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2018 Executive remuneration trends:
Movement under the spotlight
PwC Australia
July 2019

Summary of 2018 executive remuneration practices

- Executive pay decisions in FY18 were made against a varied performance backdrop with sluggish economic growth to December 2018 (GDP 3.25%[1], ASX 100 EBIT growth of 5%[2]) and substantial share price depreciation for some given reputational damage ensuing from the Royal Commission into the Banking, Superannuation and Financial Services (FS) Industry.
- The community focus on executive remuneration practices over the past 12 months has heightened, particularly in FS. Regulators (such as APRA and ASIC) raised concerns over both the way pay has been designed and governed. The Royal Commission attributed many of the poor practices within FS to reward.
- Even so, across industries, investors, shareholders and community members have questioned the fairness in the absolute amounts of pay, particularly as general employee wage growth remained low (2.3%[3] to March 2019), and poor executive conduct or performance was not always accompanied by sufficient remuneration consequences. Indeed, we observed some of the highest proportions of ‘no votes’ against remuneration reports in corporate Australia history[4].
- And so, unsurprisingly, executive pay outcomes in FY18 remained relatively flat - with fixed pay movements and bonus outcomes slightly down on FY17.
- Executive pay and incentive fameworks also saw little movement in design.
- Looking back on the year that was, in our view, it doesn’t reflect the amount of change to come given APRA’s updated requirements for remuneration are imminent[5], and recommendations from ASIC’s thematic review into corporate governance and executive remuneration of large listed companies (under its Corporate Governance Taskforce) are also expected in 2H of 2019. We expect such recommendations to have an impact on pay practices across industries, as they inevitably become the ‘gold standard’ for remuneration design and governance.

1. Reserve Bank of Australia, Economic Outlook (May 2019)
2. CapIQ 31 December 2017 and 31 December 2018
3. Australian Bureau of Statistics (March 2018 to March 2019)
4. See PwC’s ‘10 minutes on… 2018 Annual General Meeting season - The big squeeze’, December 2018 (link).
5. APRA will consult on a new prudential standard on remuneration in mid-2019, to be finalised in 2020.

Highlights

- Median fixed pay movements for same incumbents were moderate:
  - **1.5% for CEOs** (with 35% receiving no increase at all)
  - **2.0% for other executives** (with 29% receiving no increase at all)
  - **2.5% for NED** base fees
- Median STI payments were down slightly, at 100% of target for CEOs and 92% of target for other executives (versus 105% and 100% respectively in 2017). Although, CEO STI outcomes as a percentage of target were slightly less variable than prior years, with 56% having less than 20% year-on-year variation.
- Higher LTI hurdle vesting rates occurred compared to FY17, for both external and internally calibrated hurdles.
- The structure of executive pay frameworks remained largely unchanged in FY18, although the prevalence of more bespoke models increased from 5% to 13%. “Traditional” models, comprised of fixed pay, STI and LTI, continued to dominate the market (87% of companies), including:
  - Fixed pay weighted at 30% for CEOs and 37% for executives (similar to FY17), with LTI weighted more heavily than STI within the variable pay component
  - An STI delivered as a mix of cash and deferred equity (82% of companies), measured against a scorecard of financial and non-financial measures
  - A LTI measured over 3 years (79% of companies), with relative TSR remaining the most prevalent measure (82% of companies)
- Some changes to incentive plan metrics were observed, where the use of leadership and culture measures declined, with uptick noted in the use of both operational and customer measures in STI plans.
- The prevalence and quantum of minimum shareholding requirements (MSRs) remained unchanged in FY18, with the median MSR for CEOs being 100% of fixed pay.

Notes on methodology

Our market data provided in this publication covers Key Management Personnel (KMP) at S&P ASX 100 companies (excluding foreign domiciled companies) as at 31 December 2018. All data is presented in AUD (but where appropriate individual year on year analysis has been completed in home currency). Data is based on 2018 Remuneration Reports and other publicly available sources. Company size and performance data has been sourced from CapIQ.

Fixed pay increases were conservative amid enhanced scrutiny on executive pay and a mixed performance backdrop

Facing a period of sluggish economic growth, economic uncertainty, share price depreciation (for many FS organisations in particular), and significant regulatory pressures, companies have continued to show restraint in executive fixed pay movements.

Fixed pay for ASX 100 CEOs moved slightly for FY18 with the median fixed pay movement at 1.5% and 2.0% for all other executives (which includes changes to either base salary or fixed benefit values). For the first time since 2016, our analysis shows that CEO and executives fixed movements have both fallen below general employee wage growth of 2.3%[1].

As reported last year, fixed pay increases at the executive level are no longer a “given”. It is increasingly common to target fixed pay increases to certain executives, rather than to apply marginal increases across the executive team. Approximately a third of CEOs did not receive a pay increase at all (35%), along with 29% of other executives. CEOs that did not receive an increase were concentrated at the “top end of town” with almost all being from ASX 25 companies. In the FS sector, pay increases were also less prevalent with 77% of CEOs not receiving any increase.

Median fixed pay increases for those that did experience an increase were still moderate at 3.3% for CEOs and 3.7% for other executives. Significant increases were still experienced by some, possibly to address gaps to market. Across the ASX 100 8% of CEOs and 16% of other executive KMP had significant increases of greater than 10%.

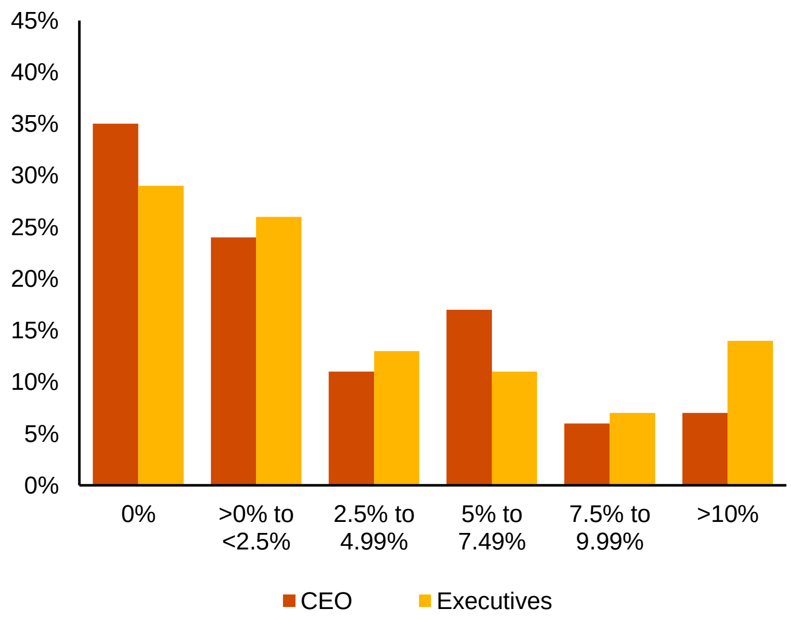
We observed new incumbent CEOs typically being paid less than their predecessor (approximately 17% less). Some variation was observed across internally promoted CEOs and external hires, where internal appointments typically received ~15% less than their predecessor, vs. external hires at 8% less.

1. Australian Bureau of Statistics (March 2018 to March 2019)

Figure 1: CEO and other executives pay movements (ASX 100, same incumbent)

	Median fixed pay movement		Median increase (increase >0%)		% with no pay increase	
	CEO	**Others**	**CEO**	**Others**	**CEO**	**Others**
FY18	1.5%	2.0%	3.3%	3.7%	35%	29%
FY17	0.6%	2.9%	3.6%	5.3%	41%	28%

Figure 2: CEO and executives fixed pay movements by percentage band



Similarly, little change was observed for Non-Executive Director fees

Non-executive director (NED) fees are typically not reviewed annually, but just over a third of companies did provide increases to NED base fees in 2018. The median increase for Chairman fees in FY18 was slightly higher at 4% compared to FY17 at 3%. Other NEDs saw a smaller median increase in FY18 of 2.5% compared to FY17 at 3.3%.

In some cases NED base fees have decreased with announcements following the Royal Commission. Specifically, three companies (AMP, ANZ and CBA) reduced their Board Fees for the remaining period of 2018 or for the following year (for example, by 20% for those that sat on the Board in 2018) referencing the Boards' role and accountability in Royal Commission findings.

Committee fees saw higher increases than base NED fees with the median increase being 6.3%[1]. Increases for chair and membership fees for prevalent committees are presented in Figure 4.

Most notably the increases received for the Remuneration Committee (Chair and Members) were more sizeable than for the Audit and Risk Committee (Chair and Members). These increases may be partly in response to increased time and workload required by some Remuneration Committees to broaden their remit beyond KMP to front-line employees in some cases, and more extensive engagement requirements with external stakeholders (including regulators). Audit and Risk Committee fees are typically higher than Remuneration Committees and the increases observed may also be an attempt to reduce the gap between the two given the prominence of remuneration related issues.

In 2018, 14 companies increased their NED fee pool by a median of 17%, with 8 other companies indicating in advance that they will increase their NED fee pool in FY19 by a median of 23%.

1. Excluded from analysis Tabcorp Holding Ltd. which restructured its NEDs following the merge of Tabcorp and Tatts at the start of the calendar year and therefore not reflective of a year on year movement.

Figure 3: Median NED fee increases received in 2018

	Median movement (all roles)		Median increase (increase >0%)	
	Chair	**Other NEDs**	**Chair**	**Other NEDs**
FY18	0.1%	0.0%	4.0%	2.5%
FY17	0.0%	0.0%	3.0%	3.3%

Figure 4: Median committee fee increases (increase >0%) received in 2018

	Audit and Risk Committee (Combined)		Remuneration Committee	
	Chair	**Member**	**Chair**	**Member**
FY18	2.8%	3.3%	16.4%	9.3%
FY17	3.6%	3.7%	7.2%	7.9%

Annual STI bonus outcomes were down slightly on prior year, but payouts still tended to approximate target

Median STI payments were 100% of target for CEOs and 92% of target for other executives. This represents a slight decrease from payout levels observed in FY17 (105% and 100% of target respectively). This slight drop may have been driven by the sluggish economic performance context for many, and external pressures to adjust remuneration outcomes to reinforce accountabilities, including as a form of consequence management within FS organisations. Although on average these outcomes still amount to very little variation in bonus outcomes relative to target opportunities.

We observed slightly less variation in CEO STI outcomes as a percentage of target in FY18, with 56% having a year-on-year variation of less than 20% in their payments relative to target (compared to 49% in FY17). External pressure to increase variability in STI payments in recent years appears to have had little impact.

In FY18, 14% of ASX 100 companies explicitly reported discretionary “adjustments” being made to short-term remuneration outcomes. Disclosed reasons for such adjustments included the impact of the Royal Commission for many FS organisations, and significant safety incidents for non-FS companies.

Of those organisations that applied remuneration adjustments:

- Most applied an in-year adjustment to STI outcomes either collectively (via a group wide reduction to the incentive pool), and/or to individual executives.
- Very few applied malus to unvested STI and/or LTI equity.
- Most adjustments occurred in FS organisations with collective adjustments typically ranging from 20-30% of the bonus pool, with broad ranging individual downward adjustments up to 100% of target in some select cases.
- Other non remuneration related consequences often also applied (e.g. termination / loss of role).

Deferral practices remained unchanged

Approximately 82% of companies in the ASX 100 utilised STI deferral arrangements in FY18. The most common deferral amount was 33% of STI awards, mostly deferred into equity. Of the companies that have STI deferral arrangements in place, the most prevalent arrangement is a two year deferral with cliff vesting (34%). The next most commonly utilised arrangements were split vesting over a one and two year period (23% of companies) or a one year deferral with cliff vesting (22% of companies). Remaining companies (approximately 21%) have all or some portion of their deferred STI stretching over three years or longer.

A number of regulatory inquiries involving executive pay in FY18 may lead to enhanced deferral requirements (both quantum and proportion) and so market practice could well shift in the upcoming year.

Non-financial metrics indicative of risk behaviours are on the rise

The prevalence of non-financial STI metrics such as customer, risk, and operational effectiveness have increased in FY18, reflecting the increasing focus on the link between remuneration and risk, and the push to assess performance more holistically.

Operational (e.g. priority projects, cost out programs, productivity gains) and customer (e.g. NPS) STI metrics had the highest rate of increase (29% and 8% respectively), while individual and leadership & culture metrics saw the largest decrease (-12% and -8% respectively). The prevalence of financial metrics decreased overall but only by 1% from FY17.

Figure 5: Year-on-year STI variation (ASX 100 CEOs only)

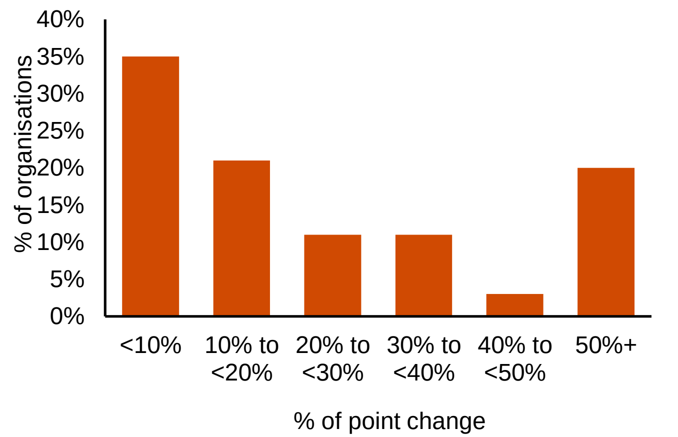
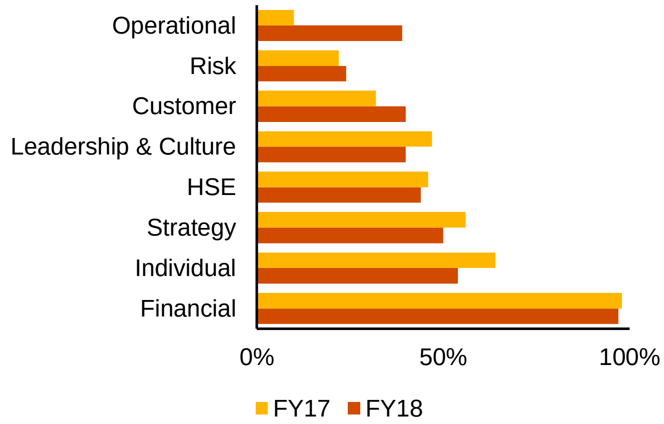


Figure 6: STI metric prevalence in ASX 100 year-on-year comparison



Long term incentive practices remain unchanged, although non-financial hurdles are under the spotlight

Relative TSR continued to be the most prevalent LTI hurdle, closely followed by other financial metrics

82% of companies utilise relative TSR (or 83% if including relative and absolute TSR) as a sole LTI metric or in conjunction with another metric (a single percentage decrease from FY17). The three most common LTI hurdles (or combination of hurdles) define approximately half of all LTI plan designs being:

- TSR only: 13% of companies
- TSR + EPS: 22% of companies
- TSR + Return based measures: 16% of companies

The prevalence of non-financial measures is up slightly, now being utilised by 16% of companies, up from 14% in FY17. Non-financial metrics most commonly relate to Customer, Safety, Strategy and Reputation. APRA[1] has indicated a desire to see a higher emphasis on non-financial metrics and for relative TSR to no longer be the dominant metric. As such, market practice may shift further over the coming year, although this change is viewed less favourably by some proxy advisors. For those that do employ both, financial metrics still attract the majority weighting, with an overall average weighting on non-financial metrics of 23%, which is a decrease from FY17 (30%).

3 year performance periods remain the most common

The median LTI performance period continues to be three years (79% of companies[2]), with four years being the next most common (10% of companies[2]).

This three year period is consistent with the median minimum vesting period observed. There has been a slight increase in companies with 5 – 7 year performance periods (from 2% in FY17 to 6% in FY18), the remaining 5% have only a service condition in place. For FY18 the most common type of vesting was cliff vesting (all grants vest in full at the end of the vesting schedule) at 80% whilst pro-rata or phased vesting (grants vest in certain portions throughout the vesting period) operated in 20% of plans[3, 4].

Higher vesting of internal and external hurdles

LTI plans tend to have slightly higher prevalence / weighting on external or market related measures (87% prevalence / 58% average weighting) as compared to internal / company specific measures (78% prevalence / 54% average weighting).

The incidence of both internal and external hurdles vesting increased to 73% (FY17: 58%) and 67% (FY17: 54%) respectively. External hurdles were slightly more likely to return zero vesting outcomes. However, median weighted vesting outcomes are on par (with 35% for internal hurdles and 33% for external hurdles), as internal hurdles tend to be less heavily weighted and less prevalent. This suggests that internal hurdles may be slightly easier to achieve, as is the view of some proxy advisors and investors, although they have less impact on overall LTI vesting outcomes.

1. APRA speech by Wayne Byrnes - Building resilience in three dimensions (March 2019)
2. Based on performance periods of ASX 100, which includes four companies with only service based LTI plans
3. Excludes bespoke incentive plans
4. Includes companies that operate multiple plans that may have different vesting types (cliff or pro-rata/phased)

Figure 7: Prevalence of LTI hurdles across ASX 100 FY18 LTIPs (either as a sole metric or in conjunction with another metric), percentage of companies

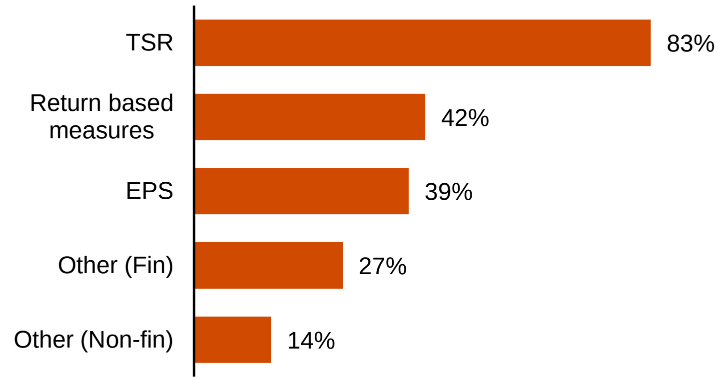
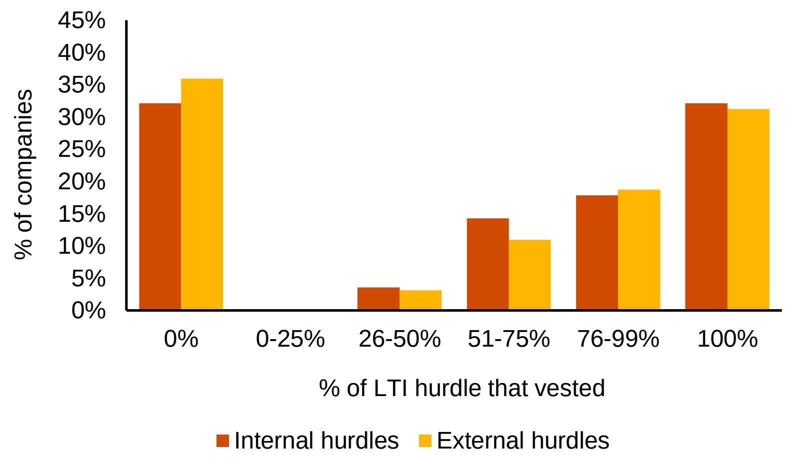


Figure 8: Distribution of vesting patterns for LTI hurdles

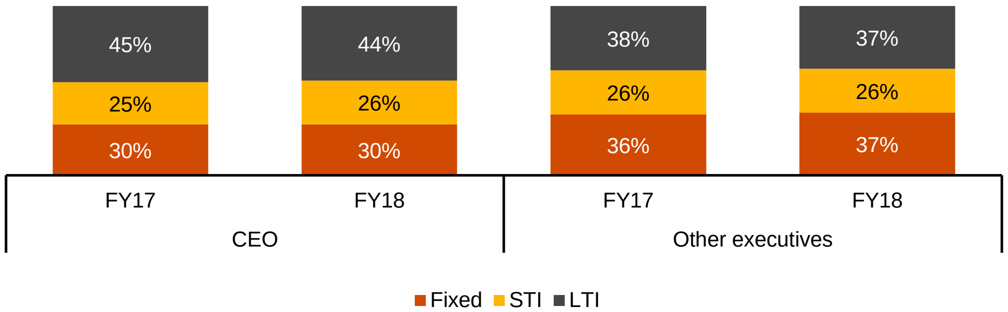


Relative emphasis on fixed vs. variable pay remains unchanged, although CEO realised pay deviates from target remuneration mix

Pay mix in traditional pay models remains unchanged

The balance of pay between fixed, STI and LTI (or 'pay mix') for CEOs and other executives remained unchanged in FY18[1]. We observed almost no change in the distribution of pay for CEOs and other executives across pay elements, bar a 1% shift away from LTI towards fixed pay (executives) and STI (CEOs).

Figure 9: CEO and other executives average pay mix variations year-on-year (ASX 100, same incumbent)



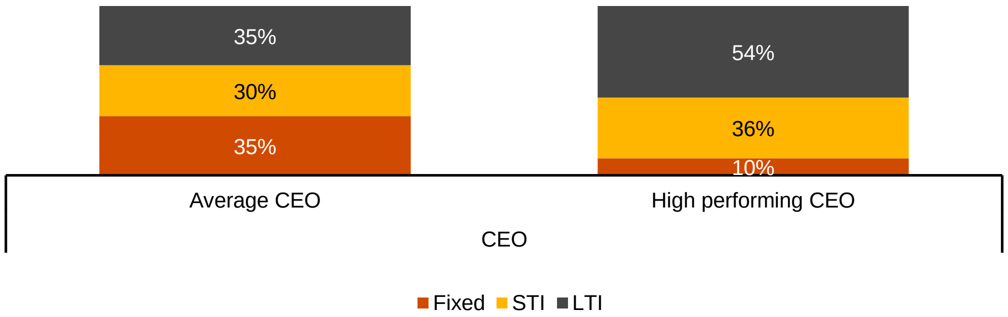
1. Pay mix analysis is based on target and comprises fixed pay, target STI and face value LTI (at grant)
2. Macquarie Group Limited has been excluded from the above analysis and table above, given that the CEO pay outcomes are a significant outlier.

ASX 100 CEO actual pay mix outcomes

Whether or not the target pay mix is realised, depends on multiple factors including STI performance metric outcomes, LTI performance metric outcomes, any overlay adjustments such as those resulting from consequence management, and share price movement. In FY18, we saw average CEO actual pay outcomes[3] (illustrated in Figure 10) resulting in a more balanced remuneration mix than target (illustrated in Figure 9), with both the actual fixed pay and STI elements forming a slightly higher proportion of overall total remuneration, and the LTI comprising a smaller proportion of total remuneration (35% vs. target of 44%).

As we would expect when there is pay at risk, we observed significant variations in the CEO actual pay outcomes relative to their target pay mix. There were instances of CEOs receiving only fixed remuneration for FY18, while variable remuneration accounted for up to 90% of total remuneration (with STI at 36% and LTI at 54%) for high performing CEOs in high performing companies experiencing share price appreciation. Such variation reinforces the need for greater clarity in remuneration report disclosures regarding realised pay, and helps to explain why a number of organisations have begun to voluntarily disclose realised pay numbers, consistent with the expectation set out in some proxy advisor guidelines.

Figure 10: CEO Actual outcomes[2,3]



3. In determining actual CEO pay outcomes we've included remuneration received/vested in FY18, this includes:
- Fixed pay (inc. superannuation/pension, non-monetary benefits (exc. travel/relocation))
- Short term cash received for performance relating to FY18
- Deferred short term equity that vested in FY18
- Long term incentives that vested in FY18

In determining the value of equity the number of shares that vested is multiplied by the end of trading share price at vesting date (or next following business day)

Traditional remuneration models continue to reign, mandatory shareholder requirements may increase

Emerging models of pay

"Traditional" remuneration structures, comprising of fixed pay, STI (in a combination of cash and deferred equity), and performance hurdled LTI, remain the most prevalent executive remuneration framework in the ASX 100 (87% of companies).

Whilst we have observed an increasing number of companies deviating from this "traditional" remuneration structure, with the disclosure of more "bespoke" models increasing from approximately 5% to 13% of companies in FY18, we do not expect this trend to continue into FY19.

Of those companies utilising more "bespoke" models, 8 companies currently use some version of what has come to be referred to as a "combined incentive model" (incorporating a significant restricted share element rather than, or as well as, a traditional performance hurdled LTI element) (e.g. AMP, ANZ, Iluka, NAB, QBE, Telstra, Wesfarmers and Woodside). Following substantial 'no votes' against their remuneration reports, three of these organisations have already indicated they will review the suitability of their incentive structure in the upcoming year.

A handful of other companies have retained the three traditional elements to executive pay but have introduced more unique LTI arrangements (e.g. Bluescope Steel, CSL, and QUBE). Such arrangements include features such as:

- An element of equity deferred into restricted share/rights over a longer term period (4-5 years) with less stretching, performance/holding requirements post vest.
- In-built share price.
- Enhanced focus on non-financial metrics.

Prevalence of mandatory shareholding requirements remained unchanged

The prevalence of minimum shareholding requirements (MSRs) remain unchanged from FY17, with 62% of companies requiring their CEOs to hold a minimum value of shares, typically expressed as a percentage of base salary or fixed pay. Similarly, there was no increase in the number of companies (60% in both FY17 and FY18) requiring other executives to hold a minimum value of shares. However, some additional organisations have disclosed intentions to introduce MSRs for their CEO and executives in FY19. Five years remains the median timeframe for executives to meet their shareholding requirement.

Quantum also remained unchanged in mandatory shareholding requirements

In FY18, median quantum for CEO MSRs remained unchanged from FY17 to FY18 at 100% of fixed pay[1]. Executives and non-executive directors median quantum also remained unchanged at 100% of NED fees.

There is significant variation in the range for quantum of CEO MSRs, ranging from 60% to 489% of fixed pay[1]. In some cases, MSR quantum is set in total shares or as a percentage of their profit share allocations.

For other executives, it ranged from 50% of fixed pay or base salary up to 300%. Again, in some cases, MSR quantums are set as a total number of shares.

Holding locks can be a design feature to help achieve MSRs

Holding locks (a period of time following vesting/performance period where executives are restricted from trading in their equity) are increasingly utilised as a mechanism to enable executives to achieve MSRs.

Holding locks (post vesting) are observed in 25% of combined incentive plans and 16% of traditional incentive plans with a median period of 3 years and 1 year respectively. However, in some cases this ranges higher, up to 7 years.

1. Where CEO and Executive MSRs were expressed as a percentage of base salary, this has been converted to percentage of fixed pay for consistency

Outlook for 2019

Regulatory pressure will drive change across all sectors

During the upcoming year, regulatory refinements will directly drive change for FS remuneration, and less so for others but stakeholder expectations and market practice will shift across the board as a result. Drivers of regulatory change will include:

- The new draft APRA standard on remuneration to be released for consultation during second half of calendar year 2019; focusing on strengthening alignment of remuneration with both financial and non-financial risks
- The extension of the Banking Executive Accountability Regime (BEAR) across the Financial Services industry
- Recommendations resulting from the ASIC Corporate Governance Taskforce which includes a focused workstream on executive remuneration, particularly the granting and vesting of variable remuneration

Trends that we expect may emerge as a result are:

- Increased weighting and enhanced rigour of non-financial metrics (STI and LTI)
- More transparency in remuneration reporting particularly as it relates to non-financial metrics and application of discretion, and
- Increased deferral quantum and periods for some roles.

Financial incentives aren't dead but will look different

While a small number of companies are already investigating reward frameworks that remove variable pay altogether (given the "poor brand" of incentive pay), we predict that the vast majority have already concluded or will conclude that there is merit in preserving variable pay as part of reward strategy.

Having said that, we are not expecting the status quo but rather:

- Role based removal of variable pay in some instances where variable pay has been associated with reputational damage and does not form a significant component of total reward (eg <5%)
- Reduction in variable pay for some roles via i) reducing the portion of pay at risk for roles with significant variable pay, shifting it to fixed pay ii) removal of 'upside e.g. accelerators, and iii) reducing the number of customised sales incentive plans as the Group STI becomes the default plan
- Refinements to incentive metrics to reflect 'whole of role'; and
- Enhanced risk adjustment mechanisms through increased weighting on risk (particularly non-financial), and/or the introduction of risk modifiers/overlays.

There will be more variability in variable pay

A lack of clarity and/or conflicting stakeholder views regarding the purpose of variable pay has contributed this year to challenges by some related to the appropriateness and/or fairness of pay outcomes. This year it was made clear that there was not always a shared understanding of the purpose of variable pay. "Is part, or all of the variable remuneration to be paid unless there are disqualifying reasons? Or is part or all of it to be paid only if certain conditions are met?"[1]

In the upcoming year, we predict that Boards and HR teams will seek to be clearer on the purpose of variable pay and will actively take steps to facilitate understanding across stakeholder groups. With more clarity on the purpose of variable pay, we also expect:

- Greater variability in year on year outcomes, as we see more instances of individual accountability reinforced
- Lower participation rates in any given year
- Pay models being explored that rebalance money towards fixed pay in acknowledgement that part of variable pay has traditionally been for 'delivering to expectations'; and
- Introduction of clawback policies on pay already paid/vested.

The role of the Remuneration Committee will continue to evolve

With executive pay constantly under the microscope, the expectations and accountabilities for Remuneration Committees (RemCos) are shifting.

This year, we expect there will be even greater expectations for Boards and RemCos to use discretion in determining variable pay outcomes, and to hold executives accountable for their performance and conduct via remuneration (and other) consequences.

Remuneration governance changes are expected including:

- Broader remits for some RemCos as they enhance their attention on frontline pay
- More active monitoring of the implementation of reward frameworks, including establishment of an "effectiveness" measurement framework and conduct of regular remuneration policy effectiveness reviews
- Development and application of enhanced guidelines for use of discretion; and
- More rigorous performance reporting, involving more data flow/requests by RemCos from management and from other committees (e.g. risk).

1. Final Report: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (1 February 2019)

How can PwC help?

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

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