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Inquiry into Executive Remuneration

The Finance Sector Union (FSU) represents 50,000 members employed in the finance sector across Australia, with the majority of these employed in the major banks. The FSU welcomes the opportunity to submit to the inquiry on executive pay and supports initiatives to ensure responsible remuneration practices are observed throughout the finance industry and beyond.

The issue of executive remuneration is particularly relevant to our industry. While many areas of the finance sector are regulated to ensure a functioning market exists, executive remuneration is one area that has not received the same level of oversight.

The finance industry is a critical component of the economy, and problems within this sector can have far-reaching consequences as evidenced by the current global financial crisis. There has been a recent period of excessive risk-taking that has demonstrated the issues of inappropriate incentive systems. This has ultimately led to market failures, and indeed it could be said that more regulation is required to correct the market failures of the current executive market.

The FSU believes there is opportunity for the Australian finance sector to be a global leader in executive remuneration best practice. Through additional disclosure and the prohibition of inappropriate practices, a more responsible executive remuneration culture may emerge.

The FSU makes the following recommendations in relation to executive remuneration:

1. performance measures should be relative to the benchmarking group rather than expressed in absolute figures that neglect macro-economic forces;
2. the criteria that executives must meet to receive performance pay should be outlined in the remuneration report and divided into financial and non-financial measures;
3. short-term incentive payments to executives are irresponsible, and should be abolished or replaced by long-term incentive payments;
4. long-term incentives are an appropriate way to recognise performance, but should be coupled with CSR obligations;
5. disclosure of pay relativity ratios would be helpful in allowing investors to make an informed vote on the remuneration report;

6. the provision of non-recourse loans that allow an executive to purchase shares without being held liable for repaying the debt should be prohibited;
7. the practice of hedging 'at risk' pay whereby potential reductions in performance pay are offset by other investments should be prohibited;
8. termination payments or "golden parachutes" to executives should be capped at no more than one year's base pay in total;
9. equity payments such as shares can be used to provide long-term incentives, provided the executive is unable to sell the equity for at least two years;
10. full disclosure of benchmarking processes should be made within the remuneration report;
11. remuneration consultants who assist with formulating executive remuneration should be under similar disclosure requirements as auditors

Remuneration Structures

We note and endorse the Uni Global Union EU policy on Director's Remuneration:

> "In the finance sector, prudent supervision should oversee that remuneration structures at all levels – incl. sales and advice functions – are appropriate and risk conscious. Authorities should be able to penalise inappropriate practice."[1]

The practice of irresponsible lending should be clearly defined and prohibited by legislation. The FSU believes that a large amount of activity in the finance sector marketplace is based on short term competition for growth or market share rather than sustainable practices. This type of activity is often promoted by short-term incentives for executives, which are then imposed on finance sector staff as sales targets for a wide range of financial services such as home loans and credit cards.

The FSU has developed a *Charter of Responsible Lending* that was launched on 1 October 2008. Legislating recommendations from this document which mandates 'responsible lending' would be an effective way of beginning to address this issue. We have included a copy of the *Charter* and ask that it be considered as part of our submission.

Performance Pay

Performance measures should be relative to the benchmarking group rather than expressed in absolute figures that neglect macroeconomic forces. This ensures that when market forces negatively impact the earnings of a sector, aggressive cost-cutting measures are not made for the sake of hitting a target. Conversely, when market forces are applying positive influence on earnings this is not attributed to the executive.

The criteria that executives must meet to receive performance pay should be outlined in the remuneration report and divided into financial and non-financial measures. This information would assist investors in knowing to what degree non-financial measures were used in creating a balanced group of performance indicators.

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[1] '*EU Policy on Remuneration in the Finance Industry*', Uni Global Union. 14th April 2009

Short Term Incentives (STIs)

The FSU regards the concept of STI payments to executives as irresponsible, and propose they be abolished or replaced by LTI payments. STI payments often misalign the interests of executives with shareholders and the wider community by encouraging short-term gain at the expense of longer-term capacity. In the finance sector this has included decisions such as mass-redundancy to reach profit targets.

The remuneration structures set by boards often have target breakdowns of executive pay into fixed salary, STI and LTI. These remuneration compositions represent the reward structures that the board aims for when determining executive pay packages. The tables below detail target STI levels, LTI levels and base pay at the five largest Australian banks.

Target STI and LTI payments to bank CEO's in 2008

Bank	STI %	LTI %	Base Salary %	Target STI payment based on salary
ANZ	33%	33%	33%	$3.27 million[2]
CBA	55%	17%	28%	$6.13 million
NAB	30 – 40%	30 – 50%	25 – 35%	$2.35 – $4.38 million[3]
SUN	150% of base salary	No LTI target	Unable to calculate	$2.85 million
WBC	40%	30%	30%	$4.07 million[4]

Target STI and LTI payments to bank executives in 2008

Bank	STI %	LTI %	Base Salary %	Target STI payment based on average of top 5 base salaries
ANZ	45%	18%	37%	$0.47 million
CBA	60%	10%	30%	$0.66 million
NAB	25 – 50%	15 – 35%	25 – 40%	$0.74 – $2.39 million
SUN	100 or 150% of base salary	No LTI target	Unable to calculate	$0.78 – $1.17 million[5]
WBC	50%	20%	30%	$0.41 million

[2] Annualised figure based on CEO departure during the reporting period.
[3] Target remuneration is expressed in percentage ranges. This figure represents the possible range of payments.
[4] Annualised figure based on CEO departure during the reporting period.
[5] Target remuneration is expressed in percentage ranges. This figure represents the possible range of payments.

The magnitude of target STI payments to CEOs is obscene. As the above tables demonstrate, the target remuneration structures for other senior executives places an even greater emphasis on reaching interim hurdles regardless of long-term consequence. When executives can potentially double their salary based on short-term measures, the incentive to assume a perverse level of risk-taking is clear.

Perhaps the most notable example of an ill-thought short-term incentive in 2008 can be found at Macquarie Bank. Alan Moss had STI awards totalling $27.2 million which was more than 40 times his base salary. In the same period STI payments totalled 78% of all executive remuneration. In light of the issues that have since reduced shareholder value at Macquarie, the inappropriateness of STIs in rewarding performance is obvious.

LTIs

Long-term incentives are an appropriate way to recognise performance, but should be coupled with CSR obligations. An example of performance indicators that are relevant to employment are outlined by the Global Reporting Initiative.[6]

These areas include:

- Diversity and Equal Opportunity
- Training and Education
- Occupational Health and Safety
- Employee / Management Relations

An appropriate financial measure could be total shareholder return above the median for the benchmarked group. Similar to the Australian Shareholder Association, the FSU believes these should be assessed over no less than four years and vesting cease not before this date.[7]

Equity Payments

Equity payments should always be attached to vesting periods of at least two years, except in the case of LTIs whereby four years is an appropriate period. Vesting periods should remain in force after an executive has left an organisation and not be shortened as a result of employment ceasing.

Golden Payments

Termination payments or "golden parachutes" to executives should be capped at no more than one year's base pay in total. The acceleration of vesting periods should not occur, and the organisation should not enter into agreements with the executives that offset their tax obligations.

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[6] *Labor Practices & Decent Work Performance Indicators*, Global Reporting Initiative, Version 3.0, 2006
[7] *Executive Remuneration*, Australian Shareholders' Association. Policy Statement 23 March 2009.

Payments made to finance executives during last year of tenure

Organisation	Name	Salary	Termination	Total Amount
CBA	Chris Cuffe	$2.82 million	Unknown	$32.75 million
AMP	George Trumbull	$0.86 million	$7.50 million	$14.08 million
NAB	Frank Cicutto	$0.68 million	$6.62 million	$7.54 million
SUN	John Mulcahy[8]		$2.4 million[9]	
ANZ	John McFarlane	$2.08 million	$0.92 million	$6.75 million
SUN	Steve Jones	$0.25 million	$2.05 million	$6.70 million
WBC	David Morgan	$0.63 million	Not indicated	$6.28 million
AMP	Tom Fraser	$0.89 million	$4.68 million	$6.10 million
AXA	Geoff Tomlinson	$1.21 million	$4.16 million	$5.56 million
NAB	Peter McKinnon	$0.69 million	$1.30 million	$3.39 million
AMP	Tim Wade	$0.57 million	$1.96 million	$3.28 million
NAB	Ian Scholes	$0.28 million	$2.24 million	$3.26 million
AMP	Paul Batchelor	$1.33 million	$1.4 million	$2.92 million
NAB	Mike Laing	$0.59 million	$1.23 million	$2.86 million
NAB	Ian Crouch	$0.74 million	$0.98 million	$2.85 million
AMP	Warwick Forster	$0.46 million	$1.74 million	$2.83 million
AMP	Gary Trail	$0.12 million	$2.06 million	$2.19 million

Source: Annual Reports[10]

The figures above were taken directly from annual reports in the final year of an executive's tenure. Most examples demonstrate a disconnect between items declared as 'termination' benefits, the salaries paid for a part year and the ultimate payment made for that financial year. Additionally, many of those listed represent examples where the executive was fired following poor performance.

When John McFarlane retired from ANZ, his final year payment included $1 million to buy back his vested shares.[11] Despite the considerable personal tax savings Mr McFarlane had enjoyed by accepting his remuneration almost entirely in shares,[12] the board believed it was 'inequitable' that tax be paid on the vested shares in case performance hurdles weren't met – a scenario that would entitle Mr McFarlane to a tax

[8] Total payment will be unknown until 2009 annual report is released.
[9] "Suncorp's John Mulcahy paid $20m as company loses $20b", *Courier Mail*, James McCullough. February 6 2009.
[10] *Termination Benefits for Executives of Australian Companies*, Geof Stapledon. Sydney Law Review, Volume 27, No.4, 2005.
[11] *ANZ Annual Report 2007*, ANZ. p15
[12] In 2006 John McFarlane received $50 cash and the remainder in equity.

refund. The FSU believes examples like this are an abhorrent abuse of an executive's position within an organisation.

The FSU finds termination payments that are beyond one year's base salary excessive and offensive, particularly in circumstances of poor performance. The FSU would like companies to revise current severance arrangements as was recently done at QBE to reduce Frank O'Halloran's retirement benefit from $7.35 million to $2 million.[13] Additionally, the FSU believes boards should be able to reduce the size of executive termination payments in light of poor performance as was the case when Paul Bachelor's termination payment from AMP was significantly reduced.[14]

With respect to mergers and acquisitions, payments should only be eligible if the executive is made redundant and not re-employed by the new entity. In one recent example, $44 million in cash and shares were paid to departing executives of Promina during its acquisition by Suncorp despite some being re-employed as consultants.[15] In addition to $8.1 million in termination payments, Mike Wilkins received $1.5 million to provide consultancy for a period of six months. Executive remuneration loopholes that allow practices such as these should be prohibited.

Other Issues

Pay Relativities

Disclosure of pay relativity ratios would be helpful in allowing investors to make an informed vote on the remuneration report. The pay relativity ratios that might be useful to investors are:

- CEO : ordinary employee average earnings
- CEO : executive average earnings

There has been an exponential growth of CEO pay that has been observed in recent history. In Australia, different sample groups can be used to demonstrate the ratio of CEO to average worker pay.

Sample	Period	Ratio Change
Top 50 Companies[16]	1992 – 2002	27:1 to 98:1
Top 100 Companies[17]	1990 – 2008	18:1 to 80:1
BCA members[18]	1994/5 – 2004/5	29:1 to 63:1

Often the excuse used to justify this exponential increase is a 'global market' for executive talent, which is usually in reference to the US CEO salary scale. In addition to

[13] "Shareholders told that golden parachute for insurer QBE chief executive is 'excessive'", *Herald Sun*, Fleur Leyden. April 2 2009

[14] "Hasty deal secures riches for former CEO", *The Age*, Malcolm Maiden. May 23 2003

[15] "Execs grab $44m bonanza", *Sydney Morning Herald*, Danny John. March 6 2007

[16] "Executives and the new wage crisis", *Fast Thinking*, Fran Molloy.

[17] "Time to outlaw greed in corporate Australia", *Newcastle Herald*, John Sutton. March 19 2009

[18] Setting the double standard: Chief Executive pay the BCA way, *Journal of Australian Political Economy*, No 56, p302

the US markets being a significantly larger size, this pay differential is an outcome that should be avoided in Australia. For example, in the US in the 20 years between 1985 and 2005 the ratio of CEO to average worker pay has increased more than ten-fold to 262 times.[19]

Of additional concern is the ratio between CEO remuneration and the other executives in the remuneration report. In an international study,[20] it was demonstrated that best practice was to pay the CEO twice what the next management layer is paid. A large gap was indicative of broader management and decision-making issues.

Non-recourse loans and hedging

The provision of non-recourse loans that allow an executive to purchase shares without being held liable for repaying the debt should be prohibited. This position is consistent with the positions adopted by both ASA and ACSI. Allowing these loans for executives who can directly affect share price misaligns shareholder and executive interest.

> "The provision of non-recourse loans to executives does not typically represent "best" corporate governance practice, because such loans weaken the link between performance and rewards by diluting the "at risk" aspect of share ownership (i.e., the personal wealth of the executive is not at risk if the company's share price falls). In addition, where there is a dramatic fall in company share price, shareholders can lose out twice – the fall in value of their personal holdings as well as the loss to the company because the loan is not recouped."[21]

The use of hedging 'at risk' performance pay should be prohibited for similar reasons to non-recourse loans. This position is consistent with ACSI and ASA, and acknowledged as best practice by Deloitte.[22] An example 'hedging' policy can be found in the Westpac Annual Report:

> "Hedging refers to using financial products to protect against or limit the risk associated with equity instruments such as shares or securities employees may receive as part of their performance-based remuneration. Under our policy, participants are strictly forbidden from entering into hedging arrangements in relation to their unvested employee shares or securities, whether directly or indirectly. If a participant attempts to hedge unvested shares or securities those instruments are liable to forfeiture."[23]

Benchmarking

Full disclosure of benchmarking processes should be made within the remuneration report. Peer selection will usually determine current executive pay and be used to measure performance. Consequently, the rationale behind selecting comparison organisations should be clearly articulated. More specifically, disclosing the relative size and relative pay of the organisation would help shareholders decide whether the magnitude of compensation is appropriate.

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[19] Lawrence Mishel, Economic Snapshots, Economic Policy Institute 2007

[20] Mark Van Clieaf in *Key Considerations in Executive Pay*, Risk Metrics. May 2008.

[21] *Non-Recourse Loans Provided to Executives*, Australian Institute of Company Directors. May 2008.

[22] *Executive Remuneration: Best Practice Principles and Guide*, Deloitte. November 2003

[23] *Westpac Annual Report 2008*, Westpac. p47

Remuneration consultants who assist with formulating executive remuneration should be under similar disclosure requirements as auditors.[24] There has been criticism from shareholder groups[25] as well as research bodies[26] about the current involvement of remuneration consultants in artificially inflating executive remuneration. The criticisms mainly relate to inappropriate competitor selection and target pay that is beyond the size or performance of the organisation. By requiring remuneration consultants to adhere to the standards already in place for auditors, this would assist the impartiality of consultants.

Some of the additional requirements of the *Corporations Act* would include:

- the consultant's independence declaration being part of the remuneration report;
- details of the amounts paid or payable to the remuneration consultants for other services provided, during the year, by the consultant (or by another person or firm on the consultant's behalf);
- a statement of whether the directors are satisfied that the provision of other services during the year by the remuneration consultant (or by another person or firm on the consultant's behalf) is compatible with the general standard of independence for auditors imposed by the *Corporations Act*; and
- a statement of the directors' reasons for being satisfied that the provision of those other services during the year by the remuneration consultant (or by another person or firm on the consultant's behalf) did not compromise the independence requirements of the *Corporations Act*.

If you have any questions in relation to this submission please contact Rod Masson, National Communication and Policy Manager, on (03) 9261 5330 or Keegan Hayden on (03) 9261 5342.

Yours sincerely

Leon Carter

National Secretary

29 May 2009

[24] *Audit-related disclosure requirements of the Corporations Act and accounting standards*, Australian Government Financial Reporting Council.
http://www.frc.gov.au/reports/2007_2008_AAIR/2007_2008_AIR-11.asp
[25] ASA and ACSI
[26] Riskmetrics

Finance Sector Union – Charter of Responsible Lending

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The Finance Sector Union of Australia calls on all members of the finance industry and the Australian Government to adopt, implement and adhere to a national Charter of Responsible Lending. The key principles and regulatory initiatives underpinning the Charter are as follows:

- A consistent Commonwealth regulatory regime covering the provision of financial products should apply to all credit products and providers; incorporating the highest standards of disclosure and procedural fairness, access, and affordability of redress for consumers,
- All loans and credit products must be based on a genuine assessment of the consumer's needs, the suitability of the product to meet those needs, and demonstrated capacity to meet the repayments;
- No unsolicited pre-approved credit offers should be made to consumers;
- Sales targets for finance industry staff should only be linked to remuneration if a living wage and across the board, guaranteed minimum salary increases are already in place;
- Consumers must be informed of any commissions, bonuses, incentives or remuneration implications that those making the sale may receive as a result of selling a financial product;
- Consumers must be allowed to 'opt-out' of receiving unsolicited product offers in their dealings with their financial institution;
- Information about assistance mechanisms for people facing financial hardship must be made easily available;
- All institutions must be members of an alternative dispute resolution scheme with the powers to resolve disputes without redress to the courts;
- Financial literacy and education programs must be encouraged and supported by the industry and governments and provided to the community, particularly to vulnerable or disadvantaged groups.
- Financial institutions will improve their credit risk management by developing comprehensive programs, and contributing capital, to enable consumers to reschedule credit repayments during periods of short-medium term cash flow asymmetries.

Background

The finance industry plays an essential role in Australian society as a provider of capital, insurance, investment, personal credit, financial advice, assessment and deposit taking. In Australia, the finance industry makes up approximately 40% percent of the value of our stock market and employs around 400,000 people.

The people and practices in the finance industry determine public goodwill and confidence in its reputation and sustainability – without these it could unravel causing enormous damage to the Australian economy.

The Finance Sector Union (FSU) accepts and understands that the finance industry must be a very competitive industry; however finance products can have serious or long term implications if sold inappropriately.

Purchasing any financial product is a serious matter, especially a home loan which will usually be the biggest financial commitment a person makes in their lifetime. Financial institutions should always try to ensure that products are appropriate to a persons circumstances and do not result in people becoming overly financially committed.

Australia's level of personal debt is at record highs and continues to rise. In 1981 personal debt as a proportion of GDP was 50% by early 1999 it had risen to 100% and in 2007 it was 156%. If the current trend continues, it will reach 200% of GDP by 2015.[1] Given this trend the FSU advocates that all financial institutions adopt and that Government's enact the necessary regulation to give affect to this Charter of Responsible Lending to preserve the good reputation of our industry, the financial welfare of our citizens and the economy of our community.

Regulatory arrangements

Under the current national regulatory regime, most financial service providers are required to hold an Australian Financial Services (AFS) licence. This includes banks, credit unions, insurance companies and financial advisors. Licensing conditions include training requirements and membership of an industry alternative dispute resolution scheme.

However, the provision of credit is regulated under the Uniform Consumer Credit Code which is enacted through State based legislation. Under this regime credit providers are not automatically required to hold an AFS licence and consequently may not be members of a dispute resolution scheme.

The FSU also calls for the regulation of credit to be brought into a Commonwealth regulatory regime, consistent with other financial products to ensure that consumers have the same level of protection and avenues for redress. In addition there should be national legislation to regulate the conduct of finance brokers in the marketplace.

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[1] *Deeper in Debt - Australia's Addiction to Borrowed Money*, Dr Steve Keen September 2007.

As part of such a regulatory regime, all providers of credit must be members of an alternative dispute resolution scheme.

Credit assessment and increases

Institutions must not sell credit products to a customer unless they have carried out a genuine assessment of the customer's needs and capacity to repay the credit product.

This process must sufficiently consider the debtor's financial situation to satisfy a diligent and prudent credit provider that the debtor has a reasonable ability to repay the amount of credit provided or to be provided.

Institutions should obtain information about the customer's financial position with specific regard to:

- level and type of income; and
- all credit accounts and applicable limits and balances;
- other repayment commitments; and
- credit history.

If this process suggests that a consumer will have difficulty meeting the repayments then approval should not be given unless changes are made that would ensure the consumer has sufficient capacity to make repayments.

Institutions should not increase the amount of credit available unless the consumer has requested the increase in writing, and the credit provider has carried out a satisfactory assessment as previously outlined.

Where credit limit increases are offered they should include details about what the new minimum repayments would be if the consumer accepted the increased limit.

Unsolicited offers of credit, including credit cards and increasing credit card limits must not be made.

Sales targets and finance sector employees' remuneration

The FSU is concerned that the industry is increasingly moving towards a culture of sales targets and incentive based remuneration for employees. Achievement of targets is now explicitly linked to remuneration outcomes – unfortunately, achieving targets is now becoming the only way employees can access pay increases.

The culture of sales targets is, by definition, designed to maximise sales which (even inadvertently) will lead to a higher risk of inappropriate sales occurring. The FSU policy on performance pay[2] clearly states that sales targets or performance hurdles should only be linked to remuneration outcomes where across the board, minimum pay adjustments

[2] *FSU Policy - Regulation of Performance Based Pay*, 2007 – www.fsunion.org.au

already exist to provide employees with sustainable cost of living and real wage growth increases. Base salary levels should reflect the professional nature of the service being provided and reflect the need to attract and retain a skilled and responsible workforce.

In addition, consumers must be informed of any commissions, bonuses, incentives or remuneration implications that finance sector employees may receive as a result of selling a financial product.

'Opt out'

Financial institutions that wish to offer superior customer service should offer consumers an 'opt-out' mechanism. Under such mechanisms, customers can indicate they do not wish to receive unsolicited offers of products either when dealing directly or indirectly with their financial institution. This would ensure that consumers who are not interested in additional products do not feel pressured by constant unwanted offers and ensure that finance sector employees do not have to persistently make such offers.

Assistance for people facing financial hardship

A proportion of consumers will experience financial difficulty at some stage of their lives. In many cases this will be temporary and institutions can help consumers to manage these periods if they have policies and procedures in place to provide assistance, advice and information.

These procedures should include:

- clear contact points for people experiencing financial difficulty;
- discretion to grant relief mechanisms such as deferred repayments or penalty waivers;
- contacting customers who appear to be having difficulty managing their repayments;
- referral to free and independent financial counselling where appropriate; and
- information regarding dispute resolution procedures.

Financial Literacy and Education

Given the increasing complexity and essential nature of financial services it is critical that people have access to education and information to increase their level of financial literacy. This is particularly important for young people and other potentially vulnerable groups. Industry should take a leading role along with Government in providing these education programs and include them as part of the mainstream curriculum in secondary schools.