GRG Remuneration Review

Analysis of the ASA's New Policy on Executive Remuneration

Remuneration Review No. 15

May 2009

INTRODUCTION

The Australian Shareholders Association (ASA) has released a policy statement dated 23 March 2009 titled "Executive Remuneration". This statement is to be applied for financial years ending 2010 onwards. Thus, it will apply to financial years commencing in 2009. The delayed application is presumably intended to give companies time to change their current practices. This policy statement may be accessed via the ASA's web site: www.asa.asn.au.

Some aspects of the ASA's policy reflect what may be regarded as current "best practice" and therefore warrant little comment. However, others are seeking to significantly change executive remuneration practices in Australia and should be subjected to widespread discussion and critical review before being accepted or rejected by Boards.

This GRG Remuneration Review focuses mainly on those aspects of the ASA's policy statement that are seeking to change established remuneration practices and therefore need to be critically analysed.

The ASA's policy statement is divided into four sections being:

- Background,
- The ASA Position,
- Guidelines on Long Term Incentives, and
- Guidelines on Short Term Incentives.

Comments follow on the relevant parts of each of these sections.

BACKGROUND SECTION

In this section, the ASA broadly criticises executive remuneration practices and indicates that its views as expressed in this policy statement represent a "hardening of the ASA's position".

It should also be noted that the ASA "does not support statutory restrictions on remuneration levels and believes it is the responsibility of the boards of companies to deal with the problem".

The fact that the majority of Australian companies have been well managed and have not had remuneration practices that have influenced excessive risk taking or poor business practices seems to have been overlooked by the ASA.

THE ASA POSITION SECTION

Remuneration Strategy and Profiles

In this section the ASA is seeking to impose a single remuneration strategy and remuneration profile for Chief Executive Officers (CEOs) of all companies irrespective of their circumstances.

GRG Remuneration Reviews are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

GRG Godfrey Remuneration Group Pty Ltd
ABN: 38 096 171 247
56 Berry Street
North Sydney NSW 2060
Phone (02) 8923 5700
Facsimile (02) 8923 5706

www.godfreyremuneration.com

Their proposed remuneration strategy is as follows:

- Base salaries (presumably they mean Base Packages or Total Fixed Remuneration or Fixed Annual Remuneration as most ASX listed companies do not refer to or focus on salary) should be set at "sufficient levels to provide full and adequate compensation where performance is adequate but not superior".
- "Incentives payments in addition to base salaries are acceptable where these reward superior, as against merely adequate, performance".
- For CEOs "an incentive award equal to the amount of the base salary package is acceptable" if they have "achieved significantly superior performance".
- Generally incentives for CEOs should be in the form of long tem incentives (LTI) only, as short term incentives (STIs) "are questionable as incentives for CEOs".

If we assume that "satisfactory performance" is equal to planned performance then incentives would only be available for exceeding planned performance which may well involve significant additional risk taking. Encouraging additional risk taking is inconsistent with many of the views being expressed both in Australia and internationally.

To properly consider the ASA's proposed approach, it may be helpful to look at three indicative remuneration profiles at stretch performance for a CEO of an ASX listed company with a market capitalisation of around $2 to $5 billion.

The "past remuneration profile" reflects common practice of the target STI and LTI being about equal. The stretch STI has been shown as double the target level and there is no stretch LTI as the value is of the equity units granted and it generally does not change irrespective of vesting or the value actually realised by executives.

The "emerging remuneration profile" had commenced prior to the global financial crisis and is now increasing in use. Further comments on this profile are provided later in this article.

The ASA approach does not include any STI and limits the LTI to an amount equal to the Base Package. The result is a much lower total remuneration package. In fact the ASA position may be lower than indicated as they may mean that the benefit derived by the executive from the LTI should be limited to an amount equal to the Base Package.

Remuneration Profiles Comparison

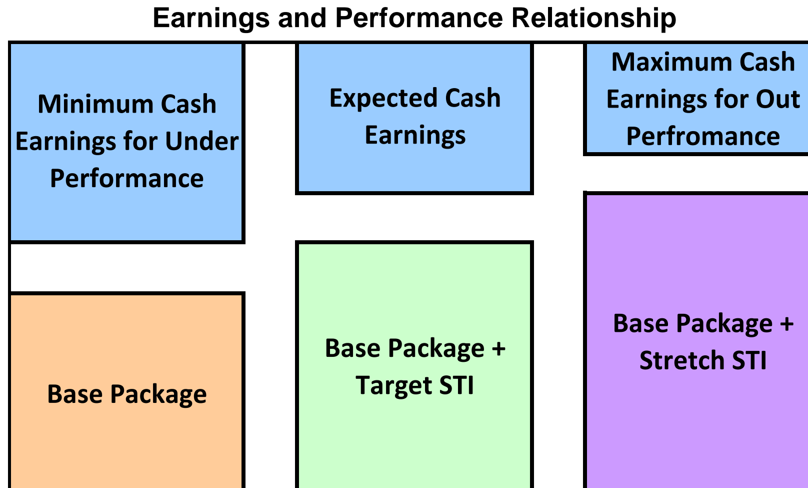
Past Remuneration Profile	Emerging Remuneration Profile	ASA Policy Approach
LTI	LTI	
STI - Cash	STI - Deferred Shares	LTI
	STI - Cash	
Base Package	Base Package	Base Package

The "past and emerging remuneration profiles" seek to help in the attraction, motivation and retention of key executive talent by achieve appropriate balances between:

- Base Packages and incentives, and
- Short and long term performance incentives.

In addition, the "emerging remuneration profile" seeks to reduce the possible incentive to take excessive risk to earn STI awards by deferring part of such awards and linking their future value to the company's value as measured by share price.

In relation to the STI, under both the “past and emerging remuneration profiles” the total of the Base Package and the target STI award are seen as the remuneration for delivering planned results which would generally be set at challenging levels. By setting the expected remuneration at Base Package plus target STI the executive is penalised through lower cash remuneration if performance falls below plan and rewarded if performance exceeds expectations. This is depicted in the following diagram.



Although the ASA believes that for the great majority of companies the current Base Package levels represent “full and appropriate compensation” for satisfactory performance it would be problematic for companies to discontinue STI plans without providing compensation such as higher Base Packages and/or higher LTI awards.

As both the “past and emerging remuneration profiles” are, in GRG’s view, preferable to the ASA proposed approach and the ASA has not provided any justification for its approach being an improvement, GRG would caution board’s against adopting the proposed ASA approach.

Re-election of Non-executive Directors

A new and challenging aspect of the ASA’s policy is that it intends to vote undirected proxies against the re-election of non-executive directors at AGMs that follow:

- a significant (e.g. 20%) vote by independent shareholders against a Remuneration Report, and
- “the Board concerned has failed to take appropriate action”.

Each Board will need to determine whether such a vote would be significant and whether it should override their professional judgement as to the most appropriate remuneration arrangements for their company.

GUIDELINES ON LONG TERM INCENTIVES SECTION

In relation to LTI plans, the ASA is seeking to significantly change market practice and the more debatable changes are discussed below.

ASA Policy	Comments
Vesting of LTI grants should be based on two types of measures being total shareholder return (TSR) and company earnings.	Company earnings may not be an appropriate measure in some circumstances e.g. exploration and start-up companies. Company earnings is a measure that has not been supported by institutional investors.

ASA Policy	Comments
TSR vesting scale should be: • Nil vesting below the 51st percentile, • ≤10% vesting at the 51st percentile, • Pro rata vesting between 51st and 75th percentiles, and • 100% vesting at ≥75th percentile	This vesting scale may encourage excessive risk taking. Also by lowering the probability of vesting the value of the rights or options will also be reduced. A consequence of this will be increased numbers of rights and options to be granted with potential for dilution to be excessive.
Performance measurement period should be at least four (4) years.	The combination of extending the vesting period and introducing forced retention periods will diminish the impact of LTI plans particularly for executives in the early period of participation. Given that executives often do not have long periods of service with a single company, they may discount the relevance and value of the LTI plan as a component of remuneration. Except when executives have made elections to be taxed in the year of grant, it is usual for a termination to trigger the taxing point for LTI equity grants. As most executives do not make tax elections the termination triggers a tax liability in relation to LTI equity grants. In these circumstances, it would not be appropriate for companies to insist on executives retaining vested shares, rights or options past the date of termination of employment. It is for this tax reason that most LTI plans require vesting to be determined at the date of termination even if the measurement period that would otherwise apply extends beyond the date of termination.
Two year minimum holding period following vesting even if a termination occurs.	
No retesting.	This is a long standing view of the ASA which has experienced considerable resistance from Boards which often feel that retesting is a critical design feature particularly in relation to TSR performance.

Other aspects of the ASA's policy appear to be sound and may well be acceptable to many boards.

GUIDELINES ON SHORT TERM INCENTIVES SECTION

Two aspects of the ASA's policy on STI plans warrant discussion.

Firstly, the proposal that companies should disclose the performance indicators for STI plans even if such disclosures are retrospective, seems excessive. The key performance indicators (KPIs), weightings and performance standards will generally involve significant financial data which will generally be commercially sensitive. Further, in the absence of the company's strategic plans and assessment of economic circumstances and competition, the STI performance indicators would be of little, if any, value to shareholders.

Even on a retrospective basis some of the information that could be disclosed may not be in the company's interests to have placed in the public domain.

The second aspect is for part of the STI awards to be made in the form of equity that cannot be accessed for two years even if termination of employment occurs during that period. This would typically be done via a tax deferred share plan and a tax liability would be triggered on termination of employment. As a minimum, 50% of deferred awards should be able to be accessed on termination of employment so as to allow disposal of sufficient shares to cover the tax liability on both the sold shares and the remaining deferred shares.