



Executive Compensation
No longer an art becoming a science?

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Executive compensation

The Australian perspective
 The new environment: Australia & global
 What investors want
 How to achieve it
 The way forward




The Australian perspective

Components of remuneration

- base salary
- short term incentive
- long term incentive
- termination payments

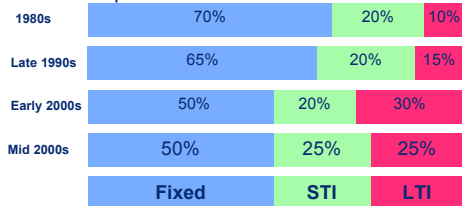
Measuring performance

- CEO performance
- company performance
- the problems

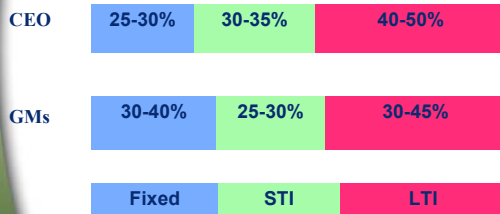


The Australian perspective

Performance based pay
the at-risk component of remuneration



NAB Target reward mix

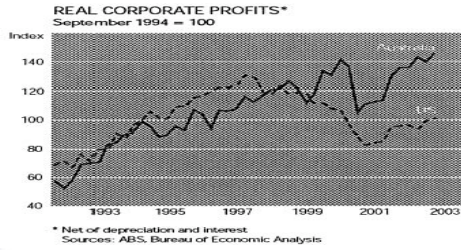


Business Council of Australia Discussion Paper

June 2004 Executive Remuneration Discussion Paper
The pay debate in Australia focussed on a small number of the 1500 listed companies
Australia's current disclosure rules are stringent
Determining executive remuneration is complex and beyond prescriptive rules



The Australian perspective



Performance based compensation

“Recent reports in Australia.....have shown substantial increases in remuneration but without a corresponding improvement in performance....”.

Parl. Joint Committee on Corporations and Financial Services June 2004


The Buck Stops Here: Private Sector Executive Remuneration in Australia
Shields, O'Donnell and O'Brien 2003

What's happened

- 1995 US Congress rejected FASB on expensing
- 1990s Tech boom, economic growth
- 2001-03 Enron, Worldcom, Adelphia, Global Crossing in the US
- 2001-03 One.tel, HIH and others in Australia


The new environment in Australia

Section 300A Corporations Act
ASX Corporate Governance Principles
IFRS2 / AASB2
AASB 1046
CLERP 9
BCA Discussion Paper Executive Remuneration




Objective, purpose of the new environment

- Increased disclosure
- Transparency
- Linking pay to performance
- Identifying the drivers



Remuneration Disclosure

Section 300A Corporations Act 1998
1 July 1998, Directors report to include
Discussion of policy on board and senior executive remuneration
Discussion of relationship between the policy and company's performance
Details of remuneration of directors and 5 officers




Remuneration Disclosure

".....Section 300 and Section 300A of the Corporations Act 2001 are not having their intended effect. Remuneration disclosures, generally, do not discuss alignment with company performance...

The findings help explain why community focus is on headline remuneration, not on alignment of reward...."


Position Paper – Executive Remuneration research commissioned by Public Sector and Commonwealth Superannuation Schemes, Catholic Super Fund and NT Government Superannuation Scheme, 2003



ASX Corporate Governance Council

March 2003
Principle 9 Remunerate fairly and responsibly
 Ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined

- attract and retain
- talented and motivated executives
- enhanced company performance
- relationship between performance and remuneration
- clear remuneration policy




Corporations Law Reform

30 June 2004, CLERP 9
 Extends the disclosure requirements beyond the listed company
 Enhances the specific disclosures
 Gives shareholders more power to hold directors accountable
 Gives shareholders more say on termination payments



CLERP 9

Section 300A amendments
Discussion of board policy on the nature and amount of remuneration
Details of directors and 5 highest paid executives in consolidated group




CLERP 9

Purpose: establish a link between remuneration and performance


"...research...found that remuneration is strongly correlated with the size and complexity of the company, but the link to company performance in terms of return on equity and return on assets is largely absent...."

2004 Parliamentary Joint Committee




CLERP 9

Parliamentary Joint Committee 2004
Boards must link remuneration and performance
"The problem appears to lie in putting this requirement into practice and the lack of willingness by some corporations to comply with this intention.
The Committee sees a clear need for ASIC to take a strong and early stand in making known... that disclosure should explain the basis on which remuneration packages are structured and how this relates to corporate performance."



CLERP 9


Disclosures should explain:
Basis on which remuneration packages structured
How this relates to corporate performance
The specific performance hurdles
Why these performance hurdles are appropriate
Methods used to determine whether performance hurdles are met



CLERP 9

Amends section 300A
The "Remuneration Report" must deal with


- The company's earnings
- Effect of company performance on shareholder wealth over 4 years
- Having regard to total shareholder return (TSR) in that year



CLERP 9

Amends section 300A(I)
Details of 5 named executives of group companies
If no performance condition, why not
For each executive

- explanation of performance related proportion v non-performance related
- value of options at grant
- value of options at exercise
- value of options at lapse
- the aggregate of the values
- the percentage of remuneration that are options
- contract details



The rationale

- Link pay to performance
- Widely held view link not yet made
- ACSI study: "size of CEO's salary has no correlation to the performance of the company..."
 "Performance requirements more like small humps than hurdles..."
- H.Onsman: "... performance pay neither motivates executives nor is linked to organisational performance...They are effective in attracting and retaining executive talent..."

Share-based payments

Calculate the fair value of equity instrument
At grant date
Recognise an expense for the fair value

- straight line
- over the vesting period

Can reverse the expense when fail

- service conditions
- non market conditions

Vesting conditions

Service conditions

- complete set period of service

Performance conditions


- market conditions
- non market conditions

Market conditions

Vesting or exercise subject to the market price of the share
Impacts the initial estimate of fair value
Cannot reverse expenses for SBPs with market conditions that do not vest

Examples

- minimum share price
- specified increase in share price
- total shareholder return



Non market conditions

Vesting not tied to market price of shares
Do not impact initial estimate of fair value
Can reverse expense when fail to vest

Examples

- minimum profit growth
- earnings per share
- business unit performance
- individual performance



What does all this mean?

Acceptance of equity compensation, but
The regulators and the market want:
A significant level of 'at risk' pay
Reward linked to company performance
Plans and policies clearly disclosed
Value of equity compensation recognised



Reward and company performance

Type	Service	Non-Market	Market
Measure	Absolute	Absolute	Relative
Example	Years	EPS	TSR
Reverse	Yes	Yes	No

Performance hurdles

Market conditions: preferred by investors
 Market conditions: lower amount of expense
 Cannot reverse the expense if market conditions not met

Options

Value for employee depends on share price growth
 Can vest, but be underwater
 Long life
 Linkage with shareholder interests

- Yes: require cash to exercise
- No: can ride the market


Super reward when company outperforms

- leverage

Impacted by market cycles
 No downside risk for employee

Restricted shares

Granted with restriction on sale
Value provided on grant
Retention mechanism, rather than incentive
Fixed grant
Inappropriate at senior levels



Performance rights/shares

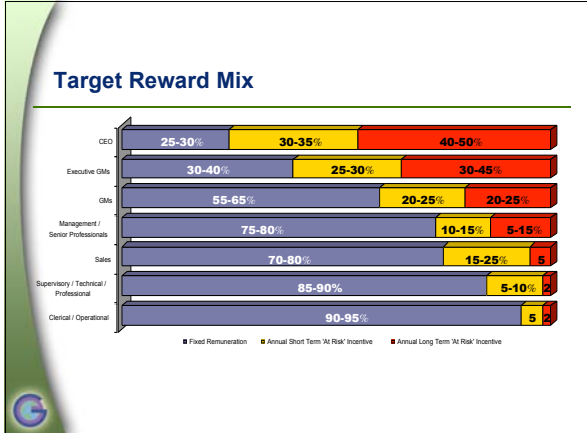
Rights to be granted shares
Specified performance hurdles
No exercise price
Pro rata vesting
Less leverage than options
Known value reward
Potentially unaffected by cycles



National Australia Bank – Reward Philosophy

- Create an environment where people can be motivated with energy and passion.
- Differentiate performance and recognise future potential.
- Manage Total Reward, ie Fixed Remuneration+ Short Term Incentive (STI) + Long Term Incentive (LTI).
- Focus on creating value for shareholders by rewarding employees based on improvements in Earnings Per Share (EPS), Economic Value Added (EVA), Total Shareholder Return (TSR) or a correlated localised proxy.
- Motivate, attract and retain top talent to deliver superior performance.
- Fair and consistent rewards across the organisation to support corporate values.
- Reward employees commensurate with their contribution to the business.





- ### NAB: Key Principles of reward strategy
- The highest performers and those of the greatest value get the greatest reward.
 - Greater emphasis on 'at risk' reward (STI + LTI), with the emphasis increasing with levels of responsibility/criticality of role and with amounts above 'on target remuneration' being deferred in shares with vesting, subject to quality gates.
 - Key performance indicators that include financial and non-financial measures (financial/business management; customer and community; employees; and process, quality and capability leverage).
 - Fixed remuneration is generally targeted to market median levels.

- ### NAB: Performance Management Principles
- Clearly defined objectives
 - Clearly defined behaviours
 - Balanced scorecard format
 - Measure to incorporate compliance, sustainability, behaviours and values
 - Round table agreement of ratings
 - Consistent tools

NAB: Long Term Incentives

- Long-Term Incentive Hurdle:
 - 50% TSR Financials (P51-P76%)
 - 50% TSR Top 100 (P51-P76%)
 - 8 year life to 5 year life
 - 60 day smoothing
- Executive Contracts:
 - termination with the "effluxion of time" - no severance
 - termination on notice - 1 year severance
- Quality Gates (fail either = nil incentive):
 - compliance
 - behaviour
- Long-Term Incentive linked to talent assessment
- Detailed Annual Report disclosure
- STI for Senior Executives – predominantly cash EPS

The way forward?

Basis of executive remuneration
 Greater reward to best performers
 Greater emphasis on 'at risk' reward
 The greater the responsibility, the greater the risk
 Clearly defined financial and non-financial hurdles
 Greater emphasis on performance measurement
 Clear linkage of vesting to company performance

What is the way forward?

Long Term Incentives

- Will continue to be equity based
- Up to 50% of total remuneration
- Mix of options and performance rights
- Market conditions at CEO, senior executive level
- Non-market conditions down the line
- Clearly defined rationale
- Incremental vesting linked to market percentiles
- Five year life

LTIP structures

Combination of performance rights and options

- 50% performance rights
- 50% market value options

Split benchmark groups

- base comparator group
- S & P / ASX Index, with removals

Mix of performance hurdles

- TSR for C-level executives
- EPS with targeted growth over performance period

Incremental vesting from 50 to 100 percentiles

The future?

Even more scrutiny

Art becomes science!

Future Changes

- Impact of accounting changes on LTI hurdles
- Long-term incentive performance hurdle review
- Consolidated STI programs
- Review current Reward Strategy

Questions?

Thank you for your participation

