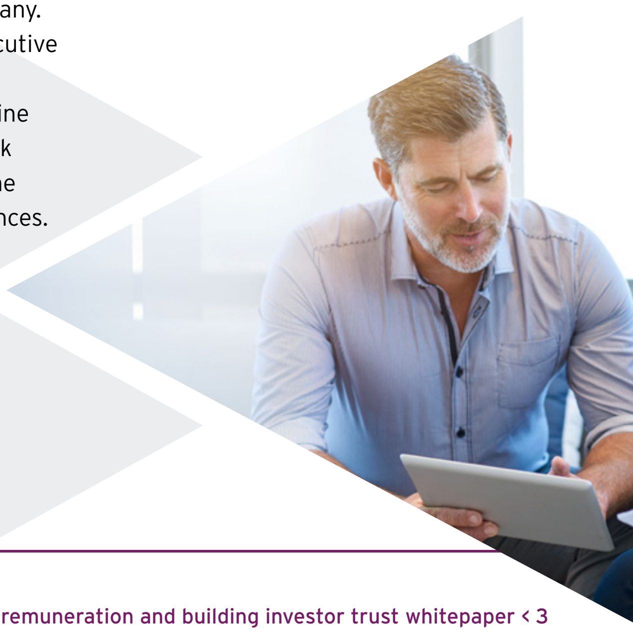
As we approach the upcoming AGM season, it is important for listed companies to recognise there has been a loss of trust in corporate remuneration in the wake of the royal commission. Companies must take this into account when communicating their remuneration outcomes.

Moves to simplify remuneration frameworks and adopt ‘fit for purpose’ structures have suffered a near-mortal blow in the past 12 months, as large investors have voted against nearly all such programs. This is not necessarily because of the design of these plans, although some investors have a real issue with removing a long-term performance test, but their application. A number of companies were seen to be paying more for the same or lesser levels of performance.

Institutional investors appear more comfortable with the homogenous structure of fixed pay, short-term and long-term incentives with relative total shareholder return (TSR) and an earnings or return-on-capital measures. Qualitative measures such as customer metrics have not received the same degree of acceptance, despite being important tools in some businesses when assessing performance.

In this environment, boards need to take the lead and management teams must support them, ensuring they are able to clearly explain the performance that resulted in specific outcomes this year, and how that performance aligns with the long-term strategy of the company. To restore shareholder trust in executive remuneration, boards also need to put aside strict formulas to determine incentive outcomes and instead look at the quality of results to determine what’s reasonable in the circumstances.

These were some of the themes that were explored in a series of recent roundtables featuring key stakeholders involved in this debate, including listed companies and remuneration advisers. In this whitepaper we unpack some of the central themes examined during these events to help guide listed businesses’ thinking in the lead-up to this year’s AGM season.



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Strategic alignment and transparent communication

At the core of every well-received remuneration plan is alignment with a clearly defined corporate strategy. For shareholders to approve the remuneration structure, they need to appreciate how the executive remuneration framework supports longer-term, strategic success, rather than simply acknowledging a short-term spike in annual performance.

Early and regular communication to, and engagement with stakeholders, is the key to a successful remuneration design and AGM season. Transparency around what has been paid, and what performance underpinned those payments, is paramount. In the past, organisations that have suffered and subsequently overcome a strike against their remuneration report have in the following year been able to outline investor concerns and articulate how they have addressed those they have been able to, and also acknowledge those they have not been able to address and why.

Executive pay trends

Community, media and investor focus has placed downward pressure on the quantum of remuneration, especially for CEOs. But even in light of the present debate in the community about executive remuneration, there are questions about whether ongoing pressure on executive pay is sustainable, especially given the potential effect on the quality of senior management. This is particularly so when listed companies need to look outside Australia for talent.

Newly-appointed ASX50 CEOs during the past financial year now earn less, in fixed pay than the person they replace. This has a flow-on effect to incentive pay, which is usually set by reference to fixed pay levels. This is the second year of this phenomenon. This demonstrates a recognition by boards that restraint on fixed pay, as well as at-risk remuneration at CEO level, is important to rebuilding trust with investors. Given the average tenure of CEOs in the ASX100 is around four years, this rate of change is significant.

This does not stop companies paying more for external talent. However, remuneration restraint is in the forefront of many board's minds when looking to appoint a new CEO.

In some markets including the UK, there is an increasing trend for long-term incentives to be five years or longer

Long-term incentive trends

Expectations around the way long-term incentives are designed are shifting. Data shows that while the vast majority of ASX100 companies continue to operate a three-year, long-term incentive plan, since 2018, *under the Banking Executive Accountability Regime1[1] (BEAR), Australia's listed major and other banks have been required to implement remuneration policies. These policies enforce 40% of senior executives' variable remuneration to be deferred for a minimum of four years (60% in the case of CEOs). In some markets including the UK, there is an increasing trend for long-term incentives to be five years or longer, something local regulators may be keeping in mind. The pressure will be on companies to justify not moving to a longer long-term incentive period.

most ASX100 companies

continue to operate a three year long term incentive plan

40% *Senior executives*

60% *CEOs*

Variable remuneration is deferred for a minimum of four years

[1] https://www.apra.gov.au/sites/default/files/180328-Information-Paper-Remuneration-Practices.pdf

To successfully make use of non-financial measures, companies need to clearly articulate why the specific measures chosen are important to the organisation, how they fit strategically and also prove veracity of the measurement

This is a complex area – particularly if executives' long-term incentives measured over such a long period are due to vest in a year in which company performance has suffered. It is also worth understanding the average tenure of an ASX100 CEO is just over four years. So if the rules change so long-term incentives only vest after five years or longer, some CEOs may never experience vesting while they are in the role. This could be an issue when it comes to attracting top executive talent. As this shows, balancing regulators', customers', investors' and staff interests is complex.

Additionally, appropriate incentive structures differ between industry sectors. Some companies, for instance retailers, find it hard to plan beyond the current year given shifting market conditions. Others, such as miners and large infrastructure companies that make multi-billion dollar investments over lengthy periods, with long-term contracts locked in, have very different timeframes. So methods that test whether these businesses are delivering for shareholders should necessarily be different and so should the way they incentivise and pay executives. The fact different shareholders are motivated by different factors and over different time periods adds an additional layer of complexity.

When designing a remuneration plan, boards must consider the conflicted interests between attracting, retaining and motivating executive talent and meeting investors' expectations regarding company performance over a defined time period. Long-term incentives need to be achievable and of value to executives to justify their cost. If they are not valued, they won't attract the right people or incentivise the right behaviour.

The role of non-financial measures in remuneration plans

Non-financial measures are another contentious issue in executive remuneration. The Australian Prudential Regulation Authority (APRA) is vocally supporting the use of non-financial measures for long-term incentives in the financial institutions it regulates. This call is being made to try to counter balance the pursuit of purely financial metrics over the longer term.

Across the financial services sector, which came under fire during last year's AGM season for executive remuneration, non-financial performance measures in short-term incentives are common. This is because qualitative factors such as customer satisfaction can have an impact on long-term performance. As such, APRA's position is it is appropriate to include risk and other strategic but non-financial measures such as customer measures in long-term incentives. Many investors and proxy advisers, however, have a different view and prefer hard financial measures over perceived soft, qualitative measures when it comes to executive remuneration.

To successfully make use of non-financial measures, companies need to clearly articulate why the specific measures chosen are important to the organisation, how they fit strategically and also prove veracity of the measurement. For instance, while a bank's net promoter score may be rising, this also needs to be balanced by ensuring it is continuing to lend in a responsible manner and not just making customers happy by giving them loans they cannot service.

The 'unintended consequences' of incentives requires boards to look at the quality of the result and not just the result itself

Further, companies linking data about a more engaged workforce to executive remuneration should show higher productivity and/or better financial results. The onus is on listed businesses to explain why non-financial measures are important, why they are being measured and why they mean better outcomes for the company and shareholders over time.

Businesses need to achieve an appropriate interplay between non-financial and financial measures in a way that will satisfy regulators, customers, investors and proxy advisers and, at the same time, ensure they don't degrade the company's financial performance over the long term.

Considering unintended consequences

Setting performance measures is an important exercise. It sends a signal about elements on which the CEO and board want management to focus. However, it is vitally important that focusing on a few scorecard items does not mean emphasis is removed for other important aspects. The 'unintended consequences' of incentives requires boards to look at the quality of the result and not just the result itself. For instance, it's not enough for banks to simply measure, and then reward, how many personal loans are approved across a period without also assessing whether borrowers have the capacity to repay loans.

Companies require lead indicators that will give an early warning sign if incentives are producing unanticipated results. Incentives will always produce unintended outcomes. The key is trying to anticipate and minimise them.

Conclusion

As we approach the upcoming remuneration season, board members should be looking at how to clearly explain how they arrived at decisions on executive remuneration and how issues such as reputation, customer, conduct risk, environmental impact and social licence have been considered.

Expect discussion and debate around how boards have exercised discretion on remuneration. In particular, when engaging with investors, listed businesses should be prepared to demonstrate robust processes around non-financial elements of any short-term incentives.

The right way forward will be different for every company. The idea is to heed the lessons of last year, engage early with investors and proxy advisers and clearly communicate the rationale behind decisions concerning the remuneration plan. Simplicity will win over complexity.

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