GEOFF NUNN & ASSOCIATES
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Board & Executive Remuneration Reviews—2021

Restraint or a Time For Catch-Up

It's just on 15 months since the impact of the pandemic really began to impact on businesses in Australia. Executives and directors in some sectors of the economy took pay cuts or accepted a freeze in 2020. Airlines, universities, tourism, financial services and many others felt the pain. Alan Joyce, Qantas CEO lost his slot as the highest paid executive in Australia and had a lean year with both the STI and LTI failing to activate. Not surprising given that the airline was operating at a very limited capacity and is unlikely to resume full service for some time.

The Federal and several state governments froze remuneration increases for senior public servants and heads of government business enterprises in 2020. The level of restraint was largely symbolic and designed to send a message to those on lower incomes, or who had lost their job, that the pain was being shared, if not equally at least in part.

For other sectors it was business as usual. Our annual benchmark study of energy-based utility companies indicates that most awarded modest increases in fixed annual remuneration during the year and paid out between 60% to 90% of STI maximums. LTI awards were down as Return of Equity (ROE) and Total Shareholder Returns (TSR) dropped significantly for most.

A number of sectors have done well over the past 15 months including some of the larger retailers, transport, information technology, telecommunications etc. Some listed companies made STI and LTI awards whilst receiving JobKeeper. However there has been a general backlash from industry associations and other commentators. Several such as Premier Investments, Dominos, Nick Scali and Toyota Australia have returned the JobKeeper payments to the ATO after posting profit figures.

This raises the vexed question of how organisations should proceed with annual reviews of director and executive fixed remuneration in 2021 and how they should approach making STI and LTI Awards. Our thoughts are set out on the next page.

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Alan Joyce, Qantas CEO

In this Newsletter we discuss the vexed question of how companies should approach the 2021 annual review of remuneration for CEOs, executives and non-executive directors. We discuss the governance issues and review proposed changes APRA's Draft regulation CPS 511 for executive remuneration in financial services entities. See Pages 2-3.

2021 will continue as a year of challenges for boards and executives with cautious optimism in many sectors.

Geoff Nunn & Associates

Geoff Nunn & Associates was established in 1993 as an independent provider of services to the government and corporate sectors. We specialise in working with Boards and CEOs in the areas of corporate governance, board dynamics and renewal, governance structures and executive remuneration strategy.

Our Services

- Board Advisory Services
- Board Governance Advice
- Facilitated Boardroom Dialogue
- Focused Board Renewal
- SME Strategic Navigation
- Board & Executive Remuneration Strategy

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Remuneration Reviews—2021

The Macro Question - When Not Enough is Too Much

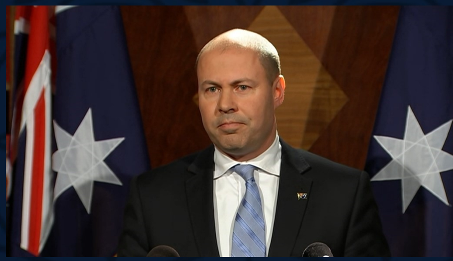
Over the last few years there's been a lot of discussion about the salary differential between CEOs and executives at the upper end of the corporate sector, particularly the ASX 100, and those in lower income brackets. 2020 provided a period of restraint and many remuneration committees took the opportunity to reconsider executive remuneration levels.

Our analysis indicates that increases in fixed annual remuneration in the order of 2.0% to 2.5% may be appropriate for directors and executives in 2021 to keep pace with inflation and maintain relative market position. There are a number of factors to take into account when planning for your next annual review:

1. Check your market alignment on a job evaluated basis. Be cautious about positioning of above the Median (Percentile 50) in the current climate.
2. Assess market movements in your industry sector. Check your usual remuneration survey sources, consider how the market has moved over the past 12 months and the forecasts for the next year. Be cautious of any figures that seem inflated.
3. Analyse how business performance over the past 12 months has impacted on affordability. Despite predications of a major bounce this will not be seen for some time in many sectors .
4. Review how supply and demand are impacting upon your capacity to attract capable executives and directors. If you are in the medical sciences or IT and communications you could be facing some pressures.
5. If the bulk of your workforce is covered by an enterprise agreement what are the built in increases? If the agreement was renewed over the past 12 months it is likely that they will be below 3.0%.

For many organisations 2021 offers a unique opportunity to make a correction to your executive remuneration policy. Governments, regulators, shareholders, other stakeholders and the community have been concerned for some time about what they perceive as excessive levels of remuneration at the upper end of the executive remuneration market. 2021 is the right year to take a conservative approach to fixed remuneration reviews for executives. It may also be the year to hold board fees steady.

If you currently position above Percentile 50 it might be timely to consider pulling back. If enough companies position at Percentile 50 or below, it will place downward pressure on the market. Now is the time to do this.



Federal Treasurer Josh Frydenberg

STI and LTI Plans in 2021

APRA Draft Standard CPS 511 specifies that non-financial metrics should be allocated significant weighting in variable reward plans for executives in the financial services sector. Following extensive consultation this looks set to be phased in during 2023. Most will adopt the specified measures in advance of this date. See discussion on the next page.

Whilst applying only to the financial services sector it provides a useful model for consideration in other sectors. From our perspective the balance needs to shift such that the interests of key stakeholder groups are considered, especially in STI Plans. Typical weightings might be:

Measure	Weighting
Financial Performance	50.0%
People & Safety	10.0%
Customer & Community	10.0%
Operational Effectiveness	10.0%
Stakeholder Relations	10.0%
Environmental Performance	10.0%
Total	**100.0%**

LTI Plans might balance ROE and TSR measures with key metrics which form part of the business strategy and support long term sustainability from a broad based perspective.

Again 2021 might provide the opportunity for organisations to re-visit the structure of their STI and LTI Plans as described above. The approach to weighting KPIs contained in APRA's Draft Standard has merit. However, other aspects of the Standard still raise questions of workability, like deferral of 60% of awards for 6 years for CEOs, when the average tenure is less than 5 years. See Page 3 for further discussion.

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APRA Draft Standard on Executive Remuneration CPS 311

APRA Chair Wayne Byres

Good Governance or Embedding the Status Quo?

In July 2019 APRA released a draft standard (CPS 511) for executive remuneration in the financial services sector. The proposed regulations contained in the draft were a direct result of the Hayne Royal Commission findings. In our view the draft standard had significant short comings. See: https://www.gna.net.au/apra-draft-standard-cps-511

After a period of consultation progress on finalizing the standard was postponed during 2020 to allow APRA to focus on more pressing priorities associated with financial resilience. An updated draft was released in November 2020 for a further round of consultation. The stated objectives are as follows:

1. To strengthen governance oversight. Specifically for the Remuneration Committee in Signification Financial Institutions (SFIs) to be actively involved in all major remuneration decisions.
2. To promote alignment with long term business objectives and the organisation's risk management framework.
3. To encourage organisations to allocate material weight to non-financial metrics in STI and LTI plans. This includes the potential to reduce awards to zero for adverse risk and conduct outcomes.
4. To strengthen deferral and clawback of STI and LTI Plans. CEO 60% deferral for six years with pro-rata vesting for four years. Other executives 40% deferral for five years with pro-rate vesting after four years.

In its second draft APRA dropped the requirement that 50% of the weighting in STI and LTI plans be allocated to non-financial metrics. Rather they have changed the words to indicate that "significant weighting" be allocated to non-financial measures. The argument was made in feedback that the non-financial metrics lacked the maturity of financial measures and were less well defined. This is no doubt correct. Many such measures at best give a surface approximately of what they purport to measure. Employee Engagement and Net Promoter scores are two cases in point. With the current emphasis on corporate culture and customer engagement these measures fall significantly short of what they attempt to measure. Rather than rely on metrics an in depth qualitative analysis might provide meaningfully insights.

CPS 511 also requires financial entities to assess risks associated with remuneration arrangements for third party providers. Examples are investment managers, mortgage and insurance brokers. The Royal Commission highlighted the impact of perverse incentives.

Our concern with CPS 511, like the BEAR, is that it further embeds the existing executive remuneration paradigm in the larger listed financial services organisations. Many argue that the current FAR, STI and LTI model works well and serves the interests of all stakeholders. Some fine tuning of the metrics, more regulation and governance oversight is all that is required to iron out the problems associated with a focus on shareholder returns rather than a broader purpose based perspective.

I have long argued that, by delivering rewards in equity, the underlying message is that TSR is all that really matters. And it is important that shareholders receive a fair return for the risks involved with share ownership. But not at the expense of other stakeholders.

As mentioned previously 2021 provides a unique opportunity for board remuneration committees to consider their CEO and executive team remuneration mix. It might be timely to consider going back to basics and reducing "At Risk" remuneration. Fair and equitable fixed annual remuneration should provide the base line for an executive remuneration package. A focus on delivering financial and non-financial performance outcomes are core accountabilities for any executive role. The are covered by FAR and need to be factored into the annual review.

Strong performance might be rewarded through modest STI and LTI Plans and equity participation encouraged by offering shares at a discount rate (outside of package).

CPS 511 does not require a financial institution to have a variable reward plan for its executive team. Rather it encourages entities to determine the design with best suits their operating environment and business model. Interestingly some industry super funds do not have incentive plans for their CEOs and executives. Yet some deliver very sound returns to members.

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