AUSTRALIAN BANKERS' ASSOCIATION INC.

Response to Productivity Commission Discussion Paper on Director and Executive Remuneration

Australian Bankers' Association

May 2009

PART A: Key Points & Executive Summary

The Australian Bankers' Association (ABA) welcomes the Productivity Commission's review into director and executive remuneration practices in Australia. We see this as an opportunity to set down information useful for evaluating bank remuneration practices, and as a potential means of improving the regulatory framework in this area.

Our submission focuses on remuneration practices of banks rather than the wider set of listed corporations. The four major banks are amongst the 10 largest ASX listed companies, and banks in total constitute approximately 25% of the stock market's total capitalisation.

Bank remuneration attracts a lot of media and community attention, mainly because average remuneration levels for bank executives is typically higher than for other executives in other industries.

Another qualification is that our submission addresses only remuneration practices for executives, and not of board non-executive directors. We see practices regarding executive remuneration as being of more concern to shareholders and the wider community.

This submission is primarily structured around the Productivity Commission's discussion paper questions, but there are three themes which we stress in our answers to those questions:

1. There is no obvious evidence that remuneration practices of Australian banks (in general) have been defective.

Australian banks have high credit standings, have produced average return on equity (ROE) rates over the last decade of 17%, and have performed strongly through the current global financial crisis and the preceding Asian financial crisis in 1997.

This strong performance has yielded a significant social dividend to Australia. In those countries where their banking systems have faltered or proven weak, unemployment levels are considerably higher.

2. The ABA believes responsibility for remuneration of chief executives and senior executives should remain squarely with the company board.

Boards are responsible for appointing senior executives and setting the terms and conditions of employment. All banks are required to have a board majority composed of non-executive directors. Given non-executive directors can be voted out by shareholders, bank boards are highly accountable to shareholders for performance.

Consistent with this responsibility, boards should be autonomous in setting executive remuneration policies. It is inconsistent to require and expect bank boards to take full responsibility for remuneration practices and performance outcomes, but then have the board's autonomy materially limited by regulation.

3. The ABA believes there is scope to improve the regulatory framework regarding remuneration practices, particularly in relation to taxation and disclosure.

Taxation

Currently, when an executive terminates employment, any shares granted as remuneration are taxable. This is the case, even if the executive is restricted in selling these shares (i.e. they are subject to a vesting period and, potentially, performance hurdles.)

In order to prevent the executive from experiencing a cash-flow problem created by the tax liability, company boards may waiver the vesting period to allow executives to sell their shares. The tax treatment, therefore, is inconsistent with the aim of encouraging boards to set remuneration that is dependent on long-term company performance.

While the tax issue outlined above is long-standing, two taxation issues have arisen recently that will also have unintended consequences. The first is the proposed policy to reduce to 1 year's base pay the maximum termination benefit an executive can receive (without shareholder approval). This will have the effect of skewing remuneration packages towards greater reliance on base pay. The problem is that base pay is criticised for not providing sufficient performance incentives.

Another significant issue is the Government's proposed policy outlined in the Federal Budget 09 to make income tax payable on all shares granted as remuneration in the year granted. This threatens the viability of the schemes and is contrary to other efforts aimed at encouraging boards to defer income and place conditions on vesting.

Disclosure

Currently, banks are required to disclose the remuneration of board members and executives in their annual report. While this provides a substantive benefit in enabling shareholders to evaluate the board's remuneration practices, there is scope for improvement. The remuneration reports are lengthy and complex to understand.

The requirement to disclose share-based payments in accordance with AASB 2 "Share-based Payment" is particularly problematic. Many shareholders believe that the disclosed value is the remuneration actually received by the executive during the year. But this is not the case. The actual realised value could ultimately be significantly different (nil, more or less).This is primarily due to equity awards being typically subject to performance hurdles.

There is a need to go "back to basics" with disclosure. Firstly, the policy objective must be clear. Secondly, regulatory rules should be the minimum necessary to achieve that policy objective.

The original purpose of the remuneration report was to provide shareholders with information to evaluate the relationship between remuneration and performance. Yet, the amount of detail now required and the complexity due to the accounting concepts has eroded this original purpose. The challenge going forward is to have remuneration reports more clearly establish the links between pay and performance.

The ABA recommends that Treasury establish a consultative/working group (similar to that established for the corporate law simplification project) to work through issues and solutions.

PART B: Answers to the Productivity Commission's discussion paper's questions

Definition and scope

What is an appropriate definition of 'remuneration'?

Remuneration is the amount of wealth the executive is compensated for through his/her employment. It typically includes cash payments, benefits (salary-sacrificed or otherwise), superannuation, short-term incentives and long-term incentives (typically options, performance rights or shares).

What aspects or elements of remuneration should be included?

All aspects of remuneration should be included in the general definition. However, there is a complexity regarding how equity benefits should be disclosed.

The current disclosure requirements under AASB 124 "Related Party Disclosures", which require equity to be valued and disclosed under AASB 2 "Share-based Payment", cause confusion.

This is because the disclosed value may not reflect the value that the executive has realised or will realise in future years. For instance, the potential value could be as low as 'nil' if the equity benefit is contingent on performance conditions.[1]

An important consideration is the context in which the definition is being used. For example, the definition of remuneration for the purposes of termination payments should not include unvested shares. In other contexts, it may make sense to define unvested shares as part of remuneration. It is desirable for definitions to be determined on a case-by-case basis.

What is an appropriate definition of 'executive'? Does the remuneration report required under the Corporations Act and its coverage of key management personnel provide a suitable definition? Should the Commission's coverage of executives go beyond this, and if so, why?

The remuneration report covers the board directors, the CEO, the five highest paid group and company executives and key management personnel. It effectively captures all executives that have influence over the organisation's strategic direction and overall performance. We don't believe it needs to be extended.

One suggestion for improvement is that it could be made clear that the remuneration report should not have to cover directors that sit on bank subsidiaries, particularly where the subsidiary is minor (i.e. a P&L business representing less than 5% of the group P&L). This is particularly important if the remuneration report's definition is used for other purposes, such as capping termination payments. Having a definition that can potentially include many employees' risks creating an unnecessary compliance burden.

How should 'corporate performance' and 'individual performance' be defined? Is it possible to define them in general terms that are applicable across most businesses? Or is transparency in performance hurdles for incentive payments the more important issue?

Corporate performance is performance at the company-wide level. The applicable corporate performance metrics are determined by the

[1] It can also lead to large reported "termination payments" which are in fact merely retained bonuses not reported in the year to which they related.

board and typically consist of both financial and non-financial metrics.

Examples of financial metrics are relative total shareholder return (relative TSR), earnings per share (EPS), return on equity (ROE), and net profit after tax (NPAT). Examples of non-financial metrics are customer satisfaction, environmental/sustainability practices and employee engagement.

Individual performance is typically assessed through measuring the executive's performance against their key performance indicators (KPIs). These KPIs[2] are typically specified at the start of the year and are aligned with the company's strategic objectives. More so than corporate performance metrics, individual performance metrics are generally within the executive's sphere of control – also known as the executive's 'direct line of sight'.

The ABA agrees 'transparency' is the more important than strict definitions. However, disclosure has costs and benefits. One serious negative consequence of disclosure is that the competitive process can be harmed if commercially sensitive information is revealed.

For this reason, the ABA doesn't support mandated disclosure of short-term incentive (STI) or even long-term incentive (LTI) metrics as these metrics can reveal strategically important information. If disclosure is required, it is critical that the disclosures are post-event and generic terms.

To what extent do external performance indicators 'net out' underlying market growth from entrepreneurial and managerial performance?

There is no perfect mechanism for netting out market growth changes from performance hurdles. One common approach is to use relative TSR. This compares a bank's total shareholder return over a period of time with that of a peer group or relevant market index.

Yet, even this approach can be problematic. A bank reported to the ABA that they have observed anomalies with TSR hurdles caused by abnormal temporary factors materially affecting share prices at the beginning of the period of comparison – i.e. the peer group is not at a consistent starting point.

The difficulty in finding an ideal hurdle to net out market growth has led to the use of split hurdles such as a combination of TSR and earnings per share (EPS), but ultimately nothing is likely to fully replace the need for boards to exercise a judgement about underlying

[2] Note that the more senior an executive, their KPIs will typically be broader. It is unlikely a senior executive's role can be accurately captured with a narrow-set of KPIs. This then implies that holistic judgement is also needed to assess an executive's performance. An executive's performance is also best assessed over long time periods, taking into account factors such as organisational culture. These broader factors are important and can be minimised by a focus on short-term financial performance measures.

sustainable performance and use discretion to grant appropriate awards.

Terms-of-Reference 1: Trends in remuneration

How are levels of director and executive remuneration determined? What constraints exist?

Executive remuneration packages are determined by the bank's board, typically on advice from the board's remuneration committee. The board decides what information it uses to determine the executive's remuneration. It often seeks advice and market information from an external remuneration consultant.

There are only two direct regulatory constraints on executive remuneration packages. The first is in relation to termination payments[3] and the second is in relation to granting of fresh equity to directors[4].

Boards are constrained by the Corporation's Act in that it requires board members to act in the best interests of the company. This means they cannot undertake actions which benefit executives ahead of the wider company.

Boards are also constrained indirectly by shareholders through the shareholder's capacity to vote out non-executive directors. It is possible that a remuneration policy is changed through the removal of board members or the likelihood this will happen if the policy is not changed. While indirect, this can still be considered a constraint.

What is the market's role in determining remuneration levels?

Remuneration levels are determined in the market for executive employment services. This market, like most markets, reflects the forces of supply and demand.

When a board (demand-side) and an executive (supply-side) agree on a remuneration package (a price), then this represents a market outcome.

The relevant geographic market for bank executives is international. For example, of the last eight chief executive officers (CEOs) of Australia's major four banks, four were recruited from overseas[5].

[3] Currently under the Corporations Act, termination payments made to directors can be up to seven times the director's total annual remuneration. On 5 May 2009, draft legislation was released indicating that the termination payments threshold for shareholder approval would be reduced to one times base salary. This law would also be extended to apply to the five highest paid groups and company executives and the key management personnel.

[4] Shareholder approval is required if a company wishes to grant a director fresh equity (rather than equity that is purchased on-market).

[5] Mike Smith (ANZ), John McFarlane (ANZ), Ralph Norris (CBA), John Stewart (NAB).

What are the major drivers of negotiated outcomes? Have they changed over time?

The agreed remuneration level is the result of a negotiation process undertaken between the board's delegate (most likely the Chairman) and the incumbent or prospective executive. The negotiation will reflect the marketplace realities such as the price for executive remuneration services, but also the negotiation will also reflect relative bargaining power of the two parties.

Where one party has a stronger incentive than the other to finalise the agreement, then this bias is likely to be reflected in the final outcome.

In looking for explanations as to why executive salaries have grown faster than average salaries, the ABA has identified three key reasons. These are:

1. Globalisation created significantly larger and more complex businesses, requiring higher levels of responsibility, expertise and general management experience. This has put a significant premium on the skills and experience needed to manage these global businesses, creating a global talent pool;

2. The strong and buoyant economic period since the early 1990s meant that incumbent executives could generate significant bargaining power with boards because they could point to strong company performance. This was particularly the case in banking where this period was marked by strong balance sheet and profit growth; and

3. Mandated disclosure of executive remuneration (in Australia and overseas) set up a competitive dynamic amongst executives, ultimately placing upward pressure on remuneration.

<u>The global financial crisis may reverse these influences</u>

While these factors put upward pressure on remuneration over the last 15 years, the global financial crisis may reverse their impact. Globalisation is in retreat, particularly in banking, because governments and shareholders have become concerned over the size and complexity of large conglomerate groups. Pressures are emerging for smaller and more locally focussed banks.[6]

[6] US President Barack Obama has predicted a decline in the size of the US banking system. This will put downward pressure on remuneration levels, not only in the USA but in banking generally.

The global financial crisis has impacted negatively on company earnings. This will not only reduce incentive payments, but will put downward pressure on remuneration levels, particularly sign-on payments.

Disclosure of executive salaries may act to magnify the downward pressure remuneration caused by a move to smaller institutions and relatively weaker performance.

Another influence may come from government regulation. Recently, the Federal Government announced it will be amending the Corporations Act to require shareholder's approval for any executive termination payment that is greater than one year of base pay. This is a reduction from the current threshold of seven years total remuneration. While this may have an influence on total remuneration, the more likely effect will be to encourage executives to seek remuneration packages skewing remuneration towards base pay and short-term incentives.

What growth in the level of director and executive remuneration has taken place over recent decades, both within Australia and internationally? What factors contributed to this growth? Has the experience differed across different industries or sectors of the economy?

The growth in bank executive remuneration has been strong over recent years. While the data is lumpy requiring caution in interpretation, ABA estimates that since 2001, average CEO remuneration has grown annually by 14%.

ABA estimates that average CFO remuneration has grown by about 10%.

Total remuneration growth for Australian bank CEOs and CFOs reflects the three main factors (described above). These are: solid economic growth, globalisation and remuneration disclosure.

Is there any relationship between director and executive remuneration, and the remuneration of other company employees? Are there flow-on effects from executives to other employees? Do big disparities serve to motivate or de-motivate other employees?

There is correlation between executive remuneration and remuneration of other employees, but this does not extend down the whole organisation. The correlation extends to those positions that are linked to the factors that have placed upward pressure on executive salaries – globalisation, strong performance and disclosure.

For example, positions under executive level are rarely actively recruited from overseas global talent markets.

Major bank remuneration outcomes shows that growth in remuneration of bank staff below executive level is less than that for executives.

Having said this, most employees will have some interest in the size of the profit pool and with share price increases if they have been given shares as part of their remuneration.

There is little evidence that high executive salaries de-motivate workers - the opposite is likely to be true. High executive remuneration is likely to provide a strong motivational force for employees, especially for those employees who strive to reach executive level or reach a position where a high remuneration level is achievable.

Are current director and executive remuneration levels justified? Have increases over recent years been justified? How should the Commission determine what is 'justified' – what tests should be applied?

One common means of determining whether remuneration is justified is to assess whether there is an appropriate link between variable pay and company / divisional / individual performance.

Over the last 15 years, Australian banks have performed very well. Australia's banks not only have produced sound returns, they weathered the 1997 Asian financial crisis and the recent global financial crisis. We have one of the strongest financial systems in the world.

What relationship exists between levels of remuneration and individual and corporate performance?

The evidence shows a correlation between company performance and executive remuneration. In ABA's confidential Attachment, we show performance benchmarks against bank CEO remuneration growth.

Notwithstanding the aggregate data showing a link between performance and remuneration, the link between individual executive performance and that of company performance can only sensibly be analysed at the individual bank level.

To what extent are remuneration levels required to generate an adequate supply of suitable directors and executives; that is, are they primarily aimed at hiring and retaining the right person, rather than influencing their performance?

Total remuneration levels are important in attracting and retaining executive talent. Like most employees, an executive will have an

idea of their market value and will seek to be compensated accordingly. In order to attract a suitably qualified executive, the board will need to be prepared to offer remuneration consistent with the market price.

But the board also has an incentive to ensure the executive is appropriately motivated to perform in the position. This is where the structure of remuneration is important. By offering executives more reward for performance, the board can increase the executive's efforts to perform.

What becomes a critical decision is the 'performance hurdles' set by the board. If the hurdles are not achievable, then the executive will not be motivated to achieve the hurdles. Likewise, if the quantum of performance pay is not a reasonable portion of the executive's total remuneration.

Remuneration structures and incentives

What are the key drivers of performance for directors and executives? Are there factors other than remuneration that influence their performance?

The key drivers of executive performance will differ depending on individual preferences. For some, remuneration is a very important (if not the most important) driver of performance.

For others, remuneration is like a "hygiene factor" in that the executive needs to earn an amount that they feel reflects their worth, but other factors are more important for them such as being able to demonstrate leadership abilities, recognition, and the opportunity to work with a strong team and be challenged on a day-to-day basis.

What changes have taken place in the type and structure of remuneration over recent decades? What has driven these changes?

The key changes that have occurred in the type and structure of remuneration over recent decades are:

1. **The emergence of long-term incentive (LTI) benefits**.

These typically account for between 20-30% of the executive's total target remuneration package depending upon their role.

LTIs emerged because of the desire from shareholders to ensure that executive pay levels were aligned with the company's long-term performance. Common LTI performance hurdles for Australian banks are relative total shareholder return (relative TSR), earnings per share (EPS), return on equity (ROE) and growth in NPAT.

In recent years, there has been a move away from LTI towards use of 'deferred' short-term rewards. This trend has been driven by a realisation that LTI may not motivate executives because achieving the performance hurdles is seen by many executives as a 'lottery'.

2. The introduction of rigorous short-term and long-term incentive performance hurdles.

Going back 10-20 years, it was uncommon for banks to set objective performance hurdles. Instead, it was more prevalent for variable pay to be paid based upon a fully discretionary assessment of performance.

These performance hurdles have been driven by companies becoming more sophisticated in their planning and aiming to drive performance by focusing executives on core strategic objectives.

3. The deferral of short-term incentives (STI).

In the past, short-term incentives were predominantly paid out as cash. Now, it is much more common for an element of the annual STI to be paid in shares and access deferred over a one - three year period.

The quantum that is deferred is typically in the range of 25-30% but in some cases can be as high as 50%. This change has been driven by boards responding to shareholders' desires to align executive interests to the companies' share price over the medium-term and to encourage an employee ownership culture.

Tax changes announced in May 2009 threaten to end the practice of banks providing employees with shares as part of their remuneration.

4. Formal recognition of risk in remuneration structures

Since Australia's adoption[7] of the Basel II capital regime, the Australian Prudential Regulation Authority (APRA) has insisted that banks include a recognition of sound risk management objectives as part of key executive's performance indicators.

5. Greater customisation of remuneration levels and structures

Traditionally in banks, remuneration levels were rigidly determined in fixed bands. Each band would correspond to the seniority level of the employee, with the top level being for the chief executive officer (CEO). With globalisation, boards have had to move to more customisation of remuneration in order to secure the executives they target.

[7] Commenced in January 2008.

6. Tax changes

Tax changes have significantly influenced remuneration practices. This is illustrated clearly through the history of defined benefit superannuation. Up to the 1970s, defined benefit superannuation was a key element of an executive's remuneration structure.

Tax changes to defined benefit superannuation commencing in the early 1980s slowly reduced the benefit of this form of remuneration to both executives and companies. Today, although most banks still operate legacy schemes, there are few cases of bank executives commencing employment with a contract for defined benefit superannuation.

As discussed elsewhere in this submission, taxation of an executive's shares on termination of employment has influenced boards to waive vesting period in order to avoid negative cash flow situations.

Have changes to the structure of remuneration resulted in inappropriate risk-taking or other forms of director behaviour inconsistent with the interests of the company? Has the experience differed across sectors (for example, the finance sector relative to other areas of business)? Who should determine what is an appropriate level of risk-taking or an appropriate corporate strategy, and how should this be done?

It is the ABA's view that the above changes to Australian bank remuneration have not resulted in inappropriate risk-taking or other behaviours inconsistent with the interests of the company. Australian banks have low risk profiles. Of the twelve AA-rated banks in the world, Australia has four.

Under Australia's prudential regulatory framework – administered by the Australian Prudential Regulation Authority (APRA) – bank boards are required to take responsibility for the bank's risk management framework and risk appetite.

Why and/or when are the dealings between shareholders and companies on remuneration issues a matter of public interest?

Unless there is evidence that executive pay structures threaten the public interest, through encouraging executives to act contrary to the public interest, then executive remuneration should be in the domain of the company's shareholders, board and executives.

In the US, there are allegations that remuneration practices in the home mortgage financing industry helped create the sub-prime lending crisis, but these allegations are not applicable to Australian banks. Australia does not have a sub-prime lending crisis.

Australian banks are strong, well managed with sound credit ratings. While some high-risk loans were issued in Australia (primarily by non-banks), the proportion issued by banks was very small – about 1% of total loan books, compared to 15% in the USA.

What relationship exists between the structure of remuneration and individual and corporate performance?

There is a strong relationship between variable remuneration and company / divisional / individual performance.

Short-term incentives are typically based on a bonus pool which, in turn, is usually based on a proportion of the company's annual profit. The quantum of the executive's STI award is then typically leveraged[8] based upon their own individual and divisional performance.

Most banks will grant a proportion of this short-term payment in the form of shares and held for a vesting period of one to three years. This aligns the executive's interests with the shareholder by encouraging the executive to make decisions in the medium-term interest of shareholders.

Long-term incentive payments typically come in the form of company shares, options or performance rights. They are generally subject to company-based metrics such as relative total shareholder return (TSR), EPS, ROE or NPAT growth and vest over a typical period of three years.

What are the key drivers of performance for directors and executives? What arguments, for and against, are there for linking remuneration and the share price?

Key drivers of performance have been outlined earlier in this submission.

By linking remuneration to the share price and requiring the executive to take a significant proportion of remuneration in shares, the executive's interests are aligned with shareholder's interests. Executives become shareholders, so they will only benefit and receive performance-based rewards when shareholders are similarly rewarded.

A potential disadvantage is that the share price may move in ways that the executive cannot control, regardless of their efforts. Due to this, long-term incentive hurdles linked to relative TSR are often perceived by executives to be a "lucky dip". Relative TSR hurdles can be de-motivating when executives know that irrespective of their

[8] In this context, leverage means the executive can earn over 100% of their bonus target, if there are performance related justifications.

performance, they will not receive any reward because of external events impacting on the company's share price.

<u>Data sources</u>

Are there other useful data sources on director and executive remuneration over time in addition to those noted above (i.e. RiskMetrics, Towers Perrin and Fairfax Business Research)?

The ABA has included in this submission a statistical Attachment which compiles information from the four major banks. Given the lumpiness of the data used, caution is needed in interpreting most of the data.

At this stage, the ABA is not publicly releasing the Attachment because the data is not sufficiently robust and is, therefore, at risk of misinterpretation.

For example, the data does not reflect the practice of deferring short-term remuneration. Further work will be done to improve the data and it may be released in due course.

Terms-of-reference 2: Effectiveness of regulatory arrangements

Given that it is ultimately the responsibility of the board to engage a managing director and other key executives, including associated terms and conditions, what changes would assist the board in fulfilling this role, consistent with shareholder interests?

The ABA has no suggestions in response to this question.

How effective are arrangements for director and executive remuneration under the Corporations Act and ASX Listing rules and guidelines? Do arrangements provide sufficient transparency and accountability on remuneration arrangements and practices? How might transparency be increased, and what might be the impacts of this? Are the current disclosure requirements in the remuneration report too complex?

The ABA believes that the desire for greater transparency has actually led to the reverse in that remuneration reports are now so complex that they are very difficult for a typical shareholder to understand.

Transparency and accountability could be increased if the remuneration report requirements were simplified and focused on information that shareholders are really interested in, namely:

1. What is the company's remuneration policy and is there an appropriate level of remuneration governance?

2. What is the remuneration level received by directors and the senior management team over the year?

3. Is there a rigorous link between pay and performance, and is variable pay incentivising executives to achieve the company's strategic objectives?

Unfortunately, the important information that a shareholder wants to understand often gets lost in the detailed requirements of remuneration reports.

One specific aspect of the Corporations Act that could be improved is the requirement to value share-based payments under AASB 2 "Share-based Payments" for the purposes of individual disclosure.

This often leads to confusion because many shareholders believe that the disclosed value is the amount of remuneration that the executive actually received during the year. This is a misinterpretation. The actual realised value could ultimately be nil or significantly different (more or less) than what is disclosed. This is because equity awards are typically subject to performance hurdles.

Is the coverage of executives in the remuneration report appropriate? Would shareholders benefit from access to readily accessible, consolidated information, on director and executive remuneration?

Coverage of executives in the remuneration report is appropriate. We see no evidence that shareholders and the broader community are seeking information on executive remuneration that goes further than already provided.[9] If anything, the concern over length and complexity of the reports suggests coverage is too wide already.

Although shareholders may appreciate a readily accessible consolidated report, the more pressing and beneficial task is to simplify the current remuneration reports by clarifying the objective of the reports and ensuring they are user-friendly.

Is there an appropriate balance between legislated requirements and voluntary guidelines? What is the role of voluntary guidelines in governance of director and executive remuneration?

The ABA's view is that there is a role for both legislated requirements and voluntary remuneration guidelines.

The legislated requirements should aim to ensure shareholders have sufficient information to hold their boards accountable for remuneration decisions. This would include the:

[9] One suggestion for improvement is that it could be made clear that the remuneration report should not have to cover directors that sit on bank subsidiaries, particularly where the subsidiary is minor (i.e. a P&L business representing less than 5% of the group P&L).

- company's remuneration policy and governance structure;
- remuneration levels of directors and key management; and
- nature of the company's incentive plans. This is to ensure that shareholders have the necessary information to determine the link between pay and performance.

Legislative requirements ensures that there is a basic level of consistency of remuneration requirements across companies, enabling shareholders to compare remuneration practices amongst peer companies.

Voluntary guidelines can then be viewed as "best-practice principles" that companies take into account if they believe it is appropriate to do so. A form of competition can emerge between companies with boards seeking shareholder confidence by subscribing to sound principles and practices.

Is the case for regulation stronger where government is an active participant in company activities, for example through the use of taxpayer's funds to bail out companies in financial difficulty or through other ongoing support activities?

There is a stronger case for Government intervention in commercial decision making if the Government is a full or part owner of the company.

In the United States and UK, respective governments have taken equity positions in many of their major banks. In the ABA's view, these governments should exercise influence on the company in their capacity as large shareholders.

In Australia, no taxpayer's money has been used to support Australia's banks. It is sometimes alleged that Australian banks have been 'bailed out' by the Commonwealth Government, but this is false. The Government's liability guarantees cannot be regarded as a 'bail out'.

For instance, roughly $1 trillion of bank liabilities are guaranteed under the guarantee schemes. Yet, the taxpayer's risk is currently only around $100 billion (10%). The bulk of the risk (90%) is borne by banks through a legislative mechanism in the Financial Claims Scheme for the banking industry to cover any deposit insurance losses.

Banks are also paying for the insurance on the $100 billion through insurance premiums based on the institution's credit rating. There is no payment on the other liabilities because it is the banks that are underwriting the risk, not the government.

Are there any voluntary, good practice guidelines or codes applying internationally that may be of interest in an Australian context? Should Australia consider the adoption of a code of practice?

There are currently numerous good practice guidelines within the Australian context such as those from the ASX, the Australian Institute of Company Directors (AICD), the Australian Council of Superannuation Investors and the Australian Shareholders' Association.

To what extent have remuneration committees been used in Australia? What effect have these had on the linkages between remuneration levels and individual corporate performance?

All the large listed banks have board remuneration committees. The extent to which these committees have directly impacted on the link between remuneration levels and individual and corporate performance is difficult to assess.

That said, one of the underlying principles of most bank remuneration policies is to promote a rigorous link between pay and performance. Given banks have performed soundly over the last 15 years and this continues today, this suggests the remuneration committees have performed adequately.

Do conflicts of interest arise in the arrangements by which remuneration consultants advise on director and executive remuneration? If so, how significant and how might they be addressed?

The concern over conflicts of interests appears to be that remuneration consultants will shape their advice on executive remuneration in order to garner goodwill with the executive so he/she will return the favour by granting the remuneration firm future consultancies.

In discussing this issue with a remuneration consultant, it was stressed to the ABA that the market data that they provide to boards / remuneration committees is based on public disclosures, typically sourced from either remuneration reports or salary surveys. Accordingly, there is little scope for a remuneration consultant to inflate remuneration above market rates.

If a remuneration consultant did recommend a remuneration package inconsistent with the market and the executive's experience and skill, then they would be risking their reputation. This is particularly the case now with increased media focus on remuneration packages.

In addition, as directors are typically on more than one board, they would also be receiving similar information from various remuneration consultants in their different directorships.

Accordingly, any inflated data provided to any one company would be easily noticeable by the director.

In the end, the bank board must make a decision. While the board will use remuneration consultant reports, it should only view this as one input amongst other inputs.

Terms-of-reference 3: The role of institutional and retail shareholders

What degree of influence should shareholders have in their own right in determining remuneration practices? Do current regulatory reporting arrangements enable shareholders to be adequately involved? If not, why?

Shareholders elect non-executive directors and expect them to conduct themselves in the shareholder's interests. In listed banks, boards are dominated by non-executive directors, indeed this is a requirement under APRA's prudential governance standard.

Given boards are accountable for executive remuneration; shareholders will hold them accountable for their decisions through elections.

In addition, shareholders vote on the remuneration report. This gives the board valuable information to take into account when they are designing remuneration packages.

The ABA believes the non-binding vote is appropriate. Binding votes would undermine board accountability and be unworkable.

Does the current non-binding vote require strengthening? Is it appropriate for directors and executives that are named in the remuneration report, and who hold shares in the company, to be able to participate in the non-binding vote?

The ABA does not believe that the current non-binding vote requires strengthening. Market evidence suggests that boards do take the vote seriously even though it is non-binding and do take action when they have received a significant "no" vote (i.e. above 15%).

In ABA's view, it makes sense to exclude senior executives from voting on their own remuneration packages in their capacity as shareholders to avoid perceived conflicts of interest.

To what extent have large institutional investors used their voting rights to influence remuneration practices and other areas where they have voting powers?

Our assessment based on anecdotal evidence is that institutional investors have taken a more activist role in recent years when voting

on executive remuneration practices. When voting, they often follow the stakeholder guidelines such as those from the AICD, ACSI, RiskMetrics or Corporate Governance International.

The following quotes give a flavour to the more activist role of shareholders:

- *"The FY AGM season saw the highest level of votes against the remuneration report, with a larger proportion of companies (57%) receiving 'no' votes of greater that 5%. Significant 'no' votes were also received on other remuneration related resolutions such as grants of equity to CEOs, increases to NED fee levels, and termination payments. For example, 67% of resolutions regarding grants of equity to CEOs received 'no' votes of greater than 5%."* (PricewaterhouseCoopers, 'Executive Remuneration Fit for the Future?*', 2009 edition, p.35.)

- *"The recommendation from the influential proxy advisory group, RiskMetrics, that helped swell the big protest vote against Sir Rod Eddington's…RiskMetrics recommended shareholders vote against Eddington because of his role as an Allco non-executive director, although the recommendation wasn't quite as unequivocal as it has generally been portrayed."* (Stephen Bartholomeusz, Commentator, 'The trouble with Allco', Commentary, Business Spectator, 29/4/2009. available at www.businessspectator.com.au.)

- *"It is not unexpected in today's climate that shareholders vote against the remuneration arrangements for senior executives, but as I looked around the floor on each of those two resolutions, it was a resounding yes vote from the floor and had I not taken into account the proxies, then each of those resolutions would've passed. Then you go to the proxies and say 'well, why were they so solidly against the two resolutions' and answer to that is that those proxies are coming in principally from institutional investors who are required under their mandates to follow the recommendations of services such as RiskMetrics or Aussie Super…"* (Kerry Roxbury, Chairman of Babcock and Brown, quoted in the Business Spectator in the article titled 'Proxy power play', 29/04/2009. Available at www.businessspectator.com.au.

Are there areas where the rights of institutional investors should be strengthened? Does institutional voting typically align with the broader interests of shareholders?

The ABA does not believe that institutional investor voting rights need to be strengthened. They currently have a non-binding vote on

the remuneration report and also have a binding vote on the election of directors themselves.

Institutions typically vote “for” remuneration reports where they can see that there is an appropriate level of remuneration governance and that there is a rigorous link between pay and performance. Accordingly, the ABA believes that institutional voting typically aligns with the broader interests of shareholders.

In what aspects of remuneration practices and setting remuneration levels would it be appropriate to increase shareholder involvement? How would this be best achieved – without, for example, diluting the intended function of the board in engaging the managing director/chief executive officer?

The ABA sees no obvious changes to the current arrangements that would increase shareholder involvement in remuneration setting without eroding the board’s responsibilities and accountabilities.

Terms-of-reference 4: Aligning interests

To what extent do current taxation arrangements influence the level and structure of executive remuneration?

Given there is an international market for executives, taxation is likely to play a role in remuneration levels because the most relevant metric from an executive’s point-of-view is ‘after-tax’ income as opposed to ‘before-tax’ income.

We know anecdotally that Hong Kong, Singapore and the United Kingdom have been very successful in attracting highly skilled bank executives, including Australian bank executives, because they had lower income tax rates[10].

Given this, Australia’s relatively high income tax rates has likely put upward pressure on executive remuneration as companies seek to counter the tax effect with higher remuneration.

One example to show how current taxation arrangements influence the structure of executive remuneration is how unvested equity is taxed upon termination of employment (if the executive has not made an election to be taxed at grant).

Under the current rules, an executive that terminates employment is required to pay income tax on unvested company shares. This means tax is payable even if the executive cannot sell the shares, creating a potential cash flow problem.

[10] Note the UK Government has recently increased it top marginal tax rate to assist in reducing its budge deficit.

This taxation treatment makes it more likely that boards will accelerate vesting of equity upon employment termination to minimise cashflow problems for the executive.

If equity was taxed at the time that it vests, rather than on the earlier of this and termination, boards would be more inclined to keep the equity “on-foot” subject to the original performance conditions and time periods. This would create better alignment of interests between departing executives and shareholders.

An announcement in the May 2009 Federal Budget to require income payment on employee share schemes in the year granted is likely to result in the disappearance of these schemes.

To what extent should bonuses be an allowable tax deduction for companies? Should bonuses be subject to special/higher taxation rates?

Bonuses constitute a legitimate component of an executive’s remuneration that aligns the executive’s interests with shareholder interests. Bonuses are typically based upon a pool of funds based on the company’s overall profit. As profit increases, the bonus pool also increases.

Subjecting bonuses to higher taxation would increase pressure on boards to raise base pay to compensate the executive for the lower bonus value. This, in turn, may work against shareholder interests which are more aligned with performance incentives than base pay.

What evidence or examples indicate that the interests of boards and executives may not be adequately aligned with those of shareholders and the wider community? What factors have contributed to any misalignment?

The ABA sees no evidence that there is misalignment between executive remuneration in Australian banks and that of shareholders and the wider community. Indeed, we believe the opposite is true.

Bank shareholders have earned solid returns from banks over the last 15 years.

The Australian community and taxpayers are benefiting greatly from the strength of our banking system. Weak banking systems in the US, UK and Europe have resulted in higher unemployment than in Australia.

While the strength and performance of our banks result from a wider set of forces than just executive remuneration, there is certainly no evidence that the bank remuneration policies have been defective.

In the recent bank reporting season, banks have reported earnings downgrades and dividend cuts. These earnings downgrades will result in less returns for both shareholders and executives.

- NAB CEO, Cameron Clyne was quoted as saying that bank executives would "…probably take a haircut on their variable bonus this year, given NAB's earnings slump." (Business Spectator, 'Clyne calls for interest rate debate', 20/4/09).

- Bendigo Bank CEO has taken a leadership position in his business by not taking a higher salary when he was promoted internally to CEO. (AFR, 18 May p.44.)

- An e-mail by ANZ CEO regarding remuneration was quoted in the Australian Financial Review: "Chief Executive Mike Smith told staff yesterday in an e-mail obtained by The Australian Financial Review the bank's top 156 executives would receive no salary rises this year in a move that effectively freezes their pay for 18 months…" (AFR, 22 April 2009, p.52).

- Macquarie Bank CEO, Nicholas Moore, has taken a massive reduction on the value of his stock options that he has been accumulating over 10 years. His annual remuneration is forecast to fall from $26 million (FY08) to $290,000 (FY09). (Weekend AFR, 2 May 2009.)

- Commonwealth Bank CEO, Ralph Norris, has publicly announced that he and his board of directors will have their base pay reduced by 10% this year, and his executive team will see a 5% reduction, whereas CBA employees earning under $100,000 will receive small pay increase. AAP report, http://www.news.com.au/business/story/0,27753,25346765-462,00.html, 19/05/2009.

A number of companies have effectively reduced pay by introducing policies that have the effect of reducing pay. One is for company executive's to take voluntary unpaid leave in order to reduce base payments, but still demanding the same level of performance.

What are the interests of the wider community in relation to director and executive remuneration within a company? To what extent do the interests of shareholders and the wider community align? In what circumstances will they not be aligned?

Executive remuneration is a matter between shareholders and board, not the wider community. The board does what is in the best interests of shareholders. However, there appears little if any conflict between the interests of shareholders and the wider community.

Can cost cutting by companies, including sacking workers, align with the public interest? Is it reasonable to reward executives for actions that promote shareholder interests but which may not align with the public interest?

Cost cutting is a legitimate part of a company's strategy to remain strong, competitive and deliver valued products to customers. Sound profitable banks deliver significant social benefits.

During the 1990s, the major banks undertook major restructures of their operations, resulting in many redundancies. While at the time there was severe community backlash against the changes, and difficulty for those made redundant, history has shown this period to have yielded many benefits. For example, the banking industry's efficiency and productivity increased markedly which contributed to the wider performance of the economy.

Also, even though there were widespread redundancies, there was no material increase in unemployment. It appears that redundant bank staff readily found alternative employment.

In fact, banking has traditionally had one of the lowest unemployment rates of all private sector industries. In other words, there is no evidence that previous bank cost cutting has been of detriment to the wider community.

In terms of services, the banks reduced their extensive branch networks diminishing "face-to-face" services, but they massively expanded their electronic banking facilities, including greater rollouts of ATMs, EFTPOS terminals, Internet banking and improved telephone banking services.

Over the last 12 months, the banks have shown creativity in their response to tougher trading conditions. They have minimised redundancies by a range of other measures (e.g. forced unpaid leave). This makes good business sense as they will retain talented staff for the economic upswing.

What types of performance measures/hurdles could be used to accurately measure performance and align interests of executives and shareholders?

There is no perfect performance hurdle. Each hurdle has its advantages and disadvantages and, therefore, each board needs to find the right hurdle to incentivise executives to achieve their targeted outcomes.

The most common performance hurdles used by Australian banks to measure performance and align executive and shareholder interests are:

- 'Relative Total Shareholder Return' (relative TSR) – this measures the company's dividend payments plus share price movements over a specified period. It is clearly aligned to shareholder interests. However, critics argue it is often remote from the executive's control and does not adequately reflect underlying risk.

- 'Net profit' (NP) measures company profit (revenue minus costs) over a specified time period. While it is a primary driver of dividend payments and share price movements, it does not on its own reflect long-term shareholder returns.

- 'Earnings per share' (EPS) is a commonly used measure. It divides profit by total share number. Its weakness is that it does not reflect share price movements.

- 'Economic profit' (EP) adjusts company profit by subtracting the cost of capital. Capital costs are higher in riskier companies, so the measure reflects risk. There are two weaknesses: (a) it doesn't fully reflect share price changes, and (b) it is complicated to estimate.

Boards also use a range of non-financial measures such as employee and customer satisfaction.

How can opportunities for executives to 'game' incentives be minimised?

There is a theoretical risk that a company using a performance measure such as relative TSR, could undertake a strategy to weaken its effectiveness as a performance measure.

For example, a company that was withholding market-moving information at the time equity was being granted (or when equity is vesting), could potentially 'game' the performance measure.

However, the continuous disclosure requirements are designed to ensure the market is well informed of all material developments impacting on the company's share price.

EPS and NPAT could potentially be gamed through the use of acquisitions, i.e. acquiring a company in order to boost earnings. But this can be addressed by adjusting performance hurdles to 'net out' these impacts, although these adjustments can be complicated.

In reality, executives are unlikely to "game" these metrics through acquisitions simply because of the complexity, time-commitment and cost associated with acquisitions. In addition, the practice of making annual grants rather than mega-grants also makes this practice unlikely.

Economic profit could be gamed through the statistical adjustments that are made to the accounting profit number in order to arrive at an ‘economic’ profit.

Ensuring the integrity of performance measures must be a key issue for the bank’s board. Boards should set out clearly and transparently how they intend to make appropriate adjustments to ‘net out’ impacts not related to executive performance.

Boards have demonstrated commitments to imposing rules to manage these gaming problems. Boards will have rules prohibiting the issuance of equity during certain periods, and periods in which executives cannot buy or sell securities.

Boards should also ensure they retain some discretion to make one-off adjustments to ensure a fair outcome to executives and companies. For example having discretion can ensure the executive does not receive some windfall payment due to something like unexpected market uplift. Discretion is also an important protection against manipulation.

Are boards properly exercising their functions on behalf of shareholders? Are they being unduly influenced by chief executive officers? If so, why?

Based on the ABA’s knowledge of bank board processes, we believe that they are properly exercising their functions on behalf of shareholders and not being unduly influenced by CEOs.

Ultimate accountability for executive remuneration rests with the board. We noted previously in the submission that globalisation, strong performances and remuneration disclosure have probably increased the bargaining power of executives over the last 15 years, but this cannot be characterised as undue influence.

Are some forms of remuneration more likely than others to promote a misalignment between the interests of boards and executives and those of shareholders and the wider community?

With each component of executive remuneration there are strengths and weaknesses, but taken as a whole, we believe the remuneration practices of banks are sound.

- Base salary of executives is important in attracting suitable candidates for the position. Its weakness is that it is not associated with performance hurdles and therefore provides little motivational value.

- Short-term incentives, essentially annual bonuses, provide a strong motivating force for executives. Its weakness is that it may generate excessive short-term risk-taking which may be inconsistent with the long-term interests of shareholders. To

mitigate against this, Australian bank boards typically require executives to take a meaningful proportion of bonus payment in shares with vesting periods of one to three years.

- Long-term incentives, typically shares, options or performance rights, provide a strong incentive for executives to take decisions in the long-term interests of shareholders. There is a concern, however, that the typical performance hurdles used to vest these shares are outside the executive's control. This can be a dampening force on motivation.

With each component of remuneration having strengths and weaknesses, boards must carefully weigh the package offered to executives, and ensure the package is as closely aligned with shareholder interests as possible. The optimal package is also likely to vary according to the company's strategic objectives.

Are taxation considerations, either from the company's or executive's perspective driving design of remuneration packages? If so, what changes are required? How should bonuses be treated for taxation purposes – should they be an allowable tax deduction for companies? Should bonuses be subject to special/higher taxation rates?

The ABA's comments on taxation considerations driving the structure of remuneration packages, and on the appropriate taxation treatment of bonuses, have been made earlier in this submission.

In summary, the ABA believes that increasing tax on bonuses will lead to unintended consequences such as significant increases in base pay which are not aligned to shareholder interests.

Also, increasing base pay represents an increase in the fixed cost base of the bank. This can be a serious disadvantage during times of stress. Rather than reduce employment costs to weather difficult periods, banks may be forced to shed more staff. The problem with shedding staff is that it can undermine customer service.

The government's recently announced plans to tax employee share schemes is likely to see a winding down of these schemes, and have the effect of increasing base pay as a proportion of total remuneration. The Government's announced changes to termination pay is likely to contribute to the skewing of remuneration towards base pay.

Is it appropriate that there be separate treatment of financial institutions? If so, why and in what way? Are there any risks from such an approach? Are there other sectors that would require a differentiated approach?

Based on the view that remuneration practices in US investment banks was a factor in driving high risk sub-prime lending, the G20 agreed that it was necessary to increase prudential oversight of bank

remuneration and, implicitly, differentiating remuneration in financial institutions from that of other sectors.

Following this, APRA published a consultation document on 28 May this year setting out proposed remuneration principles for boards, executives and certain other employees. The two main requirements are for institutions to establish a Board Remuneration Committee (BRC) and for the BRC to implement a remuneration policy.

In the ABA's view, APRA's prudential standard does not undermine the bank board's responsibility to set executive remuneration, so the proposed changes appear to be reasonable. There is likely to be considerable work in ensuring APRA's remuneration principles can be made workable in practice. (See ABA media release – Appendix 1.)

If current arrangements are not serving to align the interests of the board and executives to those of shareholders and the wider community, how could regulatory arrangements and remuneration practices better secure this? For example:

- ***Should shareholder votes on remuneration be (more) binding?***

The ABA disagrees with the proposition that there is misalignment between banks boards, shareholders and executives.

We disagree that shareholders should be given a binding vote on remuneration as employing the executives and setting terms-and-conditions is a board responsibility.

In addition, it is practically very difficult to make the remuneration report vote binding. For example, how would the board manage a situation whereby shareholders had strong differing views on how the remuneration packages should be structured?

Also, how could a board maintain confidentiality of a recruitment process if it had to seek shareholder approval of remuneration? Presumably the shareholders would want to see the CV of the prospective executive before determining the remuneration package.

Lastly, a shareholder 'no' vote may be difficult to evaluate i.e. what was the vote against? Was it the level, structure or some other issue like performance hurdles?

Shareholders can act on any concerns about remuneration policies through their non-binding remuneration report vote and their vote on elections for board directors.

- ***Are the current approval processes for equity-based remuneration appropriate?***

The board should set executive pay, including equity-based components.

There are a series of guidelines on best practice in this area, including ASX listing guidelines. The ABA supports voluntary guidelines in this area.

- ***What effect does hedging have on aligning interests, and should this practice be permitted?***

Hedging should not be permitted[11] on unvested equity as this can potentially undermine a board's attempt to align shareholder and executive remuneration. For this reason, the ABA encourages boards to ensure there are strict policies in place to prevent this practice.

That said, hedging should be permitted on vested equity as this is equity that the executive can sell at any time. It can therefore be characterised as a personal investment rather than remuneration.

- ***Is the current regulation of non-recourse loans appropriate?***

The ABA is not aware of regulations regarding non-recourse loans.

However, it is up to the board to determine whether this remuneration structure is appropriate given specific company circumstances.

- ***What is the role of remuneration consultants and what has been their influence on remuneration practices, including levels, growth and structures of remuneration practices? Do conflicts of interest exist?***

See earlier comments on remuneration consultants.

- ***Should government have a greater role in regulating remuneration?***

The only area where we see a potential increased role for government is through the prudential regulatory framework. Given the world's experience over the last two years of the global financial crisis, there may be a case for prudential regulators to take a greater role in ensuring remuneration practices are not contributing to excessive risk.

While the ABA sees no evidence that Australian bank remuneration practices have caused excessive risk-taking, there is a case for at

[11] APRA's draft remuneration principles guidelines –released on 28 May 2009 - recommends that banks prohibit executives from hedging unvested shares.

least examining this issue and possibly setting down some core principles for remuneration practices.

What are the costs and benefits of any options/mechanisms to more closely align the interests of boards and executives with those of shareholders and the wider community? What could be some unintended consequences of limiting or more closely regulating executive remuneration in Australia?

The Government could (theoretically) intervene heavily in remuneration setting by amending the Corporations Act to: (a) cap remuneration, and/or (b) set remuneration structures, such as dictating the balance between base, STI and LTI components and mandating that incentive plans operate in a particular way.

This intervention would have the effect of removing the company board's role and accountability in making these decisions. A question arises as to who will then take responsibility for the decision.

Currently, if a board performs badly through poor decision making, the non-executive directors can be held accountable by the shareholders for the poor decisions by voting them off the board. If the Government makes key decisions such as remuneration, how will shareholders enforce accountability?

Terms-of-reference 5: International developments

Are there any international approaches particularly applicable to Australia?

The ABA is not aware of any.

Are there particular lessons for Australia from international approaches and experience – both successes and failures?

The ABA believes the problems experienced by Wall Street investment banks provides an opportunity for Australian boards to examine whether remuneration policies contributed to the problems and, from that, assess their own policies.

In our view, bank boards will be actively assessing international experience to inform decision making going forward.

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Appendix 1

MEDIA RELEASE

Australian Bankers' Association Inc.

Australian Bankers' Association's initial response to APRA's Prudential Standard on remuneration

Sydney, 29 May, 2009: The Australian Bankers' Association (ABA) welcomed the consultation on the Australian Prudential Regulation Authority's (APRA) Prudential Standard on remuneration.

APRA's principles aim to ensure a bank's remuneration policies are aligned with the bank's risk management policy. Australian bank boards and executives have been very effective in implementing policies to control risk. Australia has one of the safest banking systems in the world.

For example, of only 12 private banks in the world with AA or higher credit ratings, Australia has four. Australian banks produced strong results throughout the financial crisis. And unlike many countries, no taxpayer money has been spent supporting our banks.

Notwithstanding this sound record, if there are sensible ways of improving risk management through imposing remuneration principles by legislation, then the ABA will support them.

The ABA intends to make a submission to APRA (submissions are due by 24 July).
At first reading, the ABA fully endorses the principle of requiring boards to take responsibility and be accountable for remuneration policies. This is already a key principle, and there is no downside in enshrining it in a prudential standard.
One initial concern is that the proposed standard requires the Board's Remuneration Committee to recommend remuneration for a wide range of bank employees: key management personnel, risk and financial control personnel, and all other employees who have significant variable remuneration. Given the size of some banks, there is a question of whether this is requirement might be difficult, in practice, to implement.

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