# GRG Remuneration Insight 165

# Equity Bank

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## Introduction

This GRG Remuneration Insight (Insight) discusses the concept of an Equity Bank ("Bank"). An Equity Bank is a group of equity interests that are vested and no longer "at-risk" but cannot be accessed for the long term. The triggers for considering such a Bank were an intersection of prior Insights that dealt with various environmental, social & governance (ESG) issues, with increasing interest among various stakeholder groups to increase long term alignment, equity holdings and "skin in the game" for executives. However, the Bank could be useful for many other purposes. This Insight approaches the discussion in a way that balances the needs of all stakeholders, from executives themselves, through to shareholders and governance groups. While this topic relates to the use of equity, and therefore is likely to be best suited to listed companies at present, recent changes in the regulatory environment have made these approaches practical for unlisted companies.

## Purposes of an Equity Bank

There are many potential reasons for introducing an Equity Bank. Some of these are discussed below.

### Superannuation Supplement

In FY25 the maximum company superannuation contribution is 11.5% of annual earnings of $260,280. This percentage is scheduled to grow to 12% the following year but it is generally recognised that such a level of contribution will be inadequate to provide executives with sufficient superannuation to support an acceptable standard of living in retirement. Accordingly, there is a need for executives to accumulate significant investments over their working life to supplement superannuation. Provided that executives maintain reasonable standards in relation to ESG and other issues, it may be expected that most Equity Banks will remain intact and provide executives with a substantial investment featuring favourable tax treatment that may be accessed in retirement or earlier depending upon circumstances.

### Cashflow Savings for the Company (e.g. as part of Fixed Pay or short term awards)

When equity is provided via a new issue by a company in lieu of cash remuneration, the company retains cash that would otherwise have been paid out. Particularly for those companies that have limited cash flow in development, or that focus on cashflow to a greater extent than profit as a strategy, the use of equity for remuneration delivery can be a significant advantage. When major changes occur in company circumstances, such as rapid increases in size or market position, significant increases could be delivered partly in banked equity. From an accounting point of view there can be a trade-off for the Company; if the equity is not acquired until exercise, then the tax deduction will be delayed compared to paying cash. However, the amount of the deduction can be much larger than the accounting cost recorded when the share price has risen (should be expected if held long term). It should be noted that a tax deduction is only available for contributions to an employee share trust and only to the extent they relate to equity that is unvested or vesting i.e. not for future allocations.

## Tax Effective Remuneration

The following table shows the impact of providing a 5% increase in Fixed Pay as a grant of shares or share rights instead of as increases in salary and super. Two scenarios are shown with different super contribution obligations and marginal tax rates. The tax rates used are for FY25. In each scenario three columns are shown:

a. the position before the 5% increase,
b. the position after the increase but with no Equity Bank addition, and
c. after the increase with the increase being provided as an Equity Bank addition (note in this model the Equity Bank Addition is considered part of Fixed Pay).

| | Scenario 1 | | | Scenario 2 | | |
|---|---|---|---|---|---|---|
| | a | b | c | a | b | c |
| Total Fixed Package | $250,000 | $262,500 | $262,500 | $500,000 | $525,000 | $525,000 |
| Equity Bank Addition | | | $12,500 | | | $25,000 |
| Super | $25,785 | $27,074 | $25,785 | $29,932 | $29,932 | $29,932 |
| Salary | $224,215 | $235,426 | $224,215 | $470,068 | $495,068 | $470,068 |
| Tax | $71,519 | $76,788 | $71,519 | $187,070 | $198,820 | $187,070 |
| **Net Cash** | **$152,696** | **$158,638** | **$152,696** | **$282,998** | **$296,248** | **$282,998** |
| **Monthly Cash** | **$12,725** | **$13,220** | **$12,725** | **$23,583** | **$24,687** | **$23,583** |

In scenario 1(b) there is a slight increase in super contributions and salary with the result that the executive's cash flow is increased by $495 per month. In 1(c) there is no increase in super or salary but $12,500 of equity is provided to the executive.

In scenario 2(b), there is no increase in super as the person has reached the maximum superannuation guarantee contribution amount, so the increase goes into salary increasing the executive's month cash flow by $1,204. In 2(c) there is no increase in super or salary, but $25,000 of equity is provided to the executive.

Under a properly structured equity plan, tax on the equity may be deferred for up to 15 years and during that time the executive should receive dividends (or equivalent) and should benefit from growth in the value of the equity with the growth being free of capital gains tax. These gains are ignored in the model but should be expected to lead to significant financial benefits assuming there is share price growth over a period of long term holding. Refer to our insight outlining the advantages of ESS tax here: https://www.grg.consulting/the-myth-of-cgt-tax-advantages/

## "Extra" Remuneration

During periods of risk and volatility, which have been prevalent in recent years, companies often consider offering ad-hoc remuneration that is additional to market competitive remuneration. Often these are poorly regarded by external stakeholders because they are "extra" remuneration and typically have poor alignment with shareholders. Examples could include sign-on grants, retention grants, grants made to compensate for the lack of variable remuneration paying out, or increases given above market movement and benchmark levels to retain key talent, or remuneration that is simply increased to "high" levels. Offering such remuneration in equity is not uncommon, although it is often short term with few if any conditions. Offering such equity as part of a bonus bank and requiring it to be held for the very long term may address some of the concerns other stakeholders have about such remuneration.

## Malus and Clawback

In prior Insights, it was recognised that many of the environmental and social aspects of ESG are truly long term, and it can take many years before poor performance is recognised. Further, when it is recognised, the executive remuneration impact needs to cover poor performance over many years and potentially involves substantial penalties to be commensurate with the damage caused. Current typical

deferral of short and long term variable remuneration for 1 to 4 years covers periods that are too short and involve deferred values that are too low and potentially represent inadequate penalties. Accordingly, there is a need for an Equity Bank to be accumulated so that penalties may be applied at levels that are commensurate with the damage caused.

## Equity Bank

An Equity Bank is a group of equity units that are fully vested but cannot be sold or otherwise converted into cash for an extended period. As such they are not at risk of being lost due to performance or termination, but will vary with the share price, and may be subject to malus and clawback in exceptional circumstances. Following are some design aspects of equity in an Equity Bank.

### Type of Equity Units

There are basically two types of equity units that may be used being shares and rights. If shares are used, it will be necessary for 75% of permanent employees with 3 or more years of service to receive an offer, including the current offer, under an employee share scheme (ESS) operated by the company and for the shares to be subject to a real risk of forfeiture and disposal restrictions for tax deferral to apply.

These conditions do not apply to rights, but two additional features will need to apply being: dividend equivalents will need to be paid to holders of vested rights and restrictions will need to be applied to the rights to restrict exercise of the rights and disposal of the shares acquired on exercise of the rights.

It should also be noted that rights do not carry voting entitlements, but shares do. For the foregoing reasons, a modernised Rights plan that includes malus, clawback, dividend equivalents and 15 year manual exercise is usually used for these types of purposes.

### How Much and For How Long

### Superannuation Perspective

As will have been seen from the scenarios under Tax Effective Remuneration, superannuation contributions do not apply to income above $260,280 in FY25. To ensure that higher income earning employees can adequately provide for their retirement, the value provided to the Equity Bank each year could be the excess of the amount calculated by applying the then SGC contribution rate (11.5% in FY25 and 12% in FY26) to the executive's salary above the maximum SGC contributions. Thus, if an executive had an income of say $500,000 in FY25 and the 11.5% SGC contribution rate was applied to the full salary then the amount would be $57,500. If the SGC maximum of $29,932 were deducted, the remainder would be $27,568 which could be provided as an addition to the Equity Bank. As the $27,568 represents 5.5% of the $500,000 salary, it would be relatively easy to fund this with future remuneration increases - at no additional cost to the company. Of course, with higher levels of salary, the gap would be larger and the percentage higher. Thus, it may take more than one year's increase in remuneration to cover the gap, and the executive would need to be prepared to forego the cash in return for improved retirement savings. This would usually be negotiated on an individual level, and should be expressed in ways that avoid the arrangement being considered a "contribution" i.e. renegotiation of employment terms.

### Government Perspective

Other than in relation to the finance sector, the government has not provided guidance on how much or for how long equity remuneration should be deferred. In the finance sector, large financial institutions are required to defer 40% of variable remuneration for 4 to 5 years for senior executives. For CEOs, it is 60% for 6 years. Given that variable remuneration in this sector tends to be more than the Fixed Pay for senior executive roles, it follows that the deferred amounts equal at least 40% to 60% of Fixed Pay each year.

Combining the annual deferral quantum with the deferral periods means that Equity Banks need to be around 3.5 times Fixed Pay for CEOs and 1.5 to 2 times Fixed Pay for senior executives.

### ESG and Other Penalties Perspective

GRG is not aware of any method for calculating how much needs to be accumulated as an Equity Bank so that any penalties that Boards may wish to apply to executives will be considered reasonable by

stakeholders. Taking into account the foregoing comments on superannuation and government views, consideration could be given to Equity Banks having target balances over the medium term as outlined in the table that follows:

| Company Size<br>Market Capitalisation | Equity Bank Value as a Multiple of Fixed Pay | |
|---|---|---|
| | CEO | Other Senior Executives |
| <$100 million | 1 | 0.5 |
| $100 million to $500 million | 2 | 1 |
| $500 million to $5 billion | 3 | 1.5 |
| >$5 billion | 4 | 2 |

Of course, each board will need to carefully consider their company's circumstances and decide on the appropriate medium-term values for Equity Banks.

### Holding Periods

The optimal length of the holding period is a matter of judgement and will relate to the nature of a company's business and the ESG risks it faces. The holding period is likely to fall between 3 years, being the typical length of long term incentive measurement periods, and 15 years, being the maximum ESS tax deferral period. As a starting point, a period of 7 years could be considered and if applied would require the following levels of annual additions to the Equity Bank:

| Company Size<br>Market Capitalisation | Annual Additions to Equity Bank as a % of Fixed Pay | |
|---|---|---|
| | CEO | Other Senior Executives |
| <$100 million | 15% | 7.5% |
| $100 million to $500 million | 30% | 15% |
| $500 million to $5 billion | 45% | 22.5% |
| >$5 billion | 60% | 30% |

Given that Fixed Pay levels increase with company size, it would be expected that executives in larger companies would be able to manage the levels of Equity Bank additions shown above and are likely to have appetite to access the benefits of long term investment and ESS tax treatment. To achieve these levels in the short term may require renegotiation of the elements of total remuneration packages.

It is important to note that holding periods should not be shortened because of termination of employment. This will ensure that value is held in the Equity Bank following cessation of employment so that it is available for clawback, if required.

## Conclusion

As discussed in this Insight, the Equity Bank concept is one that should be considered by all companies. It has many benefits for employees, the company and various stakeholders. Of course, some companies may wish to try the concept with an initial modest commitment, while others may prefer to dive in as they, and their executives, see great value for an Equity Bank in their circumstances.

If you have any questions, please feel free to reach out to your GRG consultant or call (02) 8923 5700 or email [info@grg.consulting](mailto:info@grg.consulting).