STATE BUILDING SOCIETY LIMITED
24 MAR 1988
GENERAL MANAGER

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F/I.

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23rd March, 1988

Mr D.C. Cleary
General Manager
State Building Society Limited
1 Oxford Street
Whitlam Square
SYDNEY NSW 2000

cc. J. Brown, PMH

Dear Mr Cleary,

TREASURY BONUS SCHEME

Peat Marwick Hungerfords was commissioned by the Society in February 1988 to provide advice in relation to a proposed Treasury Bonus Scheme. Our letter of 16th February 1988 outlines the background associated with that request and details our approach to the assignment. As agreed, our advice covers three main areas:

. A review of the Treasury Bonus System as outlined by the AGM - Finance & Administration in a memorandum dated 2nd February 1988;

. A review of alternative bonus system suggestions;

. Provision of a recommended course of action;

Details are set out in the sections which follow.

Proposed Treasury Bonus System

We agree with the basic philosophy expressed in the memorandum that a bonus system should reward Treasury staff for profitable performance above budget expectation. We also recognise that it is essential that a bonus system be constructed in such a way as to encourage profit generation without causing reduction in portfolio yield as a consequence of trading strategies which are geared solely towards profit generation.

There are four main areas which need to be taken into consideration when considering a Treasury Bonus System, these are:

. Actual profits realised from treasury activities;

- Fluctuations in market valuation of the portfolio or instruments traded;

- Budgeted profit performance as influenced by fluctuations in the marketplace; and

- Operating costs associated with the running of a Treasury Department.

The Treasury Bonus System proposed in the memorandum of 2nd February does seek to address above budget profit performance, to make allowance for operating costs and to consider market revaluation of the portfolio. However, we are uncertain about the proposed method of calculation of Budgeted Trading Profit. Our concerns relate to the definition of terms used in the memorandum and their application in the calculation.

This system appears to be orientated towards calculating bonus entitlements for the Treasury Division, assuming that the Division operates as a single functional entity. However, we suggest that there are two broad functions to be considered within the Treasury Divsion, firstly the generation of an acceptable net return on the liquid assets portfolio; secondly, the generation of profit from trading activities. Recognition of these different activities should be built into a bonus scheme.

The concept of distributing 25% of the calculated Net Trading Profit Surplus is favourable to the Society but may prove to be difficult to explain to Treasury staff who may be used to more direct methods of calculating bonus entitlements. Furthermore, we suggest that it is inappropriate to restrict the upper levels of individual bonus entitlement as this is contrary to the motivational principles of a bonus system.

Finally, we believe that it is appropriate to consider the calculation of bonus entitlements on a quarterly basis and to retain some payments to offset against shortfalls for calculation in subsequent periods.

<u>Alternate Bonus Systems</u>

During the course of our discussion with the Treasurer, a more simple method for the calculation of Treasury Bonuses for trading generated profits was raised.

The suggested method involved the calculation of a budget level for trading profits by multiplying Dealer Salary costs by a factor of 4.0 to achieve an acceptable base level of profit performance. Once this level of performance has been determined, bonus entitlements are accrued to a central pool on the basis of the percentage above budget profit which is generated. This percentage share of above budget profit is increased as the level of profit increases.

This method of calculation is outlined below:

TABLE A

BUDGETED PROFIT = ACTUAL COST OF DEALER SALARIES X A MULTIPLIER OF 4.0

No bonus entitlement is due until Realised Trading Profit reaches Budgeted Profit. Realised Profit above the Budgeted Profit level is distributed to a bonus pool on the following basis:

% Achievement of Budget	Bonus
up to 100%	Nil
100 - 150% @ rate of	15%
150 - 200% @ rate of	25%
200 - 300% @ rate of	35%
300% & above @ rate of	50%

We understand that the practice of using a factor of 3-4 as a multiplier of actual salary costs to determine acceptable levels of profit generation for individual dealers is accepted as generally fair within the wholesale banking marketplace. The major drawback to be considered in this proposal, is that it assumes that all operational costs plus a reasonable level of profit for the Society are covered by utilising a multiplier.

We suggest that the use of a multiplier should only be adopted in those organisations where there is a high level of accurate information available on the actual costs associated with the Treasury Division which will allow the determination of an appropriate factor. A further issue associated with this methodology is that it does not allow for market valuation fluctuations of a portfolio or the instruments which are traded. Therefore, we suggest that this system is inappropriate for the Society.

It should be noted that the Treasurer appears to be comfortable with an approach which includes the determination of a minimum level of yield from the liquid assets portfolio.

Recommended Course of Action

Resulting from our review of the two proposed bonus schemes and our discussions with management and the Treasurer we recommend that the Society considers a two-tier approach to the calculation of entitlements in a bonus pool. That is, the return on the liquid assets portfolio be considered separately from profit generation caused by trading activities.

We recommend that the generation of a Bonus Pool be created through the utilisation of five factors:

- Portfolio Budget (return on the liquid asset portfolio);
- Trading Budget (all instruments traded other than the liquid asset portfolio); and
- Operating Cost Budget Variance (where the operating cost budget includes all direct costs associated with running the Treasury Division);
- Actual Profit;
- Expected profit.

These factors are considered in greater detail below.

Portfolio Budget

definition of cost of funds?

Due to the nature of the Institution, we recommend that a minimum level of return on the liquid assets portfolio be set as a precondition to the generation of any bonus entitlements. This minimum return should include both the net yield to maturity and any income generated from trading activities conducted with the portfolio. This figure will be the Portfolio Budget for the purposes of bonus calculations.

The Portfolio Budget would be strongly effected by market forces and therefore the rate of return would require regular review in light of changing market circumstances. Our discussions indicate that a figure of 1.5% is considered appropriate by the Society for the Portfolio Budget at this time.

Trading Budget

The next factor to be considered is the generation of income from all other trading activities exclusive of the portfolio. We recommend that the Trading Budget be determined by applying a multiplier to the total remuneration packages paid to the dealers. We recommend that this multiplier be initially set at 3.5. For the purposes of this calculation, dealer's remuneration is to be the "Total Cost to the Society" value of those remuneration packages.

x support staff

Operating Cost Budget Variance

costs to be all inclusive & redefined

The third factor to be taken into consideration is variance from Operating Cost Budget. This factor is directly related to the effectiveness of the Treasurer's management of this Division. The Operating Cost Budget should be set by the Society after consultation with the Treasurer and should include all direct employment, processing and technology charges associated with the operation of the Treasury Division. However, only the variance between the actual and budgeted operating costs should be used in the bonus calculation. That is if the Division is managed in such a way that actual costs are less than budgeted costs then the effect will be positive for the bonus pool. Similarily, if actual costs exceed budgeted costs, then there will be a negative effect on the size of the bonus pool.

Actual Profit

The Actual Profit should be calculated by determining the actual interest earned from the portfolio and all trading activities less the cost of the funds used to generate that interest. Unrealised losses on revaluation of the portfolios should be considered in arriving at Actual Profit. It would be inappropriate to distribute a bonus if losses will be realised in a future period.

Expected Profit

Expected Profit comprises Portfolio and Trading Budgets and the Operating Cost Budget Variance.

When the Actual Profit is in excess of the Expected Profit a percentage of this surplus will be allocated to a bonus pool. The difference between Actual Profit and Expected Profit is the Trading Profit Surplus and this figure forms the basis for calculation of bonus pool entitlements. The bonus pool would be created in the following manner:

Table B

1) TRADING PROFIT SURPLUS = ACTUAL PROFIT - EXPECTED PROFIT
(Basis of Bonus Pool Entitlement)

2) BONUS PAYABLE WHEN ACTUAL PROFIT > EXPECTED PROFIT

3) ACTUAL PROFIT = INTEREST/DISCOUNT + TRADING - COST OF FUNDS

4) EXPECTED PROFIT = PORTFOLIO BUDGET + TRADING BUDGET +/- OPERATING COST BUDGET VARIANCE

where

PORTFOLIO BUDGET = NET INTEREST/DISCOUNT RECEIVED + TRADING RESULTS

= 1.5% x PORTFOLIO VALUE

TRADING BUDGET = SUM ("TOTAL COST TO THE SOCIETY" OF ALL INDIVIDUAL TRADER REMUNERATION) x 3.5

The above system allows the calculation of a Trading Profit Surplus which is similar to the one calculated by the previous AGM - Finance & Administration. Once this surplus has been determined, we recommend that the amount of this surplus which is placed in the Treasury Bonus Pool - should be calculated in the manner outlined in Appendix 1. This will form the basis of a Bonus Pool which is to be distributed to Treasury Staff. This pool should be restricted to Treasury Dealing staff. Treasury Support Staff should be remunerated primarily on the basis of fixed remuneration and bonus entitlements should be due as a consequence of operational effectiveness in line with a more broad Society policy.

In reaching this recommendation there are a number of additional issues to be considered. These include:-

- Treasury Budget Committee
- Pool Calculation Frequency
- The Budgetting Process
- Pool Distribution Mechanism
- Communication with Dealers

and they are considered below.

Treasury Budget Committee

x Deputy GM

We recommend that a Treasury Budget Committee be established. This committee should comprise the General Manager, the Treasurer and the AGM - Finance and Administration. As the name implies the key role of the Committee is to set and assess the Treasury Budget targets.

Question of 3.?

Pool Calculation Frequency

We recommend that the calculation of bonus pool entitlements be conducted on a quarterly basis. However, it would be wise to withhold payment of bonus entitlements for at least one quarter to allow for market fluctuations in the following periods. We recommend that consideration be given to making payments to Dealers on a six-monthly basis. That is, at half year and year end only. The quarterly and six-monthly periods should coincide with your financial year to reduce extra administrative costs. The payment of first and second quarter bonuses at the half year should be partial payments. We recommend that between 50% and 70% of bonus entitlement be withheld until year end depending upon an assessment of prevailing and future market conditions. This determination should be made by the Treasury Budget Committee.

at 6 months pay 50% of entitlement

The Budgetting Process

The effectiveness of the budgeting process is central to the success of the bonus scheme. At the conclusion of the budgeting process, figures should be generated which are fair and reasonable to both parties. In our opinion fair and reasonable to the Society means the level of profit expected should be in excess of:

- the profit achievable through conservative yield maximisation strategies implemented through clerical staff; plus

- an additional profit from liquid asset portfolio trading generated by a highly skilled professional; plus

- a return from the dealing staff sufficient to justify the establishment of a trading room.

In relation to the Dealing staff, fair and reasonable assumes that budget expectations are set which are achievable under the prevailing market conditions.

Pool Distribution Mechanism

The determination of individual entitlements from the Bonus Pool warrants some consideration. Given the Society's desire to foster a team approach in the Dealing Room and to implement total dealing strategies which benefit from co-operation between Dealers, it is appropriate to base pool calculations on total Treasury performance. In this instance, it is acceptable that the allocation of individual entitlements be made on a discretionary basis by a small committee. It would be appropriate for these allocations to be determined by the Treasury Budget Committee.

Whilst this arrangement will further the goals of the Society, it should be recognised that there will be individual traders who may find the discretionary allocation of bonus pool entitlements difficult to accept.

Communication with Dealers

Given the emphasis upon the achievement of portfolio budget expectations, it should be recognised that, in addition to their own personal performance, an individual Dealer's bonus entitlement will also be influenced by the effectiveness of the portfolio management strategy which is implemented by the Treasurer. Additionally successful implementation of this strategy is dependent, in part, on the people management skills of the Society's Treasurer and his ability to create and maintain a co-ordinated Treasury Team.

We recommend that to avoid potential misunderstandings by Dealers, this point should be made very clear to all Dealers upon appointment to the Society.

The discretionary allocation of bonus pool entitlements to individual Dealers will to some extent be effected by the relationship that each Dealer is able to establish with the Treasurer. We believe that this factor can be moderated by the mechanism of using the Treasury Budget Committee to decide upon final individual allocations. However, this is also an area which may cause some concern to certain Dealers.

We recommend that this bonus distribution mechanism be made extremely clear to Dealers prior to appointment.

The methods of calculating profit, defining cost, evaluating the market value of the portfolio/instruments traded and determining budgets all need to be clearly understood by both management and staff participating in any bonus system. It is essential for the effective operation of any bonus scheme that these definitions are clearly understood by all parties prior to the implementation of any system.

We wish to add that our experience indicates that the size of bonus payments is an important psychological factor in maintaining Dealer motivation. In our opinion the bonus system recommended above is favourable to the Society. During the initial 12 months of the system it will be very important to monitor Dealer reaction to the quantum of bonus entitlement generated. If the size of bonus entitlement is too small, the Society may run the risk of losing Dealers.

Concluding Comments

The two factors which will be extremely crucial to the success of the systems are the size of the Portfolio Budget and the percentage of the Trading Profit Surplus (Appendix 1) which is shared with the Dealers. The Portfolio Budget should be reviewed on a quarterly basis and the percentage of the pool allocated to the Dealers (Appendix 1) should be reviewed annually.

It should be remembered that all of the criteria used in the bonus system should be regularly reviewed in the light of market conditions. The responsiveness of the budgetting and review process, particularly in relation to the Portfolio Budget is crucial to acceptance of the system by the Dealers and therefore, the overall effectiveness of the system.

We trust that the above advice is of benefit to you. Thank you for the opportunity of assisting you in this important area of the Society's operations. If you have any queries please do not hesitate to contact either Richard Lumley, Peter Donnan or John Hancock at this office.

Yours faithfully,
PEAT MARWICK HUNGERFORDS MANAGEMENT CONSULTANTS

Peat Marwick Hungerfords Management Consultants

R. J. LUMLEY,
Partner.

* Lets do some calculations with 1987/88 results.

CALCULATION OF TREASURY BONUS POOL

Increments

Bdt x 50% = a;	Act-a = b;	If b < a then if not	b x .15 =) a x .15 =)
Bdt x 50% = c;	Act-a-c = d;	If d < c then if not	d x .25 =) c x .25 =)
Bdt x 100% = e;	Act-a-c-e = f;	If f < e then if not	f x .35 =) e x .35 =)
	Act-a-c-e = g;		g x .50 =)

dt = Expected Profit

ct = Actual Profit

Actual Profit/less Expected Profit x 100

* The sum of P1 to P4 as appropriate represents the bonus pool entitlem distribution.