10 minutes on...

2017 Executive remuneration trends: In the eye of the storm

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Summary of 2017 Executive Remuneration

- Against the backdrop of a relatively soft economy in 2017 - with GDP increasing 2.4% to December 2017,[1] ASX 100 companies delivered similarly with average EBIT growth at 2.4%, up on prior year growth of 0.6%.[2]
- This translated into executive pay outcomes that were not too dissimilar to what was observed in FY16 - with CEOs receiving fairly moderate fixed pay uplifts in the order of 3-4% (where made), short-term incentive (STI) outcomes up 4% (at median), and no material change in long-term incentive (LTI) outcomes.
- Whilst these outcomes don't feel particularly "newsworthy", and the number of "strikes" recorded in the ASX 100 were down on the prior year, we may be in the eye of a storm given….
  - Low or stagnant wage growth for the broader population combined with an increasing sense of inequality, is continuing to result in challenge regarding the relative fairness of pay practices at the top of our largest organisations
  - Some of the largest "No" votes against remuneration reports in Australian corporate history occurred during this AGM season, albeit for companies with shareholders that were disgruntled with broader company performance issues
  - Regulatory and political pressure (e.g. Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry; Government's Remuneration Tribunal into CEO pay for GBEs) is driving companies to increase transparency regarding pay arrangements, and in many cases, to change them
  - There are a significant number of reviews and regulatory developments into remuneration practices. Whilst a number of these are focused on financial services institutions, the issues being uncovered are somewhat industry agnostic and, for this reason, we expect to see change in remuneration practices and governance occur more broadly.

Highlights

- Median fixed pay movements for same incumbents that received an increase were:
  - 3.6% for CEOs
  - 5.3% for other executives
  - 3.3% for NED base fees
- The balance between fixed pay, STI, and LTI for CEOs remained largely unchanged year on year, whereas packages for other executives shifted slightly toward LTIs in FY17 (away from fixed pay and STI in equal proportions)
- More than 90% of the ASX 100 continue to operate a "traditional" remuneration model in FY17, comprised of fixed pay, STI and LTI. However, 17% of ASX 100 companies have disclosed the use of more customised reward models in operation already for FY17 or will be for FY18
- Median STI outcomes have risen slightly, with outcomes continuing to show some degree of consistency year on year with 35% of same incumbent CEOs receiving similar payouts (as a % of target STI) as the prior year
- Relative Total Shareholder Return (TSR) remains the dominant LTI measure, often combined with EPS or a return based measures such as Return on Equity
- Internal and external LTI performance hurdles vested at a similar rate, suggesting the degree of difficulty associated with internal and external hurdles was not too dissimilar
- Companies with minimum shareholding requirements have continued to increase, with 62% of the ASX 100 now requiring at least their CEOs to hold a minimum value of shares

Our market data provided in this publication covers key management personnel at S&P ASX 100 companies (excluding foreign domiciled companies). All data is presented in AUD and is based on 2017 Remuneration Reports and other publicly available sources. Company size and performance data has been sourced from CapIQ.

[1] Australian Bureau of Statistics, *December key figures*, March 2018 (link)
[2] Same companies' year on year EBIT movements as at 31 December 2016 and 2017, compared to same companies' movements as at 31 December 2016 and 2015. Source: CapIQ

Movements in fixed remuneration remained modest in FY17

Despite the continued attention in the media being directed to "excessive executive pay quantums" and "executive pay increasing at a faster pace then employee pay", we continue to observe restraint in relation to fixed pay increases for Key Management Personnel (KMP).

The median fixed remuneration movement was 0.6% for CEOs and 2.9% for other executives (which includes both increases and some decreases related to change in benefit values as opposed to base salary reductions) for same incumbents. This compared to increases in average weekly ordinary time earnings of a full time adult of 2.4%.[1]

Furthermore, increases are certainly not a "given" at the CEO level with 41% of CEOs (up from 30% in FY16) receiving no fixed pay increase at all. In addition, we have observed new incumbents in CEO roles, receiving on average approximately 16% less than their predecessors. This trend of incoming CEOs on lesser fixed pay is occurring across both internally promoted CEOs and external hires.

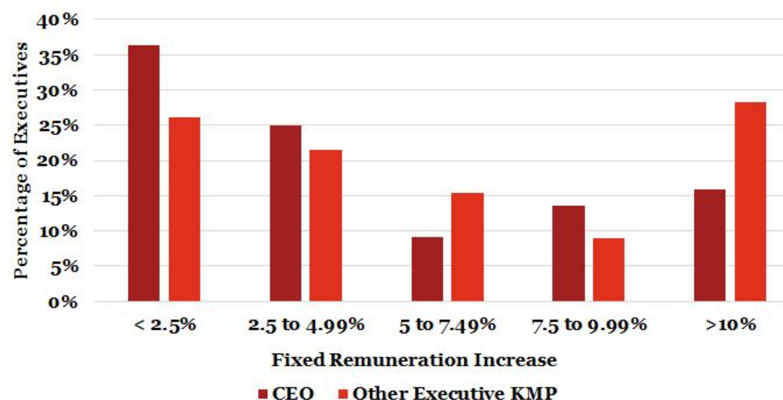
Similarly, approximately one third of KMP Executives (direct reports to the CEO) did not receive fixed pay increases this year. For those that did receive pay increases, it appears more common to have passed on targeted increases to select executives, rather than applying marginal increases for all executives (although this did occur in some companies).

Significant increases were experienced by some, with approximately 15% of CEOs and almost one third of other executives receiving an increase greater than 10%.

Figure 1: Executive KMP pay movements (ASX 100, same incumbent)

	Median fixed pay movement		Median increase (increase >0%)		% with no pay increase	
	CEO	Others	CEO	Others	CEO	Others
FY17	0.6%	2.9%	3.6%	5.3%	41%	28%
FY16	2.4%	1.9%	3.5%	6.2%	30%	34%

Figure 2: KMP fixed pay movements by percentage band



[1] Australian Bureau of Statistics, *Average Weekly Earnings, Australia*, Feb 2018 (link)

We have not seen a radical shift in reward structures but change is occurring

The significant majority of organisations still maintain a version of the "traditional" executive reward framework, comprised of fixed pay, a STI and a LTI in broadly equal proportions.

More specifically, most ASX 100 organisations currently offer executives:

- **fixed pay** as cash plus superannuation
- **a STI**, delivered as a mixture of cash and deferred equity (80% of companies), measured against a balanced scorecard of financial and non-financial measures
- **a long-term equity incentive** measured over a minimum of 3 years. Relative TSR remains the most prevalent measure for inclusion in LTI plans for executives (see Figure 6 on page 6).

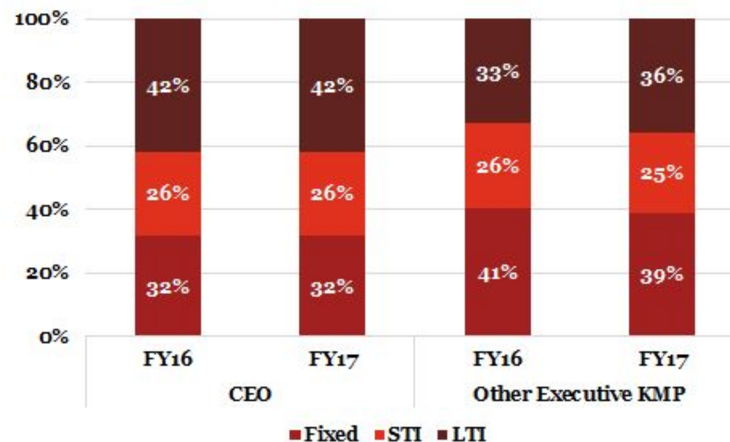
Whilst there will be increasing change in the upcoming year (with now 17% disclosing new models for FY18 vs 9% in FY17), our analysis suggests that the majority of companies did not significantly deviate from the traditional reward model. Among the ASX 100 today:

- more than 90% operate a "traditional" reward framework,
- 8 companies use (or intend to use in FY18) a combined incentive model (that no longer incorporates a traditional LTI element) or some variation of such including ANZ, AMP, Iluka Resources, Perpetual, QBE, Telstra, Wesfarmers, and Woodside; and
- 2 companies have moved to alternative models that reduce or remove the focus on STI such as: Alumina, and Seek;
- a small handful of companies have adopted more unique arrangements such as Bluescope Steel, CIMIC, CSL, FlightCentre and QUBE.

Greater weighting on LTI for executives in FY17

The balance of pay between fixed, STI and LTI (or 'pay mix') for CEOs remained unchanged in FY17. However, we observed a slight change in the distribution of pay for other executives - with a small shift towards the LTI element.

Figure 3: Executive KMP pay mix variations year-on-year (ASX 100, same incumbent)[1]



Simplifying LTI allocation

In line with efforts to simplify reward practices, we have observed a continuing trend for companies to allocate their LTI equity utilising a "face value" approach, rather than a "fair value" approach. In FY17, 72% of ASX 100 companies that had LTI plans utilised a face value allocation methodology (compared to 64% in FY16). This also reflects the greater emphasis - from both within companies and through scrutiny by external shareholders - on increasing the transparency of remuneration arrangements, particularly maximum earnings opportunities.

[1] *Our FY16 year in review presented LTI at fair value for our pay mix analysis. Given the trend to allocate LTI equity awards based on face value, we have updated our methodology to report LTI on face value. This methodology change has been reflected in both FY16 and FY17 numbers presented in Figure 3 above.*

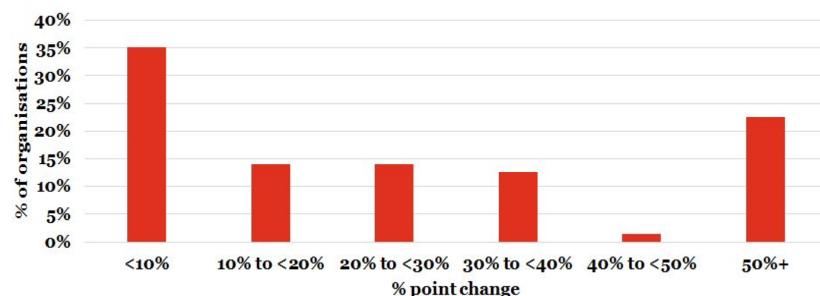
Short-term incentive payouts are again on the rise

Median STI payments were 105% of target for CEOs and 100% of target for executives. This represents a slight increase from payout levels observed in FY16 (4% and 5% respectively). The uplift in STI payouts is directionally in line with the overall performance of the ASX 100, with average EBIT growth at 2.4%.[1]

We have observed slightly more variation in CEO STI outcomes as a percentage of target in FY17, with 65% having a variation of more than 10% in their payments relative to target (compared to 60% in FY16).

External pressure on the limited variability in STI payments in recent years appears to be having an impact, albeit it is fairly minor.

Figure 4: Year-on-year STI variation as a percentage of target (ASX 100 CEOs only)

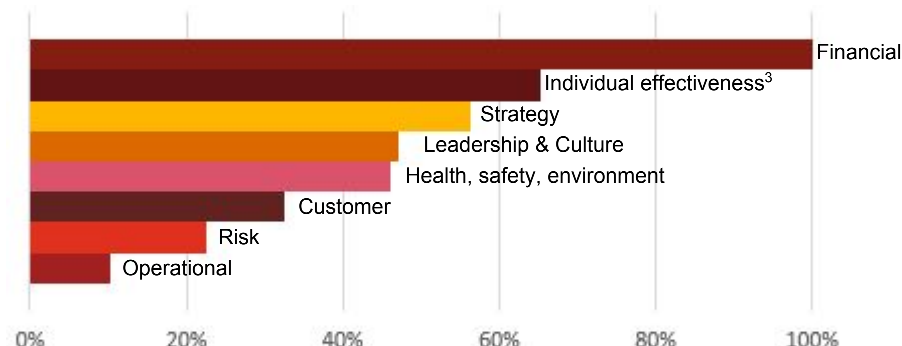


Following the 2016 AGM season, we reported that non-financial measures had become a point of contention.[2] However, a year is a long time and the conversation is now more focused around the importance of taking into account the full context within which incentive payments are determined, helped by pressure from financial services regulators. This has resulted in both an increase in the number of companies applying judgement to incentive outcomes, or taking into account factors not explicitly incorporated into an incentive scorecard.

Increasingly, the factors which are considered as part of that judgement are non-financial issues such as risk, reputation, culture, safety and sustainability. While these also may appear as metrics in the scorecard (eg risk or HSE), often there is a perception that the possible consequences - particularly of poor risk behaviour - may not be sufficiently captured in a scorecard.

Within the scorecard itself, we have observed little change in the prevalence of metrics, as shown in Figure 5 below. Financially skewed scorecards remain common, with non-financial measures typically making up between 30-50% of STI scorecards.

Figure 5: STI metric prevalence in ASX 100



[1] [2] Same companies' year on year EBIT movements as at 31 December 2016 and 2017. Source: CapIQ
[2] PwC, *10 minutes on… Soft measures: harder than you think*, Mar 2017 (link)
[3] Individual effectiveness metrics include individual performance, objectives, values, and behaviours

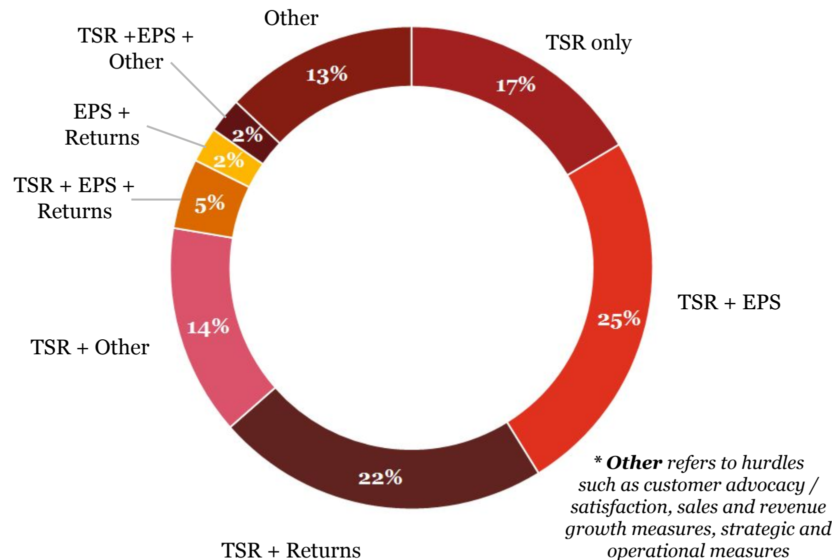
Long-term incentives remain relatively unchanged

TSR remains the most common LTI hurdle

85% of companies that have LTI plans utilise relative TSR as a whole or partial metric. Of these companies, the median weighting of the relative TSR hurdle is 50%, the same median weighting as in FY16. Only 6 companies use absolute TSR as a whole or partial LTI metric.

EPS and return base measures are often utilised alongside TSR or as a standalone measure (38% and 34% respectively).

Figure 6: LTI measures in the ASX 100



* ***Other*** *refers to hurdles such as customer advocacy / satisfaction, sales and revenue growth measures, strategic and operational measures*

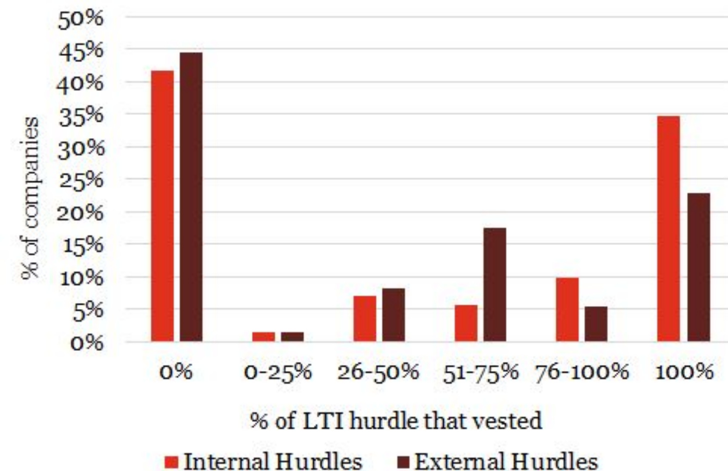
There was no material difference between the vesting of internal or external hurdles in FY17

In contrast to vesting patterns observed in FY16, both internal and external hurdles vested similarly in FY17:

- 58% of internal hurdles vested in part or in full (FY16: 68%)
- 55% of external hurdles vested in part or in full (FY16: 54%)

This reduction in vesting outcomes for internal hurdles indicates that targets may be more stretching than in FY16, resulting in a lesser proportion of awards being realised, however internal hurdles were still more likely to vest in full than external hurdles. It remains to be seen if this will be a long-term trend.

Figure 7: Distribution of vesting patterns for LTI hurdles



Despite calls for longer deferral periods, practices remain steady

ASX 100 organisations typically defer a material portion of executive remuneration in equity - including a portion of the annual STI payment being deferred, and a long-term equity element that is dependent on future performance.

Four in five ASX 100 companies operate STI deferral

80% of the ASX 100 have a deferral mechanism in their STI plans (79% in FY16), with the median deferred amount being 40% of the STI outcome. It is most common for STI deferral to apply over 2 years, either with phased vesting (i.e. at the end of year 1 and year 2) or 100% vesting after 2 years. There are limited examples of longer STI deferral periods, for example up to 5 years (BT Investments) and 7 years (Macquarie Group).

Three year LTI performance periods remain the norm outside financial services organisations

The majority of ASX 100 companies measure LTI performance over a minimum 3 year period (77% of companies) or a 4 year period (21%) of companies). 4 year LTI periods are more common within financial services (2/3rds of FS companies with an LTI plan measure performance over 4 years).

We expect to see deferral periods for both STI and LTI lengthen over the coming years, initially in the the financial services sectors with likely flow on effects to other large listed organisations.

The primary pressure for longer deferral periods (and in some cases larger deferral amounts) is largely coming from within the financial services industry, with the drivers being a) to ensure the deferral period reflects the period over which the impact of decisions in any one year may play out in future years, and b) that there is sufficient facility to reinforce accountability for those decisions through remuneration reductions if necessary. New legislation impacting Authorised Deposit Taking institutions (ADIs), the Banking Executive Accountability Regime or BEAR,[1] will require up to 60% of variable remuneration to be deferred for at least four years (for the CEOs of the largest ADIs), firstly impacting awards made on or after 1 January 2019 by the Big 4 banks. There is an expectation for these requirements to be extended to cover other APRA regulated institutions (such as insurance and superannuation trustees) at some time in the future.

[1] Further reading on BEAR, see: PwC, *10 minutes on… Perspectives on the new Banking Executive Accountability Regime*, May 2017 (link)

More companies are requiring their executives to have "skin in the game"

Minimum shareholding requirements

The prevalence of minimum shareholding requirements has continued to grow, with 62% of the ASX 100 requiring at least their CEOs to hold a minimum value of shares typically expressed as a percentage of base salary or fixed pay (vs. 51% in FY16).

The median minimum shareholdings requirement for CEOs and other executives remains consistent with FY16, requiring an amount equal to 100% of base salary or fixed pay to be acquired over a 5 year period. As was the case in FY16, minimum shareholding requirements are more common for CEOs than other KMP.

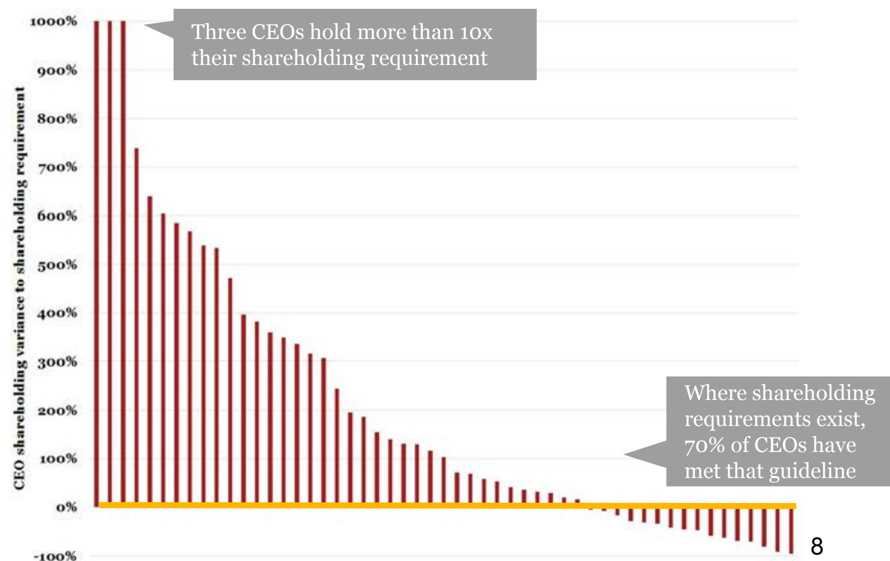
Shareholding requirements are also common for NEDs

59% of companies in the ASX 100 also require their non-executive directors to hold a minimum amount of shares, with the median level equal to 100% of director base fees to be acquired over a 3 year period. There are a small number of instances where shareholding requirements differ for the Chairman compared to other NEDs - where the Chairman is required to hold 2x the requirement of other NEDs as a percentage of base fees.

Where shareholding requirements are in place, the median value of shares held by CEOs are lower than where no guideline applies. Whilst this may sound counter intuitive in the first instance, it can be explained by the fact that companies where executives have low to no shareholdings are more likely to introduce minimum shareholding guidelines. This finding is consistent with FY16.

As shown in Figure 8, the actual value of shares held by CEOs varies greatly from their minimum shareholding requirement. There are examples of founding and long-standing CEOs holding in excess of 10 times their shareholding requirement, as well as 6 new CEOs who are yet to build up a shareholding, and typically have 5 years to reach their shareholding requirement. It is not expected that all CEOs are compliant with these guidelines at all times.

Figure 8: CEO shareholding variation against requirement (0% = in line with respective company guideline)



Non-executive directors

Whilst Non-executive director (NED) fees are not typically reviewed annually, we still observed 39% of companies providing increases to NED base fees in FY17, with the median increase being 3% for Chairman fees and 3.3% for base NED fees.

The median increase for committee fees in the ASX 100 was 4%. Increases for chair and membership fees for common committees were:

- Combined Audit and Risk Committee Chair: 3.6%
- Combined Audit and Risk Committee Member: 3.7%
- Remuneration Committee Chair: 7.2%
- Remuneration Committee Member: 7.9%

As seen, remuneration committee fees moved more significantly than than the rest of the market in FY17, possibly reflecting the changing nature of these committees. Many are incorporating additional responsibilities such as some degree of oversight in terms of sales and frontline incentives (so not just executive pay) as well as broader people, culture and nominations matters. And so fee increases may reflect broader charters as well as the perceived requirement to spend additional time engaging with external stakeholders on remuneration related matters.

21 companies increased their NED fee pool in 2017, with the median increase to fee pool size being 17%. Further increases are being proposed to NED fee pools for 2018, with the median increase proposed being 20%.

Figure 9: Median NED increases received in 2017

	Median increase (increase >0%)		Median increase (all roles)	
	Chair	Other NEDs	Chair	Other NEDs
FY17	3.0%	3.3%	0.0%	0.0%
FY16	4.5%	4.5%	0.9%	1.3%

Outlook for 2018

Notwithstanding the FY17 pay outcomes were relatively stable and somewhat vanilla, the ‘heat’ around executive pay has certainly not dissipated.

Heightened number of reviews and regulatory developments

There are a significant number of reviews and regulatory developments into remuneration practices.

Whilst a number of these are focused on financial services institutions,[1] the issues being uncovered are somewhat industry agnostic - related to leadership, accountability, culture, conduct and governance. For this reason, we expect to see change in remuneration practices and governance occur more broadly and across industries.

For example:

- Hayne Royal Commission into misconduct in the Banking, Superannuation and Financial Services Industry has had a significant focus on remuneration, particularly - transparency and disclosure, conflicts of interest, instances of misconduct being attributed, at least in part, to remuneration practices.
- APRA review of remuneration practices at large financial institutions found a focus on meeting minimum standards only, often falling short of sound / strong governance.
- APRA Prudential Inquiry into the CBA, with dedicated chapters on remuneration and culture. Large listed companies may self assess against these findings, particularly the degree to which risk is reflected in remuneration structures, the coordination of risk and remuneration decisions and committees, and the degree to which accountability has been appropriately reinforced in remuneration policy and practice.
- BEAR - which includes deferral and clawback of executive remuneration to reinforce executive accountability.
- Review of the ASX Corporate Governance Council’s Principles and Recommendations which proposes changes to Principle 8 (Remunerate fairly and responsibly).

Fairness of pay

Societal concerns of inequality and levels of executive pay has been on the rise for some time.

The global political context has led to enhanced regulations around pay such as the disclosure of pay ratios in the UK and US, and the proposals to change the ASX Corporate Governance Council’s Principles and Recommendations.

We have observed the first wave of pay ratio disclosure in the US, for companies with calendar fiscal year ends, and UK companies are preparing for their first round of pay ratio disclosures. The headline finding in the US is that the overall pay ratio has come down. Unsurprisingly, pay ratios have differed significantly across industries somewhat perversely in some circumstances - for example, the retail sector has the highest median CEO pay ratio at over 313:1 - that is almost two times that of the median CEO pay ratio for the S&P 500 overall (158:1).

In our view, Australian companies can get on the front foot by considering and better articulating what they think fair means from an employee, customer and shareholder perspective. And whilst we don’t believe CEO to worker pay ratio disclosure is necessarily imminent for Australia, it is certainly worth understanding where your company currently stands, and tracking any movements year on year, which is likely to be more informative than the absolute ratio itself.

Alternative models - harder to implement than they should be?

Only a few investors globally have openly backed pay reform, including Blackrock, Norwegian oil fund, Hermes and Old Mutual. Many more leading investors, including in Australia, are privately prepared to consider changes. Whereas others have fixed views on executive remuneration, or insufficient capacity to take up offers of engagement, making pay reform very difficult. In the UK, the Purposeful Company task force and an Executive Remuneration Working Group established by the Investor Association have both put forward recommendations to simplify pay structures while improving alignment with shareholders.

Of the ASX 100 organisations that have announced alternative models, the majority of changes have been well received by proxy advisors and investors at their respective AGMs, particularly where there is a clear narrative about why a particular model is right for the particular organisation in question. Although shareholder acceptability is again tested when the first awards are made under the new framework, and even more so when the general performance context of the organisation is challenging. The ultimate test of any model is still the alignment between pay and performance outcomes.

[1] Further reading at: PwC, *10 minutes on… Remuneration, risk and conduct following the APRA review*, April 2018 (link)

How can PwC help?

To have a deeper discussion about these issues, please contact:

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