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Submission on the Banking Executive Accountability Regime Consultation Paper

We appreciate the opportunity to make a submission to Treasury on the proposed Banking Executive Accountability Regime (BEAR). Allan Gray Australia is an Australian-based investment manager with over \$4.5 billion in funds under management, invested on behalf of superannuation funds and retail clients. We are long-term investors in Australian companies from every industry and are currently invested in certain ADIs. We are also active participants in remuneration discussions with Boards of companies in which we invest. Our submission only addresses the remuneration aspects of the current proposals, through a general discussion below and answers to selected questions in the consultation paper.

We understand and applaud some of the policy objectives of the remuneration elements of BEAR. Sound risk management and incentivising a long-term focus among executives are important for ADIs and companies more broadly. However, we believe there are better ways to achieve Government's objectives than requiring a minimum proportion of remuneration to be deferred for four years. In particular, we believe the option should exist for the Boards of ADIs (particularly listed ones) to make awards to executives in cash with the after-tax benefits (roughly 51% of the total award) needing to be invested in that particular ADI's shares. The shares acquired, while being owned directly by the executive, would need to be held by that executive for at least 2 years but preferably 5 years, after they leave the employ of the ADI. Our proposal is set out in the Schedule.

We believe this meets Government's objectives:

- It discourages short-term risk-taking as the executive's shares and hence wealth would suffer directly.
- It is long-term in nature, particularly with appropriate escrow periods. Executives remain exposed to remuneration adjustments resulting from poor decision-making.

But it also has several advantages over the currently prescribed structure:

- Deferral and subsequent vesting, in the minds of most executives we speak to, adds an element of risk to compensation, which results in that risk being priced into all other aspects of remuneration. With shares in hand, executives know exactly what they have and what is at risk.
- Executives will make better capital allocation decisions with shares in hand as they will weigh the benefits of investment in the business and dividends in a more considered manner.

- We believe the cultural and mindset shift of having executives behave more like owners is an important risk-mitigation strategy.
- It is simple to administer and even simpler to value. Deferral and vesting results in all manner of complication, which ends up meaning that no-one actually knows the true value of total compensation. Remuneration in shares provides certainty around costs.

There may well be improvements to our proposed remuneration structure. But we believe the current consultation is too specific in its proposals to defer a minimum amount of variable remuneration. In fact, with the current proposals, it is unclear whether our suggestion would pass muster even though it compels executives to focus on the long-term impact of their decisions. That would be a concern, especially as ADI compensation structures would likely influence schemes adopted by other listed Australian companies. As long-term investors, that would be a disappointing outcome.

Answers to selected questions in the Consultation Paper (from Chapter 6)

6. *Would deferring variable remuneration be likely to result in a shift from variable to base remuneration? Would this be problematic and, if so, can anything be done to prevent this outcome?*

As discussed above, we believe deferral inevitably results in greater base remuneration as executives tend to apply a discount to anything that has not vested immediately. We believe expanding the definition of deferral to incorporate escrowed shares would be an improvement. While the executive would enjoy the benefits of share ownership (e.g. dividends), he or she would not be able to realise the value of those shares until a later date.

7. *What are the complexities in defining variable remuneration, including in relation to non-cash remuneration.*

Suggesting that at least 60% of variable remuneration be deferred is potentially problematic. For non-cash variable remuneration, like the granting of shares, it is likely that almost 50% of that remuneration would need to be paid to the ATO. This is often done by selling a portion of the equity grant to meet those obligations. As a result, the 60% threshold may need to be refined to allow the payment of cash solely to meet tax obligations (as per our proposal).

We would be happy to discuss.

Yours faithfully,



Simon Mawhinney
Managing Director and Chief Investment Officer

Schedule – Proposed Structure

We recommend the following features.

1. The replacement of STIs and LTIs with a single bonus scheme, say an Executive Incentive Plan (EIP).

This eliminates short-term cash bonuses, makes it easier for management to understand, and minimises the number of remuneration structures on which shareholders are expected to opine and vote. Structured well, the EIP should also ensure that management are appropriately rewarded only for good long-term decisions.

2. EIP awards to be free of ALL vesting requirements.

Bonuses are paid for services already rendered and are therefore already earned. We propose abolishing future vesting hurdles which are unnecessarily complex and less important when the awards are used to buy shares (see 3 below). As a general rule, we think that alignment with shareholders is better achieved through the type of award rather than through its vesting conditions (most companies currently do the latter).

3. The after-tax bonus amount is invested in shares in the company, not paid in cash. These shares are purchased on market rather than being issued by the company.

Subject to their performance, executives will have an increasing amount of their wealth invested alongside shareholders.

These shares will rank equally with all paid-up shares in issue – they will carry votes, receive dividends and, importantly, their value will go up or down with the market. Poor decisions or badly executed corporate strategy will likely see a company's share price fall and along with it, the value of this award. Consequently, despite the award being free of vesting hurdles, outcomes will still be symmetrical.

Its simplicity will save significant costs (tax consultants and accountants tasked with approving and monitoring complicated schemes) currently borne by shareholders.

To avoid doubt, where an EIP award of \$1 million is made, this will be paid to the executive in cash with close to 50% being withheld by the company to pay the Australian Tax Office. The 50% cash component will then be used to buy shares on market. Various alternatives are possible that achieve the same impact e.g. the company withholding the entire amount, paying the tax on behalf of the employee as is normal and buying the shares on behalf of the executive.

4. EIP shares purchased are escrowed for a period of at least 2 years but preferably 5 years after executive's employment with the company ends. Ideally, the time period should align with the company's natural capital investment cycle.

Allowing the executive to sell the shares immediately is equivalent to paying the entire EIP award in cash. This would undo the policy objective of better aligning risk with reward.

Australian corporate history is littered with the kitchen-sinking of a company's finances when new executives take the helm. The ills of poorly executed corporate strategy often only manifest themselves years later and then often only with the benefit of fresh eyes. It is only

fair that departing management share in the fruits of their long-term decisions after they leave the company's employ.

Worked Example

A CEO's fixed remuneration is \$1m and the current share price of the company is \$1 per share. The CEO receives a bonus for services already rendered (based on various quantum-determining KPIs) of \$1m.

Of that \$1m, ~\$500k goes to the ATO. The other \$500k is used by the company to buy 500k shares on-market.

From here, two things can happen over the next 5 years before the shares come out of escrow.

- a) **Good outcome:** the CEO executes well in subsequent years, the company pays dividends and retained earnings are invested wisely. In 5 years, the share price is worth \$1.50. The CEO's stake from the first bonus is now worth \$750k, and the CEO has received dividends in the meanwhile. Shareholders are also better off, but the cost of this performance is \$500k.
- b) **Bad outcome:** the company's prospects don't live up to expectations and the share price goes down to 50c. The CEO has felt the pain along with other shareholders as the CEO's stake has dropped to \$250k.