Commonwealth Bank
Commonwealth Bank of Australia
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CORPORATE GOVERNANCE IN THE COMMONWEALTH BANK OF AUSTRALIA

The forthcoming Annual Report for the Bank will contain a statement by the Bank's Chairman, Mr John Ralph, on how corporate governance is practised in the Commonwealth Bank of Australia.

In view of the current interest in the topic, the content of this statement is being released now and is attached for the interest and information of shareholders.

CORPORATE GOVERNANCE IN THE COMMONWEALTH BANK OF AUSTRALIA

Corporate governance of corporations is a subject that has come sharply into focus as the result of some spectacular collapses of corporations in the USA and in Australia, and as a result of concern being expressed in relation to the validity of reported results by some companies.

The Board of the Commonwealth Bank has consistently placed great importance on the governance of the Bank, which it believes is vital to the wellbeing of the corporation. There are two elements to the governance of corporations: performance and conformance. Both are important but it is critical that focus on the latter does not crowd out attention to the principal function of an enterprise, which is to undertake prudent risk-taking activities to

- generate rewards for shareholders who invest their capital,
- provide goods and services of value to customers, and
- provide meaningful employment for employees,

and to do so in a way that contributes to the welfare of the community.

The Bank has for some years carried out an annual review of the Board's performance, and of its policies and practices. These reviews have sought to identify where improvements can be made, and have also assessed the quality and effectiveness of information made available to Directors.

During the last financial year, a more extensive external review was conducted. The consultant who conducted the review interviewed separately each Director and each member of the senior Executive team. Following the review, the Board confirmed a number of significant policies and has also implemented some changes.

Some of the principal features of the Bank's corporate governance, including changes made as the result of the review, are:

- The Nominations, Remuneration and Audit Committees consist only of non-Executive Directors. This has been the established position in relation to the Audit Committee for some time and the CEO has not participated in deliberations of the Remuneration Committee when matters could affect his position.
- The Nominations Committee establishes the criteria for appointment of new Directors and will continue to engage external consultants in the search for new Directors. Before a Director is nominated for re-election at a shareholders' meeting, the Chairman consults with the rest of the Board and reviews the Director's performance before endorsing his or her re-nomination.

- The non-Executive Directors meet annually without any management present. This is in addition to the consideration of the Chief Executive Officer's performance and remuneration which is conducted in the absence of the CEO.
- The positions of Chairman and Chief Executive Officer are required to be held by separate persons, as has been the case since before the Bank was publicly listed.
- The Chairman meets annually with the senior executive team to discuss with them their views of the Board's performance and level of involvement.
- Directors participate in an induction programme upon appointment and in a refresher programme on a regular basis. Directors are also regularly updated in their knowledge of issues, trends and challenges relevant to the Bank, the financial services industry and the economy. This includes sessions with local and overseas experts in the particular fields relevant to the Bank's operations.
- The Board has in place policies, which set out the windows in time when directors can purchase or sell shares in the Bank so long as they do not have price sensitive information. These policies also preclude any trading in Bank shares of a short term nature, In addition, directors are required, in any case, to inform a board committee of their intention to buy or sell Bank shares.
- Directors are required to take a minimum of 20% of their fees in shares in the Bank, acquired at market price, and are required to hold these shares for ten years or until they leave the Board. Non-Executive Directors do not participate in any of the Bank's incentive plans.
- The Board has decided to close the Directors' retirement scheme, which was approved by shareholders at the 1997 Annual General Meeting. The entitlement for current Directors will be "grandfathered" and no new members will be admitted to the scheme.

Audit Committee

The Board of the Bank had an Audit Committee prior to the Bank's listing as a public company and has had an Audit Committee at all times since.

The Charter of the Audit Committee incorporates a number of policies and practices to ensure that the Committee is independent and effective. Among these are:

- The Audit Committee consists entirely of non-Executive Directors, all of whom have familiarity with financial management and at least one has expertise in financial accounting and reporting. The Chairman of the Bank is not permitted to be the Chairman of the Audit Committee.
- At least twice a year the Audit Committee meets the external auditors and the Group Internal Auditor independently of management.
- The Audit Committee is responsible for nominating the external auditor to the Board for appointment by shareholders. The Audit Committee

approves the terms of the contract with the external auditor, agrees the annual audit plan and approves payments to the auditor.

- The Audit Committee discusses and receives assurances from the external auditors on the quality of the Bank's systems, its accounting processes and its financial results. It also receives a report from the Auditors on any significant matters raised by the Auditors with management.
- All material accounting matters requiring exercise of judgment by management are specifically reviewed by the Audit Committee and reported on by the Committee to the Board.
- Certified assurances are received by the Audit Committee and the Board that the Auditors meet the independence requirements as recommended by the Blue Ribbon Committee of the SEC of the USA.
- The Board has in place policies governing the nature of non-audit work which cannot be undertaken by the Bank's auditors for the Bank or its subsidiaries. There are also procedures in place governing approval of any other non-audit work before that work can be carried out. The objective of these approvals is to avoid prejudicing the independence of the Auditors and to prevent their developing undue reliance on revenue from the Bank. The policy ensures that the auditor does not
    - Assume the role of management;
    - Become an advocate for their own client; or
    - Audit their own professional expertise.

  Under the policy, the auditor will not provide the following services:
    - Bookkeeping or services relating to accounting records
    - Appraisal or valuation and fairness opinions
    - Advice on deal structuring and related documentation
    - Tax planning and strategic advice
    - Actuarial advisory services
    - Executive recruitment or extensive human resource functions
    - Acting as broker-dealer, promoter or underwriter, or
    - Provision of legal services.
- The Bank currently requires that the partner managing the audit for the external auditor be changed within a period of five years.

Further details of the functions and relationships of the Audit Committee will be found in the section on Corporate Governance in this year's Bank's Annual Report. The Bank is already materially in compliance with the framework of the legislation recently enacted as the Sarbanes-Oxley Act in the USA. This is largely reflective of the fact that corporate governance in

Australia had generally moved ahead of that in many corporations in the USA.

Executive Remuneration

Executive remuneration is another aspect of corporate governance on which there is much focus currently. Remuneration for the Bank's Executives is determined, after taking advice, to ensure competitive remuneration packages are in place to attract and retain competent and high-calibre staff.

Incentive payments for Executives are related to performance. Short term incentives actually paid depend on the extent to which operating targets set at the beginning of the financial year are achieved. Half of the short term incentive earned is paid in cash and the balance in two instalments at yearly intervals in shares. These instalments are only paid if the Executive is still in the employ of the Bank on the relevant dates.

Vesting of options and shares allocated under the long term incentive plan is directly related to shareholder value, measured by Total Shareholder Return over a minimum three year period, which requires the return to be equal to or higher than the average return of peer institutions for vesting to occur.

Like most Australian companies, vesting of options and restricted shares allocated to Executives is dependent on the Bank meeting the performance hurdles in the plan as approved by the shareholders at the 2000 Annual General Meeting. This differs from the US practice where vesting generally only depends on remaining in employment to the vesting date.

The Bank has restructured its long term Executive incentive plan, effective from the beginning of the current financial year. Previously half the value of long term incentive benefits under the shareholder approved Bank's Equity Reward Plan were paid in Options, valued on the Black-Scholes method, and the other half in Performance shares valued at market price at the date of allocation. These options and shares only vest to the Executive provided the prescribed performance hurdles are met. From the beginning of this financial year options have been eliminated from the remuneration package of Executives and the total value of the long term incentives allocated under the Equity Reward Plan will be in the form of Reward shares.

A further change introduced is that whereas previously allocated options and shares vested upon the average Total Shareholder Return of peer institutions being exceeded, a sliding scale has been introduced so that 50% of allocated shares vest if the Bank's TSR is equal to the average return, 75% vest at the 66th percentile in the index and 100% when the return exceeds the 75th percentile, ie. when the Bank's return is in the top quartile.

Options and shares previously allocated under the Equity Reward Plan will continue until they vest upon the prescribed performance hurdles being met or they lapse.

Currently, restricted shares purchased on market to satisfy incentives earned by Executives are charged against profit and loss as are incentives paid in cash and deferred shares. As from the beginning of the current financial year, total remuneration, which will include the full cost of the plan and also the distribution of shares to employees under the ESAP, will be expensed against profits. A basis of valuation, that takes account of the conditional nature of potential incentive benefits in the Australian environment, will be developed to reflect appropriately the cost to the company.

It is worth noting that of the total distribution of equity to employees in each of the last two years less than 20% went to the senior executive team and the rest to other employees.

Conclusion

This statement has highlighted in some detail the Bank's corporate governance policies and practices to give shareholders some feel for how the Group approaches this important aspect of the Bank's operations.

The philosophy underlying the approach to corporate governance is consistent with the ethical standards required of all employees of the Bank.