GRG Remuneration Review

Executive Remuneration & Global Financial Crisis

Remuneration Review No. 10

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INTRODUCTION

At the time of writing this article there has been considerable comment and reaction in relation to what has been perceived as the possible role of executive remuneration in contributing to the current global financial crisis.

This GRG Remuneration Review provides a broad overview of the current situation and then canvasses aspects that relate to executive remuneration.

OVERVIEW OF SITUATION

As a starting point, it may be helpful to outline what appear to be the relative positions of broad groups of companies. For simplicity, we have selected two broad categories being:

- Villains, which are companies in the financial services sector which had a significant involvement with sub-prime loans which led to the current financial crisis.
- Victims, which are companies that were not villains i.e. did not have a significant involvement with sub-prime loans but have been adversely impacted by the financial crisis.

Given that Australian banks seem to have emerged largely unscathed by sub-prime loan losses the following is presented as a broad overview:

Major Involvement With Sub-prime Loans (Yes = villains, No = victims)

Regions	Financial Services Sector Companies	Other Companies
USA, UK & European	Villains	Victims
Australia	Victims	Victims

This GRG Remuneration Review does not seek to canvas the roles played by ratings agencies and auditors, other than to point out that they were giving strong credit ratings and clean bills of health, respectively, to many financial institutions not long before they became terminal.

GRG Remuneration Reviews are articles to assist directors and senior executives who have responsibilities in relation to Board and senior executive remuneration and other human resources issues. Their role varies between articles with some aimed at stimulating critical thinking, others updating information and others simply acting as a reminder of principles and approaches where awareness may need to be heightened.

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If executive remuneration has contributed to the current financial crisis, then it follows that it would have only been the remuneration practices of companies heavily involved in sub-prime loans and they seem to have been concentrated in several overseas countries. This is depicted in the following table.

Role of Remuneration in Causing Global Financial Crisis

Regions	Financial Services Sector Companies	Other Companies
USA, UK & European	**Possible contribution by some**	**None**
Australia	**None**	**None**

OVERSEAS REACTIONS IN RELATION TO EXECUTIVE REMUNERATION

Two Broad Reactions

Overseas reactions to the possible contribution that executive remuneration may have had to the global financial crisis have fallen into two broad categories being:

- Specific conditions that are attached by governments to the provision of financial assistance to banks that have sought to avail themselves of the opportunity for such assistance, and
- General guidelines that have been released for consideration and use by companies in the financial services sector, particularly banks.

Specific Conditions Applicable to Bailed-out Financial Institutions

Specific conditions have been imposed by the USA government in relation to remuneration of senior executive officers (SEOs) which are the CEO, CFO and the 3 other highest remunerated officers of the company. These conditions apply to companies in receipt of government financial assistance i.e. those in which the US Treasury holds an equity or debt position. The conditions fall into the following four categories and apply so long as the financial assistance continues to be provided:

1. Limits need to be placed by Remuneration Committees on remuneration to prevent incentivising SEOs from taking unnecessary and excessive risks that threaten the value of the financial institution.
2. The financial institutions need to provide for recovery of any bonuses or incentive remuneration paid to a SEO if the financial criteria it was based on were later proven to be materially inaccurate.
3. Financial institutions are prohibited from making "golden parachute" payments to SEOs. A "golden parachute" is any payment in the nature of compensation to a SEO made on account of an "applicable severance from employment" to the extent that the aggregate present value of such payments equals or exceeds an amount equal to three times the SEO's base amount which is generally the average annual compensation over the five years prior to the severance. The term "applicable severance from employment" means either by reason of involuntary termination of employment or in connection with any bankruptcy filing, insolvency or receivership of the financial institution.
4. The limit on tax deductible remuneration has been reduced from US$1 million pa to US$500,000 pa but does not apply to "performance based compensation" and certain deferrals of income. Why they would even continue this limit on deductibility let alone reduce it makes little sense when it is recognised that the limit itself may

have contributed to the financial crisis by discouraging remuneration in the form of salary and encouraging remuneration in the form of incentives which have been blamed for contributing to the global financial crisis.

Other countries have imposed or may be expected to impose restrictions addressing similar issues e.g. in Germany a limit of €500,000 has been imposed on the size of salaries being paid to bank managers where the government has bailed out the bank.

General Guidelines

The guidelines that have been released will have implications beyond those financial institutions receiving government financial assistance and will most likely lead to changes in remuneration practices for executives outside the financial services sector.

Two sets of guidelines that have been released and may be relevant are:

- "Principles of Conduct" released by the Institute of International Finance (IIF) based in Washington, DC, and
- "Criteria for 'Good' and 'bad' remuneration policies" released by the Financial Services Authority (FSA), a UK regulator.

Principles of Conduct

The principles released by the IIF are as quoted below:

Principle i: Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital.

Principle ii: Compensation incentives should not include risk-taking in excess of the firm's risk appetite.

Principle iii: Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.

Principle iv: Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organisation as a whole.

Principle v: Incentive compensation should have a component reflecting the firm's overall results and achievement of risk management and other general goals.

Principle vi: Severance pay should take into account realized performance for shareholders over time.

Principle vii: The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

Criteria for 'Good' and 'bad' remuneration policies

The criteria released by the FSA for financial institutions generally are as quoted below:

a) Measurement of performance for the calculation of bonuses	
Bad or poor practice (firm view)	**Good practice (initial thoughts)**
Calculated on the basis of revenues, without any counterbalancing risk controls	Calculated on profits, and by reference to other business goals if appropriate

a) Measurement of performance for the calculation of bonuses	
Bad or poor practice (firm view)	**Good practice (initial thoughts)**
Does not take risk or capital into account	Uses a measure of risk-adjusted return. Measure likely to be based upon economic capital calculation, and should take proper account of a range of risks including liquidity risk.
Performance assessed entirely on the results for the current financial year	Performance assessed on a moving average of results (linked to deferred compensation, see below)
Employee bonuses calculated solely on the basis of financial performance	Bonuses awarded take into account appraisal of other performance measures, including risk management skills, adherence to company values and other behaviours.

b) Composition of the remuneration	
Bad or poor practice (firm view)	**Good practice (initial thoughts)**
Remuneration which has little or no fixed component	Fixed component of the remuneration package to be large enough to meet the essential financial commitments of the employee.
Paid wholly in cash	Appropriate mix of cash and components which are designed to encourage corporate citizenship and alignment of interests between those of the employee and those of the firm. (For example shares, or appropriately priced share options).
No deferral in the bonus element	A major proportion of the bonus element is deferred so that the impact of the performance (see 1 above) in one year on the firm/unit's long term profits can be established.

c) Performance adjusted deferred compensation	
Bad or poor practice (firm view)	**Good practice (initial thoughts)**
Payout of the deferred element is not linked to the future performance of business undertaken in previous years.	A significant proportion of the deferred compensation element to be held in a trust or escrow account, from which funds can only be vested according to rules which take account of the performance of business undertaken in earlier years. Deferred compensation is determined by a performance measure which is calculated on a moving average over a period of several years.

c) Performance adjusted deferred compensation	
Bad or poor practice (firm view)	**Good practice (initial thoughts)**
Performance adjusted deferred compensation schemes can be waived/not enforced despite evidence of poor performance or wrong doing.	Performance adjusted deferred compensation schemes are legally robust and contractually enforced.

d) Governance	
Bad or poor practice (firm view)	**Good practice (initial thoughts)**
No independent oversight of remuneration policies or of remuneration awards to executives or senior staff.	Board level remuneration committee with majority of non-executives. Committee has effective control of remuneration policies across the firm and of individual remuneration awards above a certain threshold.
No process, or no transparent process for managing conflicts of interest.	Areas such as HR and Risk have strong and independent role in setting compensation for the business areas.
Business areas can determine the compensation of staff in risk and compliance.	Compensation for staff in risk and compliance is determined independently of business areas.
Staff have an ability to influence unduly the valuation of their own positions and hence the determination of performance measures. Ability also to front load profit from transactions.	Valuations and risk reporting subject to independent verification.
Incomplete separation of duties between front and back office: ability of the front office to influence back office procedures.	Overall control of the back office vested in operations.

AUSTRALIAN COMPANIES' SITUATION

The Australian Government's responses to the financial system crisis have been to:

- Guarantee bank deposits,
- Guarantee wholesale term funding of Australian incorporated banks,
- Purchase Residential Mortgage Backed Securities, and
- Make a range of grants to pensioners, first home buyers etc.

All of the above were aimed at counterbalancing the negative impact of overseas finance sector events on the Australian economy.

To date the Australian Government has not needed to bail-out Australian financial institutions. Therefore, there is no case for the specific conditions cited earlier, that are being applied overseas to remuneration of executives in financial institutions receiving government financial assistance, to be applied in Australia.

At the broader level, the Australian Prime Minister has indicated that the government would create new rules that discourage excessive risk taking by financial institutions. Presumably this would be along the lines of the FSA approach outlined earlier in this GRG Remuneration Review.

However, the general guidelines cited earlier, are likely to have implications for executive remuneration well beyond the financial services sector. Already, Boards of non-financial sector companies are starting to review their remuneration strategies with particular attention to their executive incentive plans to ensure that they are soundly based and do not contain deficiencies similar to those now recognised as potentially contributing to the sub-prime loans fiasco.

Another proposal that has been aired in the Press has been for a new top marginal tax rate of 50% (51.5% including the Medicare Levy) to be introduced on incomes in excess of AUD$1 million. While the rationale seems to be to penalise highly paid executives it would undoubtedly apply to all taxpayers as it is inconceivable that a higher marginal tax rate would apply to executives, only.

What has not been explained is why executives need to be penalised given that, according to the Prime Minister, “in Australia, we have among the best regulated banks, with the best balance sheets, in the world” – televised address by the Prime Minister on 14 October 2008.

In any event, it is perhaps timely for Board Remuneration Committees to obtain independent reviews of executive remuneration practices for both top executives and other executives. Based on our experience we would expect some tweaking of Australian executive remuneration policies and practice rather than wholesale changes.

Attached in the Appendix to this GRG Remuneration Review is a checklist which reinterprets and builds upon the IIF and FSA guidelines in terms that may be more relevant to Australian companies.

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GRG Contacts

GRG is well positioned to assist boards in reviewing their company’s remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies are among our substantial client base.

GRG maintains databases on director and executive remuneration. We capture all the aspects required to be covered in Remuneration Reports and therefore provide an authoritative source of advice in relation to market practices and emerging trends.

Please feel free to call any of the following consultants on **02 8923 5700**

- Denis Godfrey
- Jeff Smith
- Allan Vernon
- Tony Santiago

More information on GRG may be obtained from our website: www.godfreyremuneration.com

APPENDIX - EXECUTIVE REMUNERATION GUIDELINES CHECKLIST

Remuneration Element/Aspect	Aspects that May be Considered

Remuneration Strategy and Profiles	• Should total remuneration packages have an appropriate mix/weighting of:
	  o base package (salary, allowances, superannuation, other benefits and FBT),
	  o cash short term incentive (STI),
	  o deferred STI with vesting conditions attached, and
	  o long term incentive (LTI) in the form of shares, rights or options with performance based vesting conditions?
	• Should a significant proportion of executive remuneration be in the form of incentives which are performance based?
	• Should the approach, principles, and objectives of incentives be transparent to stakeholders?
	• Should remuneration strategy and profiles reflect the company's stage of evolution and its business plans and strategies?
	• Should remuneration terms and conditions be clearly expressed (less Board discretion), legally robust and enforced? This would include: employment contracts, incentive plan rules and invitations to participate.
	• Should the need for termination payments in respect of past performance be avoided by ensuring that remuneration levels remain market competitive when company and/or market conditions change?

Internal Processes	• Should Board Remuneration Committees have:
	  o a majority of non-executive directors ,
	  o effective control of remuneration policies across the Company, and
	  o effective control of individual remuneration awards above a certain threshold?
	• Should the remuneration of staff in HR, Risk and Compliance areas be determined independently of business areas?
	• Should areas such as HR and Risk have strong and independent roles in setting remuneration for the business areas?
	• Should there be transparent processes for managing conflicts of interest?

Base Package	• Should Base Packages be large enough to meet the essential financial commitments of employees?

Remuneration Element/Aspect	Aspects that May be Considered
STI	• Should STIs o contain a number of components, o not be confined to financial performance of the business unit or individual, and o use measures designed to generate returns for shareholders with acceptable risk exposure and recognition of the cost of capital? • Should revenues be a performance measure for a STI plan (not allowed for executive directors of ASX listed companies) and if so what counterbalancing risk controls should apply? • Should STI performance be assessed on a moving average of results at least for any deferred component? • Should a major proportion of STI awards be deferred so that the longer term implication of one year's performance can be taken into account? • Should STI awards be paid wholly in cash?
LTI	• Should the selection of shares, rights or options have regard to the risk profile of the company? • While total shareholder return may remain the dominant vesting condition, should consideration be given in some companies to whether: o relative TSR performance may encourage excessive risk taking and may reward unacceptable performance, and o absolute TSR performance may encourage a more balanced approach to risk taking and may be more likely to reward acceptable performance? • Should holding periods apply after vesting so as to expose executives to the longer term implications of their plans and decisions but allowing adequate access to accrued benefits so as to be able to fund taxation and other liabilities in relation to the LTI plan? • Should holding periods extend beyond termination of employment for a portion e.g. 25% of LTI awards, so as to expose executives to the longer term implications of their plans and decisions but allowing adequate access to accrued benefits so as to be able to fund taxation and other liabilities in relation to the LTI plan?
Severance Payments	• Should severance payments take into account realized performance for shareholders over time? • Should current levels of severance payments be continued? • Should severance payments seek to replace the executive's Base Package for the period it is likely to take to find an equivalent position rather than length of service?