
4 Drivers of executive remuneration

Key points

- In principle, as for other labour, companies will be prepared to pay up to the value of an executive's perceived potential contribution. By the same token, executives will want a remuneration outcome that is at least equivalent to what they can earn elsewhere, or enjoy in other pursuits.
- But information asymmetries loom large in the market for executive services, because of the 'principal-agent' dichotomy arising from separation of company ownership and control.
 - Incentive pay can promote appropriate executive effort and decision-making, but increased pay risk will inevitably require payment of a premium.
 - The efficiency of executive pay outcomes will be influenced by the efficacy of corporate governance arrangements and the capacities of boards, and by shareholder influence.
- There is no single explanation of the rapid growth in executive pay in Australia.
 - Greatly increased scale of many Australian companies, accompanied by heightened competition for the best executives, appears to explain around one-third of observed changes.
 - Increased globalisation has also led to executive remuneration being influenced by overseas trends, including the 'importation' of incentive pay structures from the United States in the 1990s. Increased use of incentive pay has been a major contributor to pay growth.
 - Board weakness is likely to have been a factor in instances of apparent 'rewards for failure', while complex pay structures are likely to have yielded higher payments than anticipated in some cases.
- Enhanced disclosure will have accelerated the adjustment of pay relativities. It will also have encouraged many companies to position themselves above the 'median', leading to increased average pay.
 - But disclosure does not appear to have led to permanently higher rates of pay growth.
- Improved governance arrangements and enhanced remuneration reporting and shareholder oversight, are providing some protection against executives being able to unduly influence their own remuneration. But not all companies meet best practice so it is difficult to be categorical that senior executives have not, or could not, engage in 'rent skimming'.

Analysis presented in chapter 3 shows that growth in chief executive officer (CEO) remuneration was faster on average in the 1990s than the 2000s. Moreover, recent increases in CEO pay (until 2007) came almost entirely from incentive pay rather than base salary. Furthermore, the reduction in average total remuneration across the ASX300 companies in 2008 and 2009 was driven by reductions in incentive pay.

This chapter examines the forces potentially underlying these observed trends. Establishing why executive pay has increased is important to any assessment of whether intervention is warranted and the most appropriate response. The first section considers the ‘market’ for executives, to identify the range of possible factors that can influence remuneration outcomes and the efficiency of those outcomes. The remainder of the chapter analyses changes in these factors and interactions among them that might explain the trends reported in chapter 3.

4.1 The ‘market’ for executives

In some fundamental ways, the market for executives is similar to other labour markets. In principle, employers will be prepared to pay up to the value of a worker’s contribution, while employees will want remuneration (pecuniary and non-pecuniary) that is equal to at least what they can earn elsewhere, or can enjoy in other pursuits. However, the eventual outcome will also be influenced by information available to each party (for instance, about the quality of the person or the nature of the work), and any other sources of ‘negotiating’ power. Such information ‘asymmetries’ are particularly important in the market for executives, because of the principal–agent dichotomy that arises from separation of ownership and control of public companies discussed in chapter 2. There are two main implications for setting remuneration.

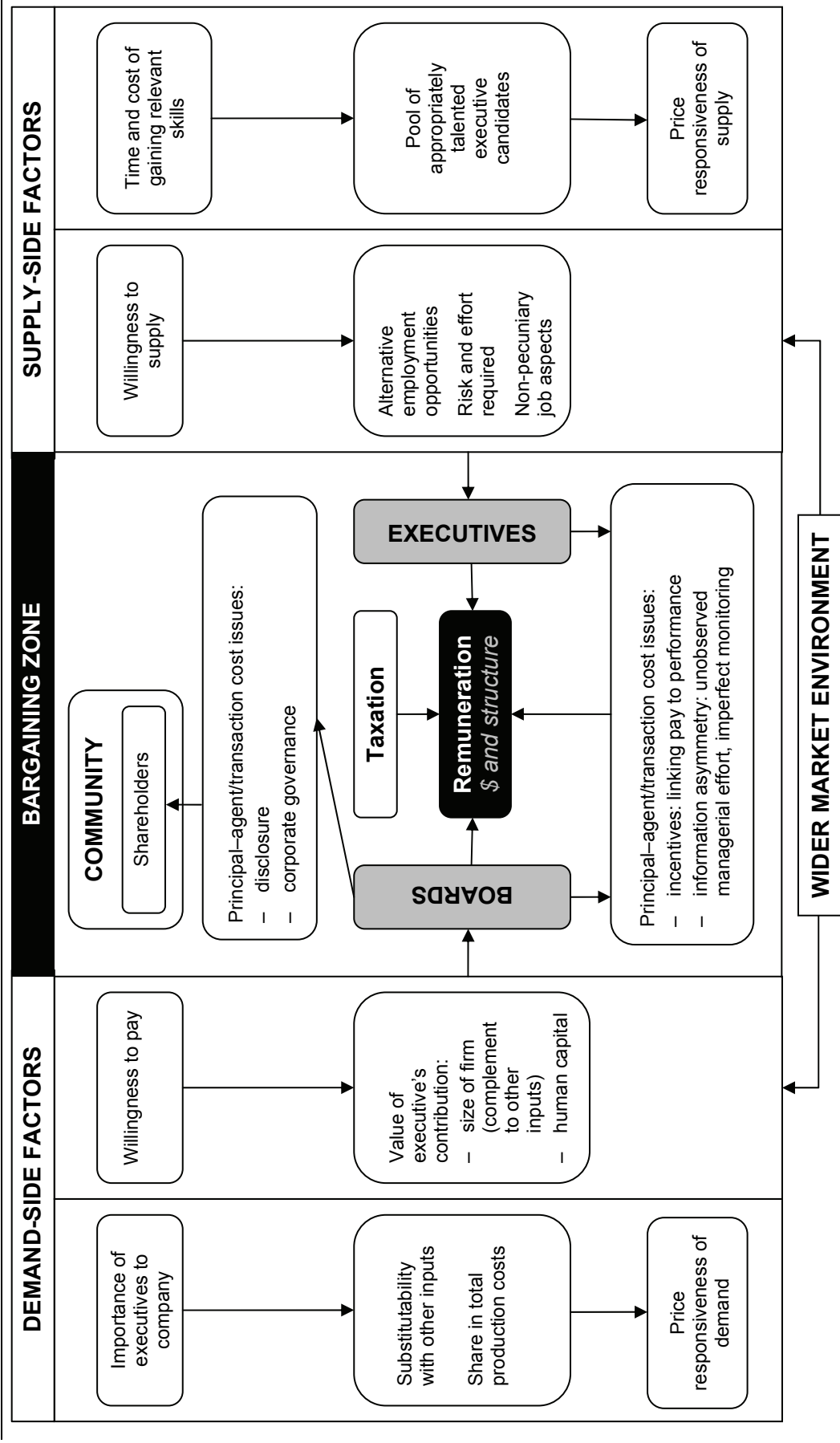
- First, a chief executive performs a distinct and powerful role, with their actions having pervasive effect throughout the company they run. Although executives generally would not wish to harm their reputations by acting in a way that damages their company, their personal goals and perspectives need not always translate into decisions and actions that align with the interests of the company and ultimately shareholders. As *direct* monitoring by the board of the level and quality of executive effort is often difficult and costly, the *structure* of pay can act as an important mechanism for promoting and guiding appropriate executive effort and decision-making.
- Second, a chief executive answers only to the board that hires, rewards and occasionally fires him or her. Consequently, the nature of the relationship, including the balance of power between boards and executives, plays a crucial

role in the negotiation of pay levels and structures and in determining how effective they are in aligning executive actions with company interests in practice. In turn, the degree of alignment between the board's actions and the interests of the shareholder body it represents is crucial for the efficiency of executive remuneration outcomes.

Figure 4.1 depicts the various elements that could have some bearing on observed changes in executive pay outcomes.

- In the panel on the *right* are factors influencing the supply of executive services and the supply 'price' — that is, the minimum, certain, after-tax amount that an executive will require. That minimum will be influenced by: the costs of accumulating the skills, education and experience required for an executive job; potential remuneration in alternative positions (in listed companies or other organisations in Australia or overseas); and the nature of the job, including the risks involved and the effort it demands, as well as any non-pecuniary benefits.
 - The sensitivity of supply to price is a function of the supply of suitable executives. In one sense, the potential supply pool is large as there are many people with managerial experience and qualifications. However, executive quality is likely to vary significantly, with a limited number of executives perceived to have the range of key elements — including judgment, leadership and communication skills — to a sufficiently high degree.
- Demand factors, which influence how much a company is prepared to pay, are summarised in the *left* panel. Broadly speaking, the value of an executive to a company is a function of the task (that is, the contribution of the role to company profitability) combined with the skills and capability brought to it by the individual concerned.
 - The price responsiveness of demand will likely be limited, principally because executive functions can only be performed by executives with appropriate characteristics. Although pay for the CEO is unlikely to form a major component of the firm's total costs, it can have some bearing on pay setting for other company executives and possibly for other employees, which would make companies more sensitive to pay quantum.
- The peculiar 'double-barrelled' principal-agent relationship between executives and boards, on the one side, and between boards and shareholders on the other, is captured in the *middle* panel. Factors influencing this relationship and pay outcomes include: information asymmetries and transaction costs that can lead to potential misalignment between executive actions and decisions and the interests of the company and shareholders; and the efficacy of governance arrangements in place to address conflicts of interest, including scope for executives to set their own pay.

Figure 4.1 Many factors can affect remuneration outcomes



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- Taxation and the broader market and social environment could also influence remuneration design and outcomes, and are included in the middle panel. In particular, the nature of regulatory and market conditions will likely affect the incentives facing all parties. For example, where companies operate in protected markets, executives and boards may be able to take a greater share of profits or pursue a quieter life, with shareholders still able to enjoy high returns (at the expense of consumers). In competitive trade-exposed industries where company performance will be more closely related to executive performance, executives will have a greater need to perform well in order to preserve their position and reputation, and shareholders will have greater incentives to monitor executives. Thus, competition in product and capital markets will place pressure on executives to perform in the company's interests, complementing incentive pay and governance arrangements.

It follows that increases in executive remuneration could result from increases in the supply price or demand for executives, a change in the relationship between boards and executives or, indeed, interactions among any number of such factors. Some factors are potentially of greater potential policy interest than others — essentially those impeding efficient outcomes. As discussed in box 4.1, efficiency requires that all potentially valuable transactions (in the sense that they generate net benefits for both parties) take place, so that total community 'surplus' is maximised.

In the context of the market for executives, efficiency would require that firms hired the most suitable executive for them, paying up to the value of the contribution of the particular executive in that position (including any 'spillover' effects on other employees' productivity). But because each executive will have different abilities, there will not be a single market 'price' — just as there is no single price for differentiated goods and services. Therefore, in a reasonably well-functioning market, differences in executive pay ultimately would reflect different levels of talent and ability in broadly similar jobs, as well as the different nature of jobs. Furthermore, it would be expected that the returns to 'talent' would largely be appropriated by the owners — that is, the executives. In this way, the price mechanism ensures that the most highly-talented executives are allocated to their most highly-valued uses.

Box 4.1 **Executive remuneration and economic efficiency: some theory**

Economic efficiency requires that all potentially valuable transactions take place. In the context of the market for executive services, efficiency means first, hiring the executive with the greatest potential to enhance company profits over time (accounting for the social costs of production) and second, making sure he or she does so.

- To attract the 'right' person, companies may have to pay a premium to match what other potential employers are prepared to pay. This will ensure executives are employed by companies that place the highest value on their services. To that extent, the higher remuneration represents a transfer of producer surplus rather than an efficiency loss. Indeed, without the ability to bid up remuneration to reflect the premium placed on particular characteristics, there could be an efficiency loss from misallocation to lower-valued employment. (Of course, if there were an unlimited supply of identical, equally highly-talented and able executives, there would be no 'scarcity' premiums.)
- As in any market, outcomes will be affected by various 'transaction costs', including the costs of obtaining information and monitoring performance. While transaction costs are real costs and any reduction in them represents an efficiency gain, the costs of reducing them must also be accounted for.
- Information asymmetry pervades the relationship between executives and boards and, taken to the extreme, could only be eliminated by not separating ownership and control and relinquishing the benefits of specialist managers. More realistically, efficiency can be promoted by implementing measures designed to ensure that executives' actions promote profit maximisation over time (such as incentive pay structures, monitoring and governance arrangements), to the point that the incremental benefits they provide equal the costs. Put another way, the potential gains forgone because it is too costly (or simply infeasible) to monitor executives to the *n*th degree, or to design 'optimal' remuneration packages, do not represent a net efficiency loss because they can only be realised by incurring even greater costs.
- The cost–benefit tradeoff and hence the case for action, will be affected by the magnitude of the potential impacts of executive actions. For example:
 - CEOs of large companies have the potential to generate large absolute gains and losses in company and shareholder value, and thus the payoff from efforts by boards to align executive performance with owner interests will be greater
 - performance of some firms might have broader sectoral or community 'spillover' impacts (for example, a loss of confidence in the financial sector) which should be taken into account in assessing whether action on executive pay is warranted
 - even 'overpayments' that involved a relatively small transfer of profits from the company's shareholders to executives, might be interpreted as board 'failure' and, if occurring in a number of companies, undermine investor confidence in corporate governance, with ramifications for equity markets.

Consequently, if remuneration increases were driven by increases in value generated by executives, or increased competition for the most highly-talented candidates, this could be seen as the outcome of a reasonably well-functioning market. Nevertheless, shifts in demand and supply could be driven by inefficient or undesirable external ‘shocks’, such as strong pay growth in the United States. If remuneration increases were underpinned by a diminution in board independence or accountability, this might indicate a poorly functioning market, with adverse efficiency implications — particularly if such remuneration increases were linked to actions that harmed company performance or undermined investor confidence (box 4.1).

4.2 Explaining increases in executive remuneration

A number of hypotheses seeking to explain why executive remuneration has grown in recent decades have been advanced by researchers and practitioners, as well as by participants to this inquiry. Some emphasise the role of imperfections in corporate governance that allow successful rent-seeking to occur. This view, with Bebchuk and Fried its main proponents, is popularly referred to as managerial power theory (box 4.2).

However, the managerial power hypothesis has been challenged by others who consider that market forces have increased both the willingness of companies to pay for executives and the opportunity cost of potential executives, and that these are the primary reasons for the growth in executive remuneration (box 4.3).

Although these perspectives might seem diametrically opposed, they are not mutually exclusive, as Bebchuk and Fried themselves have noted:

Although the managerial power approach is conceptually quite different from the optimal contracting approach [whereby company boards design remuneration packages to maximise shareholder welfare], we do not propose the former as a complete replacement for the latter. Compensation arrangements are likely to be shaped both by market forces that push toward value-maximising outcomes, and by managerial influence, which leads to departures from these outcomes in directions favourable to managers. (2003, pp. 72–3)

In other words, both efficient market influences as well as some degree of failure by boards to set executive pay efficiently, could co-exist.

Box 4.2 **Bebchuk and Fried's 'managerial power' hypothesis**

According to US academics, Bebchuk and Fried (2003, 2004), US executives have the ability to obtain remuneration arrangements that are more favourable than those that would arise from 'arm's length' bargaining processes, due to their influence over 'captive' company boards. Not only is there a principal-agent problem between company owners and managers, there is also an agency problem between shareholders and the boards they elect to represent them.

The ability of executives to obtain higher remuneration, however, is limited by so-called 'outrage' costs and constraints; that is, negative reaction by shareholders, the business media and others, which can lead to reputational embarrassment for executives and company directors.

To extract higher pay, executives (and compliant boards) therefore will seek to 'camouflage' their remuneration arrangements to limit external scrutiny. Bebchuk and Fried contend that US executive pay rose significantly from the 1990s because:

- executives used their influence to obtain significant amounts of option pay without forgoing corresponding amounts of cash remuneration
- options were not tightly linked to the performance of executives, allowing them to 'reap windfalls' from movements in share prices that were due to market and industry trends beyond their control ('pay for good luck')
- the rising sharemarket of the 1990s provided a 'convenient justification' for increases in remuneration at many companies (even relatively poorly performing ones) due to the long-established correlation between remuneration and company size
- 'outrage costs' and constraints were also weakened in the market boom, with shareholders less likely to scrutinise generous remuneration arrangements
- termination and other deferred pay and company loans could be 'hidden'.

The following examination of potential explanations for pay increases of Australian executives explores all the possible channels set out in figure 4.1, beginning with factors influencing the efficiency of arrangements negotiated between boards and executives, before considering demand and supply drivers.

Box 4.3 **‘Market-based’ explanations of pay rises**

Alternative explanations for the observed rises in executive remuneration include: growth in company size (Gabaix and Landier 2008), increasing importance of general managerial, as opposed to company-specific, skills (Frydman 2005; Murphy and Zabojnik 2004, 2006), higher incentive pay and risk aversion requiring increases in overall remuneration (Gayle and Miller 2008), and talent and risk (Sung and Swan 2009).

Other aspects of remuneration arrangements that Bebchuk and Fried (2003, 2004) argue indicate ‘rent’ skimming, may actually be efficient, according to some researchers:

- Apparent insensitivity of pay to performance: Haubrich (1994) demonstrated that, if executives are sufficiently risk averse, low pay-performance sensitivities may be optimal, while Edmans and Gabaix (2009) argue that even a small equity stake is sufficient to deter shirking in large companies due to the large effect of CEO effort in large companies.
- Sensitivity of pay to luck: Gopalan, Milbourn and Song (2008) show that the absence of payment for luck can make company investment decisions insensitive to industry performance, which is suboptimal if company performance depends on industry performance. Noe and Rebello (2008) postulate that past company performance, even if unrelated to CEO effort, provides information about the company’s ability to generate future cash flows, raising the CEO’s contribution to the company, and hence, remuneration.

4.3 ‘Principal-agent’ issues and executive pay

As shown in chapter 3, increases in Australian CEO pay over the 2000s came almost entirely from short- and long-term incentive pay rather than base salary. This was particularly the case for the largest companies.

At issue is whether observed trends resulted from board efforts to promote incentive alignment and hence company performance, or were symptomatic of poor corporate governance and weak ‘outrage’ constraints. Governance arrangements for Australian public companies are explored in greater detail in part C of this report. The following sections briefly examine the evidence of any links between apparent gaps in governance and limited board capacities, and movements in executive pay.

Board independence

Weak or compromised boards might be expected to ‘give in’ to executive demands for higher pay compared with competent, independent boards. Measurable

indicators of board independence include whether the CEO chairs the board, the representation of independent directors and the size of the board.

Having a dual CEO/chair (particularly for so-called ‘widely-held’ companies with diverse ownership) has the potential to concentrate a significant degree of power on the CEO, and lead to less effective monitoring of the actions of executives. Indeed, the ASX Corporate Governance Council, in its principles and recommendations on corporate governance specifies (recommendation 2.3) that ‘the roles of chair and chief executive officer should not be exercised by the same individual’ (2007a, p. 10).

Board size also is used as an indicator of the effectiveness of board monitoring. Some, such as Jensen (1993), have argued that the larger the board, the lower the likelihood of individual members being held accountable for their decisions, also making it easier for CEOs to exert influence. Recent analysis of pay differences between the United States and the rest of the world suggests that larger US boards explain a small part of the gap (Fernandes et al. 2009). Table 4.1 illustrates some of the differences in the characteristics of US and Australian boards according to various studies. Generally, Australian boards are smaller than US boards and have a much lower incidence of CEO/chair duality (particularly for larger companies).

Table 4.1 Characteristics of US and Australian boards

<i>Study</i>	<i>Nation</i>	<i>Period</i>	<i>Companies</i>	<i>Incidence of</i>	<i>Average board</i>
			<i>covered by</i> <i>study</i>	<i>CEO/chair</i> <i>duality</i>	<i>size</i>
			no.	%	no.
Lau, Sinnadurai and Wright (2009)	Australia	1997–2004	108	5	8.5
Cornett et al. (2008)	United States	1994–2003	S&P100 companies	na	12.8
Fahlenbrach (2009)	United States	1993–2004	2 071	68	9.8
Kiel and Nicholson (2003)	Australia	1996	348	23	6.6
Linck, Netter and Yang (2008)	United States	1990–2004	6 931	58	7.5

na Not available.

Sources: Cornett et al. (2008); Fahlenbrach (2009); Kiel and Nicholson (2003); Lau, Sinnadurai and Wright (2009); Linck, Netter and Yang (2008).

More recent data from the Australian Council of Super Investors (ACSI 2009c) show that, in 2008, for a sample of 87 ASX100 companies, average board size for an Australian company was 8.8 (in contrast to the previous year’s 8.5). The

positions of CEO/chair were combined in only two of the companies in the sample studied.

In addition, in 2007-08, for the top 300 Australian companies, three-quarters of directors were non-executive directors, increasing to 80 per cent for the top 50 companies (Korn/Ferry International and Egan Associates 2008). The average proportion of *independent* directors was a little over half for boards of the top 300 companies, with larger companies having a higher proportion of independent directors (Guerdon Associates 2009b).

While these indicators provide some *prima facie* evidence that Australian boards (especially of larger companies) are notionally independent — and more so than their US counterparts — they do not prove that ‘rent skimming’ has not occurred. In practice, some nominally independent directors may still be dominated by the CEO.

Have Australian boards been captured by CEOs?

Indicators of how independently boards operate in practice include the extent to which they hire externally and how they remunerate external appointees relative to internal hires, their propensity to fire CEOs, and the independence of their decisions on remuneration setting.

External versus internal hires and relative pay

If CEOs and senior executives exercise undue power over the board of directors, it might be expected that most CEOs would be recruited internally and, moreover, that internally-promoted CEOs would earn more than those recruited externally (Murphy and Zbojnik 2004). The reason is that internal applicants are likely to have established relationships with the board and already be accustomed to extracting ‘rents’.

The Australian Council of Super Investors (ACSI) commissioned a study by RiskMetrics analysing executive hires and departures at the 50 largest ASX companies between 2003 and 2007 (ACSI 2009b). A comparison of the fixed pay of newly-hired CEOs with that of the outgoing CEO indicated that 16 of 28 (nearly 60 per cent) newly-hired CEOs were promoted internally, while 10 (around one-third) were hired externally (the others were accounted for by firm acquisition). Of the 10 externally-hired CEOs, five were paid more fixed pay than their predecessor, two received the same fixed pay, and three received less fixed pay. The median increase in pay for external hires was a little over 4 per cent. Conversely, pay for internal hires was generally less than for their predecessor — the median decrease in fixed

pay was around 12 per cent. The study also notes that the remuneration received by externally-appointed CEOs could be under-estimated, because ‘sign-on’ payments to compensate for accrued benefits forgone at their previous company are common.

How real is the threat of being fired?

Weak or ‘captured’ boards generally would not be expected to fire their CEO. A recent study by Manning and Mottram (2009) reveals that between 2000 and 2008, an average of eight CEOs in ASX200 companies were fired each year (see figure 4.2). According to ACSI (2009b), terminations accounted for more than one-third of all executive departures over the period 2003–07 (82 out of 230), using a sample of 50 of the largest ASX-listed companies. While providing evidence that termination is a real threat for some executives, the extent to which this threat extends to other companies listed on the ASX is unclear.

Independence of remuneration decision making

Because some executives invariably sit on company boards, conflicts of interest can arise when boards set executive pay. Boards can employ various procedures to reduce such conflicts, including establishing remuneration committees and seeking external advice on market comparators to frame their offer.

As outlined in chapter 6, most large Australian companies have established remuneration committees (almost all of the top 50 companies); around three quarters of remuneration committees in larger firms have only non-executive directors as members, and a majority of the remuneration committees of the top 400 companies comprise a majority of *independent* non-executive directors and have an independent chair. The flipside is that a significant minority of remuneration committees still comprise executive directors (CGI Glass Lewis and Guerdon Associates, sub. 80; WHK Horwath 2009a, 2009b).

While it is known that boards typically seek and receive advice from remuneration consultants, apart from anecdotal evidence, there are few data about the procedures followed to avoid conflict of interest where a consultant also advises management on remuneration or other matters.

It could also be the case that because many non-executive directors are former executives, the distinction between current executives and directors in practice is blurred. In essence, they could be regarded as members of the same club or ‘culture’. As discussed in chapter 6, there are issues about the diversity of board composition and the contestability of appointments. But it is impossible to conclude

that former executives are more likely to be sympathetic to executive pay demands than other directors. Indeed, it is conceivable that former executives are more astute in pay bargaining matters than directors who lack first-hand experience (and they may be more resistant to remuneration levels greatly exceeding what they earned in the same role).

Transparency

Remuneration disclosure requirements in Australia have been progressively strengthened over the past 25 years, as illustrated by box 2.5. Prior to 1986, listed companies were only required to disclose the total level of collective remuneration paid to all executives earning more than \$100 000 during the year. Current disclosure requirements require listed companies to disclose the remuneration packages of all company directors, key management personnel and the five highest-paid executives (including details on the structure of payments, such as cash, short-term incentives, and the like). Increased disclosure might be expected to have reduced the extent to which executives could camouflage remuneration and strengthened ‘outrage’ constraints, although there remain issues about the quality of remuneration reports and the extent of disclosure about performance hurdles (chapter 8).

A related reform was the introduction of the non-binding shareholder vote on company remuneration reports in 2004-05. The vote has allowed shareholders to voice their (dis)approval of a company’s remuneration report in its entirety, giving shareholders an additional avenue for expressing ‘outrage’. As set out in chapter 9, while very few remuneration reports have attracted a majority ‘no’ vote, 12 per cent received a ‘no’ vote above 20 per cent in 2008, compared with 3 per cent in 2006 (PricewaterhouseCoopers, sub. 85).

The United States does not have a vote on executive remuneration, leading Bebchuk to observe:

Introducing advisory votes on compensation at the annual meeting, as the UK and Australia did, would help shareholders influence pay arrangements and would move pay arrangements toward those that best serve shareholder interests. (2007, p. 4)

But the benefits of enhanced disclosure and the advisory shareholder vote to shareholder scrutiny might have been offset to some degree by complacency among shareholders about returns and company performance during the sharemarket boom over the 2000s. Shareholders could have become relaxed about executives receiving higher pay because of strong profits, even though profits might have reflected factors outside the executive’s control. While such ‘profit-sharing’ might have been

a considered choice by shareholders, it could nonetheless have contributed to higher pay outcomes.

Remuneration disclosure and ratcheting pay

While disclosure of executive pay generally is seen as increasing board accountability and thus potentially constraining executive pay, many participants argued that enhanced disclosure had been a significant contributor to pay increases. For instance, Mercer submitted:

Disclosure requirements are also seen as adding to the ratcheting-up effect of CEO remuneration. Directors take for granted that CEOs compare their own pay relative to peers, thus providing a further avenue for CEOs to establish their respective expectations and negotiating stances. Similarly, remuneration committee members use the data to benchmark their chief executives and make their own assessments of appropriate external relativities. (sub. 41, p. 5)

Similarly, Chartered Secretaries Australia stated:

It can be argued that disclosure has led to upward pressure on remuneration. Boards benchmark the remuneration of executives with the remuneration of executives of companies in a peer group, as this information is publicly available. Combined with the practice of aiming to reward executives at the median or upper quartile of such peer group, an autonomous upward pressure ('ratchet effect') on the remuneration of executives of all companies is created ... (sub. 57, p. 16)

But some others countered that pay arrangements had always been known among executives and boards, with public disclosure introduced in 1998 bringing little new information to the negotiating table. For instance, ACSI stated:

Some commentators have also suggested that improved levels of remuneration disclosure may have also contributed to the ratcheting up of executive remuneration. It is however, ACSI's long held view that executives and boards have always had access to remuneration data from remuneration consultants with the only change being that shareholders now have access to similar information. (sub. 71, p. 2)

It can be plausibly argued, nevertheless, that the *public* disclosure of an individual's remuneration brings an additional 'signalling' role. Referred to as the 'Lake Wobegon' effect,¹ public disclosure might have triggered a pay adjustment spiral as companies and executives sought to 'position' themselves in, say, the third quartile of the market, with no one wishing to be seen as hiring, or being, a 'below average' executive.

¹ Lake Wobegon is the fictional hometown of US humorist Garrison Keillor, a place in the mid-West where 'all the women are strong, all the men are good looking and all the children are above average'.

For instance, based on a game theoretical model, Schaefer and Hayes (2008) suggest that if executive pay is viewed by investors as an indicator of executive quality, companies might increase remuneration in order to enhance market perceptions of talent and company prospects (box 4.3 and appendix D).

It also has been postulated (by, for example, Camerer and Malmendier 2007) that if executives are paid less than peers they regard as undeserving, pay ratcheting could be unleashed by disclosure — a so-called ‘positional’ externality effect. However, such demands are less likely to be met when board governance and the ‘outrage’ constraint are stronger — and enhanced disclosure simultaneously strengthened the latter.

For Australia, there is little empirical evidence of an acceleration in the growth of executive remuneration following introduction of the new disclosure rules in 1998. Indeed, pay growth slowed somewhat in the 2000s compared to the late 1990s (although there may have been other forces at work). The observed decline in executive remuneration since 2007 provides further evidence that not all companies are locked into providing above average remuneration regardless of market circumstances.

That said, detailed knowledge of pay arrangements for individuals will certainly have improved access to market comparator information for both executives and boards, which in some cases could have strengthened the executive’s bargaining position (particularly as disclosure could facilitate ‘poaching’) and, in other cases, that of the board (armed with knowledge of the market norm).

Enhanced disclosure would also be expected to have facilitated more rapid adjustment where ‘equilibrium’ relativities were disturbed (for example, by a firm hiring an overseas executive at a significantly higher level of remuneration).

Pay disclosure and tournaments

The Lake Wobegon effect specifically considers the pay differentials between executives of different companies, and what effect this has on equilibrium remuneration in the market for executives. Pay differentials also obviously exist *within* companies, and the ‘tournament theory’ of corporate advancement (Lazear and Rosen 1981) provides an explanation as to why large pay differentials might exist between individuals working in distinct hierarchical positions within a company. It is conceivable that changes in inter-company differentials might have contributed to the observed increase in executive remuneration, which, in the context of this theory, would mean that an internal ‘ratcheting’ mechanism of sorts is present.

The tournament theory suggests that high remuneration for senior company officers does not necessarily reflect their current productivity, but instead provides an incentive to those in more junior positions to increase their current productivity. The objective of this payment structure is to make individuals more productive over their working lives by inducing them to work harder now in order to receive a promotion (and increase in pay) in the future, and provide the appropriate incentives to acquire the necessary skills before being appointed to a senior position. In essence, pay differentials within the company are ‘prizes’ that accrue to individuals who are the winners of contests based on performance for more senior positions within the company. As noted by Lazear (1989) however, the larger the spread between the remuneration received by the winners and losers of contests, the greater the possibility that such a pay structure can encourage uncooperative behaviour and lead to disharmony. If cooperation and harmony are important to the company, some degree of pay compression may be optimal on efficiency grounds.

Although the tournament theory may in part explain why there can be large observed differences between the remuneration of individuals within a company, it provides a less compelling explanation of why the level of executive remuneration, or the size of the prize, has continued to increase (in real terms) over time. That is, what would have changed about the nature of tournaments to make larger prizes to the winners necessary?

In other words, rather than accounting for the dynamics of movements in executive remuneration, tournament theory instead could at best explain, at least to some extent, the static structure of pay arrangements within companies.

The role of incentive pay in driving remuneration increases

From the late 1980s, the composition of executive remuneration in Australia has changed fundamentally, with a much greater focus now being placed by boards on equity-based remuneration, such as options and ordinary company shares, and other incentive-based forms of remuneration. As observed by Egan Associates:

Executive performance awards in the 60s and 70s through to the early 80s reflected more of a modest profit share than the outcome of a multi-factor formal incentive program. Progressively from the mid 80s there was an increasing emphasis on profitability and growth in a company’s market value. (sub. 105, p. 17)

Incentive-based pay has the potential to reduce the ‘agency’ costs that might arise if executives were paid fixed cash amounts only. At the heart of the principal–agent problem is the reality that executives might naturally be inclined to exert less effort or, perhaps more realistically, focus on growth and acquisition strategies that fit their risk preferences, rather than strategies that would maximise

company profitability over time. Consequently, in principle, companies will be willing to implement incentive-based forms of remuneration if they can (at least) offset the extra outlays either by influencing executives appropriately or by reducing the costs of monitoring executives. (If direct monitoring of executives by boards is relatively inexpensive, incentive pay will not be an efficient alignment strategy.) Of course, whether incentive pay arrangements are successful will depend on the quality of their implementation in practice. Successful implementation will depend on the quality of their design by the board, which in turn will be influenced by the capacities and experience of directors.

Incentive pay goes with higher 'expected' remuneration

While incentive pay can promote alignment of managerial and shareholder interests, it:

- typically introduces additional variability and hence uncertainty about the *level* of remuneration executives will eventually receive (for example, because performance hurdles are susceptible to the influence of forces outside their control or because of the uncertain value of equity-based remuneration)
- can constrain executives' ability to diversify their wealth, thus exposing them to portfolio *risk*
- usually involves *deferral* of pay (and thus losses from delaying the benefits of consumption).

As executives typically are 'risk averse' with respect to their own income (see, for example, Hall and Murphy 2002), they will want to ensure that the incentive pay offered (in current dollars) at least compensates them for the additional earnings risk involved. (Of course in practice, this will be a somewhat intuitive calculation, requiring judgment about the riskiness of various scenarios.)

Hence, introducing uncertainty into an executive's remuneration structure generally will mean that the level of remuneration offered must increase *compared to certain, cash pay*, because of the payment of a risk premium. If boards are acting appropriately, they will be prepared to offer a premium only up to the point where it elicits an improvement in executive (and company) performance (or a saving in monitoring cost) of commensurate value.

Portfolio risk

Executives not only have their human capital (and reputation) heavily invested in the company they manage, they also typically have a significant amount of their

personal wealth (shares and options) tied to its performance. Indeed, this is a major objective of equity-based incentive remuneration. However, remuneration via equity, and requirements to hold equity in the company for which they work, can be risky for executives. As an illustration, table 4.2 shows the holdings and computed values of ordinary company shares by ANZ executives over a period of several years. It shows that changes in share prices can have significant wealth effects. This is particularly clear with the decline in the ANZ share price in 2007-08.

Table 4.2 ANZ executive shareholdings^{a, b}

Executive	Quantity				Value			
	2005	2006	2007	2008	2005	2006	2007	2008
	no.	no.	no.	no.	\$'000	\$'000	\$'000	\$'000
1	421 733	421 733	388 399	381 976	10 122	11 328	11 535	7 162
2	88 638	96 083	332 092	332 092	2 127	2 581	9 863	6 227
3	171 919	239 319	282 054	282 054	4 126	6 428	8 377	5 289
4	641 633	660 513	572 629	574 227	15 399	17 741	17 007	10 767

^a Quantity held and value at 30 September, or where appropriate, last business day in September. ^b Includes directly and indirectly held shares, and shares held by related parties.

Sources: ANZ annual reports (various); Yahoo! Finance (2009b).

Table 4.3 gives another example, using three executives from Wesfarmers. Even though the Wesfarmers share price fell by nearly \$8.50 between 30 June 2007 and 30 June 2008, the value of shareholdings by the three executives considered here rose due to an increase in the quantity of shares held, indicating that the personal wealth of executives is indeed linked to the fortunes of their company.

Table 4.3 Wesfarmers executive shareholdings^{a, b}

Executive	Quantity				Value			
	2005	2006	2007	2008	2005	2006	2007	2008
	no.	no.	no.	no.	\$'000	\$'000	\$'000	\$'000
1	106 048	119 256	195 633	302 757	4 243	4 213	8 946	11 293
2	142 908	153 224	191 412	260 669	5 718	5 413	8 753	9 723
3	48 131	57 416	79 837	104 589	1 926	2 027	3 651	3 901

^a Quantity held and value at 30 June, or where appropriate, last business day in June. ^b Including shares held by related parties.

Sources: Wesfarmers annual reports (various); Yahoo! Finance (2009c).

Meulbroek (2001) analyses the impact of the inability of executives to hold optimally diversified portfolios on their valuation of equity-based forms of remuneration. Her estimates of the value of option payments to executives for New York Stock Exchange listed companies are presented in table 4.4. The less

diversified the executive's portfolio, the lower the valuation of the option relative to its cost to the company, reflecting increased exposure to company-specific risk. Similarly, the longer the vesting period, the lower the net present value to the executive of the uncertain payment. This general framework can be applied to all forms of risky pay that restrict the ability of executives to hold a fully diversified investment portfolio.

Table 4.4 Executive discounting of equity-based remuneration^a

Value of options to manager as a ratio of company cost, per cent^b

	<i>Vesting in 3 years</i>	<i>Vesting in 5 years</i>	<i>Vesting in 10 years</i>
Completely undiversified	77	66	45
75 per cent undiversified	80	70	51
50 per cent undiversified	84	76	60
25 per cent undiversified	91	85	74

^a New York Stock Exchange listed companies. ^b Mean values.

Source: Meulbroek (2001).

Hall and Murphy (2002) likewise find that as the degree of executive risk aversion increases, and the more an executive's wealth is held in company shares, the amounts required to compensate executives for forgone certain cash remuneration increase. They also construct 'risk-adjusted' (certainty equivalent) measures of remuneration for CEOs of companies listed on the (US) S&P 500 industrial index in the 1990s. Their results suggest that the growth in the discounted 'certainty' value of remuneration to CEOs during this period was significantly lower than the growth in the reported cost of CEO remuneration to companies.

In a similar vein, Fernandes et al. (2009) suggest that a significant part of the observed gap between reported US executive pay levels and those for the rest of the world (including Australia) is attributable to the 'risk premium' to compensate for the higher proportion of performance-linked pay, especially equity and option-based pay, in that country.

Although these studies relate to the United States, they have general application, including to Australia. As shown in chapter 3, the composition of CEO and other senior executive remuneration has become more heavily weighted towards short- and long-term (mainly equity-based) incentives since 2003-04. Furthermore, since 2003-04, for CEOs of ASX300 companies, all of the increase in executive remuneration that has occurred has been in the form of short- and long-term incentives. It is therefore likely that reported fair values (which estimate the expected cost to the company of equity-based pay) as well as values of cash-based incentive pay, incorporate a risk premium for the uncertainty they create.

More incentive pay for bigger companies?

For larger companies, agency costs can be larger because of more dispersed ownership and the potentially greater influence of executives over company assets (Jensen and Meckling 1976). This means that larger companies might have a greater willingness to issue incentive pay to executives in order to more closely align the interests of managers with those of the company and its shareholders.

Gayle and Miller (2008), with specific reference to the United States, argue that the most important influence on the increase in executive remuneration in the industries they analyse (aerospace, chemicals and electronics) is related to this ‘moral hazard cost’ of increasing company size (their model explains around half of the variation in remuneration during the sample periods studied). If Gayle and Miller are correct, executives of larger Australian companies would be expected to receive a higher proportion of their remuneration in the form of short- and long-term incentives, rather than base pay.

The evidence in chapter 3, while not demonstrating a perfect relationship, lends some support. For example, figure 3.2 shows that, for CEOs and executives in the ASX20 companies, short- and long-term incentives form a higher proportion of total remuneration than for smaller companies, where base pay is relatively more significant. For CEOs in the largest 20 companies, nearly 60 per cent of the total remuneration package consisted of short- and long-term incentives in 2008-09, while at the lower end of the spectrum, for the companies ranked 151–200 in the sample, short- and long-term incentives accounted for around 40 per cent of the total remuneration package. A similar story holds for senior executives (see appendix B).

Has incentive pay disguised rent-skimming?

While in theory incentive-based pay can be an efficient means of aligning executive performance with shareholder interests, incomplete knowledge and pay complexity could give executives scope to mould performance measures and hurdles in their favour, such that ‘at risk’ pay becomes a virtual certainty, even rewarding failure. In this case, the premium that firms are prepared to pay for alignment would simply translate to additional pay, not pay for incremental performance. This could occur even if boards were not under a CEO’s influence, but just incapable of properly understanding the implications of the arrangements they agree to.

Bebchuk and Fried (2003) contend that the rapid growth in remuneration of US executives largely from options-based incentives supports the notion of board capture by CEOs, because there was no offsetting reduction in cash pay; there were

few performance hurdles; and executives could benefit from good luck without facing consequences of bad luck.

A number of participants suggested that the recruitment of US executives to Australian firms in the early 1990s, including notably Bob Joss, Frank Blount and George Trumble, spearheaded the importation of US remuneration levels and structures, in particular, incentive-pay arrangements. As noted by Mercer:

... these high profile appointments were influential in the subsequent widespread adoption of equity-based incentive remuneration systems by Australian corporations during the 1990s. For example, the median percentage of the long-term incentive component of a benchmark of Australian CEO remuneration packages increased from 6.3 per cent of total remuneration to 32 per cent over the period 1987 to 2000 and the total performance component of pay (i.e. short- and long-term incentives) rose from 9.5 per cent to 47 per cent. (sub. 41, p. 2)

According to Egan Associates, incentive pay had been growing in Australia from the mid 1980s, but its adoption accelerated following the early 1990s recession, with:

... a progressive emphasis on equity-based, long-term incentives and the meeting of performance hurdles, initially related to share price and then progressively total shareholder returns and earnings per share ... (sub. 105, p. 18)

Though influenced by the United States, incentive pay arrangements in Australia have significant differences.

- Options — which have particular incentive properties (box 4.4) — have not been used widely in Australia. ACSI (2009d) estimates that the use of options peaked in 2001-02, accounting for about one-fifth of total CEO pay (for CEOs of the top 100 companies), falling to approximately 11 per cent by 2008 (albeit with some volatility year-on-year). The decline in option pay has been broadly matched by an increase in performance rights, which accounted for around 12 per cent of remuneration by 2008.
- Options have also been more ‘visible’ in Australia because of an accounting standard requirement to debit their expected costs in the company’s financial statements, and the requirement to disclose the individual costs for the CEO and other executives in the remuneration report since 2003-04.
- Compared to the United States, where there is ‘higher leverage to at-risk pay ... in the form of options, and incentives that are linked to tenure rather than future organisational performance’ (Mercer, trans., p. 331), performance hurdles have been more routinely applied to option grants and other equity-based remuneration in Australia. Short-term hurdles often comprise both financial and non-financial metrics such as accounting performance, company strategy

implementation, succession planning and workplace safety. Since the mid 2000s, the most common long-term hurdle appears to be *relative* total shareholder return.

Box 4.4 Options: rent extraction or efficient incentives?

The use of options *per se* may not signal rent extraction by executives. The critical test is whether they elicit appropriate performance at least cost to the firm.

In theory, options could form part of an ‘optimal’ contract. As Edmans and Gabaix observe:

... owing to their asymmetric payoff structure, options limit the CEO’s downside upon bad luck, and this insurance is particularly valuable to a loss averse agent [CEO]. (2009, p. 491)

In other words, providing ‘carrots’ could be less costly for the company than imposing penalties for poor performance, because in the case of the latter, a risk averse CEO would demand offsetting ‘certain’ pay that could cost the company more than the carrot.

Options also encourage risk-taking, which might be appropriate for an immature company seeking to grow rapidly, but not for a more mature company where the potential for loss of shareholder value is much greater. They also offer a relatively cheap form of incentive for cash-constrained venture companies. In the latter case, executives are essentially paid tickets in a lottery where the size of the ultimate prize, to some degree, lies within the CEO’s control.

But as discussed further in chapter 7, options have the potential to encourage harmful behaviour — for example, for executives to take action to increase the share price in the short term so that options are ‘in the money’.

While suggestive, the imposition of hurdles arguably is not sufficient evidence that incentive pay has been appropriately set — for example, hurdles might be ineffectual or inappropriate. Egan Associates noted that by 2005, boards had come to believe that hurdles provided ‘an inappropriate lottery effect’ (sub. 105, p. 18). Moreover, in the late 1990s ‘board discretion or no hurdle at all applied in approximately 30 per cent of organisations’ (sub. 105, p. 22).

A number of other criticisms of incentive-pay arrangements have been raised by investors and proxy advisers participating in this inquiry (box 4.5), including that:

- long-term incentives are not sufficiently long term to promote appropriate alignment
- there is too much focus on short-term incentives (often with undisclosed hurdles)
- performance hurdles generally are too ‘soft’, excessively rewarding mediocre performance and good luck (yet shielding executives’ pay from bad luck).

And although (as discussed in chapter 3) there is evidence of a correlation between growth in aggregate executive pay and aggregate corporate performance (including during the recent downturn), this could mask substantial variation across companies.

Box 4.5 Participants' concerns about incentive pay arrangements

The Australian Shareholders' Association commented:

The current unsustainable and unacceptable levels of executive remuneration stem primarily from the following:

- equity incentive schemes which award average, not superior performance
- rewards for short-term results for executives, particularly CEOs whose primary motivation should be long term
- an increase in the proportion of remuneration which is said to be at risk (frequently two-thirds) which in fact is placed at very little risk because of poorly structured incentive schemes which pay out even when performance is only average
- incentive schemes which are said to be long term, which on average measure performance over three years or in some cases less. (sub. 54, p. 7)

While acknowledging the high level of support for remuneration resolutions for the top 200 companies, ACSI observed that remuneration resolutions attracted higher levels of dissent where packages contained:

- short vesting periods for long-term incentives, i.e. less than three years
- insufficiently demanding hurdles without a clear link to long-term performance
- undisclosed hurdles
- increased prevalence of short-term or retention payments in lieu of long-term arrangements e.g. 'de-risking' of pay. (sub. 71, p. 5)

And according to Regnan:

... there is compelling evidence of short-termism in executive remuneration. (sub. 72, p. 4)

Have executives been 'rewarded for failure'?

As outlined in chapter 1, arguably the strongest motivator for this inquiry is the general perception that executives have been rewarded for failure. This encompasses situations where an executive whose actions have adversely affected the company's profitability or viability, receives bonuses or other rewards, as well as where executive pay, despite an ostensible link to performance, appears unaffected by the general sharemarket downturn.

- The culture of extremely high short-term bonuses in financial market institutions does not appear as pervasive in Australia as overseas; short-term incentives comprised a little over 30 per cent of remuneration for finance sector CEOs in

2008-09 (table 3.5), compared with an average of 25 per cent for CEOs of the top 300 companies. Moreover, as discussed in chapter 7, short-term incentives increasingly are being paid as deferred equity, combining short-term hurdles with medium-term alignment.

- As discussed further in chapter 7, there have been instances where termination payments appear to have exceeded contractual obligations to executives. While payments in excess of obligations might be justifiable (see, for example, Almazan and Suarez (2003) and Heen (2008)), they might also result from a board's aversion to standing up to a departing CEO (or a perceived need for a quiet exit).

A one-way bet?

It is suggested that 'efficient' incentive pay would be associated with a corresponding reduction in fixed pay, and neither reward executives for good luck, nor shield them from bad luck. While incentive pay being added to fixed pay can indicate rent skimming, in principle there are reasons why a fall in base pay need not be observed, including that the additional pay could be designed to encourage incremental performance, and that, in the absence of incentive pay, base pay might have risen (more).

Egan Associates (sub. 105) suggested that incentive pay in Australia initially partly substituted for fringe benefits (after introduction of the Fringe Benefits Tax in 1986) and defined benefit superannuation schemes, neither of which had previously been reported in pay data. This would have led to a significant jump in reported total pay — because of the risk premium incorporated in incentive pay and the shift away from unreported pay forms to a reported one. In the past few years, base pay for CEOs and senior executives of the top 300 companies has fallen slightly in real terms, with its share of total pay falling (table 3.2).

Several participants also observed that executives had benefited from the rising sharemarket in the 2000s, yet their pay had not fallen in line with share price declines in 2008. As the Australian Shareholders' Association stated:

Incentive schemes such as these [using share prices as a performance metric] have driven growth in executive remuneration based simply on windfall gains from a rising market, rather than actual sustainable long-term performance. If truly at risk, such schemes should not be altered because of the declining market, however it is frequently the case that options are 're-priced' as the share price falls. (sub. 54, pp. 7–8)

It was also argued that if executive pay is related to firm size, a decline in market capitalisation should lead to commensurate reductions.

As discussed in chapter 7, whether or not an executive should be exposed to ‘downside’ remuneration risk will depend on the risk preferences of both the company and the executive. For highly risk-averse executives, in order to achieve desired incentive alignment, it might cost the company less to offer ‘carrots’ only, rather than a mix of carrots and sticks that penalise the executive for the effects of factors outside the executive’s control (that is, bad luck). Moreover, incentive pay is ultimately about providing incentives to perform relative to the (unobservable) counterfactual. In the absence of appropriate incentives, company performance may have been even worse in a difficult economic environment.

Nevertheless, in general, a protracted decline in market capitalisation and company performance should lead to a decline in total executive remuneration, broadly in line with the relationship observed in a rising market. Evidence presented in chapter 3 confirms this, revealing an average annual decline in (real) CEO remuneration across the ASX300 companies between 2007 and 2009 of around 11 per cent, with that for non-CEO executives being 14 per cent (the median decline was around 7 per cent for CEOs and non-CEO executives alike). Furthermore, as illustrated by tables 4.2 and 4.3, remuneration changes can be amplified by wealth changes arising from executives’ shareholdings. As noted by Charles Macek:

... due to the collapse of the share market executives have lost \$billions of income value of equity grants, which have previously vested or have been earned by individual accountabilities. This is not recognised in the reporting of their remuneration ... (sub. 55, p. 13)

Did boards simply lose control?

Even with the best intentions, the design of incentive-compatible remuneration is difficult because any ‘solution’ depends on the degree of income-risk aversion of the manager, the risk preferences of company owners, and the assumed likely relationship between managerial effort and observable performance. As explained further in chapter 7, for these reasons there is no single ‘correct’ incentive structure. A pay vehicle and structure that delivers ‘money for jam’, or even dangerous incentives in one situation, could promote desirable alignment in another. In practice, incomplete knowledge of parameters can lead to packages that fail to encourage appropriate executive actions (for instance, because there is inadequate reward for risk and effort) or actively encourage inappropriate ones (such as excessive risk-taking and ‘short-termism’). Some boards simply may not have been up to the task.

Furthermore, the increasing emphasis placed on equity and other incentive-based forms of remuneration in executive pay packages, particularly from the early 1990s, coincided with a period in which the sharemarket was rising relatively quickly, and

economic conditions were for the most part, quite strong. In this environment, opportunities for company expansion and profit making were enhanced, and increased the extent to which executives could realise performance-related forms of remuneration. In other words, they might have benefited from good luck.

As noted earlier, Egan Associates suggested this may well have occurred over the 1990s, but that the 2000s:

... was the beginning of the era when institutional investors were focusing on the need for performance hurdles ... Increasingly, long-term equity-based incentive plans have required either fixed rates of growth in return or relative or absolute growth in total shareholder return, where performance equivalent to a market index represents a threshold and superior performance at the base of the top quartile of the market is the position at which all equity would vest. (sub. 105, p. 22)

Unfortunately, without comprehensive data relating to realised incentive pay, it is not possible to show whether there has been a change in realised outcomes. Based on a number of case studies, RiskMetrics (sub. 58) suggested that there had been a tendency for realised pay over the 2000s to exceed estimated values, although it was also acknowledged that the introduction of relative total shareholder return hurdles might mean that accounting fair values tend to overestimate costs to companies (box 3.3). (Because of executive risk aversion, the value to executives would be even less.) However, as discussed in chapter 3, in many of the cases cited, realised pay was less than initially estimated; indeed one-third lapsed. Moreover, actual outcomes will virtually never equal estimates based on estimated distributions (box 4.6). Realised amounts should also be compared in the same dollars as the earlier estimates and care has to be taken to distinguish between remuneration and wealth changes arising from capital gains (or losses). While capital gains, as changes in wealth, clearly contribute to an executive's income, they are not remuneration involving a payment from the company.

Nonetheless, that the parameters for payment of incentive pay have been progressively tightened, reflecting learning by boards as well as demands of institutional investors, provides some evidence that incentive pay may have been introduced without adequate understanding by boards. Further, incentive-based pay remains complex and challenging to design. Egan Associates commented:

The complexity of reward structures has not transparently revealed that performance aligned awards reflect incremental and sustainable shareholder value creation. (sub. 105, p. 20)

Complexity might also have led to over-reliance by boards on outside advice. As Mercer said:

... [remuneration] committee members generally lack the time and depth of technical knowledge to be deeply involved in the fine detail of remuneration design. (sub. 41, p. 6)

And Charles Macek submitted:

The increasing complexity of remuneration arrangements has resulted in the establishment of Board remuneration committees and increased the need to engage remuneration consultants. (sub. 55, p. 5)

Box 4.6 Estimated versus actual incentive pay

Regnan considered that estimates of long-term incentive pay were overstated. In contrast, based on several case studies, RiskMetrics considered that realised pay tended to exceed estimated values.

If company valuation methods are reasonable then, over time, expected and realised aggregate values should converge (appropriately discounted for inflation and the timing of payments). But for individual cases, it is almost certain that estimates and actual amounts will diverge. Estimated values encapsulate the expected distribution of possible outcomes, but only one outcome can eventuate. For example, the ex ante valuation will take into account the likelihood of performance hurdles being met *and* not being met. In practice, the hurdles can only either be met *or* not met.

Estimates of incentive pay provide an estimate of the contingent liability being incurred by the company. For reasons noted earlier, the expected benefit to the executive generally will be (possibly significantly) less than this amount because of their risk aversion. Executive pay packages must be negotiated based on these company and executive estimates of costs and benefits of incentive pay arrangements.

Actual payments indicate how well executives have performed against performance hurdles. They also can reflect exogenous influences — on share prices, for example. Actual pay thus provides information about the accuracy of valuation methodologies over time.

And because there is no consensus about the best way of aligning incentives through pay (even in the academic literature), arrangements can be susceptible to fashion or fads. Boards, along with shareholders, might have taken comfort from following market trends. For example, there is currently some debate about the appropriateness of relative total shareholder return hurdles in a market downturn, although their widespread use arguably mitigated scope for rewards for good luck during the more recent sharemarket boom.

In practice, effective implementation of incentive-based pay is likely to require a continual process of evaluation, learning and adaptation by boards. From this perspective, arguably more telling indicators of the likely appropriateness of incentive pay arrangements are the processes boards follow to develop, monitor and adjust executive remuneration to achieve stated objectives, as well as the capacity of boards to understand such complex arrangements.

4.4 Broader market drivers of executive pay

The remainder of this chapter examines the influence of what can be described as broader market factors — represented in the left and right panels of figure 4.1. Possible ‘supply-side’ factors are considered first, followed by factors influencing the demand for executives.

Are executives *demanding* more?

Executives will be willing to offer their services at a (certainty equivalent, after-tax) ‘price’ that they consider compensates them for their effort, and the costs they have incurred in obtaining necessary skills and qualifications. They will also take into account amounts they could earn in other positions. Changes in any one of these factors could affect the remuneration they demand.

An international market for executives?

Overseas markets for executives provide alternative employment opportunities for domestically-based executives and could raise the level of remuneration required to induce executives to work for Australian-based companies. In addition, recruitment of candidates from nations where pay levels are higher than in Australia will likely require higher pay to match.

The US market may have been especially influential. US executive remuneration rose rapidly from the 1980s, coinciding with an increase in the issuance of incentive-based remuneration to executives, especially options. In 1993, the US Congress approved a law that placed a \$1 million limit on the tax deductibility of ‘non-performance’ related executive remuneration, which some have argued prompted a shift in the composition of US executive pay away from base salary towards bonuses and options (chapter 10). While there are different views about the cause, the significant increase in the quantity of incentive pay granted to US executives has likely contributed to faster increases in their total level of remuneration.

Indeed, as noted earlier, Fernandes et al. (2009) conclude that the higher proportion of incentive pay in the United States explains a large part of the observed gap between CEO pay in the United States and the rest of the world. Further, they find that the gap is slowly closing as other countries, including Australia, progressively implement US-style incentive pay structures, and that convergence has been more rapid where non-US companies have appointed executives with international experience.

According to Mercer:

The 1990s represent a turning point in the level and structure of Australian CEO pay. This decade saw a series of high profile Americans, appointed on US styles of pay, to lead Australian companies. The recruitment of people such as Bob Joss to Westpac Bank in 1990, Frank Blount (Telstra 1992), George Trumble (AMP 1994) and Paul Anderson (BHP 1998) were significant for Australian CEO remuneration ... (sub. 41, p. 2)

Thus to the extent that overseas (especially US) pay structures became more common with international recruitment of executives, it is likely this contributed, in part, to changes in the quantum and structure of Australian executive remuneration. Nonetheless, the extent of this influence is contested.

ACSI (2009b) present data on the extent of international executive mobility between Australia and the rest of the world. The research indicates that between the 2003 and 2007 financial years for 50 of the largest ASX listed companies, 10 senior executive departures (around 4 per cent) were the result of international recruitment. Conversely, 35 newly-appointed executives (approximately 11 per cent) were recruited from abroad. Of the 28 CEOs appointed during the sample period, five were recruited from overseas (around 18 per cent).

So although relatively few Australian executives were recruited *by* overseas organisations, a significant number of executives were recruited from abroad. As recognised by the CEO of ACSI:

The findings, while not providing compelling evidence of a global war for talent, were not necessarily inconsistent with there being substantial competition for senior executives. This is because pay arrangements and other changes may have been driven by companies responding to attempts to recruit their executives. (ACSI 2009b, p. 4)

Many other participants commented that international considerations, consistent with globalisation more generally, were playing an increasing role in selecting executives (box 4.7). Russell Reynolds Associates encapsulated these views:

Global executive search, which used to be the province of mainly financial services, medical and academic sectors, has spread across all sectors ... Whereas going back five years, probably 50% of our CEO work would require us to look offshore, it is now

always the case for all our CEO level work. We can confidently say that 100% of our CEO assignments involve clients specifically asking us to look offshore. (sub. 59, attachment 4, p. 2)

The dominant channel through which ‘trade in executives’ appears to have contributed to a higher overall quantum of remuneration is via the need to match rates paid overseas (adjusted for cost of living and non-pecuniary factors) to attract senior executives to Australian companies. This in turn can have flow-on effects to other companies where executives have the potential to move to other positions, including abroad.

It should be noted, however, that average remuneration for Australian executives remains lower than for many other countries, and considerably so for the United States (chapter 3). This could reflect limited mobility in some sectors (for example, mining executives might have limited opportunities other than in Australian companies, in contrast with executives in the finance sector), as well as non-pecuniary and cost of living advantages. It could also indicate differences in corporate governance that mean that some Australian companies simply are not prepared to appoint candidates who demand what are perceived as distorted US rates of pay. As mentioned earlier, Fernandes et al. (2009) find that governance does explain some part of the observed difference in pay between US executives and those in the rest of the world.

Box 4.7 International mobility of executives: inquiry participants’ views

BHP Billiton submitted:

As a company that has global operations, the market for our purposes is a global market. (sub. 45, p. 3)

Woolworths commented:

Shortages in skills in certain areas in Australia have led organisations to seek talent from overseas which also drives remuneration levels in the Australian market. There is a need to understand that the Australian labour market is influenced by both local and international labour markets. (sub. 91, p. 5)

With reference to the banking industry, the Australian Bankers’ Association claimed:

The relevant geographic market for bank executives is international. For example, of the last eight chief executive officers (CEOs) of Australia’s major four banks, four were recruited from overseas. (sub. 70, p. 7)

The Australian Shareholders’ Association noted:

To an extent international competition for talent is a factor [increasing remuneration] and Australia’s income tax system, currency and geographic isolation no doubt become factors in negotiations both in attracting executives from abroad and retaining executives in Australia. (sub. 54, p. 6)

Employment in non-disclosing entities?

It is impossible to quantify directly the range of alternative employment opportunities open to CEOs and other executives, but many participants noted that executives were able to shift to private equity companies and institutions such as hedge and superannuation funds that offered often higher rates of pay (in part to offset the ‘illiquidity’ of stock in these entities).

For example, Macquarie Group submitted:

... in attracting and retaining executives and professionals, Australian publicly listed companies must compete with private organisations that can reward their executives and professionals well, without being subject to the same level of remuneration scrutiny as publicly listed companies. The last decade saw the rapid growth of such firms. (sub. 52, p. 3)

Egan Associates (sub. 105) agreed that rewards in private equity could be substantial (many times base salary) and that in effect executives are required to become significant investors in the company.

Employment risks

The risk of dismissal or redundancy and the associated reputational damage (with ramifications for future earnings) will influence the quantum of executive remuneration. All else given, to accept employment in a challenging position where there is a heightened risk of personal failure and thus of being fired, or a higher risk of firm failure and of being made redundant, executives, as for any employees, will naturally demand higher pay as compensation.

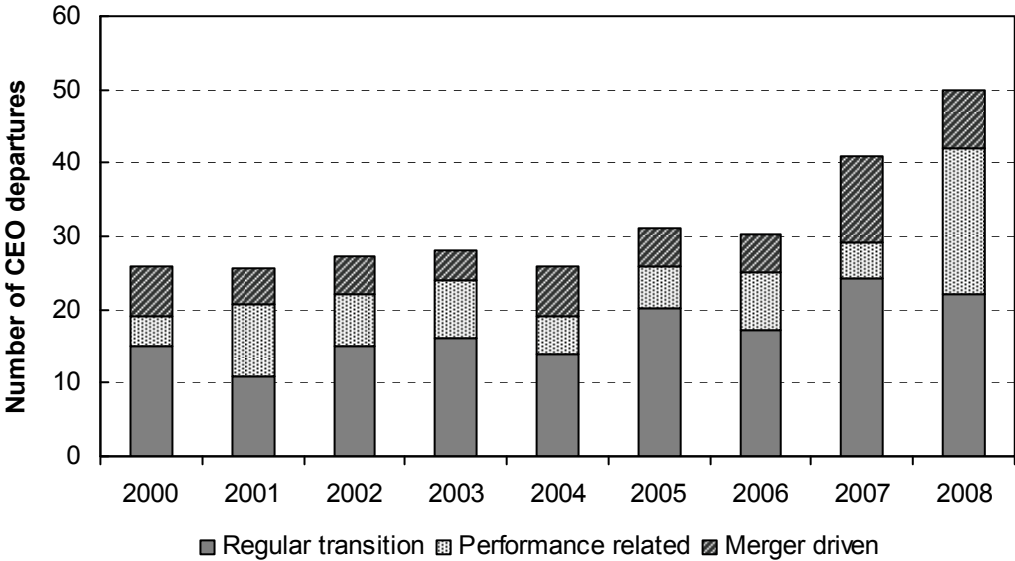
Figure 4.2 summarises results from a recent study by Manning and Mottram (2009) of CEO turnover among ASX200 companies since 2000. There was a small increase in turnover between 2000 and 2006 (from 26 departures to 30), before jumping to 41 in 2007, part of which was due to merger activity, but the bulk of which can be attributed to higher planned transitions (retirement, illness, or long-expected changes). In 2008 however, turnover increased again, rising to 50 CEO departures, including a rise in the number of forced departures from five to 20. This made forced departures almost as significant as planned transitions (which stood at 22), indicating that the risk of being fired for CEOs is nontrivial. Furthermore, this placed Australia’s CEO turnover above the global average, at 22.3 per cent versus the global average of 14.4 per cent.

Unfortunately the survey does not specify how many planned CEO departures were retirements, and how many involved CEOs leaving their company to work in

another organisation. Without knowing this, it is difficult to infer how many CEOs moved to positions overseas or to ‘non-disclosing’ institutions such as superannuation funds and private equity companies.

The number of *forced* CEO departures (as recorded) during this period averaged approximately eight per year, but is quite variable from year to year. Indeed, as noted, there was a sharp rise in the number of performance related departures in 2008, although it is not clear that this signifies a trend (excluding 2008, the average number of forced departures per year is seven). Hence, although employment risk is real for executives in ASX200 companies, it does not appear to have increased substantially, on average, over the period. Manning and Sherwood (2008) also reveal that CEO tenure in Australia was generally significantly lower than that experienced globally between 2000 and 2007 (5.9 years versus 7.7 years) (figure 4.3).

Figure 4.2 CEO turnover, by reason for termination, Australia, 2000–08^a



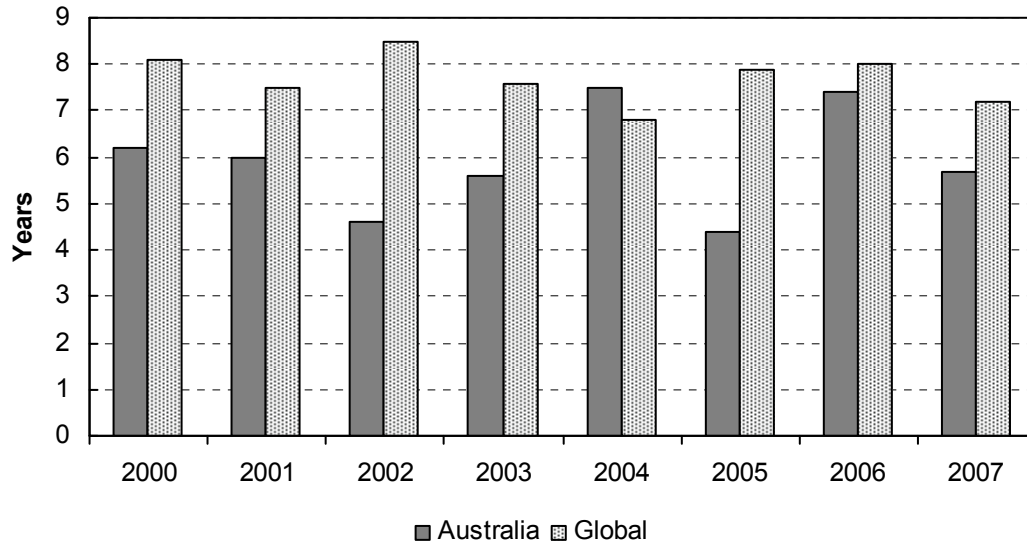
^a ASX200 companies.

Source: Manning and Mottram (2009).

The study prepared by RiskMetrics for ACSI (ACSI 2009b) referred to earlier, analysed 333 executive appointments and 230 departures at 50 of the largest ASX companies between 2003 and 2007. The largest cause of executive departures between 2003 and 2007 was termination — accounting for around 36 per cent of all departures — suggesting that performance and conduct in employment are significant determinants of whether an executive retains employment (table 4.5). It is also likely that the termination data would tend to be underestimated given

incentives for companies and executives to conceal acrimonious departures. (For example, 33 per cent of departures are classified as ‘retired’.)

Figure 4.3 Australian and global CEO tenure, 2000–07^{a, b}



^a Australian data are based on ASX200 companies. Global data are based on the world’s largest 2500 companies, based on market capitalisation. ^b Average tenure of departed CEOs.

Source: Manning and Sherwood (2008).

Table 4.5 Reasons for senior executive departure, 2003–07^a

Reason for departure	Departures		Proportion of all senior executive departures
	no.		%
Terminated	82		35.7
Retired	76		33.0
Recruited — Australia	30		13.0
Divestment	16		7.0
Recruited — internationally	10		4.3
Resigned — reshuffle	9		3.9
Other	4		1.7
Death	3		1.3
Total	230		100.0

^a Based on 50 of the largest ASX-listed companies between the end of the financial years 2003 and 2007.

Source: ACSI (2009b).

Has increased company ‘size’ led to higher pay?

In principle, companies will be prepared, at the limit, to pay executives up to the value of their contribution to company profits. This will be the product of the influence of the role an executive performs, as well as the abilities of the particular executive.

Chapter 3 documents strong positive correlation between company size and executive remuneration for Australia. This is consistent with numerous Australian and international studies on executive remuneration, some of which are discussed briefly in box 4.8 (with more detail in appendix D). The question addressed here is whether increased company size is a *driver* of increases in CEO pay.

The link between executive pay and company size has long been a matter of academic interest. Early studies debated whether executives had greater incentives to maximise the size or profitability of the companies they managed (box 4.9). This debate was at its most intense in the 1950s and 1960s, culminating in the work of Rosen (1982, 1992) which set out a theoretical explanation for the observed positive relationship. Rosen noted that the actions of executives can affect the productivity of employees at lower levels of the company hierarchy and thus have a *multiplicative* effect. This multiplicative effect increases with the number of hierarchical levels in the company.

An important consequence is that executive talent and company size should be positively correlated. Allocating the most talented executives to the largest companies maximises the effect of their greater ability by spreading it across longer chains of command and larger scales of operation (Rosen 1992, p. 184). Essentially, highly-talented executives are worth more to larger companies than to smaller ones — given that even a small difference in ability can make a significant difference to company performance — and competition between companies for the most talented executives will tend to result in relatively high levels of remuneration (Alchian and Allen 1983, p. 310).

Increases in company size could therefore have significant effects on remuneration by increasing competition for the most talented executives. This would also have flow-on effects for other executives in smaller companies. However, there would likely be some moderating influence from the effect of more people being enticed into the ‘executive services market’.

Box 4.8 Australian and US studies on remuneration and company size

- Fleming and Stellios (2002) find a positive relationship between CEO remuneration and total assets for a sample of 86 ASX500 companies in 1999.
- Using a sample of 722 companies over the period 1990–99, Merhebi et al. (2006) find a positive relationship between CEO remuneration (defined as salary and bonuses) and company size (proxied by total revenue).
- Capezio (2008) also finds evidence of a positive relationship between CEO cash remuneration and company size (measured by total assets) for companies included in the ASX500 index between 1999 and 2006.
- In the United States, one of the earliest studies to document a positive relationship between executive remuneration and company size was Roberts (1956), using data on manufacturing executives in the late 1940s and 1950.
- Kostiuik (1990) finds a positive relationship between company size and the remuneration of manufacturing CEOs over the period 1969–81.
- Murphy (1999), using data for US S&P industrial companies between 1992 and 1996 finds that CEO remuneration is higher in larger companies, referring to this as ‘the best-documented stylized fact regarding CEO pay’ (p. 2493).
- Frydman and Saks (2007) document a positive relationship between company size and remuneration for the later decades of their data set (although the relationship between size and remuneration was found to be weak in the early decades of their sample).
- Gabaix and Landier (2008) use the observed relationship between size and remuneration to develop a model describing how CEO remuneration responds to changes in company size (considered in more detail in appendix D).
- Clementi and Cooley (2009), considering CEO remuneration for a large sample of US companies in 2002, find that remuneration tends to be higher in larger companies, and that CEOs of larger companies have bigger stock and option holdings (and hence more wealth) tied to the companies they manage.

As noted earlier, while there are probably many people with appropriate managerial training and experience, they will have different levels of desirable personal qualities — including communications skills, ‘emotional intelligence’ and leadership ability of a high order (box 4.10).

Box 4.9 Company size, profitability and executive incentives

The discovery of a positive relationship between company size and executive remuneration by studies such as Roberts (1956), led to debate over whether executives had greater incentives to increase company size or company profitability.

A number of studies addressing this question were undertaken, with some, such as McGuire, Chiu and Elbing (1962) finding a larger effect of sales than profits, but others, such as Lewellen and Huntsman (1970) found the reverse. Ciscel and Carroll (1980) argued that, because profit is equal to total revenue (sales multiplied by output prices) minus total costs, the significance of sales as an explanatory factor in analyses of executive remuneration could be consistent with both the size and profit maximisation hypotheses.

Rosen (1992, p. 196) concluded that there were no clear winners of this debate, and that both company size and performance are important. Furthermore, he argued that size should be positively related to remuneration in any case, since more talented executives worked at larger companies. Hallock and Murphy (1999, p. xiii) in observing this debate, make the point that sales and profits are both ultimately measures of company size, so the question of which one executives 'choose' to maximise is, in a sense, irrelevant.

In addition to the direct effect of growth in company size on demand for highly talented executives, growth in company size may also affect remuneration in an indirect way. As noted earlier in this chapter, Gayle and Miller (2008) have suggested that as company size increases, the potentially adverse consequences of inadequately addressing the principal-agent problem are magnified. As a result, larger companies can offer more incentive-based pay to their executives who, through risk aversion, require compensating differentials, resulting in higher overall pay. Sung and Swan (2009) find that the greater total dollar variability in company returns for large companies explains a significant part of observed remuneration growth in the United States.

A number of participants discussed the role of company size in executive remuneration in Australia. For instance, CGI Glass Lewis and Guerdon Associates stated:

Theoretically, growth in market capitalisation would, to an extent, reflect additional company size and complexity, making it more difficult to source qualified executives. (sub. 80, p. 47)

Figures 3.3 and 3.4 in chapter 3 show that remuneration is typically significantly higher for companies that have a larger market capitalisation. This relationship holds for CEOs and other senior executives alike. For example, total CEO pay at the top 20 Australian listed companies is almost double that for the next twenty.

Box 4.10 What abilities should a CEO possess?

A number of personal characteristics affect the ability of a CEO to manage an organisation successfully, and thus, have implications for their suitability and the willingness of companies to pay for their skills.

Kaplan, Kelbanov and Sorensen (2008) outline a number of characteristics and abilities that a sought-after CEO is likely to possess, classified on the basis of leadership, interpersonal and motivational skills, and personal and intellectual abilities.

Desirable leadership qualities, for example, include the ability of a CEO to rapidly adjust to changing priorities or conditions, and produce significant output within a short period of time. Important interpersonal skills are the CEO's openness to criticism and ideas, and written and verbal communication skills. Motivational skills include the CEO's enthusiasm, initiative and work ethic. Personal abilities that companies are likely to seek in a CEO are those such as integrity, organisational and planning skills, and the likelihood that the CEO will follow through on commitments they have made. Intellectual abilities are those such as analytical skills, creativity, and attention to detail, in addition to brainpower (Kaplan, Kelbanov and Sorensen 2008).

That said, the correlation between remuneration, talent and company size is unlikely to be perfect, given the difficulty of making judgments about, and observing, the talent of individual executives. Other factors may also affect the relationship — for example, a highly-talented CEO may prefer (perhaps for non-pecuniary reasons) to work in a company smaller than the scale of company he or she is capable of managing. The observed relationship is also skewed by a few CEO/chairs who choose to take little direct salary, because they are substantial owners.² Indeed, based on an analysis of US data, Sung and Swan (2009) suggest that changes in executive 'talent' rather than company size *per se* explain a large part of CEO pay growth in the United States in the 1990s and early 2000s.

Nonetheless, simple regression analysis undertaken by the Commission provides some evidence that changes in company size are associated with changes in the level of executive remuneration (box 4.11).

² According to Fernandes et al. (2009), in the United States, CEO/chairs tend to receive higher pay than CEOs who do not perform both roles. The reason for the difference could be that Australian CEO/chairs are usually large owners who receive most of their rewards through equity holdings.

Box 4.11 **Regressing company size and remuneration**

In order to obtain a rough estimate of how changes in company size can lead to changes in executive remuneration, the Commission undertook some simple regression analysis. All of the estimates reported below were statistically significant.

- A regression was estimated using CEO remuneration as the dependent variable and company size, as proxied by market capitalisation, as the (sole) independent variable. Data were for 2003-04 to 2008-09, for all CEOs who served a full year in ASX300 companies.
- Regressing (the natural logarithm of) company size on (the natural logarithm of) total remuneration indicated that a 10 per cent increase in company size was associated with a 4.2 per cent increase in CEO remuneration (the latter figure is the elasticity of remuneration with respect to size). (Adding year dummies to the regression did not significantly alter the results or estimated magnitudes.) The (adjusted) R^2 was approximately 0.28, indicating that the specified model explained roughly 28 per cent of the variation in CEO total remuneration.
- Running a similar regression, but this time using base salary as the dependent variable, it was estimated that a 10 per cent increase in market capitalisation is associated with a rise in CEO base pay of around 3 per cent, accounting for around 20 per cent of the variation in CEO base pay.

For non-CEO executives, a similar regression of total remuneration on size was estimated for 2008-09. The results indicated that a 10 per cent rise in company size was associated with a 3.2 per cent increase in total non-CEO executive remuneration. This regression had an R^2 of 0.44, indicating that company size accounted for approximately 44 per cent of the variation in total executive remuneration. Running the same regression, but instead using base salary as the dependent variable returned an elasticity of 2.3 per cent (and an R^2 of 0.39).

Source: Appendix B, Productivity Commission estimates.

Using data on ASX300 CEOs and company size (proxied by market capitalisation) spanning the period 2003-04 to 2008-09, the regression estimates indicate that on average, a 10 per cent increase in company size is associated with an increase in total CEO remuneration of approximately 4.2 per cent. A similar analysis using base pay indicated that a 10 per cent increase in company size is associated with an increase in base pay of around 3 per cent. (Likewise, a 10 per cent decrease in a company's market capitalisation would be expected to result in a 3–4 per cent reduction in the remuneration of executives.) Similar results were found for non-CEO executives. The results are roughly consistent with those found in the US and Australian literature.

Thus, company size does seem to have played a major role in executive remuneration, accounting for between 25 and 50 per cent of observed increases in

total remuneration. Although perhaps the most significant individual driver of remuneration, it is not the only explanation for the observed increase in remuneration over time.

4.5 Some conclusions

The economic environment confronting Australian companies in the 2000s is far more complex and pressured than in the 1960s. Liberalisation of product and financial markets, as well as the introduction of competition in some formerly government-controlled sectors, culminated in increased international trade and financial flows and drove substantial domestic structural change, including corporate consolidation and the emergence of Australian-based global companies. In 1968-69, Australia's trade intensity (defined as the ratio of imports and exports to gross domestic product) was around 26 per cent, rising to 33 per cent by 1988-89. By 2008-09 it was 47 per cent (ABS 2009c).

In parallel with these developments, executive pay has both increased and changed in form. Until the late 1980s, executive remuneration comprised mainly cash, perquisites, with small bonuses and some equity granted as profit sharing. Since then, executive pay growth has been driven by increases in incentive pay, a trend accelerated by the 'importation' of a few high profile US executives to key CEO positions. Such a change was probably inevitable, however, given the increasingly international focus of Australian companies.

While it is not possible to be categorical about all the reasons for the substantial remuneration increases, the dominant influences appear to be:

- The growth of Australian companies in a more dynamic and global environment, which raised the importance of the most highly-talented executives for the largest companies. In essence, both job requirements and job opportunities changed.
 - Increased demand led to increased remuneration for the best executives, with ripple effects for the remuneration of other executives.
 - Globalisation increased the mobility of executives and the demand by companies for people with international experience (with some 'imported' effects from high executive pay in the United States via the appointment of particular executives).
- Enhanced disclosure rules are likely to have accelerated pay adjustments across the executive market to realign relativities, but there is little evidence that they led to a permanent lift in the growth of executive pay.

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- The growth of incentive pay has accounted for nearly all the growth in executive pay at larger companies in recent years.
 - Increasing company size appears to have led to strong growth in incentive pay, reflecting the potential benefits of closer incentive alignment (and bigger risks of imperfect alignment) for larger companies.
 - Even if efficiently set, a shift to incentive pay will have served to increase reported total pay because of the additional risks it poses for executives.
 - Initially, incentive pay may not have been closely aligned to improving performance, leading to higher than necessary payments and the more rapid overall growth seen in the 1990s. The progressive introduction of relative performance hurdles from the mid 2000s may have ameliorated this to some degree, although at the cost of introducing complexities to pay structures.
 - Although Australia’s corporate governance appears stronger than that in the United States, not all companies meet best practice requirements.
 - Where potential conflicts of interests persist, there is potential for executives to exert undue influence either directly or indirectly.
 - Board weakness or complicity as well as information asymmetry may have been factors in several instances of apparent ‘rewards for failure’.
 - The complexity of incentive-based pay raises concerns that boards may not have possessed the requisite capacities to understand their implications, becoming excessively reliant on external advice. Companies might thereby have ended up paying too much for little positive (and sometimes negative) incentive effect.

In summary, there are reasonable grounds for concluding that, to a significant degree, changes in executive remuneration in Australia can be related to market developments and pressures, and endeavours by boards to align executive effort with company interests. Nevertheless, there are also indications that some trend and specific pay outcomes have been inconsistent with an efficient executive labour market. The complexities of incentive pay arrangements have heightened the importance of having competent, independent boards and good processes to ensure that objectives are not being subverted. The extent to which Australian companies meet these criteria is the focus of the following chapters.