

# Newsletter October 2018



## Hayne Royal Commission Interim Report

The Banking Royal Commission's Interim Report provided us with insights into two very different outcomes resulting from the activities of several financial services organisations.



## Pay Equity – Is the Landscape Changing?

As traditional employer/employee relationships evolve, so does the complexity of these relationships and this complexity may foster further triggers of pay disparity.



## Recent Strikes Against Remuneration Reports

Two recent shareholder-initiated strikes, one at **Telstra** and the other at **Tabcorp**, potentially reflect different foundations leading shareholders to vote against their Remuneration Reports.



## Shareholder Disquiet Over Executive Reward

In considering executive reward, stakeholders, be they shareholders, the Board, management, regulators or proxy advisers/consultants, often review information through a lens different to that of the Executive.

# Hayne Royal Commission Interim Report

The Banking Royal Commission's Interim Report provided us with insights into two very different outcomes resulting from the activities of several financial services organisations. On one side we had the achievement of significant profits and, on the other, instances where adverse customer outcomes occurred as a result of products that were of little value to the consumer. Among its findings, the Commission determined that the way in which



remuneration is structured within segments of the financial services industry drives a focus on profit even where that focus is at the expense of customers.

A question asked by the Commission is whether the remuneration structures in place are influencing the right corporate behavior. We believe that this Royal Commission will result in an increasing focus on remuneration beyond Financial Services. Remuneration constructs will become a key area of discussion within Boards and we believe that Boards will need to increase their knowledge of remuneration levels across their companies to achieve balance between rewarding positive outcomes and recognising negative ones.

Although the Commission's focus is financial services, the assertions made regarding remuneration and conflicts of interest is relevant for all industries. Do Boards have the right tools, processes and information to establish and maintain effective implementation of remuneration policies that align with stakeholder expectations and values together with shareholder returns across short- and long-term timeframes?

The use of malus clauses within remuneration are likely to have increased weight following the Commission's finding. In effect, incentives will need to cover:

- The reward for exceeding an expected result;
- The penalty for either not achieving a result or delivering a bad result.

A lens not seen to have been widely applied is compliance with company policy and a published Code of Conduct. We believe the following questions pose a challenge for many Boards as they confront fundamental remuneration policy and practice:

- What is the organisation's desired outcome?
- How is executive remuneration including incentives, aligned with outcomes?
- Are we rewarding the right outcomes?
- How do the desired outcomes align with employee / executive conduct?
- Are malus clauses present and are they effective in driving the desired outcome?
- Are audit controls and processes sufficient to identify policy breaches and adverse activity?

As Boards tackle areas of remuneration and relevance to outcome, the Commission provides context for the following questions:

- Should incentive plans exist? And if so, do the incentives reward the core accountabilities of a job or, where relevant, outcomes beyond plan/expectation (i.e. doing more than one's basic job)?
- How should breaches of regulations or laws impact the remuneration models/outcomes? Where does accountability lie? Should breaches of this nature negate incentive eligibility?
- How should breaches of internal corporate policies or industry policies on best practice impact the remuneration model?
- Should organisations support partial achievement of outcomes as an eligibility factor?
- How important is "getting it right" all the time?

What the Commission's Report showed was that adverse outcomes, no matter how small, have a significant impact on an organisation's reputation. Already we are starting to observe financial services companies allocating significant funds (at least \$1 billion remediation in the fees for no services scandal) to address and resolve issues raised by the Commission. Is the traditional risk / return trade-off for the investor still relevant? Have the risks increased?

The Commission's findings highlight the need for Boards, not just in financial services, to increase their awareness of remuneration structures and levels well below the C-Suite and whether remuneration policies are promoting the right behaviours within organisations.

**Call Egan Associates now on 02-9225 3225. We'd be delighted to talk through your current remuneration arrangements and work with you to optimise the best possible alignment between incentives and culture for your organisation.**

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# Pay Equity – Is the Landscape Changing?

In March 2018 we considered the notion of [equal pay for work of equal value](#) and continue to monitor the pay equity landscape. As traditional employer / employee relationships evolve, so does the complexity of these relationships and this complexity may foster further triggers of pay disparity.

We believe pay equality should exist. That is, equivalent work that produces equivalent value should receive equivalent pay. While this sounds simplistic, it is often difficult to implement as there are situational factors which can influence the achievability of pay equality. For example, we live in a rapidly changing society and the probability exists that changes in social values could be a cause in itself for pay inequality.



It is our view that organisations should use a standardised framework to assess organisational roles so that they understand the work dimensions and derived value components. Using this approach, a base remuneration outcome can be derived. This base remuneration will then need to be assessed against situational factors and adjusted accordingly. Consider:

- The physical location of where the work occurs;
- Industry specific dynamics (i.e. skills shortages, supply and demand for labour and specific sector/organisation work demands);
- The relative cost of living related to where the work will be (or from where the workforce will be sourced). Is it possible for the same role and same work to have differential remuneration across states, cities or country towns?
- The qualifications required to complete the work. Should more qualified employees be rewarded more or the same?
- The relative experience of candidates available to do the work;
- Should top performers be rewarded more or the same as marginal and/or average performers?
- The continuous hours required to complete the work. Should 8 hours a day be rewarded differently on an hourly rate to 12 hours?
- The source of funding for the role. Should Government employee roles being taxpayer funded be paid less than equivalent positions in the for-profit sector?

These are just a few considerations which will put pressure on a role's remuneration and at times could result in a potential premium being paid. What should be noted is that while the consideration of multiple factors may result in actual differences in pay it may also lead to perceived pay inequality when it actually isn't. The challenge for employers when

conducting such remuneration/work value exercises is the transparency and accuracy with which the remuneration review is implemented.

Egan Associates actively works with organisations in their assessment of role accountability, work value and remuneration to understand the pay equality matrix.

While the assessment of work, value, and remuneration should lead to measurable variances in pay (or equality) our evolving social framework may be creating additional complexity as a view of value from the *employee's* perspective emerges as a value attribute. It is worth asking:

- Will the gig economy maintain value equality, or will there be a value trade off to compensate for lifestyle changes? If there is a value trade off can this be measured? Will it be consistent across employees?
- Will the employee desire and demand for work / life balance adjust the value proposition?
- Will remuneration models adjust for positive lifestyle choices relating to variable conditions such as working from home, or working remotely? Conversely, will remuneration adjust for adverse impacts such as travel or increased on-site hours to meet outcomes? A challenge in determining/agreeing value equivalence exists as the perception of value may be different for different employees.

The above reflects some of the emerging value dynamics within the workforce and what they highlight is the changing perception of work, its value to the employer and related remuneration. Traditional employer work value models may need to be adjusted to allow for employee value preferences as our society evolves and places demand on lifestyle over work. While it may not be the employers' responsibility to cater for these preferences (ultimately the employee has choice) there is likely to be pressure for an employer to account for the employee preference in remuneration.

**Let Egan Associates help you ensure your organisation remains an employer of choice in all aspects of remuneration and culture. Call Egan Associates now on 02-9225 3225 and speak to one of our Consultants.**

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# Recent Strikes Against Remuneration Reports

Two recent shareholder-initiated strikes, one at **Telstra** and the other at **Tabcorp**, potentially reflect different foundations leading shareholders to vote against their Remuneration Reports.

Without having insight into the foundation for Board decisions, it is evident to me as a participant in this process over a considerable period of time that both of these Boards:

- have the benefit of experienced Directors;
- have exercised judgement having regard to the circumstances which their organisations faced over the prior twelve months;
- have formed a view and rewarded their principal executives, particularly their Chief Executive, for accomplishing outcomes that reflected transformational or integration challenges and that these demands did not contribute in the current Financial Year to a universally positive outcome for shareholders.

In the case of **Telstra**, their Chairman, John Mullen, an experienced Director and internationally experienced executive, observed that shareholders may have formed the view that given the attributes of Telstra and the scale of Australia's leading companies, remuneration levels are high.



Also implicit in John Mullen's comments were that the Board, in determining executive reward, needed to be mindful of competitive influences in exercising their judgement in relation to either fixed remuneration or incentives. The Telstra Board acknowledged that the CEO's long-term incentive award, which was due to vest in the current year, will not vest and not deliver a benefit to the leadership team.

Shareholders, who may have acquired shares two or three years ago at about \$5, are clearly venting on the fact that their shares are currently trading in the low \$3 value and that dividends are likely to decline.

The Telstra Board indicated that they did not appoint an independent remuneration adviser who provided recommendations either in respect of the 2017 Financial Year or the 2018 Financial Year.

Proxy Advisors drawing upon recently published Annual Reports among organisations 50% smaller and 50% larger than Telstra, where there are not an overwhelming number of organisations though covering all attributes and using market capitalisation as an indicator, would have observed that the CEO's fixed remuneration (\$2.39 million) is approaching the 75th percentile (\$2.41 million). Of the comparators, every CEO bar one received an annual incentive which averaged \$2.25 million (Telstra: \$1.366 million). Total annual remuneration, including fixed remuneration and an annual incentive on average stood at \$3.88 million, at the 75th percentile \$4.44 million (Telstra: \$3.74 million).

Total statutory reward, on average, exceeded \$9 million among the eight relevant companies and around \$8 million at the median, revealing that the outcome performance aligned at Telstra was not reflective of peers (\$4.52 million).

Notwithstanding the actual outcome for Telstra's CEO, his nominal total reward opportunity stands at \$11.95 million of which \$9.56 million is at risk. This fact is likely to have been the focus of the Chairman's comments.

Using the comparative data, the average fee payable to a Non-Executive Chairman stood at around \$700,000 and at the 75th percentile around \$780,000 compared to the Chairman's fee at Telstra of \$775,000. The reward arrangements, having regard to both annual revenues and market capitalisation for Chairs, were comparable.

John Mullen referenced the influence of the international marketplace, though the Board did not specifically comment on the sourcing of their leadership team, having influence to pay levels for individuals with comparable experience, capability and leadership qualities to those that are potentially available to be sourced from a global marketplace.

The Telstra Chairman made one particularly apposite comment, which I am able to reflect upon based on my experience. If I can interpret the Chairman's observation, it was essentially that a major company places itself at serious risk if it embarks alone upon the transformation of remuneration arrangements. I have had similar conversations over an extended period of time where Chairmen and Chairs of Remuneration Committees have indicated to me that while they may be supportive of a more modest approach to reward and a more demanding approach to performance hurdles, it is impossible to pursue such a process alone and that they require another 20 like-minded Boards to adopt a similar approach to be supported by well-informed, independent advisers who would contribute to that change on a broad platform.

This will remain a key challenge for Boards unless members of organisations, perhaps following the influence of the Business Council, collectively agree to take a stand to ensure that the approach to long term incentives and annual incentives is rigorous and transparent, and discretion is applied on a very limited basis.

In an entirely different setting, the Chairman of **Tabcorp**, Paula Dwyer, faced shareholders who had a negative view of the remuneration arrangements of the company and the judgements exercised by the Board.

On the basis of our observations, this may have in part been influenced by the challenges faced by the company in their loss-making joint venture in the UK. The payment of a not insignificant incentive to their CEO appears to be associated with the successful acquisition of the Tatts Group, and the progressive integration of that group into the now expanded Tabcorp whose market capitalisation a year earlier stood at around \$3.6 billion, with an ASX rank in the mid-80s, and today has a market capitalisation marginally shy of \$10 billion ranking in the low 40s of the ASX.

While over the last two years Tabcorp indicated that it has not received a recommendation from a remuneration consultant, they revealed that their CEO, in managing both enterprises, would be paid marginally less than the Chief Executive of Tatts Group before the merger. Notwithstanding, the increase in their long-serving CEO's fixed remuneration was 60%, or \$750,000. The extent to which that was benchmarked was not disclosed. The total reward opportunity of their CEO increased from \$5 million under the prior arrangements to \$8 million under the changed arrangements, or a 60% overall adjustment.

Proxy Advisors in reviewing reward at Tabcorp among organisations with a market capitalisation 50% smaller and 50% larger, would have observed the average level of fixed remuneration was \$1.75 million, at the median \$1.64 million and at the 75th percentile \$2.2 million (Tabcorp: \$1.64 million, \$2 million from December 2017).

The average bonus received by all but six of incumbents was \$1.2 million, at the median \$1.2 million and at the 75th percentile \$1.68 million (Tabcorp: \$660,527). Total annual remuneration arrived at through fixed remuneration and annual incentives, stood at approximately \$2.8 million on average and at the median, and \$3.5 million at the 75th percentile (Tabcorp: \$2.3 million).

Total statutory reward stood at \$4.1 million on average, \$4.35 million at the median and \$5.3 million at the 75th percentile (Tabcorp: \$4.1million). While acknowledging the actual outcome for the 2018 Financial Year Tabcorp CEO's nominal total reward opportunity for the 2019 Financial Year stands at \$8 million of which \$6 million is at risk.

We note at Tabcorp Board fees, which were not the subject of a recommendation from an independent remuneration consultant, at the level of Chairman increased from \$430,000 to \$590,000 or an increase of around 37%. The prior fee for the Chairman of both organisations was similar. The combined entities total Board costs had been reduced though individual Directors' fees increased.

For organisations among Tabcorp's comparators, in terms of market capitalisation, the average fee payable to a Chair was \$466,000, at the median \$480,000 and at the 75th percentile \$533,000. Having regard to organisations with comparable revenues, the average fee was approximately \$430,000, at the median \$441,000 and at the 75th percentile \$509,000.

Another organisation where shareholders appeared to endorse high remuneration was that of **CSL** where the CEO, long-serving in the position, is US-based. CSL's market capitalisation is approximately 2.5 times that of Telstra and around 9 times that of Tabcorp. The CEO's fixed remuneration was in the order of \$2.6 million, his annual bonus \$4.3 million and his total statutory reward approximately \$16 million (2017: \$11.7 million).

The company's market capitalisation at the end of the prior Financial Year stood at around \$57 billion with the share price around \$124. At the time of the 2018 Annual General Meeting, the company's share price was over \$200 and its market cap over \$90 billion. Clearly with a \$30 billion uplift in shareholder wealth \$16 million is acceptable.

In this context it may well not be the quantum that causes concern but rather the performance. The Chairman's fee at CSL stands at \$700,000.

**Let us help you design your remuneration strategy and disclosures to build shareholder confidence. Call Egan Associates now on 02-9225 3225 and speak to one of our Consultants.**

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# Shareholder disquiet over Executive Reward

In considering executive reward, stakeholders, be they shareholders, the Board, management, regulators or proxy advisers/consultants, often review information through a lens different to that of the Executive.

A more general application of a Board and management's frame of reference is how to benchmark reasonable reward. Consideration is generally given to the nature of the position's accountability, the capabilities and competencies required, the source of applicants and the location of the position – Australasia, North America, Asia, Europe or elsewhere.



To add further complexity to these challenges are the regulations and protocols governing reporting and the material utilised by those reporting to the community generally.

In this context, impacting on the complexity, the exercise of judgement, the integrity and foundation of the judgement and shareholder and community trust relates to whether information communicated reflects statutory reporting or actual remuneration received. A further area of concern is whether the performance hurdles, if financial, reflect year on year performance or multi-year performance particularly under LTIs where the equity instruments allocated are based on an accounting value, the market value or a contrived fair value. The implications of these choices either recommended by advisers, or recommended by management and adopted by Boards, reflect on the integrity of the organisation, the adviser and the trust of shareholders.

Overlaying this complexity are views being expressed by those who modify their views from time to time, based on experience and/or a retrospective review of the correlation between traditionally adopted measures and their alignment with shareholder benefit, and/or emerging trends or comment arising from Government Inquiries or Royal Commissions which may reflect on the paucity of knowledge or information held by those in authority.

Our experience is that not all strikes against a Remuneration Report relate to remuneration but will often relate to other areas of shareholder concern, including:

- Write-downs arising from business failures or poor acquisitions;
- A decline in profitability;
- A decline in dividends;
- A decline in share price;
- A negative view by analysts in relation to prospects/sustainability.

All these will impact on the value of a shareholder's investment and their view of the Board and management.

Many organisations today do not publish the potential remuneration arising from participation in awards but rather publish the target award which is often half the potential award. They do not reveal what leads to a payment well above target or the way in which relevant metrics might operate in determining such payment.

Where they exercise discretion, they will often not indicate the foundation for the exercise of that discretion, be it positive or negative. Realised remuneration, particularly under LTI plans, can often be a benefit accumulating over a series of up to five years. It is regularly not publicly reported as an annualised reward but rather a lump sum at the time it is realised. This distorts the nature of the market's understanding of the award.

Many current shareholders, including institutional shareholders, may not have been shareholders over the duration of the incentive program and will react to recent performance rather than sustained performance.

The above summarised overview, which may lead shareholders to vote down a Remuneration Report, endeavours to encapsulate the complexity of remuneration decisions which are influenced by a multitude of factors:

- The criticality of judgement being exercised by an informed Board or management team;
- The criticality of integrity in adjudicating on remuneration outcomes;
- The relevance of each of those elements in gaining shareholder trust.

**With more than 30 years' experience in all levels of incentive structures and benchmarking, we can help you ensure your reward frameworks are underpinned by integrity and resilience. Call Egan Associates now on 02-9225 3225 and speak to one of our Consultants.**

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# About Egan Associates

For more than 25 years, Egan Associates has advised leading organisations and emerging enterprises in Australia and New Zealand on the remuneration of Board Directors, executives and key staff members, as well as performance management, corporate governance and Board effectiveness.

Our Services include:

- **Remuneration reviews and benchmarking:** for CEOs, executives, senior management and professional positions, including specialist roles
- **Annual incentive plan structures:** advice on performance criteria, target and maximum payment levels as well as deferral and clawback provisions
- **Long term incentive plan structures:** advice on participation, performance hurdles, equity instruments, valuation and allocation, as well as provision of performance monitoring services
- **Corporate transactions / IPOs:** assistance transitioning pre-IPO reward arrangements into the listed company environment (or any other corporate transformation) considering issues including escrow provisions
- **Government pay reviews:** assistance at federal, state and local level in administrative, policy and corporatised environments on reward for senior executives, professional and administrative staff, and governing Boards
- **Board fee reviews:** benchmarking Board fee levels, including Chairman and Director retainer fees, Committee Chairman and member fees and fees for adhoc engagements.
- **Board effectiveness:** assistance with Board reviews, Board skills matrices, scenario planning and Board documentation.
- **Workforce & Governance:** *Define and evaluate positions and analyse pay the easy way!* Our new cloud-based software captures more than 30 years' knowledge, learning and experience in organisation analysis and remuneration in a suite of products which operate either as powerful, stand-alone modules or as an integrated combination. Access more than 1,000 role templates and over 13,000 accountability statements or easily create your own PDs from scratch. Organisation charts are generated automatically. Powerful analytics give you pay and workforce insights in one click. And our intuitive, user-friendly job evaluation module is designed to bring your JE process into the 21<sup>st</sup> century. And because *Workforce is* designed and hosted in Australia by Egan Associates, you know you're in great hands!



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