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2nd September, 2009

Mr Gary Banks AO
Chairman
Productivity Commission
Level 28
35 Collins Street
Melbourne 3000

Dear Gary,

Re: Productivity Commission Inquiry into Executive & Director Remuneration

I am writing on the matter of the above Inquiry, and to elaborate further on an issue that was discussed between the Commissioners and myself at the second day of public hearings in Sydney during May.

I refer to the recommendation AHRI made in its formal submission for the establishment of an Executive Remuneration Code of Practice ('Rem-Code'). At the time of the hearing, and since in a separate discussion with Professor Allan Fels, the Commission has sought further elaboration on what AHRI considers might be contained within such a Rem-Code.

I remain convinced that the items proposed for inclusion in a Rem-Code within AHRI's formal and earlier written submission to the Inquiry remain relevant today. Furthermore, during the last two months, I have convened a group of senior HR directors in ASX100 companies to discuss the prospective content of a Rem-Code. Whilst preferring to be anonymous, they are thought leaders in the HR profession. They also attended a private luncheon meeting at AHRI recently, where Allan Fels was the principal guest.

The principles and components discussed below will be the subject of writings and presentations I will continue to make on this subject, in addition to the material I have already had published and which accompanied the AHRI submission to the Inquiry.

Specifically, AHRI believes any future Rem-Code should contain reference to the following:

1. A Purpose Statement

- The statement of purpose will set out the role of the board in the determination of executive remuneration, and the need for clarity around its relationship to business needs and strategy, reflecting the imperfect market in which executive remuneration is determined, namely a closed and self-regulated executive labour exchange with prices and broader values set by a single responsible party in the form of a board of directors and their delegates in management
- It will cover the impact of globalisation on executive labour price determination
- It will also cover the need for transparency for shareholders and the community:
 - to have appropriate confidence in the exercise of this delegated autonomy in an otherwise closed or private environment, especially where such a large share of remuneration has become both variable and risk-based in nature
 - where the quantum involved requires reasonable review by shareholders as to their overall equity, and that this does not involve an inappropriate transfer of economic rents that are otherwise owing to them as the ultimate owners of the business.

2. Coverage & Definitions

This section will include a statement of the principles that the corporation follows in setting its executive pay. AHRI has identified and recommended a continuation of measuring executive pay on a fixed remuneration / STI / LTI basis, and has said in addition that there should be provision for any

other pre sign-on, and post termination payments or transfers of material remuneration value from a company to an individual executive.

Extensive consideration has been given recently by AHRI as to what constitutes an 'executive' for pay disclosure and reporting

The consensus view of AHRI and senior HR practitioners is that an executive should be defined in two ways within Remuneration Reports:

- Key Management Personnel (KMP) as defined in the Corporations Law. AHRI believes that the full executive remuneration details of KMPs should be disclosed, together with material contract entitlements, especially any pre sign-on or post termination or any ex post material exercises of discretion to confer valuable consideration in their favour. The consensus senior HR view is that if there is a desire to draw this definition of 'executive' more widely, it should be done by varying the current definition of KMP within the Corporations Law, for all relevant purposes under that law.
- Operation Critical Executives (OCEs). This is not a term you will find in the Corporations Law. However, I am aware from working within two large ASX listed companies that this group is often identified internally as the people without whom the company cannot reasonably and materially perform all its necessary functions. Insurance companies occasionally require companies they are covering to identify their OCEs. More usually, identification occurs within the succession planning or talent council processes of a company, which directors rightly see as an essential part of their fiduciary duty. For this OCE group, it should be sufficient to report banded pay data publicly, say in bandwidths of \$10k or \$25k. That data could be further sub-grouped for the three principal elements of pay identified above, plus the total pay outcome, and also market benchmark data could be provided as comparators within the same pay bands, and sub-groups of each band.

- Pay market compa ratios would give some evidence of any pay skewing that may be occurring within a company or by class of pay.
- As a guide, remuneration reporting that extends across more than 10–15% of people in the company probably would not be very helpful or informative, given the fundamental purposes set out above.

3. Process

Any code of practice should include some referenced best practice internal process(es) for the determination of executive pay. The process identified in AHRI's public submission to the Inquiry that refers to the interaction of boards, management and external advisers, has been widely discussed with senior members of the profession and is a framework that has strong and widespread endorsement for inclusion in a Rem-Code.

4. Managing Pay for Performance

There is significant recognition by senior HR professionals that variable pay has at times behaved asymmetrically. The reasons for that are put down to either soft KPI targeting and/or overriding discretion by boards and/or top management when they feel an executive would be at risk of leaving after a poor pay outcome.

There is no doubt that the deferral of incentive pay over future pay periods has merit in terms of allowing the final crystallization of performance and risk prior to any substantially partial or full vesting of performance pay. Criteria for the exercise of any such discretion, and also – at the least within the banded OCE pay data – some recorded measure of its incidence, would seem to be in the public interest.

However, suggestions are being made in other places for overall constraints and inflexible rules on the fixing of shares or weights for remuneration between the fixed, STI and LTI components, and also by time with 'required' deferral rates. AHRI regards such proposals as undesirable given the different value drivers at play within different industries. I would propose as a quid pro quo for allowing corporations continued flexibility to make determinations that the companies should be able to declare, describe and justify remuneration structures, weightings and KPIs on which they choose to rely within their specific industrial context. Furthermore they should advise their policies on incentive deferral and forfeiture, and have their own practice audited against these principles transparently.

5. Risk Transparency of Pay Systems

The case of Nick Leeson and Barings, as well as the NAB foreign exchange fiasco a few years ago, demonstrate that pay systems can occasion systemic risk to a corporation as well as organisational value. Accordingly, having some form of transparent relative ranking for pay risk would seem to be of value. Reward structures are a matter for shareholders to understand and to be confident that the trustees of their equity on the board, are on top of. Criteria to include within the reward-risk algorithm for an incentive pay structure would be expected shareholder value impact, risk, volatility and likely duration.

It should be possible to produce and disclose within the Remuneration Report relative rankings on at least a two-by-two, if not a three-by-three matrix scale on which directors could then exercise their judgement, and then allocate simple rankings to the pay structures of disclosed executives, perhaps also providing some form of overall weighted average pay-risk ranking to the remuneration quantum.

Although APRA is reviewing this matter at present, it's not just an issue for financial services firms. Including this issue within the Rem-Code would seem desirable.

6. Remuneration Reporting

It seems we may be heading into a world with two sets of pay ‘report cards’: the status quo which I call ‘Jumbo-Rem’, and another that is becoming very popular with HR executives and boards which I call ‘Rem-Lite’. The latter will provide, in simple language and terms, the value of senior pay to the individual, and adjust to the contemporary reality of whether variable pay is or is not out of the money. Doing this for a KMP or an OCE – over say a five-year period of STI and LTI issues, their economic lives and when the exercise criteria themselves become live – would provide more informative and valuable results than are available from the status quo of Jumbo-Rem.

It would be preferable if these two report cards were merged but a fog of legal and accounting purity seems to have impeded that from happening to date. The Rem-Code model AHRI proposes would at least define how Rem-Lite aspects could work in practice.

AHRI maintains the recommendation made in its public submission to the Productivity Commission to have a 4 step process for public and shareholder transparency and involvement on executive pay – covering the five-year plan, annual reports as at present but with greater simplicity and emphasis on value to the executive, audits of plan, and transfer of audit qualified items to a shareholder vote. AHRI notes parts of these recommendations are controversial within the profession, but mainly as to whether votes on the various steps should be binding or non-binding.

7. Remuneration Skills and Quality Assurance on the Board

Many of my HR colleagues who sit in the boardroom advising on these matters confirm AHRI’s survey finding that board members too often demonstrate they don’t understand many of the pay concepts, values and applications they are approving. Whilst AHRI holds firm to its earlier recommendations on director

accountability and performance, it is clear that help is needed at the board table. Remuneration skill gaps require positive addressing in terms of updates to the menus of requisite board skills for directors themselves, whether that is like the defined need for OH&S or accounting skills at the board table or for co-option to membership of the board Remuneration Committee.

Furthermore it is clear to AHRI and its senior members that boards need a value enhancing process of audit and review beyond the existing audits on the numerical accuracy of pay outcomes. The absence of such a process with respect to adherence to remuneration strategy and planning on most boards amounts to a stronger reason in support of AHRI's proposal to the Inquiry for a Remuneration Plan to be approved by shareholders, and for the plan to be audited and compared against the Rem-Code. Such a process will drive boards to take the required advice ex ante that they are not necessarily taking now.

You will recall that AHRI has proposed this Remuneration Plan go to a compulsory binding vote. The outcome of more transparent, fairer and more robust pay structures and outcomes will primarily depend on the tenor and strength of Rem-Code itself, and this may be enough to drive conformance to the Rem-Code for such remuneration planning and formal plans, and do so without the need for compulsory shareholder consent. To make that non-binding may take some heat out of the issue, and that may be workable and ultimately effective, but it is not a variant recommended by us.

We remain convinced that matters which are the subject of audit qualification with respect to the Remuneration 5-year Plan, should be excised, held in reserve from payment, and put to a formal and binding vote of shareholders for validation or not, as the case may be.

In summary, AHRI believes the Rem-Code should outline a desirable philosophy on disclosure of remuneration skills and experience on the board, and also of the principles for the conduct and audit testing of remuneration plans and practices.

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8. Adviser Code of Conduct

External remuneration advisers have often lived somewhat meretricious lives with vicarious responsibilities. They must form an essential and effective part of overall governance on pay, but who they are, what skills they rely upon, and the values under which they operate, tend to be shrouded somewhat in mystery. The UK Walker review has recommended they be subject to a Code of Conduct. AHRI is also aware from its reference group discussions that Proxy Advisers seem at times to be capable of exercising somewhat disproportionate power in the negotiation of executive pay plans prior to their distribution to shareholders for approval at a meeting of shareholders. Therefore AHRI recommends inclusion of an Adviser Code of Conduct to cover both groups in the Rem-Code.

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On behalf of AHRI, I trust this conceptual outline provides further assistance to the Commission in its desire to understand more fully what stands behind our proposal for a national Remuneration Code of Practice. Enclosed also is a two page executive summary of the principles underpinning the concept. If I can be of any further assistance or clarification, please do not hesitate to contact me. I wish you and your colleagues well with your deliberations on this important subject.

Yours sincerely,



Peter S Wilson AM
National President

Encl: 'Remuneration – Code and Principles'

Remuneration – Code and Principles

For any Code or Executive Remuneration framework developed by the Productivity Commission going forward, the following principles are recommended by AHRI for both guidance and, as appropriate, inclusion within such a Code:

1. Purpose – any framework should set out its rationale up front – reflecting

- a. The role of the board in the determination of executive remuneration, and the need for clarity around its relationship to business needs and strategy
- b. the nature and operations of the executive labor market
- c. the impact of globalization – both in terms of competition for senior people, and recognition of the responsibility they have for \$billions in shareholder value, and capital at risk
- d. criteria for reasonable transparency on executive pay to shareholders and the community

2. Coverage & Definitions

- a. A Statement of the Principles that the corporation follows in setting its executive pay
- b. Pay should cover Fixed remuneration, short term incentive (STI), and Long term incentive (LTI), and any other material one off or recurring benefit available to an executive between sign on date and departure from the company
- c. Detailed disclosure of executive remuneration should only be for Key Management Personnel (KMPs) as defined under current Corporations law
- d. Any further disclosure should be in form of grouped and statistically banded data for only those executives deemed critical to the operation of the corporation
- e. Pay market benchmark data for the above should also be included

3. Process

- a. Any Code of practice should include some referenced best practice internal process(es) for the determination of executive pay. The process described in AHRI's submission to the Productivity Commission has been endorsed by senior members of the profession as one acceptable model for that

4. Managing Pay for Performance

- a. There is recognition that in the future, incentive based pay or pay at risk needs to be better aligned to actual performance outcomes, and that transparency is required for performance hurdles and also conditions of forfeiture for non performance. Such hurdles and conditions need to be sound and objectively arms length, both in terms of their nature and measurability
- b. AHRI recognizes deferral of incentive pay over future pay periods has merit, in terms of allowing the final crystallization of performance and risk prior to any substantially partial or full vesting of performance pay
- c. AHRI also recognizes that there should be no universal hard and fast rules across all industries for
 - i. shares of the pay mix between Fixed, STI and LTI
 - ii. nor for deferral requirements within at risk pay components, given the different value drivers at play in different industries

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5. Risk Transparency of Pay Systems

- a. It is recognized that certain incentive pay systems can drive not only organizational value but also company wide risk
- b. AHRI sees benefit is some form of risk ranking of incentive pay systems by corporations, and the disclosure within the Remuneration Report of those that might occasion significant risk and reward, inclusive of the rationale behind the company's use of them

6. Remuneration Reporting

- a. AHRI supports dramatic simplification of remuneration reporting, and a change in balance towards a simple disclosure of the economic value to an individual from his or her executive pay – eg for KMPs, having regard to contemporary share market values, and whether share based rewards have vested or not
- b. AHRI maintains the recommendation made in its public submission to the Productivity Commission to have a 4 step process for Public and shareholder transparency and involvement on executive pay – covering a Remuneration 5 year Plan, Annual Reports as at present but with greater simplicity and emphasis on value to the executive, Audits of plan, and transfer of audit qualified items to a shareholder vote. AHRI notes parts of these recommendations are controversial within the profession, but mainly as to whether shareholder votes on the first and fourth step should be binding or non binding

7. Remuneration Skills and Quality Assurance

- a. AHRI has significant research and evidence that remuneration skills on the boards of Australia's medium and large companies need more significant recognition as mandatory, and upgrading – either amongst the Director's stated skill matrix, or on a co-opted basis to either the Board and/or its Remuneration Committee
- b. There is also evidence that the Board remuneration processes would be improved on pay if there were audits within remunerations reports of fidelity to remuneration plans in addition to the present audits on the numerical accuracy of pay outcomes

8. Code of Conduct – Advisers

- a. AHRI believes external remuneration advisers play an essential part in the process of determining executive pay
- b. However it is believed the performance, values, behaviour and relationship of remuneration advisers to a corporation's overall remuneration practices and policies needs both clarification and strengthening in terms of the relevant principles, practices and limits of power
- c. AHRI believes there should be a Code of Conduct developed for such remuneration advisers, and that this or another code should also cover shareholder proxy advisers, who seem at times to be capable of exercising somewhat disproportionate power in the negotiation of executive pay plans prior to their distribution to shareholders for approval at a meeting of shareholders