futurefund
Australia's Sovereign Wealth Fund

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Governance of executive remuneration during the Covid-19 pandemic

Considerations relating to the exercise of voting rights in ASX-listed companies

1. Introduction

1.1. The current COVID-19 health crisis has forced governments to impose comprehensive economic and social shutdowns across the world. Virtually every company in the Australian equities book invested by the Future Fund Board of Guardians ("**Board**") has been materially impacted by the pandemic in some way. The ASX 200 stock market index has reflected this market turmoil, down as much as 37% in March 2020 from February 2020 highs. While the market has reversed some of these declines in recent months, the outlook for containing the pandemic is still unclear.

1.2. While some companies have benefited from the crisis, most have been negatively impacted with many needing to shore up capital to meet solvency requirements and cut operating expenditures including jobs.

1.3. In this economically uncertain environment, many ASX company boards will be announcing end of financial year results and executive remuneration outcomes. These results will be formally presented and put to shareholders during the main AGM season (September through December 2020).

1.4. We expect that some ASX boards will apply discretion in the application of their structured remuneration frameworks this year to improve remuneration outcomes for executives. Typically, the use of discretion by boards is carefully monitored by shareholders to ensure that pay outcomes accurately reflect performance and broader shareholder outcomes.

1.5. This paper describes the process for voting the Board's shares and the considerations that will be integrated into the Board's decision making this AGM season in relation to remuneration resolutions.

2. The Future Fund process

2.1. The Board's proxy voting framework centres around its Corporate Governance Principles, which outline its views on the key aspects of corporate governance. These Principles are available on our website.

2.2. The Board realises that the current economic and market environment is unprecedented and that many of the economic conditions facing Australian corporates are outside of management's control. The Board may therefore be more flexible this year in the application of its governance principles.

2.3. The Board will also continue to rely on external advisors – investment managers and proxy advisors – to add the necessary context for complex cases. Moreover, the Board will continue to proactively engage ASX boards on these issues to develop an informed view.

2.4. The Board also notes that regulators, most notably the Australian Prudential Regulation Authority ("**APRA**") and Australian Securities & Investments Commission ("**ASIC**"), have issued relevant guidance.

3. Issues for consideration

3.1. Given the differences in impacts on companies from COVID-19, management responses, as well as the range in remuneration structures and potential adjustments, the Board will treat each AGM voting decision on a case by case basis. It is therefore difficult to provide definitive guidance on which practices may be acceptable to the Board.

3.2. Having said that, the starting point for the Board's voting decisions on remuneration will continue to be the alignment between remuneration payouts and company performance and the shareholder experience. As long term investors, the Board does not limit such analysis of performance over merely the previous financial year.

3.3. In evaluating remuneration outcomes in the context of the COVID-19 crisis for the upcoming AGM season, the Board has identified the following key considerations:

i) For companies not materially impacted by COVID-19, the Board expects their remuneration structures to operate as previously intended.

ii) Generally speaking, the Board expects company boards to limit the exercise of (upward) discretion even where material components of variable pay are not expected to pay out. In most cases, this outcome will align with shareholder experiences. This position is also shared by the Board's proxy advisors and investment managers.

iii) In any case, most short-term incentive ("**STI**") schemes feature a balanced scorecard with non-financial metrics which will typically allow for some vesting even in periods of weak financial performance.

iv) Where boards pay bonuses, the Board would expect restraint on cash payouts (ie a greater proportion in equity), especially at companies where protecting cash levels is important.

v) Boards should not strip out the COVID-19 impact when assessing performance or apply 'creative accounting' to adjust for the impact of COVID-19 (eg taking COVID-19 expenses below the line for remuneration purposes).

vi) The Board is especially mindful of undue windfall gains. The Board would not want to see management protected from the downside impact of COVID-19, but not restrained on the upside. For example, boards may seek to adjust performance hurdles tied to financial performance in the STI scheme to allow greater vesting, but not adjust the (low) share price used to determine equity grant sizes and outcomes for the long-term incentive ("**LTI**") schemes.

vii) Where boards feel an upward adjustment is merited (eg to reward executives for strong performance even where financial performance has been weak), they could consider:

   a) Where remuneration schemes are no longer fit for purpose due to COVID-19 impacts, replacing these with restricted equity. Quantum should be materially smaller (eg 50%) due to the greater certainty of payout. However, the Board does not support a longer-term commitment to 'unhurdled' or simplified remuneration schemes.

   b) Where relevant, removing performance gateways where these are no longer justifiable. For example, a gateway of positive earnings growth (vs the previous year) may seem overly onerous in the current environment.

viii) Whilst any legitimate decision to cut jobs during this time doesn't need to be explicitly incorporated in executive remuneration outcomes, boards should consider applying a basic 'pub-test' which may suggest that some of the pain felt by staff below executive management ranks should also be applied to the remuneration outcomes of key management personnel.

ix) While having some sympathy with the view that companies on Job Keeper or which have undertaken large equity raisings should not pay bonuses, the Board also believes that management should not be disincentivised to act in the long term interests of the company. However, company boards should understand that shareholders will likely expect moderation of remuneration outcomes in these cases.

x) Boards setting forward-looking remuneration structures may wish to temporarily shift the structure of those schemes away from performance metrics that are difficult to determine in the current volatile market environment (eg earnings based metrics), to less complex metrics (eg relative total shareholder returns).

xi) In isolated cases, it may be prudent to postpone setting LTI performance metrics until economic and market uncertainty subsides somewhat. The timing and process of such postponement would need to be transparent to the market.

xii) It is essential that any discretion applied by boards should be disclosed in detail (how, what and why) and in a timely fashion to shareholders.

4. Regulatory guidance

4.1. In June 2020 ASIC released Information Sheet 245 relating to board oversight and discretion in executive variable pay schemes. This document offers guidance to support board oversight over remuneration during the COVID-19 pandemic. ASIC suggests that the effectiveness of board oversight and the exercise of discretion would be enhanced by being:

i) Guided by frameworks and processes that result in the active, timely and consistent exercise of discretion.

ii) Made with the benefit of structured and contextual information from unbiased sources.

iii) Made with the benefits of arrangements to manage conflicts of interest.

iv) Transparently recorded and communicated.

4.2. APRA issued guidance in April 2020 to deposit-taking institutions and insurers on capital management in which it outlined the expectation that "Boards will appropriately limit executive cash bonuses, mindful of the current challenging environment".