

Mr David Rush
General Manager
Policy Development
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001
remuneration@apra.gov.au

Proposed extensions to governance requirements for APRA-regulated institutions

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

Remuneration systems are powerful management tools for directing employee behaviour and decision-making within an organisation. More than 80% of market participants identified compensation as a contributor to the current Global Financial Crisis.¹ The Financial Stability Forum (FSF) identified how a short-term profit focus negatively impacted on the long-term risk positions of institutions.²

With little regard to material risks, performance-based remuneration has cascaded down through organisations from executives to customer-facing staff; sales targets have been introduced wherever possible, including areas that were traditionally service-oriented such as customer service officers and tellers.

This cultural shift to a short-term focus has not only contributed to the current crisis, but has also encouraged organisations to consider short-term responses with long-term consequences. In the Australian financial sector there has been significant redundancy³ and the removal of competitors.⁴ As the global economic downturn continues, more issues may emerge.

While we support most parts of the Governance Standards, there are significant opportunities to better achieve the intent of the Financial Stability Forum (FSF) Principles. In summary, the FSU believes:

¹ Multiple studies cited in 'FSF Principles for Sound Compensation Practices', *Financial Stability Forum*. P4. 2 April 2009

² Ibid, p1

³ Organisations that have shed more than 500 jobs include ANZ, Babcock & Brown, CBA, GE Money, IAG, Macquarie Bank, Suncorp and Westpac.

⁴ In the Credit Union market there have been 26 mergers in the last two years, and four are currently proposed. Second tier banks (St George and Bankwest) and non-bank lenders (RAMS and Aussie) have been absorbed by larger banks.

1. Requirements in the *Corporations Act* and accounting standards⁵ that apply to auditors should be applied to remuneration consultants through the proposed Governance Standards,⁶ to improve independence and accountability;
2. The independence of Board Remuneration Committees would be improved by creating a position for employee representatives. Should actual membership of the Committee not be prescribed then genuine involvement with employee representatives during and after the review process should be prescribed by the Governance Standards;
3. The third group of persons covered by the proposed Governance Standard should be redefined to reflect the intention of the Prudential Practice Guide;
4. The requirement for adequate remuneration for risk and financial control personnel should be broadened to all roles covered by the Governance Standards;
5. Employee-related risk measures from the Global Reporting Initiative should be recommended in the Prudential Practice Guide;
6. The use of escrow accounts for holding executive performance based payments that gradually vest during tenure and after retirement should be recommended in the Prudential Practice Guide;
7. Regular consultation with Employee Representatives about potential issues in APRA-regulated institutions will assist the supervisory process;
8. The Governance Standards should explicitly state the additional disclosure requirements that the proposed extensions require.

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

FSF Principle 1: The firm's board of directors must actively oversee the compensation system's design and operation.

Non-executive Directors

The implementation of this principle through the proposed Governance Standards⁷ overlooks fundamental problems with the current design of remuneration systems. The discussion paper⁸ and Prudential Practice Guide⁹ both emphasise the importance of Board Remuneration Committees only containing non-executive directors, implying that this will adequately address independence issues. The FSU believes that this is a welcomed first step in reducing executive influence on remuneration outcomes.

However, we note that many directors are simultaneously directors of other boards and have previously been executives. Examining the major banks, the overwhelming majority of directors have previously worked as executives and hold multiple Board positions. As

⁵ *Audit-related disclosure requirements of the Corporations Act and accounting standards*, Australian Government Financial Reporting Council.

http://www.frc.gov.au/reports/2007_2008_AAIR/2007_2008_AIR-11.asp

⁶ Draft APRA Prudential Standards 510: APS 65-73, GPS 69-77 and LPS 65-73

⁷ Draft APRA Prudential Standards 510: APS 44-51, GPS 45-52 and LPS 41-48

⁸ 'Discussion Paper – Remuneration: Proposed extensions to governance requirements for APRA-regulated institutions', *APRA*, p8. 28 May 2009

⁹ 'Prudential Practice Guide – PPG 511', *APRA*. Paragraphs 3-6, 28 May 2009

most directors have previously been executives, they may be more likely to sympathise with executives in regard to remuneration. Research also suggests that directors who hold multiple Board positions provide excessive remuneration for their CEOs and cater to the CEO¹⁰.

A final independence issue that relates to non-executive directors is that they are not truly independent and may not always have the longer term interests of the company at the forefront of their consideration. The role served by non-executive directors is to advance the interests of shareholders who appoint them. Investors are often looking for maximum, short term returns which can be in direct conflict with efforts to create sustainable business practice and longer-term outcomes.

Remuneration Consultants

In one recent submission¹¹ to the Productivity Commission, Professor David Peetz examines seven theories that explain relative wage growth in executive remuneration. In his submission, the overwhelming evidence supports the 'leapfrog' explanation:

“CEOs are able to disturb relativities in CEO pay and then use their occupational power to attempt to reassert those relativities, imparting an upward bias to aggregate CEO pay unrelated to performance... Remuneration consultants play a crucial role in the 'leapfrog' explanation”

The current process of selective benchmarking and then pegging wages at or above the median of this group each year applies an upward bias. Professor Peetz is highly critical of the role played by remuneration consultants. He cites multiple research¹² that shows the extreme reliance Boards have on consultants above all other sources of information, and describes the way they are integral to asymmetrical pay pegging.

There has been criticism from shareholder groups¹³ as well as research bodies¹⁴ about the current involvement of remuneration consultants in artificially inflating executive remuneration. While some remuneration consultants have suggested that no conflict of interest exists,¹⁵ KPMG recently acknowledged this conflict in a submission on executive remuneration:

“There can clearly be occasions when conflicts of interest can arise for remuneration advisors. This is the case in any number of circumstances for an organisation. It is appropriate that the organisation have controls and systems in place that address conflicts of interest. The most recent and best example of this is the arrangements put in place by companies seeking to address conflicts of interest and independence issues with their auditors”¹⁶

¹⁰ Research cited in “Busy Boards: The Effect of Multiple Directorships on Corporate Governance, Firm Monitoring and Performance in Australia”, Chongwoo Choe and Chander Shekhar. Melbourne Centre for Financial Studies.

¹¹ Submission to Productivity Commission enquiry on Executive Remuneration, Professor David Peetz. 30th May 2009

¹² Ibid. Remuneration consultants were the most important source of information with 67% of Board members regarding it as fairly or very important. A webpoll indicated remuneration consultants were one of the three most significant influences on executive pay. Nearly two thirds of companies had policies for positioning executive pay above the median.

¹³ ASA and ACSI

¹⁴ Riskmetrics

¹⁵ Mercer in their appearance before Productivity Commission on Executive Remuneration, 25th June 2009. p334 of transcript.

¹⁶ Submission to Productivity Commission enquiry on Executive Remuneration, KPMG. 23rd June 2009

The FSU agrees that the model currently used for managing conflict of interest and independence issues with auditors presents the best working model for addressing these issues with remuneration consultants. **Requirements in the *Corporations Act* and accounting standards¹⁷ that apply to auditors should be applied to remuneration consultants through the proposed Governance Standards,¹⁸ to improve independence and accountability.** By requiring remuneration consultants to adhere to the standards already in place for auditors this would assist the impartiality of consultants.

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

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

Board Remuneration Committee composition

In his submission on executive remuneration, Professor David Peetz summarises the intimate relationship between consultants, executives and non-executive directors.

“Private sector executive salaries are typically set by a body like a board remuneration committee. These may include outsiders (that is, senior executives and directors from other corporations) but in Australia they are rarely fully independent of executive influence (Schwab 2009b, Shields, et al. 2003). Particularly in large corporations, this committee typically looks at the results of executive salary surveys undertaken by remuneration consultants, and takes advice from such consultants. The committee members, who identify and network with the senior executives under scrutiny, are easily persuaded that the company needs to pay above the average in order to retain such high calibre executives. Otherwise the company may under-perform and be under threat of takeover. So a large number of firms raise their salaries so that they are paying above the median (the middle of the market), and others paying below the median raise theirs to match the median. Another survey is then published. Companies see that the market rate has risen, and they have to readjust their executives' pay so that they are paying above (or at) the market median again.”¹⁹

It is unlikely that remuneration consultants will ever truly provide advice that is free of executive bias with some even admitting that while appointed by the Board they are

¹⁷ *Audit-related disclosure requirements of the Corporations Act and accounting standards*, Australian Government Financial Reporting Council.

http://www.frc.gov.au/reports/2007_2008_AAIR/2007_2008_AIR-11.asp

¹⁸ Draft APRA Prudential Standards 510: APS 65-73, GPS 69-77 and LPS 65-73

¹⁹ Submission to Productivity Commission enquiry on Executive Remuneration, Professor David Peetz. 30th May 2009

ultimately “engaged by management and not by the board”.²⁰ Given this conclusion and our previous discussion of the ‘independence’ of non-executive directors we would question whether in practice non-executive directors alone are able to perform their duties in respect to remuneration without the influence of executives.

A serious rethink of the Committee composition is required.

The independence of Board Remuneration Committees would be improved by creating a position for employee representatives. By involving employee representatives actively in the process of overseeing and reviewing the remuneration system, this will improve the review process of executives and remuneration of employees more broadly by incorporating the perspective of a committee member who is less-influenced by the pressure of company executives.

Another desirable outcome would be increased efficiency and a reduction in information asymmetry in the employer-employee enterprise bargaining process.

The FSU acknowledges that the concept of formal employee representation is a relatively new concept for Australian companies, but the practice of co-determination in different forms can be observed in most of the EU’s 27 member states. In Germany, where Employee representatives occupy Board positions, there have been many positive outcomes including productivity gains experienced during two severe recessions.²¹ The proposed expansion to Governance Standards to incorporate remuneration issues for staff below executive level will begin to overlap with areas that were traditionally covered by enterprise bargaining. Consequently, we believe that is appropriate to ensure employee representatives are involved throughout this process.

FSF Principle 2: The firm’s board of directors must monitor and review the compensation system to ensure the system operates as intended.

Coverage

The FSU is concerned that the original intent of this principle, and wording of the Prudential Practice Guide is not captured in the Governance Standards. The Prudential Practice Guide recognised that a group of employees with performance-based remuneration could collectively pose a risk to the soundness of a financial institution.²² The guidelines identified the need to review “persons at all levels of the regulated institution who receive performance-related remuneration” and more specifically “lower-level employees”, “transaction-oriented staff and commissioned sales personnel and agents”.²³ We believe this inclusion in the scope of Board Remuneration Committee review was well-considered and appropriate.

However, the relevant Governance Standard²⁴ coverage appears inconsistent with the Prudential Practice Guide coverage by omitting key definitional terms and introducing an ambiguous test for inclusion. The Standard covers “all other employees or agents for

²⁰ Mercer in their appearance before Productivity Commission on Executive Remuneration, 25th June 2009. p334 of transcript.

²¹ ‘Co-Determination, Efficiency, and Productivity’ *Fitzroy, Felix R. and Kraft, Kornelius*, (December 2004). IZA Discussion Paper No. 1442. Available at SSRN: <http://ssrn.com/abstract=643645>

²² ‘Prudential Practice Guide – PPG 511’, *APRA*. Paragraphs 8 and 14(c), 28 May 2009

²³ *Ibid.*

²⁴ Draft APRA Prudential Standards 510: APS 37(c), GPS 38(c) and LPS 34(c)

whom a significant portion of total remuneration is variable and determined by performance measures”.²⁵ This definition limits the scope of review to only individuals with ‘significant’ portions of performance pay, without indicating what that level would be.

For a number of years we have been concerned about the practices of major lenders in focusing on the sale of more and more debt products to Australian consumers. Our members express their concerns to us about the policies and practices of their employers. They are concerned not only by the demand to always pursue sales, but also the impact this may have on their customers.

Again, remuneration incentives are designed to drive desired behaviours. The following example drawn from one major bank highlights the concern:

Bonus (STI) plans for relevant roles are weighted at 40% customer service and 60% business outcomes. Business outcomes are defined as product sales, mortgage lending sales, adjusted revenue beyond target, referrals etc.

The extent of STI potential is:

Area or Branch Manager	60% of base salary
Personal Lending Manager	50% of base salary
Mobile Lending Manager	60% of base salary
Executive Manager	60% of base salary

Considering that base salaries may range from \$60,000 to \$130,000 the STI potential will be a major influence of work priority.

While the structure of incentive schemes for these employees is enormously complex, finance employees are in no doubt about what is the principal qualifier to access the payments.

A recent survey of FSU members revealed that some 85% understood that to qualify for increased remuneration they must first and foremost meet their sales targets.

In further comparisons of member survey data,²⁶ consistent findings are observed in relation to targets. Most employees believe their targets are unreasonable and unachievable and most are pressured to sell inappropriate products to customers.

Some of the practices which are occurring and we believe are wrong include:

- High levels of sales targets for employees to reach. These can include daily or weekly requirements for new accounts, credit cards, lending levels, insurance policies or referrals to financial planners. Some of these targets involve customers taking on more debt.

²⁵ Ibid

²⁶ FSU member surveys: 2009 (1710 member responses so far), 2007 (2000 members) and 2005 (3000 members).

- The bullying tactics which are sometimes resorted to by management to force employees to reach those targets (including threatening to ‘performance manage’ and possibly dismiss employees for failing to sell all the required products).
- Some major Banks now refuse to pay employees across the board pay rises so their pay can keep up with the increasing cost of living. Many Bank employees will not receive any pay rises unless they are assessed as performing to a required level – this includes the meeting of arbitrarily set sales targets. This applied to 68% of respondents to the 2009 member survey.

The problems arising from remuneration structures that overemphasis sales volumes was highlighted in a recent article that appeared in the Sydney Morning Herald regarding financial planners in major banks. In the article the pressure to make sales, whether or not they are in the customers’ interest is discussed in detail, along with remuneration and reward structures that focussed solely on sales.

“An internal email from another ANZ practice manager to a group of planners nominates the planner who earned the highest revenue and the planner who wrote the highest managed investment business, among other dollar-based achievements. The email does not mention the word quality.”²⁷

In October 2008 FSU launched the Charter for Responsible Lending to end the link between sales volume of credit products and pay outcomes for finance sector workers. The FSU believes that by decoupling sales targets from the issuing of debt, the sale of inappropriate financial products would reduce and a focus on customer need would increase. To date no major Bank has been prepared to sign up to the Charter.

Despite the downturn in the economy, very few members report that their targets for the ‘sale’ of credit products have decreased. An FSU web poll at the end of 2008 showed 80% of respondents said their targets had not decreased since the global financial crisis intensified. In fact recent feedback suggests targets have been increased this year.

There are varying levels of roles for customer-facing employees of APRA-regulated institutions. As demonstrated earlier, some will have “significant portions” of their potential total remuneration as performance pay. Others, while as a group clearly have the ability to put the institution at risk, would not receive a “significant portion” of total remuneration as performance pay. Under the Prudential Practice Guidelines APRA would expect the remuneration of these employees to be reviewed, however, as the draft Governance Standards are currently written the status quo will continue unabated. **The third group of persons covered by the proposed Governance Standard should be redefined to reflect the intention of the Prudential Practice Guide.** This inconsistency could be addressed by replacing the Governance Standard²⁸ wording with language from the Prudential Practice Guide:

“all employees and agents who receive performance pay and whose actions individually or as a group could put the institution’s financial soundness at risk”²⁹

Review

The FSU appreciates the general intent of the Governance Standards.³⁰ The requirement

²⁷ Washington, S. “Are you being served” The Sydney Morning Herald. 18 July 2009

²⁸ Draft APRA Prudential Standards 510: APS 37(c), GPS 38(c) and LPS 34(c)

²⁹ ‘Prudential Practice Guide – PPG 511’, APRA. Combining paragraphs 8 and 14, 28 May 2009

to identify “material deviations of remuneration outcomes from the intent (and unreasonable or undesirable outcomes)”³¹ is important for making Boards accountable for the consequences of remuneration decisions. Also, the expectation that a review would be “undertaken at least every three years”³² is appropriate, however if gross anomaly is brought to the attention of the Committee between review periods there should be some requirement to intervene.

The FSU believes the review process should assist and not hinder employer-employee enterprise bargaining. The proposed Governance Standards³³ increase the scope of employees who would be subject to Board review, to include many roles that have traditionally fallen within the scope of enterprise bargaining. We are concerned that if the Board Remuneration Committee is allowed to implement changes to the remuneration of these employees without genuinely consulting employee representatives, the process may be used to adversely affect employee entitlements. Also, changes that are unilaterally imposed by the Board on the compensation system may undermine the process of good faith enterprise bargaining and contravene State and Federal freedom of association legislation.

We propose that Board Remuneration Committees be required to genuinely consult employee representatives as part of the review process. This would ensure that possible recommendations to the Board fully consider the impact on staff and do not interfere or limit the employer-employee enterprise bargaining process. Ideally this would occur by making employee representatives part of the Board Remuneration Committee as discussed for Principle 1. **Should actual membership of the Committee not be prescribed then genuine involvement with employee representatives during and after the review process should be prescribed by the Governance Standards.** Furthermore, any review findings should be produced in the course of enterprise bargaining as ‘relevant information’ in accordance with the legal requirements of good faith bargaining.³⁴

FSF Principle 3: Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

The FSU is fully supportive of any measures that increase the independence of staff engaged in financial and risk control. Separating the remuneration of these employees from the areas they oversee³⁵ and ensuring that “total remuneration packages offered... are sufficient to attract and retain staff with the skills, knowledge and expertise to discharge those functions”³⁶ are both responsible additions to current governance arrangements. We believe that ensuring remuneration levels are adequate so that any

³⁰ Draft APRA Prudential Standards 510: APS 46-47, GPS 47-48 and LPS 43-44

³¹ ‘Prudential Practice Guide – PPG 511’, *APRA*. Paragraph 6, 28 May 2009

³² *Ibid*, Paragraph 9.

³³ Draft APRA Prudential Standards 510: APS 37, GPS 38 and LPS 34

³⁴ *Fair Work Act 2009*, s228(b)

³⁵ Draft APRA Prudential Standards 510: APS 40, GPS 41 and LPS 37

³⁶ ‘Prudential Practice Guide – PPG 511’, *APRA*. Paragraph 19, 28 May 2009

performance payments are not needed to maintain a reasonable income is a welcomed initiative.

The FSF highlighted the need to adequately compensate risk and financial control personnel adequately. The issues raised with underpaying adequate wages included the independence of people in these roles and also “the quality of such employees may be insufficient to their tasks”.³⁷ If compensation of persons in credit-issuing sales roles is inadequate, it follows that the reliance on performance pay is higher and the quality of decisions may be compromised. **The requirement for adequate remuneration for risk and financial control personnel should be broadened to all roles covered by the Governance Standards.**

FSF Principle 4: Compensation must be adjusted for all types of risk.

The current processes for risk adjusting performance pay vary in the weighting applied for risk considerations and how clearly defined the measures are. For example, the 2008 incentive scheme at HBOS applied risk weightings between 25-35% for different roles within its Private Bank³⁸. This may be contrasted with the Commonwealth Bank approach which does not assign a risk weighting to any Retail Network positions.³⁹ Risk assessments at the Commonwealth Bank are conducted to enable performance payment, but vary in terms of objectivity and transparency for different roles. Service roles for example, while still involving sales targets, are entirely qualitative in terms of risk assessment. The FSU is concerned that current risk assessments may be inadequate, unless the Board Remuneration Committee review includes all roles with performance targets that affect the risk position of the institution as indicated in the Prudential Practice Guide and recommended earlier in this report.

The adjustment of compensation to account for both financial and non-financial risk is an appropriate way to encourage corporate social responsibility. The Prudential Regulation Guide correctly identified the compromise on business quality that occurs when performance measures are based mainly on “revenue, volume or market share growth”.⁴⁰ The Financial Stability Forum identified a broad range of management performance indicators,⁴¹ but neglected to mention employee-related measures. An example of performance indicators that are relevant to employees are outlined by the Global Reporting Initiative.⁴²

These areas include:

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

³⁷ ‘FSF Principles for Sound Compensation Practices’, *Financial Stability Forum*. p7. 2 April 2009

³⁸ ‘Incentive Scheme H2 2008’, *HBOS Australia*, July 2008

³⁹ ‘Retail Network KPIs’, *Commonwealth Bank of Australia*, July 2008

⁴⁰ *Ibid*, Paragraph 27.

⁴¹ ‘FSF Principles for Sound Compensation Practices’, *Financial Stability Forum*. Pp2,7,9 and 10. 2 April 2009

⁴² *Labor Practices & Decent Work Performance Indicators*, Global Reporting Initiative, Version 3.0, 2006

Employee-related risk measures from the Global Reporting Initiative should be recommended in the Prudential Practice Guide.

FSF Principle 5: Compensation outcomes must be symmetric with risk outcomes.

For responsible persons,⁴³ the FSU supports initiatives that adjust performance payments where “adverse outcomes that arise during any deferral period lessen the original assessment of the performance generating the deferred allocation”.⁴⁴ To facilitate this process, we believe an escrow service for storing the vested equities and delayed cash payment as suggested by the FSF⁴⁵ is appropriate. A recent working paper described an innovative way of utilising an escrow account to make regular payments to an executive during their tenure and into their retirement.⁴⁶ This ‘dynamic incentive account’ vests gradually to deter short-term actions by the executive and has a ‘rebalancing’ function that maintains the equity to cash ratio. **The use of escrow accounts for holding executive performance based payments that gradually vest during tenure and after retirement should be recommended in the Prudential Practice Guide.**

FSF Principle 6: Compensation payout schedules must be sensitive to the time horizon of risks.

For responsible persons,⁴⁷ the FSU supports measures that delay the payment of performance incentives until the true “outcomes of those business activities can be reliably measured”.⁴⁸ The FSF identified the encouragement for employees to “expose the firm to risks that are unlikely to be realized for some time”⁴⁹ if they are able to collect the incentive before possible negative consequences are discovered. These short-term incentive (STI) payments and the trade-off of long-term value they represent are undesirable. The move by APRA to extend monitoring periods for variable remuneration is a positive step.

STIs for Executives

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

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

⁴³ Draft APRA Prudential Standards 510: APS 37(a), GPS 38(a) and LPS 34(a)

⁴⁴ Draft APRA Prudential Standards 510: APS 36, GPS 37 and LPS 33

⁴⁵ ‘FSF Principles for Sound Compensation Practices’, *Financial Stability Forum*. p12. 2 April 2009

⁴⁶ ‘Dynamic Incentive Accounts’, *Edmans, Alex, Gabaix, Xavier, Sadzik, Tomasz and Sannikov, Yuliy*, (June 29, 2009). Available at SSRN: <http://ssrn.com/abstract=1361797>

⁴⁷ Draft APRA Prudential Standards 510: APS 37(a), GPS 38(a) and LPS 34(a)

⁴⁸ ‘Prudential Practice Guide – PPG 511’, *APRA*. Paragraph 35, 28 May 2009

⁴⁹ ‘FSF Principles for Sound Compensation Practices’, *Financial Stability Forum*. p12. 2 April 2009

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

Bank	STI %	LTI %	Base Salary %	Target STI payment based on salary
ANZ	33%	33%	33%	\$3.27 million ⁵⁰
CBA	55%	17%	28%	\$6.13 million
NAB	30 – 40%	30 – 50%	25 – 35%	\$2.35 – \$4.38 million ⁵¹
SUN	150% of base salary	No LTI target	Unable to calculate	\$2.85 million
WBC	40%	30%	30%	\$4.07 million ⁵²

Target STI and LTI payments to bank executives in 2008

Bank	STI %	LTI %	Base Salary %	Target STI payment based on average of top 5 base salaries
ANZ	45%	18%	37%	\$0.47 million
CBA	60%	10%	30%	\$0.66 million
NAB	25 – 50%	15 – 35%	25 – 40%	\$0.74 – \$2.39 million
SUN	100 or 150% of base salary	No LTI target	Unable to calculate	\$0.78 – \$1.17 million ⁵³
WBC	50%	20%	30%	\$0.41 million

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

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

⁵⁰ Annualised figure based on CEO departure during the reporting period.

⁵¹ Target remuneration is expressed in percentage ranges. This figure represents the possible range of payments.

⁵² Annualised figure based on CEO departure during the reporting period.

⁵³ Target remuneration is expressed in percentage ranges. This figure represents the possible range of payments.

FSF Principle 7: The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

The FSU agrees that sign-on “golden handshakes” and termination “golden parachutes” for incoming and outgoing executives; are generally inconsistent with prudent practice⁵⁴ and we would be supportive of phasing these payments out all together. Where termination payments are made to executives they should be capped at no more than one year’s base pay in total. The acceleration of vesting periods should not occur, and the organisation should not enter into agreements with the executives that offset their tax obligations.

Payments made to finance executives during last year of tenure

Organisation	Name	Salary	Termination	Total Amount
<i>CBA</i>	Chris Cuffe	\$2.82 million	Unknown	\$32.75 million
<i>AMP</i>	George Trumbull	\$0.86 million	\$7.50 million	\$14.08 million
<i>NAB</i>	Frank Cicutto	\$0.68 million	\$6.62 million	\$7.54 million
<i>SUN</i>	John Mulcahy ⁵⁵		\$2.4 million ⁵⁶	
<i>ANZ</i>	John McFarlane	\$2.08 million	\$0.92 million	\$6.75 million
<i>SUN</i>	Steve Jones	\$0.25 million	\$2.05 million	\$6.70 million
<i>WBC</i>	David Morgan	\$0.63 million	Not indicated	\$6.28 million
<i>AMP</i>	Tom Fraser	\$0.89 million	\$4.68 million	\$6.10 million
<i>AXA</i>	Geoff Tomlinson	\$1.21 million	\$4.16 million	\$5.56 million
<i>NAB</i>	Peter McKinnon	\$0.69 million	\$1.30 million	\$3.39 million
<i>AMP</i>	Tim Wade	\$0.57 million	\$1.96 million	\$3.28 million
<i>NAB</i>	Ian Scholes	\$0.28 million	\$2.24 million	\$3.26 million
<i>AMP</i>	Paul Batchelor	\$1.33 million	\$1.4 million	\$2.92 million
<i>NAB</i>	Mike Laing	\$0.59 million	\$1.23 million	\$2.86 million
<i>NAB</i>	Ian Crouch	\$0.74 million	\$0.98 million	\$2.85 million
<i>AMP</i>	Warwick Forster	\$0.46 million	\$1.74 million	\$2.83 million
<i>AMP</i>	Gary Trail	\$0.12 million	\$2.06 million	\$2.19 million

Source: Annual Reports⁵⁷

⁵⁴ ‘Prudential Practice Guide – PPG 511’, APRA. Paragraphs 57 - 58, 28 May 2009

⁵⁵ Total payment will be unknown until 2009 annual report is released.

⁵⁶ “Suncorp's John Mulcahy paid \$20m as company loses \$20b”, *Courier Mail*, James McCullough. February 6 2009.

⁵⁷ *Termination Benefits for Executives of Australian Companies*, Geof Stapledon. Sydney Law Review, Volume 27, No.4, 2005.

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

The FSU finds termination payments that are beyond one year's base salary excessive and offensive, particularly in circumstances of poor performance. The FSU would like companies to revise current severance arrangements as was recently done at QBE to reduce Frank O'Halloran's retirement benefit from \$7.35 million to \$2 million.⁵⁸ Additionally, the FSU believes boards should be able to reduce the size of executive termination payments in light of poor performance as was the case when Paul Bachelor's termination payment from AMP was significantly reduced.⁵⁹

With respect to mergers and acquisitions, payments should only be eligible if the executive is made redundant and not re-employed by the new entity. In one recent example, \$44 million in cash and shares were paid to departing executives of Promina during its acquisition by Suncorp despite some being re-employed as consultants.⁶⁰ In addition to \$8.1 million in termination payments, Mike Wilkins received \$1.5 million to provide consultancy for a period of six months. Executive remuneration loopholes that allow practices such as these should be prohibited.

Hedging

The prohibition of hedging in the Governance Standards⁶¹ is welcomed by the FSU. This position is consistent with ACSI and ASA positions, and acknowledged as best practice by Deloitte.⁶² An example 'hedging' policy that would comply with the Standards can be found in the Westpac Annual Report:

"Hedging refers to using financial products to protect against or limit the risk associated with equity instruments such as shares or securities employees may receive as part of their performance-based remuneration. Under our policy, participants are strictly forbidden from entering into hedging arrangements in relation to their unvested employee shares or securities, whether directly or indirectly. If a participant attempts to hedge unvested shares or securities those instruments are liable to forfeiture."⁶³

FSF Principle 8: Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.

The role of proactive supervision within the finance sector is essential to avoid market failures. We note and endorse the Uni Global Union EU policy on Director's Remuneration in reference to the role of supervisors:

⁵⁸ "Shareholders told that golden parachute for insurer QBE chief executive is 'excessive'", *Herald Sun*, Fleur Leyden. April 2 2009

⁵⁹ "Hasty deal secures riches for former CEO", *The Age*, Malcolm Maiden. May 23 2003

⁶⁰ "Execs grab \$44m bonanza", *Sydney Morning Herald*, Danny John. March 6 2007

⁶¹ Draft APRA Prudential Standards 510: APS 41, GPS 42 and LPS 38

⁶² *Executive Remuneration: Best Practice Principles and Guide*, Deloitte. November 2003

⁶³ *Westpac Annual Report 2008*, Westpac. p47

“In the finance sector, prudent supervision should oversee that remuneration structures at all levels – incl. sales and advice functions – are appropriate and risk conscious. Authorities should be able to penalise inappropriate practice.”⁶⁴

Unfortunately, as the most recent market failures demonstrate, banks are adept at finding new ways of circumventing regulation and there is often a lag time between emerging practice and a regulatory response. One way of addressing this issue is to include employees in the supervisory process to obtain timely and accurate information. This group of stakeholders are aware of the inner workings of the financial institutions that employ them and are able to identify potential problems as they arise.

Regular consultation with Employee Representatives about potential issues in APRA-regulated institutions will assist the supervisory process. As the Union for Finance workers, the FSU is in a unique position to provide APRA with current information on emerging issues. Our members provide us with information as situations happen in their workplace, which we in turn could raise with APRA for supervisory investigation. We note and endorse the Uni Global EU policy on Financial Supervision:

“Structured dialogue should be established between unions representing financial workers and financial supervisory agencies at all levels to address operating procedures, work practices affecting companies’ risk management and the stability of the financial system”⁶⁵

Under the Act, APRA has the powers “to do anything that is necessary or convenient to be done for or in connection with the performance of its functions”.⁶⁶ With this broad mandate, the FSU would expect supervisory action beyond “the imposition of additional capital requirements”⁶⁷ if organisations failed to comply with the intentions of the Governance Standards. Most Australian financial institutions have capital adequacy well above the minimum requirements, and with no indication as to the magnitude of this imposition the potential impact is unclear.

FSF Principle 9: Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

The Financial Stability Forum is clear on the importance of disclosure to stakeholders⁶⁸ and “should cover all the elements of the Principles and extend well beyond the details of the compensation of a handful of senior executives”. The FSU fails to see how this principle is adequately “catered for under the *Corporations Act 2001* and, for listed companies, under Principle 8 of the ASX Corporate Governance Principles”.⁶⁹ Current compliance with remuneration disclosure requirements of the *Corporations Act* is debatable. For example, the *Act* requires detailed summaries of performance pay conditions,⁷⁰ but the level of detail disclosed by organisations varies enormously. The

⁶⁴ ‘EU Policy on Remuneration in the Finance Industry’, *Uni Global Union*. 14th April 2009

⁶⁵ ‘EU Policy on Financial Supervision’. *Uni Global Union*. 14th April 2009

⁶⁶ *Australian Prudential Regulation Authority Act 1998, 11(1)*

⁶⁷ ‘Proposed extensions to governance requirements for APRA-regulated institutions’, *APRA*, 28 May 2009, p9

⁶⁸ ‘FSF Principles for Sound Compensation Practices’, *Financial Stability Forum*. Pp 13-14. 2 April 2009

⁶⁹ ‘Proposed extensions to governance requirements for APRA-regulated institutions’, *APRA*, 28 May 2009, p8

⁷⁰ *Corporations Act 2001*, s300A(ba)

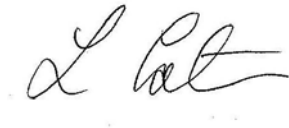
ASX principles are helpful for remuneration committee disclosure, but only apply to listed companies

The Governance Standards should explicitly state the additional disclosure requirements that the proposed extensions require. Two of the disclosure requirements not covered by the *Corporations Act* or ASX principles include:

- Remuneration Consultants – whether they were used and the extent to which their advice was relied upon.
- Review outcomes – whether significant changes were made to remuneration and the nature of those changes.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'L Carter', written in a cursive style.

Leon Carter
National Secretary
24 July 2009