June 2009

Regulation of Director and Executive Remuneration in Australia

Hay Group Submission to the Productivity Commission

HayGroup

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HayGroup

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Introduction

About Hay Group

Hay Group is a global management consulting firm that works with leaders to transform strategy into reality. We develop talent, organise people to be more effective and motivate them to perform at their best. Our focus is on making change happen and helping people and organisations realise their potential. We have over 2500 employees working in 86 offices in 47 countries.

Locally, we operate out of seven offices across Australia and New Zealand with over 100 employees. We consult to listed, private and public sector organisations as well as the not-for-profit sector.

We work with senior leadership teams to help them ensure their organisations work. This includes helping to align their strategic direction, their operating model and organisation structure to ensure the organisation can achieve its business goals.

Hay Group helps leaders and executive teams to improve their effectiveness through clarifying their purpose, and direction and helping them to work collaboratively so that they can execute the organisation's strategy.

We provide advice to and work with leaders and their teams in the areas of:

Building effective organisations

- Strategy clarification: translating strategy into actionable plans
- Operating model definition and alignment
- Organisation and job design

Leadership and Talent

- Team facilitation and improving team effectiveness
- Executive leadership development
- CEO and leadership succession
- Executive coaching

Reward

- Executive remuneration
- Reward strategies
- Reward Information

Hay Group interest in the Productivity Commission enquiry into Executive Remuneration

Hay Group's participation in the Productivity Commission enquiry stems from our belief that we will add value to the process as we:

- have proven expertise locally and globally in executive remuneration based on vast experience
- have deep insight into the issues that impact on executive remuneration
- maintain a significant database of executive remuneration globally, including many of the publicly listed companies on the world's major stock exchanges
- believe that reward is a powerful tool for company boards to use to improve company performance to the benefit of all in an economy.

Our global databases are broad and deep, representing more than 7 million employees from nearly 13,000 organisations in 63 countries worldwide. We make it easy for clients to access these databases and pinpoint critical decision-making insights through Hay Group PayNet®-our Internet-based reporting and analysis tool.

We update information at least once annually to ensure our databases provide fresh, accurate information. To maintain database integrity, we provide access only to those organisations that submit their compensation data.

Our databases contain data from the world's leading organisations, including more than 40% of *Business Week's* Global 1000 companies, as well as comprehensive coverage of major organisations in each specific country database.

In Australia our remuneration information is used by many of the top ASX listed organisations and we also advise Boards and management on director, executive and management remuneration in a number of ASX listed organisations.

- Hay Group's Australia database includes 40% of Business Review Weekly's "largest 500 organisations". In Australia, Hay Group PayNet® provides premier Reward Information from 418 organisations on over 180,000 incumbents.

Our submission includes data from our Australia database and data from a sample of our global databases. Note the following as an indication of strength of these databases:

- The US database includes one-third of the Business Week's top 100 companies.
- The UK database includes over 50% of the FTSE 100 companies.

Our approach to this submission

We have framed our submission around the five Terms of Reference (TORs) outlined in the issues paper of April 2009. However we believe that the questions posed in the five TORs do not necessarily capture all of the issues that impact significantly on executive remuneration in Australia and have thus added as appropriate to each TOR. We also believe that there is considerable overlap between the TORs and urge the reader to view our submission in its entirety to gain a holistic view of our thoughts.

We have ordered our response to each TOR with an executive summary of our response up front, then our full response.

We have also provided a number of attachments in support of this submission that highlight the views of Hay Group globally.

The information and views in this submission are current at time of submission. Our views have been informed by legislation and regulation (including those in draft form) current at the time of submission and need to be considered in the current regulatory context.

Our views have been shaped in line with evolving thought globally by Hay Group on executive remuneration for CEO's in publicly listed organisations. Salient thoughts are included below in this regard.

Common challenges in CEO pay

Big incentives impair judgment

Many CEO remuneration plans encourage short-termism. The CEO's role is primarily to create long-term shareholder value, but often the annual incentive represents the biggest potential portion of a CEO's total remuneration. This means CEOs are then encouraged to place disproportionate attention on immediate goals. In general, annual incentives should form a relatively small part of CEO pay.

It's not just about financials

The CEO's performance should be assessed against the critical factors that support future growth in shareholder value. So a significant proportion of short-term incentives should be based on relevant lead indicators – for example, effectiveness of succession planning, governance rankings or employee and customer satisfaction.

Not enough long-term focus

The CEO's primary accountability is to develop successful strategies, as evidenced by long-term, sustainable shareholder value. So the majority of the CEO's incentives should be based on shareholder value creation over a multi-year period. For established companies in mature industries (particularly cyclical industries), relative measures such as total shareholder return can be useful. In other situations a significant weight on absolute performance may be appropriate.

Long-term incentives not linked to performance

Many long-term incentive packages don't have performance conditions, as the assumption is that the CEO's performance will drive increases in share price, increasing the value of the options or restricted stock in the package. However, market value is driven by many factors, many outside the control of the CEO – by the same token, good performance by the CEO is not always reflected in increased share prices. Remuneration committees need to understand how different market scenarios and performance on key objectives will affect the value of long-term incentives, and structure the CEO's package accordingly.

Reward is not a substitute for management

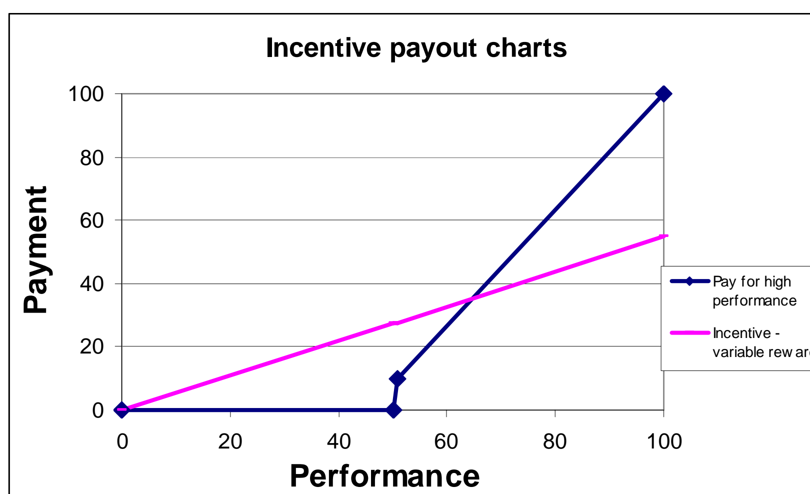
Boards sometimes use the annual incentive plan as a substitute for ongoing dialogue with the CEO on business priorities, objectives and targets. Instead, they need to ensure these are clearly understood and monitored on an ongoing basis. In particular, risk management needs board attention as many business risks are potentially too serious, or too long term in materializing, to be addressed solely through incentive plans.

Skewed incentives distort behaviour

Many plans are designed to reward only for performance above what is expected, rather than to act as a continuous incentive to improve performance. Such plans usually involve a potentially large reward, though only a small chance of getting that reward. This can mean either that the incentive is ignored, or that the plan encourages taking of undue risks or other actions that increase the chance of a payment but are not in the best interests of the business.

Bonuses used instead of variable pay

Bonuses and variable pay are not the same thing. A ‘bonus’ implies a payment for something extra, such as performance above a demanding threshold. Such payments have little impact on performance once it becomes clear that the threshold performance level will not be met. By contrast, variable pay provides for increased reward across a wide range of performance, and so has an incentive effect across the spectrum of performance.



The blue line shows a typical ‘bonus’ incentive plan, where there is a substantial likelihood of zero payment and steeply higher payments for incremental improvements in performance once the payout range is reached. The pink line shows a variable pay structure, designed to drive continuous improvement, where an increase in performance always generates an increase in payment.

Market data used as de facto strategy

It is tempting for boards – and CEOs – to presume they can set the CEO package by reference to market data only. But benchmarking provides a point of reference, not an absolute answer. Market data may reveal how much competitors paid in bonuses, but not what targets had to be reached, or whether the scheme in question actually worked to drive value creation. Ultimately, no data is perfect and boards need to consider market data as one input into a CEO pay strategy rather than the determining factor.

Compliance pressure weakens focus on business need

When institutional investors become too prescriptive on executive pay, they dilute the board’s accountability. The remuneration committee can become too focused on compliance with investor guidelines, rather than what is right for the business. For example, many UK institutional investors will only approve long-term incentive plans with tough performance conditions – but too tough conditions can render the incentive ineffective and create pressure for increase in salary or bonuses.

Tax and accounting impacts weighted too heavily

A tax-effective incentive plan or one which attracts a favorable accounting treatment may not be good value if it does not focus CEO effort on the right objectives. The primary driver of design should be performance: tax and accounting considerations are a distant second.

Blinded with science

Consultants too often assume a degree of technical expertise on the part of non-executive directors, and directors fail to challenge consultants on terminology and jargon. This can lead to boards approving remuneration plans that they don't understand, or that aren't what they wanted. For example, slogans like "upper quartile pay for upper quartile performance" are often used to justify upper quartile long-term incentive grants. But what would better meet most companies' needs would be a median grant value with a performance related design that will deliver upper quartile rewards if performance is good. Often this is because the remuneration committee has failed to understand the plan, or the consultant has failed to challenge their assumption that they have to grant upper quartile long-term incentives.

We believe that appropriate interactions between the Remuneration Committee, the Remuneration Consultant, Institutional Investors and the CEO should result in appropriate outcomes for CEO pay. The Remuneration Committee will provide understanding and focus, the Remuneration Consultant will challenge and explain , the Institutional Investors will provide oversight and governance and the CEO will input strategic and operational insight.

TOR 1: Trends in remuneration

Only the Board of an organisation can make a final and fully informed decision on the appropriate level and structure of executive reward. ***In Hay Group's experience, these decisions are mostly made in a considered and professional way by Boards, weighing up all the possible considerations.***

- The Remuneration Committee is usually made accountable for the process of reviewing and setting the remuneration of the Chief Executive Officer and of executives reporting to the Chief Executive Officer
- The Board references a wide variety of inputs in terms of setting remuneration
- External advice and information comes from a variety of different sources
- We believe that the use of a thorough and comprehensive data source is a mandatory requirement for the provision of quality advice and input into Board decision making
- For CEOs and Senior Executives the annual remuneration movements in the period 2003 to 2008 have shown a consistent upward trend, with movements increasing by approximately one percentage point per annum on fixed remuneration
- The movement in the total of fixed annual reward and annual incentives has been greater than the movement in fixed annual reward alone with a resultant change in reward mix
- When we include long term incentives data the resulting mix for Australian executives is approximately half of their reward coming by way of variable remuneration linked to performance
- Movement levels will not be as high as previous years in 2009 and 2010 given the current financial and economic situation
- In Hay Group's opinion, the contributing factors to this growth have included positive economic cycles, a greater demand for executive talent impacting the supply:demand equation, greater transportability of talent across sectors, and increased portability of executive talent overseas, leading to a "brain drain" and impacting on the need for remuneration competitiveness to retain and attract talent
- There has been a progressive downward trend towards contracted termination payments of between 10 and 15 months fixed annual reward over recent years as compared to five years ago when payments were a higher percentage of fixed annual reward.
- The ratio of CEO pay to pay of junior professionals has remained constant over recent years at approximately 16:1 for fixed remuneration and 20:1 at fixed plus annual incentives

Hay Group has utilised its executive remuneration database to develop a response to this section of the Productivity Commission review in relation to the regulation of Director and Executive Remuneration in Australia.

Data Sources

When Boards consider remuneration decisions, there are a variety of factors, advice and inputs they should seek to reach their decision. One of those inputs is quality and reliable data. We believe that the use of a thorough and comprehensive data source is a mandatory requirement for the provision of quality advice and input into Board decision making. When considering whether a data source meets such a standard, we believe there are a number of essential criteria that need to be considered.

- Breadth and depth of data – the number of companies and incumbents that are contained within a database.
- Researched basis for role comparisons – a tested methodology to extract data from the database such that appropriate role comparisons are made. The use of role titles, or simplistic measures such as revenue or market capitalisation will not ensure that valid role comparisons – and hence remuneration comparisons – are made.
- Non- published data can provide further information and information on additional roles. Detailed understanding of the operation of incentive plans is not likely to come through data alone but through having an expert adviser to interpret and apply in an appropriate context
- Timeliness of data – organisations change remuneration levels at various times during the year, not all at the same time. Databases that rely only on publicly disclosed data will not have the most up to date changes in remuneration approach included in their data.

Our Executive Database exclusively contains CEO and senior executive positions. One of the key features inherent within our database is that every position included in the database has been evaluated using the Hay Group standardised work valuation methodology globally. This makes our database unique in giving the user access to the most accurate executive market data available, thus allowing organisations to benchmark executive remuneration with the utmost confidence. Job evaluation provides a logical and defensible basis for the determination and management of internal relativities between jobs and for the design of pay structures.

Additionally, it is the supporting analysis that really underpins the use of data sources. Comparisons across data sources in executive remuneration requires great care to ensure that the same aggregates, time points, assumptions and inputs are being utilised. Hay Group would disagree with a number of the statements made in the Issues Paper based on analysis of our database, but would require greater detail in relation to the underlying definitions and assumptions. Statements around growth and “doubling” need to be used very carefully.

Trends in executive reward

Set out below are five year analyses of the following executive reward trends:

- Growth in executive reward levels
  - Overall
  - By sector
  - Compared to overseas
- Changes in executive reward mix
- Termination payment changes
- Relativities with other roles in the organisation
- Non-executive director remuneration

The analysis have used the following data and terms:

- Market data from all organisations providing data to Hay Group databases has been used.
- Trend analysis is conducted using:
  - the median result of the data. Median is the point in the data where 50% of incumbents are below and 50% of the incumbents are above. It represents a more stable view of trends in executive rewards than looking at the upper or lower end of the markets where there can be more volatility up and down.
  - the average result of the data. Average provides an indication of the volatility at either end of the market as compared to the median.
- Trends on remuneration movements are based on same incumbent analysis – that is the increase in remuneration in roles where the same incumbent is in place across the periods. When organisations appoint new incumbents, there can sometimes be an increase in executive remuneration that can inflate the trend if it is not modified.
- Two roles have been considered:
  - CEOs, representing the senior most role in the organisation
  - A senior executive role that typically reports to the CEO
- Two remuneration aggregates are presented:
  - Fixed annual reward (FAR) – includes base salary, superannuation, benefits and any fringe benefits tax
  - Total annual reward (TAR) – fixed annual reward plus any short term incentive paid.

Following the presentation of the data, we provide responses to some of the questions in the Issues paper.

Growth in executive reward levels

Set out below are tables that outline the trend movements in executive reward, drawn from our database, from 2003 to 2008. Data statistics are based on the entire CEO or Senior Executive population on the Hay Group database.

Overall executive remuneration movements, 2003 to 2008

Remuneration Movements 2003 - 2008												
	2003		2004		2005		2006		2007		2008	
	FAR	TAR	FAR	TAR	FAR	TAR	FAR	TAR	FAR	TAR	FAR	TAR
CEO Average	6.6%	19.9%	7.4%	19.0%	10.1%	34.3%	11.3%	19.1%	11.2%	13.1%	10.5%	16.8%
CEO Median	7.7%	16.1%	6.6%	8.8%	6.6%	24.1%	7.6%	14.8%	9.5%	10.6%	8.6%	4.6%
Senior Executive Average	6.9%	14.1%	7.7%	10.0%	8.0%	9.8%	7.3%	10.0%	7.1%	10.5%	6.6%	13.3%
Senior Executive Median	5.0%	9.6%	5.0%	7.3%	5.9%	9.0%	5.6%	6.9%	5.2%	8.2%	5.6%	10.6%

As can be seem from the above:

- The movement trend has been consistently upward
- The movement in aggregates including incentives has been greater than the movement in fixed annual reward.

It should be noted that it is expected these growth levels will not be as high in 2009 and 2010 given the current financial and economic situation.

Sector based executive remuneration movements, 2003 to 2008

When the different sectors are considered, the impact of various sectors in the economic cycle becomes apparent.

CEO FAR Movements 2003 - 2008						
Sector	2003	2004	2005	2006	2007	2008
Financial	9.2%	5.6%	4.2%	5.8%	10.8%	15.3%
Industrial & Service	6.0%	7.9%	11.6%	12.9%	11.3%	9.3%
Resources	n/a	n/a	n/a	10.8%	14.6%	11.0%

CEO TAR Movements 2003 - 2008						
Sector	2003	2004	2005	2006	2007	2008
Financial	29.7%	9.9%	35.5%	11.3%	2.9%	15.9%
Industrial & Service	17.8%	21.8%	34.0%	21.5%	15.0%	17.0%
Resources	n/a	n/a	n/a	21.5%	15.2%	11.0%

Senior Executive FAR Movements 2003 - 2008						
Sector	2003	2004	2005	2006	2007	2008
Financial	8.1%	6.1%	7.4%	6.2%	6.2%	8.3%
Industrial & Service	6.7%	8.2%	8.3%	8.0%	7.3%	6.4%
Resources	7.7%	10.4%	8.8%	6.4%	10.0%	7.0%

Senior Executive TAR Movements 2003 - 2008						
Sector	2003	2004	2005	2006	2007	2008
Financial	2.1%	15.3%	6.1%	9.2%	18.9%	12.8%
Industrial & Service	16.4%	8.9%	11.7%	10.5%	9.1%	13.3%
Resources	13.9%	15.4%	11.9%	12.2%	11.8%	19.5%

As can be seen from the above, sectors do differ from period to period depending on the economic cycle that is operating. Interestingly, CEO and Senior Executive remuneration does not necessarily move in the same pattern, reflective of differences in individual business unit performance versus averaging of results over a whole of company. The above tables identify peaks in movements in Resources and Financial Services aligned to peaks in those sectors, illustrative of the supply and demand effect.

International executive remuneration

USA:

Since 2006, Hay Group has conducted the Wall Street Journal Survey into executive compensation in the US. This provides us with a unique insight into executive remuneration in the US.

Included in the study are 200 US public companies with FY2008 revenues of $5 billion plus. This data is the CEO pay for 2008 and is taken from proxy filings between October 08 and March 09.

The highlight results are:

- Average base salaries increased 4.5% (as they were typically set at start of 2008)
- Annual bonuses went down significantly
- Long-term incentive (LTI) awards were essentially flat – most granted at start of 2008, were not 'performance granted'
- LTIs have more than three times the emphasis of either fixed remuneration or STIs in the package with the typical mix being 19% in base Salary, 19% in annual bonus and 62% in LTI
- Performance awards overtake stock options to make up the greatest emphasis within the LTI portfolio, with 40% stock options/SARs, 15% Restricted Stock and 45% Performance Awards
- 71% of companies take a 'portfolio' approach with a combination of options, restricted stock and performance share awards including 24% of companies using all three vehicles

In analysing these results:

- Care should be taken when comparing aggregates across geographies. Different factors are included in different jurisdictions which make direct comparisons inappropriate. For example, Australia is quite unique (with New Zealand and South Africa) in using a Fixed Annual Reward concept that includes the provision and election of benefits grossed up for FBT.
- In the US, tax legislation limits the deductibility of non-performance related pay over USD$1 million per annum to most executives. This generates a result of very few CEOs having a base salary over that amount. This has encouraged a much more leveraged approach to remuneration in that location, with the use of equity based rewards.

Europe:

Hay Group has conducted a survey of European executive remuneration for a number of years. The 2008 study covers 1,219 top executives in 229 listed companies (included in the FT Europe 500) in 18 European countries. Set out below is an example of the results for companies with market capitalisation between Euro 3 billion and 10 billion at 31 March 2008.

		UK	Germany	France
CEO	Annual Bonus as % of Base Salary	110%	160%	120%
CEO	Long Term Incentive as % of Base Salary	130%	60%	115%
Senior Executive	Annual Bonus as % of Base Salary	100%	130%	50%
Senior Executive	Long Term Incentive as % of Base Salary	120%	25%	100%

In analysing these results:

- In Europe, comparisons need to consider the multiple jurisdictions in place.
- Long term incentives in Germany are required to have ambitious performance hurdles
- As noted earlier, care should be taken when comparing aggregates across geographies.

Trends in executive reward mix

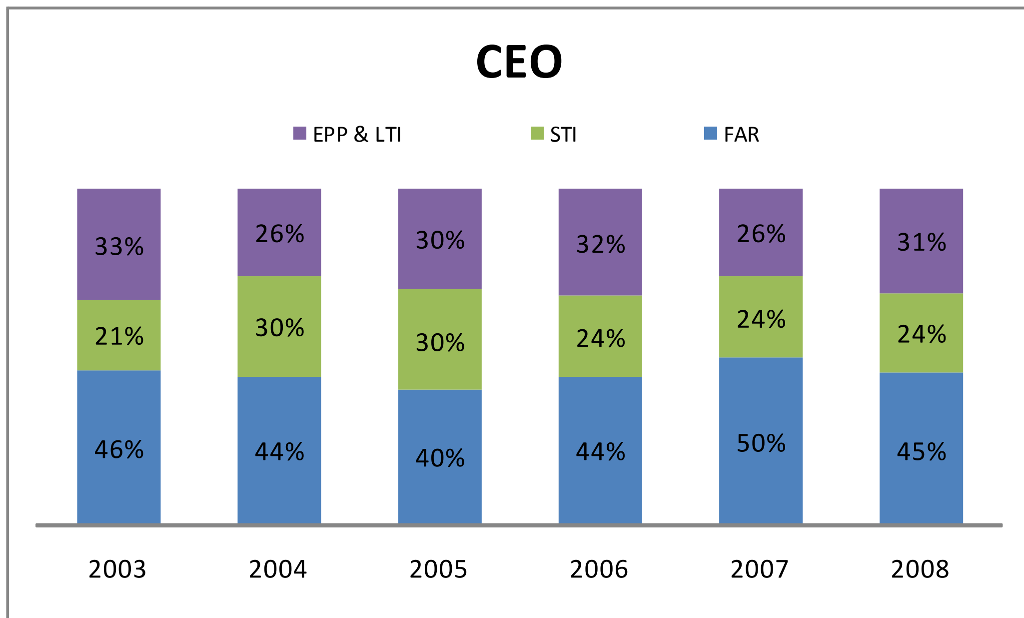
In addition to understanding the trends in reward levels, an understanding of shifts in reward mix is also relevant. Set out below are graphs that show the mix between fixed annual reward, short term and long term incentives.

The data included in these graphs is based on illustrative roles as follows:

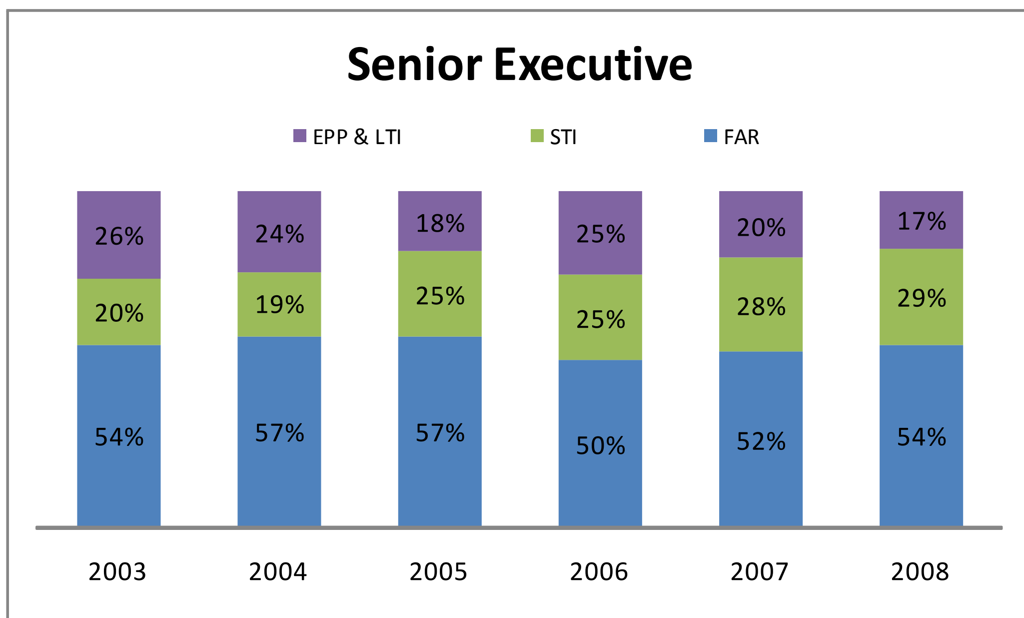
- CEOs from all organisations on the Hay Group database which are typically in a diversified company utilising several unrelated technologies, products and markets within diverse business segments. The typical dimensions are:
  - Revenue: $800 million - $2.7 billion
  - Assets: $450 million - $2.7 billion
  - Employees: 3,000 – 12,000

- Senior Executives from all organisations on the Hay Group database which typically include line managers with typical dimensions as follows:
  - Revenue: $120 million - $300 million
  - Employees: 1,000 – 2,000

Functional roles including responsibility for information systems, technology or marketing in large organisations.



Note: EPP = Equity Participation Plans; LTI = cash based LTI plans



The above graphs illustrate that approximately half of executive remuneration in Australia is linked to performance based rewards, with this more the case for CEOs than Senior Executives.

Trends in termination payments

There has been much commentary in relation to termination payments in recent times. Set out below is a table outlining how termination payments have changed over the last five years. It should be noted that this table tends to include the contracted termination amount, not the crystallisation of any payments as part of incentive arrangements that are on foot.

CEO = Chief Executive
SE = Senior Executive

		2003		2008	
Reason for termination	***Months of fixed pay***	CEO	SE	CEO	SE
Bona Fide Redundancy	Less than 3 months	0%	0%	0 %	0%
	Between 3-9 months	0%	18%	20%	20%
	Between 10-15 months	36%	73%	60%	60%
	Between 16-21months	28%	0%	10%	20%
	Between 22-27 months	18%	9%	10%	0%
	Greater than 27 months	12%	0%		
Other	Less than 3 months	10%	10%	0%	0%
	Between 3-9 months	0%	0%	27%	45%
	Between 10-15 months	20%	70%	73%	55%
	Between 16-21months	30%	10%	0%	0%
	Between 22-27 months	20%	10%	0%	0%
	Greater than 27 months	20%	0%		

Relativities between executives and other employees

The Issues Paper asks about relativities between executives and other employees.

Hay Group data the ratio has remained close to constant over recent years. This type of ratio may be of interest in examining broad trends across large numbers of companies but we do not believe it should be a significant factor in the setting of remuneration in individual cases.

Trends in non-executive director remuneration

Analysing movements in director remuneration can be more challenging as:

- Organisations seek approval from shareholders periodically for increases in the pool size for non-executive director remuneration
- The actual payments to non-executive directors will vary depending upon whether they are on additional committees (e.g. People & Remuneration Committee, Audit Committee, etc), the numbers of meeting in attendance and whether they are a member or a Chair of the board or committee.

Set out below is a table of Main Board (pool) fee movements over the last five years.

Year	Median	Avg
07 - 08	9.0%	12.6%
06 - 07	7.7%	8.6%
05 - 06	9.9%	15.0%
04 - 05	11.9%	18.7%
03 - 04	7.1%	16.4%
02 - 03	2.2%	12.5%

How are levels of director and executive remuneration determined?

Director and executive remuneration is determined by the Board using a process of gathering inputs and views, and within the context of the organisation and its objectives.

For executive remuneration:

- The Remuneration Committee is usually made accountable for the process of reviewing and setting the remuneration of the Chief Executive Officer and executives reporting to the Chief Executive Officer.
- The Board references the following inputs in terms of setting remuneration:
  - The Executive Reward Strategy implemented by the organisation and communicated to its shareholders as part of the Remuneration Report. An Executive Reward Strategy should align to the organisation's business strategy in terms of structure, mechanisms, performance measures,

market comparisons and market positioning. Shareholders are provided with the opportunity to vote on the Remuneration Report that outlines this Executive Reward Strategy annually.
- Market information is sought in relation to the movement of executive reward over the period since the last adjustment and the latest available levels of reward. This data needs to meet the data source characteristics as outlined in the Data Sources section of this response. Particularly, it needs to ensure that appropriate job comparisons are made taking into account the industry, size and complexity of the organisation and the responsibilities of the role. It is not sound to compare remuneration on the basis of job title alone.
- Organisation performance and track record over the most recent period.
- Individual performance and track record over the most recent period.
- Insight in terms of availability of appropriately qualified and experienced incumbents for the role.
- Expert advice in terms of remuneration arrangements. External advice comes from a variety of different sources:
  - Remuneration consultants with experience and expertise in advising on remuneration strategy and analysis
  - Lawyers with experience in remuneration contractual arrangements and documentation of equity plans
  - Taxation advisors with experience in the potential taxation impacts for participants in executive reward arrangements
  - Accountants with expertise in the expensing requirements of executive remuneration through the corporate accounts
  - Actuaries with expertise in valuing long-term incentives
  - Sometimes, Boards will seek input from recruitment consultants as to what remuneration levels will be required to meet hiring needs.
- Additionally, Boards seek feedback from shareholder advisory groups and institutional shareholders as they are framing remuneration decisions.

Only the Board of an organisation can make a final and fully informed decision on the appropriate level and structure of executive reward. It is only that group of people that can, using the inputs described above, understand the requirements of the role, develop an appropriate understanding of the remuneration market for that role, and then factor in the individual and organisational performance element to form an overall view.

The actual level of remuneration paid is a function of this process above, and then the actual performance levels delivered and therefore triggering remuneration payments in the form of incentives. As outlined above, the market is one input in terms of the level of fixed reward and the size of incentive opportunities made available subject to performance. It plays a role in the decision making of the Board as so far as it is important that competitive remuneration arrangements are in place to support the attraction and retention of quality executive talent. For CEO roles, it often represents the mark of perceived "equity" for the incumbent – when they compare their company and its performance to others, how does the remuneration provided to the different incumbents equate. This is often an unintended consequence of increased disclosure in so much as it makes such comparisons easier.

However, as also noted above, there are a number of other factors that are duly considered by Boards when making executive remuneration decisions. In Hay Group's experience, these decisions are mostly made in a considered and professional way by Boards, weighing up all the possible considerations.

For non-executive director remuneration:

A similar process to that outlined above is used for non-executive director remuneration, with two key differences:
- Increases to non-executive director pool size is approved by shareholders
- These increases usually only occur every 2 to 3 years

What factors have contributed to the growth in director and executive remuneration? Has the experience differed across different industries?

The growth in director and executive remuneration has been outlined above. In Hay Group's opinion, the contributing factors to this growth have been:

- Positive economic cycles, leading to most organisations performing well.
- The positive cycle supporting a greater demand for executive talent, impacting the supply:demand equation.
- Greater transportability of talent between companies and across sectors.
- Increased portability of executive talent overseas, leading to a "brain drain" and impacting on the need for remuneration competitiveness to retain and attract talent.
- The desire of boards when recruiting externally to hire the best executive for the job; the candidate considered the best will rarely be rejected on grounds of being too expensive as the extra value a high performing CEO can create for shareholders far outweighs the extra cost.

The impact of the external environment bears out when considering the experience across different industries. As the analysis has shown above, the experience can differ across different industries but this will vary depending on how the external environment is impacting that industry. In recent years when the Resources sector has been booming, the growth in executive remuneration has been very strong. Financial Services experienced similar movements at times as well. When the companies in a sector or industry are performing well due to external conditions, it will lead to strong growth in executive remuneration levels.

However, in a market like Australia, there can be greater cross-pollination of these effects across industries than in larger markets like the US. In Australia, there are more likely to be examples of executives from one industry moving to another industry than in larger markets. Therefore, one strong industry can cause an upward movement in other industries.

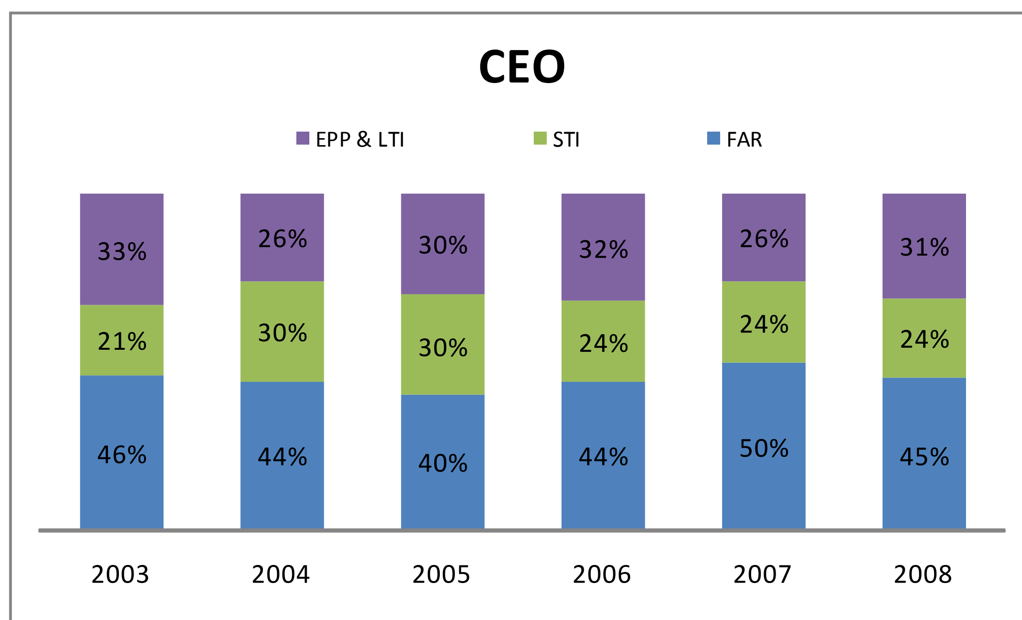
Remuneration Structures and Incentives

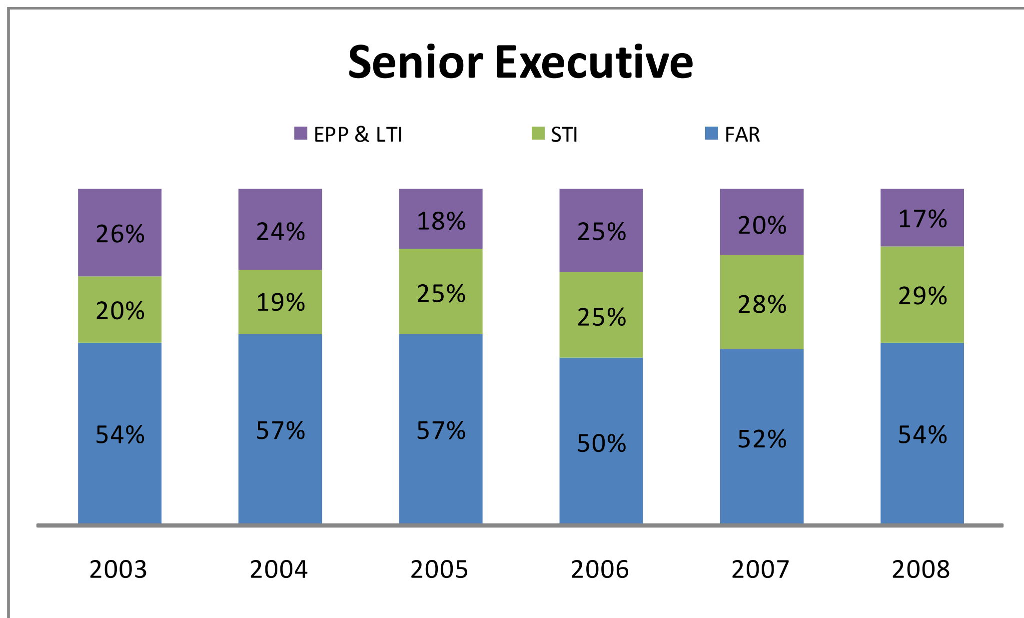
Set out below are five year analyses of the following executive reward trends in relation to remuneration structures and incentives:

- Executive reward mix
- Movements in STI payments and targets
- Changes in performance measures for STIs
- Changes in equity pay practices for LTIs

Trends in executive reward mix

The illustration of trends in executive reward mix presented earlier is repeated here as it is relevant for the discussion on remuneration structures and incentives. Set out below are graphs as to the reward mix between fixed annual reward, short term and incentive and long term incentive for illustrative CEO's and senior executives.

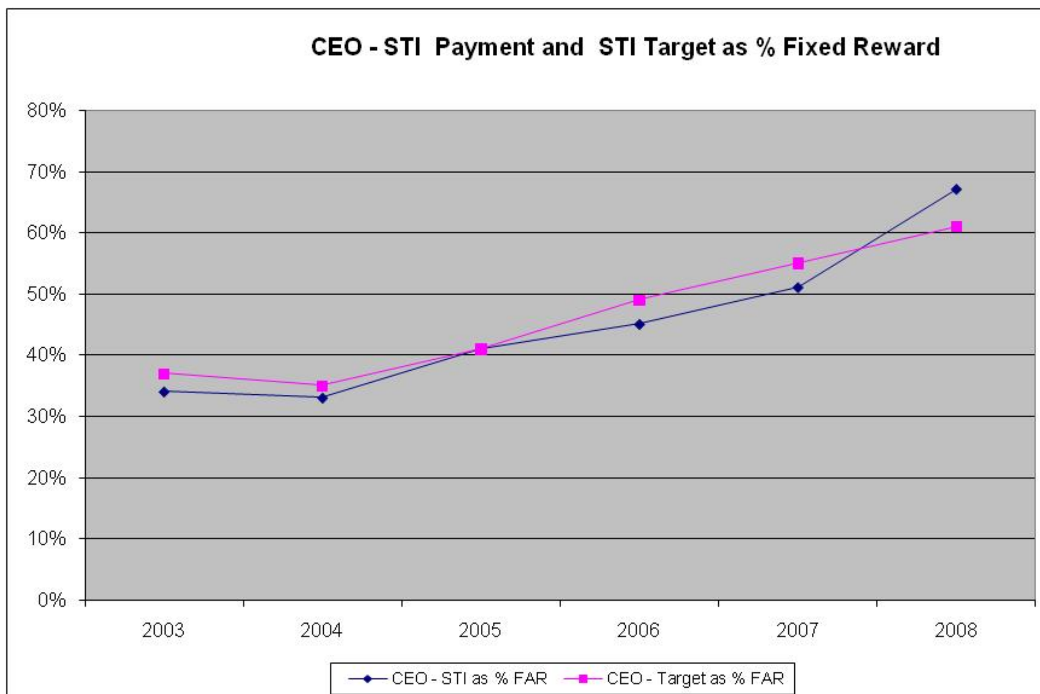




The above graphs illustrate that approximately half of executive remuneration in Australia is linked to performance based rewards, with this more the case for CEOs than Senior Executives.

Movements in STI payments

Set out below is a graph of the movements in STI payments and STI targets for CEOs over the last five years. As can be seen there has been a growth in the percentage of fixed reward paid out to CEOs, as well as the STI target as a percentage of fixed reward.



This graph illustrates that in 2008, payments on average exceeded target levels for CEO STIs – most STI plans will have a target level of reward and a maximum level of reward. Note this graph includes data from new incumbents and their STI is not pro-rated to the months served.

Changes in performance measures for STIs

Set out below is a summary of the different performance measures used in senior executive STIs. This confirms the balanced scorecard approach taken by many organisations to short term incentives.

STI Performance Measures				
2003	**2004**	**2005**	**2006**	**2007**
58% Profit (before or after tax)	**63%** Profit (before and after tax)	**74%** Profit (before and after tax)	**62%** Profit (before and after tax)	**62%** Profit (before and after tax)
35% Key management behaviours, return on capital, employed economic profit/value added and cost control	**35%** Key management behaviours & return on capital employed	**37%** Key management behaviours	**34%** Key management behaviours	**34%** Key management behaviours
	20% Cash flow & cost control	**34%** Return on capital employed **26%** Cash flow & Cost control	**29%** Return on capital employed **27%** Cost control **24%** Cash flow	**29%** Return on capital employed **27%** Cost control **24%** Cash flow
50% Individual critical success/KPI's	**50%** Individual critical success/KPI's	**64%** Individual critical success/KPI's	**55%** Individual critical success/KPI's	**55%** Individual critical success/KPI's
Safety and environment performance	Safety and environment performance	Safety and environment performance	Safety and environment performance	Safety and environment performance

Changes in equity pay practices for LTIs

Progressively over recent years, there has been a decrease in the use of share option plans, and an increase in performance share plans used by companies as part of executive reward.

Share Option Plans – involves the granting of options to executives, giving the executives the right to acquire shares in the company at a specific price, during a defined period, provided nominated performance hurdles are satisfied.

Performance Share Plans – involves the company funding the acquisition of shares which are then allocated to employees subject to performance vesting conditions and/or dealing restrictions.

The table below compares those outcomes for Chief Executives and senior executives.

	Chief Executives		Senior Executives	
	2001/2002	2006/2007	2001/2002	2006/2007
% of participants providing Share Option Plans	79%	44%	86%	39%
% of participants providing Performance Share Plans	26%	75%	42%	71%

Changes in performance hurdles for LTIs

In the last few years the use of performance hurdles for Australian companies has become commonplace for executive long-term incentives. And while the majority of plans still use a Total Shareholder Return measure, there are other measures and dual measures used, as illustrated below. Peer group performance measures usually compare performance relative to an index or group of peer companies.

	Share Option Plans		Performance Share Plans	
% of plans including:	2001/2002	2006/2007	2001/2002	2006/2007
EPS- Absolute	3%	14%	Exact data not available: generally mixed use of performance hurdles	6%
TSR – Peer	70%	65%		72%
TSR – Absolute	0%	9%		6%
Dual TSR and EPS	0%	0%		7%
None	27%	4%		0%
Other (usually internal)	0%	10%		9%

What is the role of variable pay? What relationship exists between levels of remuneration and individual and corporate performance? What actually drives performance?

Variable remuneration, in the form of short term and long term incentives, represents a valuable tool of an organisation's executive reward strategy. It enables an organisation to align the reward of executives with delivery against requirements in their business strategy. By having short term and long term incentives, organisations are seeking to reward achievement of the annual business imperatives of an organisation as well as the achievement of longer term objectives.

The linkage between levels of remuneration and individual and corporate performance is a function of:

- the selection of appropriate performance measures;
- the selection of appropriate performance levels against these measures; and
- appropriate assessment of performance against the measures and levels nominated.

Boards outline their strategic objective and business plans to the marketplace, as well as the framework for performance assessment for executive reward in the Remuneration Report. The alignment between objectives and reward frameworks is key to ensuring that there is alignment between executive reward and individual and corporate performance.

For short term incentives, the use of a balanced set of performance measures that align with performance against financial and other criteria is best practice. For example, inclusion of measures around safety for industrial organisations is considered a minimum requirement to align the criticality of those outcomes with executive reward. The inclusion of such measures can make the direct linkage between overall corporate financial performance to executive reward more challenging to assess from an external perspective. However, their exclusion would minimise the alignment with a critical business outcome.

For long term incentives, most equity based plans incorporate a measure based on shareholder returns, which provides direct linkage. Incorporation of other business measures can be relevant if relevant to the achievement of strategic objectives, but this would dilute the linkage to shareholders.

With respect to whether variable reward drives performance, this is an issue that will vary from individual to individual. The underlying motivation of a person, and whether the prospect of a financial reward would change behaviour, has long been discussed in psychological studies. However, what the use of a variable reward model does deliver is equity between relative reward outcomes and performance across executives. This equity effect of variable reward would have a positive effect on motivation – and its absence could have a negative effect.

In addition, subject to all impact from current reviews, variable rewards are usually forfeited by executives who choose to leave the company before the vesting date, which for a long term incentive may be several years after the allocation of the potential incentive. This feature can aid retention of high performing executives who may be unwilling to walk away from a plan with significant potential value. And if the executive leaves in spite of the forfeiture, the cost of that incentive has at least been saved.

Options

As illustrated above, the use of traditional option plans – as compared with performance share rights or shares – has been decreasing over recent years. This has been a much stronger trend in Australia than overseas.

The falls in share markets of late means that many options have an exercise price above the current market price so executives cannot exercise them and make a gain even where performance conditions for vesting have been met. Therefore there is no benefit available from the plan unless the share price recovers to

above the option exercise price. This outcome is a reasonable outcome in the context of the upside that executives can achieve when their share prices perform strongly.

Non-recourse loans

The use of non-recourse or limited recourse loans has decreased over time in line with concerns expressed by shareholder groups. The loaning of money to employees in connection with their remuneration does not necessarily align with good corporate governance standards.

The role of executive remuneration and risk taking

The issue of risk in corporate Australia has received much scrutiny of late. There has been a proposition that the executive remuneration frameworks have supported the taking of an unacceptable level of risk that has contributed to much of the current financial turbulence.

Such assertions need to be made carefully. The taking of risk will always form part of enterprise and support the growth of corporates and economies. Entrepreneurialism necessary for advancement and the innovation necessary for new developments and progress have risk as a central part of that proposition.

Boards define the appropriate risk profile for their organisations and set out parameters for performance based on that risk profile. A well-designed reward system for executives aligned to those parameters can be an effective supportive tool. A poorly designed remuneration package or incentive plan may lead to inappropriate risk taking, for example when there is a large difference in reward levels for performance outcomes that are not greatly different. Such designs can lead to the taking of inappropriate risk if there are insufficient controls on the level of risk taken.

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

As a matter of course, disclosure between a company via its Board and shareholders is at the foundation of good corporate governance. Disclosure on remuneration is just one part of the disclosure required such that shareholders can make informed decisions about their satisfaction with the stewardship being conveyed over a company within which they hold an investment.

Disclosure such that potential shareholders considering an investment in a listed company can evaluate the merits of investing is part of the operation of an open market, and is where the public interest emerges.

How this should extend is also a matter of opinion – disclosure through the media can sometimes be in a form that is abbreviated and sensational, when a full analysis of the facts of the situation could provide a more balanced perspective. Truncated articulation of the issues around executive remuneration can lead to a heightening of public concern that may not be as concentrated otherwise.

TOR 2: Effectiveness of regulatory arrangements

Hay Group's position in relation to regulation and regulatory arrangements are broadly that:

- voluntary codes of practice and guidelines are preferred to regulation of executive and director remuneration
- regulation can have, and has had, unintended consequences
- disclosure can be improved through provision of more information explaining remuneration decisions and simplification of LTI reporting
- corporate governance practices in Australia are generally sound with Remuneration Committees, in our experience, operating in a professional manner and basing their judgments on appropriate insight and market understanding
- Remuneration Consultants have no significant conflicts of interest when advising Boards even though they may need to interact with executives in order to fulfill their adviser duties.

Given that the ultimate responsibility for executive remuneration decisions lies with company Boards, it is important that this responsibility is not in any way diminished through inappropriate regulatory or other interference. Shareholders have a say in executive remuneration through the current non-binding vote and we believe that this is sufficient to encourage the Board to act in line with shareholder interests when making executive remuneration decisions. The role of Government is to provide policy and frameworks for the Board to work within and detailed regulation (as opposed to policy and frameworks) would not be able to cater for the multitude of different contexts and impacts on executive remuneration that each Board needs to consider. There is a real danger of detailed regulation being made on the incorrect assumption of "one size fits all" where clearly the variety of executive reward arrangements found in the market is proof of this not being the case.

It has been argued by many commentators and professionals that unintended consequences of regulation have caused inefficiencies in the United States executive pay market. For example, as noted earlier, the regulation on limiting company tax deductibility of fixed pay to $1m resulted in both an increase of some salaries to the "acceptable" level of $1m and then to substantial increases in the reliance on variable rewards as the fixed element remained at $1m while the total increased. This reliance is not considered to be in the best interest of shareholders for many organisations.

Appropriate policy frameworks, along with adherence to voluntary guidelines and codes of practice are preferred to regulation as these allow Boards to make decisions as necessary for their own environments and specific contexts. For instance, the much maligned use of options may well still be appropriate for smaller start up organisations that do not have sufficient cash flow to pay market competitive cash remuneration levels to suitably experienced executives. A policy environment that allows for, and in fact encourages, explanations of non-compliance has to be preferred to a regulated environment where Boards are forced to make remuneration decisions that are not in the company's, nor its shareholders, best interests.

Annual reports that are easy to read and provide understanding of the reasons behind remuneration decisions could go a long way to giving shareholders comfort that Boards are properly undertaking their responsibilities with regard to executive remuneration. Whilst we believe that overall disclosure requirements are sufficient in the Australian context we would like to see better, more consistent and simpler reporting of equity/LTI arrangements. The linkages to relevant accounting standards can however not be ignored and we urge the Productivity Commission to liaise as appropriate in this regard. The simple fact is that currently many readers of the annual remuneration report do not fully comprehend what they are

reading regarding LTI arrangements and form inaccurate views of just how much executives are actually paid.

Hay Group experience in working in the field of executive remuneration is that the majority of Remuneration Committees and Boards overall take their roles very seriously and do all that is necessary to ensure that they are in fact making decisions based on a detailed understanding of both the executive remuneration market and their own organisation context. Compliance to Corporate Governance requirements and best practice is generally not an issue and legislating in order to improve the remuneration decision making of only a few will not be in the best interests of the majority.

The role of the Remuneration Adviser, and in particular the protocols around Boards and Remuneration Adviser interface require some explanation here. Remuneration Advisors should be able to outline the policies and protocols in place to provide effective and objective reward advice. For example, Hay Group will only provide advice to the Board when it comes to executive and/or Director remuneration. Individual consultants responsible for executive reward advice should not also be responsible for other services provided to a company. Hay Group has clear principles for the advice it gives on executive compensation, conducting peer reviews or setting up other quality assurance processes to ensure those principles are followed.

TOR 3: The role of institutional and retail shareholders

We believe that shareholders, institutional and retail, do have a role to play. This role is best played through continuing of the current non-binding vote approach as:

- the approach is working
- it has provided shareholders with a platform for expressing concerns
- companies have being heeding messages delivered via the vote
- the Remuneration Committee and Board needs to do the job that it has been asked to do by shareholders.

Part of the issue lies in determining how the shareholder role should be exercised; in particular, should the influence be more direct, or should it be interpolated as expressed via the shareholders' election of the Board? Hay Group believes that an advisory vote, such as the current non-binding vote, is preferred with shareholders taking action against the board in need. Shareholders – both institutional and retail – have an important role to play in influencing corporate remuneration practices, but only via their advisory vote.

Increased scrutiny and discussion (and even justification) is a good thing if it leads to clearer recognition of the importance of reward strategy and linkages between reward strategy and overall business strategy, but this doesn't have to mean a binding vote that impedes the role of a Board to run the company.

Unintended consequences of too much shareholder influence

An example of what can go wrong with too much shareholder influence can be found overseas where there is insistence of many UK institutional investors on approving only LTIs with tough performance conditions. This has been counter productive and has had unintended consequences. It has led to many plans with a less than 50% chance of paying out and an even lower chance of a meaningful payout - not usually an effective incentive. We believe it better to design variable reward packages, not plans that have a small chance of a big payout. The consequences have been that many executives are not motivated by their LTI plans, leading to pressure for higher salaries and higher annual bonuses to motivate and retain key staff and encouraging a short term focus which is not necessarily aligned to long term sustainability.

Issues to consider include:

- Direct involvement of shareholders would need to be considered very carefully in terms of how it would be applied practically
- Provision would need to be made to deal with widely differing views
- The level of engagement and heated dialogue that surrounds issues of executive remuneration could lead to potentially lengthy wrangles between diametrically opposed sides
- Increasing direct shareholder involvement in remuneration practices and in setting remuneration levels would require a very high level of shareholder education and provision of information.

Shareholders are exercising influence

It should be noted that until recently, not many shareholders exercised their right to vote upon remuneration matters. The level of interest and involvement has increased in recent times. This increased activity, and the fact that shareholders are now more willing to challenge Boards by voting down Remuneration Reports, suggests that the existing provisions for shareholder involvement are working. Where shareholders have a view upon remuneration matters they are now making that view clear. There are examples of Boards having taken on the messages delivered through the non-binding vote and changed reward arrangements.

It is standard practice for conflicts of interest to be declared in company and Board votes; this should continue to be the case where a board member shareholder is voting upon a remuneration report that impacts him or herself.

Boards should run the company

There is a risk that in over reacting, too many layers of shareholder involvement could be developed and that these layers would inhibit Boards from running the company. Shareholders do not vote directly upon volumes of capital and operating expenditures, which in absolute terms are of far greater significance than executive remuneration.

It has been suggested that the way forward may be to strengthen accountability of Boards for remuneration decisions. We believe, however, that this should take the form of answerability rather than control, through for example "comply or explain" mechanisms. It is our observation that the majority of Boards are mindful of the concerns of shareholders and treat the existing non-binding vote mechanism seriously. Institutional investors in particular can place a great deal of pressure on boards to comply with the preferred marketplace model irrespective of whether it is really right for that business.

TOR 4: Aligning interests

Taking into account the Australian market context and having provided executive reward services to numerous organisations globally and in Australia over many years, Hay Group:

- cautions against heavy regulatory intervention as a means of creating greater stakeholder interest alignment as it will most likely, even with well meaning intent, lead to unforeseen and unhelpful consequences,
- asserts that executive reward is a strategic business tool which, if effectively designed and implemented, can promote behaviour and results that are aligned with the interests of key stakeholders,
- notes that, while there have been exceptions, executive reward design and application in the Australian market is generally well managed by boards, aligned with stakeholder interests and appropriately responsive to broader community sentiment.

Included in the Commission's terms of reference is consideration of any mechanisms that would better align the interests of boards and executives with those of shareholders and the broader community.

The global economic crisis has generated a strong community response as perceived poorly conceived and executed executive reward arrangements have been suggested by some as potentially being contributing factors to the crisis. The pain inflicted on shareholders and broader communities has prompted representative governments and regulators to consider potential implications of ill-conceived executive reward design or application that might create or accentuate stakeholder misalignment.

Executive reward in Australia (and in particular the finance sector) is coming under increased scrutiny despite strong prudential regulation and generally more balanced remuneration structures, relative to some overseas arrangements which in hindsight are viewed by many to have been inappropriately designed and '*played a role in encouraging behaviour which contributed to the financial crises.*' (The Turner Review, FSA, March 09)

Key Stakeholders

It is important to note that there is variation within the identified stakeholder groups of board, executive, shareholders and community. For example, community sentiment with regard to executive reward is not homogeneous and can vary according to relative socio-economic conditions and other factors.

Despite the risk of oversimplifying, it is useful to consider the salient interests of the main stakeholder groups currently shaping the executive reward debate.

Board Members

- Increased scrutiny of executive reward matters, pace of change and greater regulation has made decision making more difficult and potential consequences more substantial.
- Strong intrinsic motivation to lead and oversee a successful business that delivers shareholder value.
- Reputation is important.
- Need for external, independent and expert advice.
- Sensitive to potential instability arising from key executive separation or inability to attract suitable candidates to key roles.
- Must reconcile what are sometimes competing pressures of shareholder and executive expectations regarding executive reward.

Executives

- Like all employees, significant motivation to maximise value of total reward arrangements.
- Strong intrinsic motivation to lead and operate successful business that delivers shareholder value.
- Tendency to discount perceived value of LTI reward components relative to fixed or short-term incentive components. Devaluing of LTI a combination of market driven share price volatility, the delay associated with LTI payment and lower probability of payment due to plan design and performance hurdle calibration.
- Reputation is important, as is how they are rewarded relative to peers inside and outside organisation.
- Quality of relationship between CEO and board varies considerably and can have significant impact on how much time spent on reward related negotiations.
- Prevailing view that unimpeded market forces should determine executive reward value. Controls such as caps or fixing executive reward in terms of ratio to average earnings not appropriate.

Shareholders

- Increasingly demanding strong and transparent links between increased shareholder value and executive reward.
- Due to cases of misalignment, where significant value is realised by executives despite erosion of shareholder value, shareholders are seeking a more direct say in executive reward design and quantum i.e. binding votes. Currently using non-binding vote to register objections to executive reward arrangements that are perceived as not aligned with shareholder interest.
- Reasonably comfortable with high returns to executive provided they receive commensurate returns. However, this is coupled with increasing emphasis on need for longer-term sustainability.

Community

- Regardless of rationale, executive pay quantum relative to average salaries is perceived by many as unfair and excessive. The damage resulting from the global financial crisis, including job losses, salary freezes etc, has served to heighten negative sentiment.
- Headline numbers associated with executive reward practices such as golden handshakes are viewed as excessive and unjustified, particularly when no linkage between levels of payment and performance is apparent.
- Limited and sometimes inaccurate understanding of factors influencing executive reward. However, increase in share ownership has increased community awareness.
- Prevailing sentiment directly pressures elected representatives to respond through intervention.

Even without considering the additional complications of political and the media interest, it is clear that there are potential points of tension between the interests of key stakeholders.

Prior to the current unprecedented market downturn, simmering community and some shareholder resentment regarding high profile and exceptional executive reward payments was ameliorated by positive growth, healthy returns and a generally buoyant economy. In the current climate, government has felt compelled to review executive reward along with associated regulatory requirements as it attempts to reconcile competing interests.

However, interventions can and do lead to unintended consequences as noted earlier in the USA where the Clinton Administration capped company tax deductibility for the non-performance related component of executive pay at one million dollars. The intervention only served to skew reward design with heavier weightings on incentive payments and reduced the ability of organisations to design and implement total reward arrangements with the appropriate balance of fixed and incentive components. In extreme cases, commentators have blamed overemphasis on short-term incentive reward, to which this intervention contributed, for inappropriate levels of risk taking behaviour.

Stakeholder Alignment through Board Engagement with Executive Reward, Effective Design and Implementation

Board members must exercise their informed judgement, within legal and moral parameters, in the best interests of shareholders. They have the central role to play in balancing competing interests and determining appropriate executive reward arrangements. As such, the Board needs to ensure that:

- a robust reward philosophy is developed that communicates the organisation's executive reward approach to shareholders and the broader community. Such a statement can also guide decision making around reward strategy and policy,
- executive reward design is aligned with organisation reward philosophy and strategy. Design should be regularly reviewed to ensure it is positively contributing to desired performance outcomes and delivery of shareholder value,
- there is sufficient dialogue to ensure the CEO, and via the CEO other executives, clearly understand priorities and the intent of reward design,
- aggregate reward components are balanced, with appropriate weightings on fixed, short-term and long-term incentive components and probability of delivering value to participating executives,
- performance measures are balanced. In addition to financial return measures, annual incentives should contain a portion of key lead indicators which are aligned with longer-term sustainability and success,
- members are independently and adequately informed,
- when stress testing reward design, shareholder response to potential extreme outcomes should be assessed and considered before implementation.

TOR 5: International Developments

Hay Group believe that it is important to take note of what is occurring globally but that:

- Differentiation between the arrangement overseas for those organisations subject to government rescue and other organisations needs to be very clear
- Australian organisations have not been rescued by our government and the government has not become a significant direct shareholder in any listed organisation as a result of the GFC
- Our practices are in line with those recommended overseas for management of executive remuneration for those organisations still operating normally as publicly listed companies with non-government shareholders and do not require to be reviewed in order to function better
- Guidelines and codes of practice are preferred to regulations.

Treatment of organisations that have been rescued by government is not applicable in Australia

In commenting on these two questions posed in the Productivity Commission's issues paper under TOR 5 we believe it important to separate the developments internationally in response to the global financial crisis generally and those developments in response to government rescue or "bail out" money:

- The controls being put into place for rescue of banks/financial service organisations are different to those being put into place for other organisations
- In making this separation we need to be quite clear in our understanding that the Australian government has not provided financial support to any publicly listed companies apart from guaranteeing deposits in the banks
- Under this limited support approach the Australian Government has not become a shareholder in any stressed organisations directly as a result of the global financial crisis.

Hay Group advocates a principled rather than regulated approach to executive remuneration but believes that if risk is an issue that needs addressing in the financial services sector then this is best achieved through addressing capital requirements and not executive remuneration arrangements.

Hay Group further believes that direct Government intervention in the executive remuneration approach, frameworks or pay arrangements of any specific publicly listed organisations is therefore unwarranted and not called for. Whilst we recognise that some of the arrangements entered into in stressed/supported organisations will filter through to executive remuneration in the broader public company scenario and cannot be totally discounted, we also feel it necessary to stress that in their unfiltered form such arrangements have no relevance to Australian organisations.

Guidelines and not regulations are in place for publicly listed organisations not subject to government rescue in the international arena

It is of course important to be cognisant of the fact that most of the developed economies of the world have responded to the crisis by releasing guidelines and codes of practice, not regulations. This is an approach that we believe to be particularly applicable to Australia where on the whole our governance structures are appropriate in managing executive remuneration (see TOR 2). The governance code in France for example, mentioned in the issues paper, works through a "comply or explain" approach thereby allowing companies who have reason to not comply to explain the reasons behind non-compliance. Hay Group experience is however that most companies have been making significant effort to comply with most, if not all of the code. Nevertheless, they do have opportunity to explain non-compliance that would not be available to

them were the code a set of rules and regulations. The pressure of visible non-compliance is a significant deterrent in itself.

It is important also to note that there has been much response internationally focusing specifically on financial institutions, see for example the European Commission press release relating to Financial services sector pay, dated 29 April 2009,

http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/674&format=HTML&aged=0&language=EN&guiLanguage=en .

In this release the focus is on risk taking in financial institutions and whilst it is recognised that the subject of risk taking is important too in Australia, it also needs to be remembered that as a whole our environment is different to that in most other major developed economies. This may be (at least in part) due to increased governance and higher prudential standards because of "failures" in recent years such as that relating to the Traders at one of our big banks but regardless of the reason the fact is that our financial services institutions are comparatively well governed. In addition, it needs to be remembered that our very own Australian Prudential and Regulatory Authority (APRA) is undertaking its own review currently and we would urge more weighting be applied to the outcomes of that review than on international responses which may have varying degrees of applicability and relevance in Australia.

European Commission recommendations on executive director remuneration (generally the CEO and Direct Reports/KMP in Australian publicly listed companies) as also outlined on April 29, http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/673&format=HTML&aged=0&language=EN&guiLanguage=en in Brussels are very much in line with our expectations and current approach to executive remuneration in Australia. Although, interestingly the EU recommends 2 years maximum fixed remuneration on severance with a ban on payments for failure.

The recommendations provide for alignment of pay to performance, a balance of fixed and variable pay, and a recommendation to:

- "promote the long term sustainability of companies through a balance between long and short term performance criteria of directors' remuneration, deferment of variable pay, a minimum vesting period for stock options and shares (at least three years); retention of part of shares until the end of employment.
- allow companies to reclaim variable pay paid on the basis of data, which proved to be manifestly misstated ("clawback")."

None of the above would be considered controversial in Australia though the issue of clawback is something that has not yet been widely applied here, notwithstanding the practical difficulties in application of such a practice.

Other responses globally have been very similar to those recommended by the European Commission and comparisons between some of the voluntary guidelines in Australia, such as those published by the Australian Institute of Company Directors, show that our practices and guidelines are very much in line with global best practice. We recognise that the Productivity Commission is/has undertaken its own review of global responses and do not believe it necessary to repeat this review or summarise international responses any further than that done above with reference to the European Commission which suffices to make our point, i.e. that generally guidelines are consistent and effective, making any further regulation unnecessary.

Attachments

HayGroup®

Executive pay for sustainable performance

Restoring investor trust in financial services institutions

Financial services/reward | *February 2009*

The recent financial crisis has exposed financial services companies who have not effectively managed risk. Bear Stearns, Merrill Lynch and Lehman Brothers, three titans who had weathered the Great Depression, World War II and 11 September, could not survive the current economic crisis. In the aftermath of 2008, survivors must redesign risk management and employee rewards to ensure sustainable performance. Investors will increasingly require that executive pay be tied to sustainable performance measured by economic profit to take account of both total capital deployed AND risk.

> Uncertainty in markets persists because investor and creditor trust has been breached in a way that has not been experienced in generations.

In 2008, the global economy suffered the worst economic contraction since the 1930s. Financial services companies that survived the Great Depression, two World Wars and the attacks of 11 September, could not survive the financial crisis of 2008. What's more, despite unprecedented fiscal and monetary interventions by governments and central banks, the global economy remains highly volatile. Uncertainty in markets persists because investor and creditor trust has been breached in a way that has not been experienced in generations. While governments, central banks and regulators have taken aggressive actions to combat the painful symptoms of "frozen credit" and "toxic assets", they are reactive, insufficient and have long-term inflationary consequences. Resolution can only occur by addressing the root causes of the breach in trust.

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Reward programs have operated to encourage the highest risk investments

A concentration of risk

Although the current financial crisis may be the broadest and most severe for many years, financial crises requiring government intervention have been a pattern in the sector. In the recent past we have seen Russian and Latin American sovereign debt defaults, the reinsurance spiral and Lloyds of London collapse, the collapse of Long Term Capital Management (whose principals were supposedly the experts on risk!) and the US Savings and Loans crisis.

The common factor in these crises was the concentration of risk in a few areas that appeared to be producing high returns, without providing adequately for the possibility of a disaster. The concentration of risk has often been disguised by the recycling of the same risks among industry players. Reward programs that pay out a substantial proportion of nominal profits (or even of revenues) have operated to encourage this process, as short-term revenues and nominal profits tend to be highest from the highest risk investments – for so long as the risks do not materialize. Even companies that recognized the risks were afraid to change their reward systems for fear of losing out in the war for talent.

The transparency challenge

Post 2008, investors are demanding from management greater transparency, accountability and long-term performance sustainability than ever before. But transparency in financial services is a difficult goal to attain. Financial instruments are pioneered daily, and it is difficult to adequately describe the complexities of a single transaction, let alone a diverse global portfolio. The credit default swap market illustrates the problem, as it took the dramatic and sudden decline in the housing market to expose the riskiness of the assets. Timeliness is challenging (as we witnessed in 2008) because asset values change on a tick-by-tick basis. To determine the impact of a single change in the bid/ask spread of a highly leveraged asset can be misleading if not presented with great care. The continuing debate on marking to market centers on this issue, and is further complicated by the significant claims attached to any one asset at any point in time.

Finally, the issue of risk-adjusted performance in financial institutions is difficult since there are three categories of risk in financial institutions – credit, market and operating risk. While Basel II has provided a useful standard for "value at risk" and "risk-adjusted return on risk-adjusted capital", even the savviest investors can find these calculations difficult to interpret. Furthermore, transparency and timeliness are critical to these measures having any utility at all from an investor perspective. Highlighting in 2009 in the Bear Stearns annual report that the company was overly leveraged by credit default swaps would not be of much use.

Keeping reward in context

Reward systems have certainly contributed to the problem and need to be radically overhauled. However changing reward so that executives suffer if there is a financial crisis is not the whole solution. Financial crises are infrequent, so they only affect the executives in place at the time; they are also generally (almost by definition) not anticipated, so the possibility of a collapse tends not to affect executive behavior. In addition to changing rewards, therefore:

- financial services companies need to take measures to improve their risk assessment and to ensure that they are not betting the company on a single investment or on investments that are likely to be correlated in an economic or financial crisis. Given the long timescales, this has to be a governance and regulatory responsibility, not driven by reward - though part of top executive reward should be for doing this well;

- they also need to build up reserves against the inevitable losses from time to time, as insurance companies do. Arguably the excess of the risk-adjusted required return over the risk free rate is an "insurance premium" that should be reserved against future losses, not paid out in bonuses (or dividends).

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> The restoration of trust begins with executive pay for sustainable risk-adjusted performance.

Achieving risk-adjusted reward

Executive rewards must be based on measures of corporate performance that take account of the risks to shareholders' capital inherent in the business strategy. Notwithstanding complexity, investors will no longer be satisfied with the "too complicated" excuse on risk-adjusted performance management.

Corporate performance must be assessed based on a broad framework of interrelated metrics that influence current expectations. To succeed, the framework must first and foremost be economically sound. The "performance mathematics" must ensure that as levers are pressed, expected values are achieved and perceptions influenced accordingly. Second, it must be comprehensive and balanced. As Drucker reminded us, "we manage what we measure". History is replete with pay-for-performance issues stemming from improvement in "measured" revenue growth offset by "non-measured" expansion in assets or risk. And finally, it must be easy to implement. If it cannot be readily understood and tracked by all stakeholders, it will not work.

The two measures that should be used to tie executive pay to performance are total shareholder return (TSR) and economic profit (EP). TSR is the best de facto measure of long-term corporate performance, despite the difficulties of defining a peer group to measure relative performance and the potential impact of short-term price fluctuations.

EP is fundamentally the return on capital deployed net of its risk-adjusted cost. It is an essential measure because it ensures that return is calculated in the context of both the scale of capital deployed and its inherent riskiness. While this is a more complicated calculation for financial services companies since these companies are essentially "spread" businesses, EP is superior to other metrics like earnings per share (EPS) and earnings before interest, tax, depreciation and amortization (EBITDA) since these do not consider risk and capital deployed.

However, TSR and EP must be managed through a performance framework. Exhibit I is an illustrative example of a performance management framework that connects TSR and EP with actionable enterprise operating metrics. From a board and investor point of view, the framework provides a holistic approach that/and enables effective assessment of "performance" in the context of executive pay.

While this approach is not immune from the aforementioned issues of comparability and complexity, it is a useful paradigm for establishing a standardized approach to performance management. Investors made their voices clear in 2008 and a failure to tackle the problem will no longer be tolerated. The restoration of trust begins with executive pay for sustainable risk-adjusted performance.

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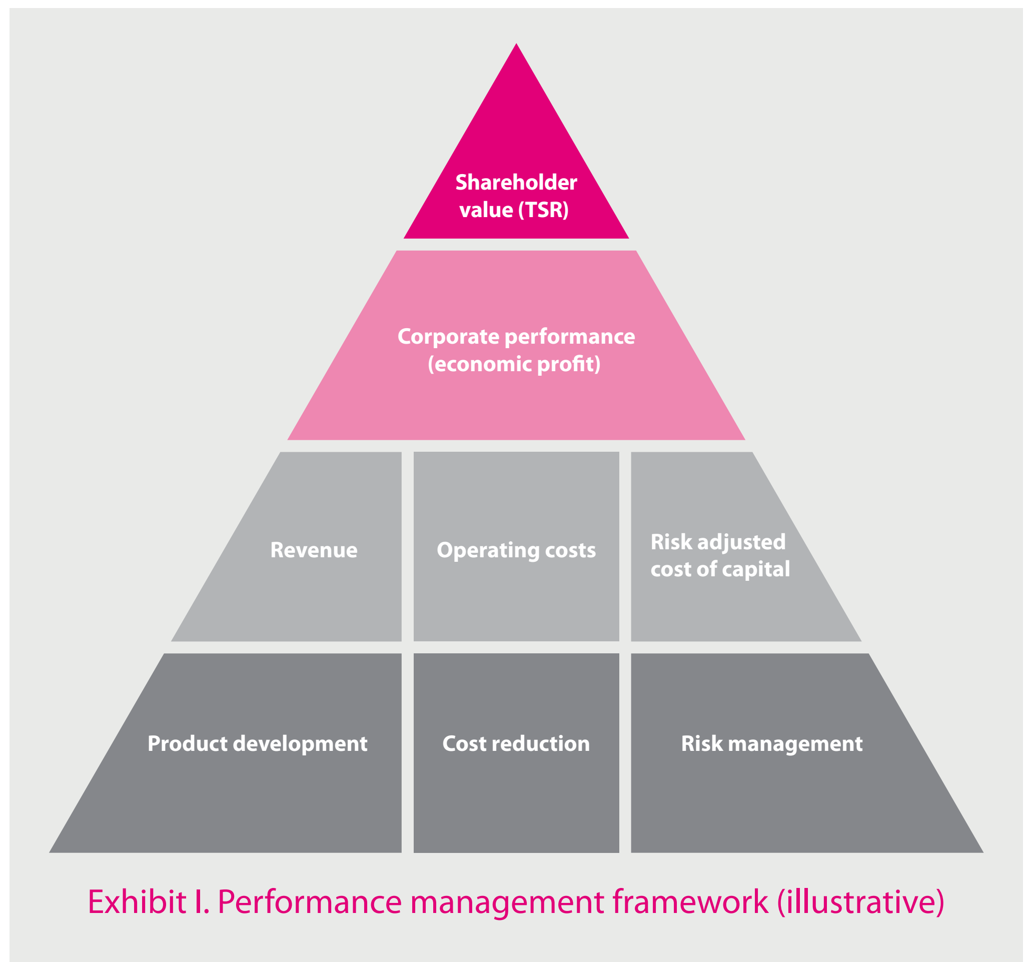

Exhibit I. Performance management framework (illustrative)

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Hay Group is a global management consulting firm that works with leaders to transform strategy into reality and to help people and organizations realize their potential. We have over 2600 employees working in 85 offices in 47 countries. For more information please contact your local office through **www.haygroup.com**.

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Is bonus banking the answer to banking bonuses?

Viewpoint | *December 2008*

Bonus banking is touted by some as the 'holy grail' of incentive structures, allowing companies to balance short term and long term value creation, satisfy their stakeholders' demands for accountability and succeed in attracting, motivating and retaining the talent they need. Regulators are looking favorably on the idea, and some banks have already announced their intention to adopt these structures.

It's a cardinal rule of reward that the more remote the payout becomes, the weaker the incentive.

Unfortunately, bonus banking is far from a complete answer to the issues surrounding incentives in financial services. While they can have many advantages, bonus banking structures are known to be difficult to implement, unpopular with employees, and ineffective at driving performance. They were pioneered by companies using economic profit (profit less risk-adjusted cost of capital) as the primary measure of corporate performance, and many have since quietly abandoned them. Why?

In theory, an appealing idea

Bonus banking describes an incentive scheme where part of the bonus earned is held back in a bonus account, to be paid out in subsequent years. It allows for the declaration of a negative bonus (or "malus") where performance drops, or where the initial assessment of performance turns out to be wrong. It is closely related to a bonus clawback, but has the added benefit of providing the company with some security for repayment.

Bonus banking has an obvious appeal to compensation committees searching for an acceptable approach to incentivizing their people. It reduces the much-criticized reliance on annual performance measures, creating stronger alignment of incentives with medium-term or long-term shareholder value creation. Depending on the measures used, it can lessen the opportunities for 'gaming' the scheme by focusing exclusively on meeting bonus targets at the expense of overall corporate performance. And it reassures stakeholders – shareholders, regulators and the wider community – that the company has some comeback against those who are seen to have caused current problems by their actions in previous years.

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We recommend that our clients avoid the 'me too' approach to incentives, and consider bonus banking to be one of the many options available to them.

But in practice, it's harder than it looks

The primary issue with bonus banking, in our experience, is the greater difficulty of managing and communicating the scheme while maintaining its effectiveness as a performance incentive. It's a cardinal rule of reward that the more remote the payout becomes, the weaker the incentive. Employees – quite correctly – feel their bonus payouts are less secure, and are often unsure about the conditions for vesting or clawback of future payments. Complex multi-year performance measures can dilute the focus on maximizing performance in the current year, without setting clear long-term performance goals.

What's more, bonus banking schemes often have an unintentionally punitive tone. Bonuses can usually only be adjusted down, which can lead employees to feel that failure will be punished, but sustained success not rewarded. This has led to them being highly unpopular, with the consequent risks to retention and performance.

Even where the company leadership succeeds in overcoming these issues, bonus banking is still far from a complete solution. Depending on how it is structured, the scheme can lead to bonuses being paid out in years where overall corporate performance is down, or to former employees who have not contributed to this year's performance – unlikely to be a popular result in the current environment. Performance measures can be difficult to construct, and as a consequence schemes are often based on rolling annual targets, which are less effective in driving a focus on long-term performance.

What's the alternative?

We recommend that our clients avoid the 'me too' approach to incentives, and consider bonus banking to be one of the many options available to them. No one vehicle will ever provide a complete solution, and financial companies need to be clear about their goals and how incentives fit within the larger strategic program before settling on a solution.

There are other options available which, depending on the circumstances, may be more effective than bonus banking. Deferring a part of the annual bonus into time-restricted shares ties the final value of the bonus to the share price – useful for focusing top executive attention on long-term shareholder value, though less effective for those employees without a line of sight to the share price. Basing some incentives on two or three year timeframes – for example risk-adjusted returns based on cash returns rather than profit estimates can reduce the danger of short-term focus.

By no means are we saying that bonus banking should never be adopted. Bonus banking can work, but only as part of an overall strategy that focuses the organization on long-term value creation. It won't by itself guarantee the achievement of a responsible reward program.

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June 10, 2009
TG-163

Statement by Treasury Secretary Tim Geithner on Compensation

For the Say on Pay fact sheet, visit link.

For the Providing Compensation Committees New Independence fact sheet, visit link.

WASHINGTON – Our financial system is built on trust and confidence. It requires rules and practices that encourage sound risk management and align the benefits for market participants with long-term growth and value creation – not only at individual firms, but for our financial system and the economy as a whole.

This financial crisis had many significant causes, but executive compensation practices were a contributing factor. Incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage.

Today, I met with SEC Chairwoman Mary Schapiro, Federal Reserve Governor Dan Tarullo, and top experts to examine how we can better align compensation practices – particularly in the financial sector – with sound risk management and long-term growth.

In considering these reforms, we start with a set of broad-based principles that – with the help of experts like those we assembled today – we expect to evolve over time. By outlining these principles now, we begin the process of bringing compensation practices more tightly in line with the interests of shareholders and reinforcing the stability of firms and the financial system.

First, compensation plans should properly measure and reward performance.

Compensation should be tied to performance in order to link the incentives of executives and other employees with long-term value creation. Incentive-based pay can be undermined by compensation practices that set the performance bar too low, or that rely on benchmarks that trigger bonuses even when a firm's performance is subpar relative to its peers.

To align with long-term value creation, performance based-pay should be conditioned on a wide range of internal and external metrics, not just stock price. Various measurements can be used to distinguish a firm's results relative to its peers, while taking into account the performance of an individual, a particular business unit and the firm at large.

Second, compensation should be structured to account for the time horizon of risks.

Some of the decisions that contributed to this crisis occurred when people were able to earn immediate gains without their compensation reflecting the long-term risks they were taking for their companies and their shareholders. Financial firms, in particular, developed and sold complex financial instruments that yielded large gains in the short-term, but still presented the risk of major losses.

Companies should seek to pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm. Asking executives to hold stock for a longer period of time may be the most effective means of doing this, but directors and experts should have the flexibility to determine how best to align incentives in different settings and industries. Compensation conditioned on longer-term

performance will automatically lose value if positive results one year are followed by poor performance in another, obviating the need for explicit clawbacks. In addition, firms should carefully consider how incentives that match the time horizon of risks can extend beyond top executives to those involved at different levels in designing, selling and packaging both simple and complex financial instruments.

Third, compensation practices should be aligned with sound risk management.

At many firms, compensation design unintentionally encouraged excessive risk-taking, providing incentives that ultimately put the health of the company in danger. Meanwhile, risk managers too often lacked the stature or the authority necessary to impose a check on these activities.

Compensation committees should conduct and publish risk assessments of pay packages to ensure that they do not encourage imprudent risk-taking. At the same time, firms should explore how they can provide risk managers with the appropriate tools and authority to improve their effectiveness at managing the complex relationship between incentives and risk-taking.

Fourth, we should reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders.

Golden parachutes were originally designed to align executives' interests with those of shareholders when a company is the potential target of an acquisition. Often, they have been expanded beyond that purpose to provide severance packages that do not enhance the long-term value of the firm. Likewise, supplemental executive retirement benefits can make it more difficult for shareholders to readily ascertain the full amount of pay due a top executive upon leaving the firm.

We should reexamine how well these golden parachutes and supplemental retirement packages are aligned with shareholders' interests, whether they truly incentivize performance, and whether they reward top executives even if their shareholders lose value.

Finally, we should promote transparency and accountability in the process of setting compensation.

Many of the compensation practices that encouraged excessive risk-taking might have been more closely scrutinized if compensation committees had greater independence and shareholders had more clarity. In too many cases, compensation committees were not sufficiently independent of management, while companies were not fully transparent in explaining their compensation packages to shareholders. In addition, existing disclosures typically failed to make clear in a single place the total amount of "walkaway" pay due a top executive, including severance, pensions, and deferred compensation.

We intend to work with Congress to pass legislation in two specific areas. First of all, we will support efforts in Congress to pass "say on pay" legislation, giving the SEC authority to require companies to give shareholders a non-binding vote on executive compensation packages. "Say on pay" – which has already become the norm for several of our major trading partners, and which President Obama supported while in the Senate – would encourage boards to ensure that compensation packages are closely aligned with the interest of shareholders.

Secondly, we will propose legislation giving the SEC the power to ensure that compensation committees are more independent, adhering to standards similar to those in place for audit committees as part of the Sarbanes-Oxley Act. At the same time, compensation committees would be given the responsibility and the resources to hire their own independent compensation consultants and outside counsel.

Beyond legislation, I also want to emphasize the importance of the efforts being taken by Chairman Bernanke and the bank supervisors to lay out broad standards on compensation that will be more fully integrated into the supervisory process. These efforts recognize that an important component of risk management is getting incentives right, and we will support the Fed and the other regulators as they work to ensure executive and employee compensation practices do not create unnecessary risk.

Finally, I want to be clear on what we are not doing. We are not capping pay. We are not setting forth precise prescriptions for how companies should set compensation, which can often be counterproductive. Instead, we will continue to work to develop standards that reward innovation and prudent risk-taking, without creating misaligned incentives.

As we seek to strike this balance, the President's Working Group on Financial Markets will provide an annual review of compensation practices to monitor whether they are creating excessive risks. And we will encourage experts in the field – academics, business leaders and shareholders – to conduct their own reviews to identify best practices, emerging positive and negative trends and call attention to risks that might otherwise go unseen.

Many leaders in the financial sector have acknowledged the problems posed by past compensation schemes, and have already begun implementing reforms. But we have more to do to address this challenge, and we look forward to continuing this conversation with a wide range of stakeholders in the weeks and months ahead.

REPORTS

- Providing Compensation Committees New Independence fact sheet
- Say on Pay fact sheet