Directors' Report – Remuneration Report
for the financial year ended 31 March 2011
continued

3.4.2 Risk is assessed as part of the profit share allocation process

The Board considers that the effective alignment of remuneration with prudent risk taking to be a fundamental criteria for any successful remuneration system. The Board's approach to risk management is to make risk decisions at multiple levels. The Board has always used both executive judgement and quantitative risk measures to determine the quantum of variable remuneration allocations. The quantitative measures are as follows:

– the profit share pool is determined by reference to both profit (not revenue) and earnings over and above the estimated cost of capital. The CRO and the CFO advise the BRC on the risk input into the calculation of the profit share pool
– ROE is taken into account at a Macquarie-wide level and economic and prudential capital usage at a business group level for profit share pool allocation
– the performance hurdle for existing Executive Director options and Executive Committee PSUs to vest is linked to ROE, not TSR.

The Board acknowledges that quantitative risk measures have limitations and, therefore, overlays these measures with executive judgement. Just as judgement is required in managing Macquarie's risk profile, significant judgement is exercised when risk-adjusting profit share allocations. When assessing the performance of businesses and individuals, management and the BRC look at a range of factors, including risk management, governance and compliance, people leadership and upholding Macquarie's *Goals and Values*. The CRO reports to the BRC on the following:

– return on economic capital, by business
– the relationship between profitability and risk (as measured by economic capital usage)
– losses by divisions and by risk type
– the contingent risks associated with large transactions concluded during the current financial year
– Information on significant losses and compliance breaches by individual.

The BRC uses this information when considering the profit share allocated to individual Operating Groups, and profit share allocations to individuals.

In addition to this, the Non-Executive Directors of the Board have discretion to change the quantum of the profit share pool to reflect internal or external factors if deemed in Macquarie's and shareholders' interests, and/or to defer the payment of profit share amounts to a subsequent year at a Macquarie-wide, business or individual level where it is in the interests of Macquarie and shareholders to do so.

The Board seeks to ensure that remuneration is sensitive to risk outcomes in the following three ways:

Remuneration outcomes must be consistent with risk outcomes

Profit share allocations are truly variable. The profit share component is variable upward and downward in response to good or poor performance. The fact that the profit share pool at a Macquarie-wide level is determined by reference to both profit and earnings over and above the estimated cost of capital means that there is generally no available profit share in the event of a loss at a Macquarie Group level other than via the Board's discretion.

Remuneration payout schedules must be sensitive to the time horizon of risks

Under the current remuneration arrangements, the proportion of an Executive Director's 2011 profit share allocation that is deferred and subject to the time horizon of risk ranges from 40 to 70 per cent, and 50 to 70 per cent for Executive Committee members and Designated Executive Directors (70 per cent for the Managing Director and Chief Executive Officer). When PSUs are taken into consideration, the effective deferral rate is increased.

A departing Executive Director's unvested retained profit share is only paid out in the case of genuine retirement, redundancy or in certain other limited exceptional circumstances, and is forfeited in stages if a 'disqualifying event' occurs within two years of leaving. For example, the payment of a departing Executive Director's retained profit share will be subject to forfeiture if it is found that the individual has acted in a way that damages Macquarie, including but not limited to action or inaction that leads to a material financial restatement, a significant financial loss or any significant reputational harm to Macquarie or its businesses.

From 2012, the Board will have discretion to reduce or eliminate unvested profit share amounts (Malus) where it determines that an Employee's action or inaction has caused Macquarie significant reputational harm, caused a significant unexpected financial loss or caused it to make a material financial restatement. For the purposes of Malus, 'Employee' includes Executive Committee and Designated Executive Directors, Code Staff under the FSA Remuneration Code, senior risk and financial control staff and any other staff as determined by the BRC. Consistent with previous arrangements there are no 'golden handshake' payments.

The mix of cash, equity and other forms of remuneration should be consistent with risk alignment

Macquarie adopts a tailored approach to ensure that the retention levels and equity-based remuneration is appropriate given the seniority of the individual and their ability to influence results.