



EXECUTIVE REMUNERATION – TIME FOR A **rethink?**

Despite comments to the contrary, directors of Australian listed companies, by international comparisons, have done a reasonably good job of handling the inherent difficulties in executive remuneration, although there are exceptions to any general rule. Some of the recent non-binding votes against remuneration reports might fall within these exceptions. Boards have, however, generally acted responsibly, with the best of motives in the environment at the time.

Large downturns in share and other markets will however continue to test the resilience of all executive contracts, particularly CEO contracts.

To be clear, we are talking about the remuneration of executives – not non-executive directors, who are typically paid a fixed fee. Also, much of the public debate about executive remuneration is largely centred on some of the top 50 listed companies. Sweeping generalisations should not be made about remuneration levels or governance based on a few Australian listed companies or US examples.

CEO remuneration is a board decision, and possibly so are the packages paid to other executive directors and direct reports to the CEO. Boards are best placed to exercise judgment, with the appropriate use of skill, reflection and advice. That is where the responsibility for remuneration setting should continue to reside.

The big issue in executive pay involves the amount of the total package – in particular, the short- and long-term incentive payments. Ironically, the increase in popularity of these incentive payments was fuelled by limits on the tax deductibility of base pay introduced in 1993 by the US Congress. This is one of the many perverse outcomes of attempted regulation in this area. This should be remembered when yet more regulation is sought to be introduced in this space.

CEO remuneration once simply consisted of base pay and a discretionary bonus. The level of trust was necessarily high and boards realised that a proper analysis of any bonus was important – not only to retain CEOs, but to attract them. That simple model has now been converted into increasingly complex incentive schemes, some of which have had unintended consequences in differing market conditions.

Attempts by overseas legislators to proscribe aspects of executive remuneration have often been ill-advised and of marginal utility. Where they have been effective in trying to suppress outcomes that are not in line with market expectations, the effect has been like

squeezing a balloon, with the tightening of one aspect of remuneration causing the underlying pressure to move to another part of the package.

Heavy-handed legislation of executive remuneration is certainly not the way forward. Sarbanes-Oxley should have taught us that. There is already a considerable amount of regulation governing executive remuneration. This includes a reasonable benefits test, limits on termination payments, extensive disclosure rules, an advisory vote on an annual remuneration report, various listing rule requirements, together with the general legal duty of directors to act in a company's best interests.

Present market conditions are likely to see a shakeout in executive remuneration. Some arrangements may already be seen, with the benefit of hindsight, as overly generous in good times given recent falls in investment returns. Others may now be under water given the current market downturn, with changes being contemplated by boards to retain good staff in difficult times.

These issues are still playing out and it will be some time before we see where they lead and what conclusions can be properly made. Given the possible need to adapt to changed economic circumstances, there will be very interesting and difficult discussions about executive remuneration in some boardrooms.

An erroneous assumption is often made that remuneration arrangements for all sorts of companies can be shoehorned into a one-size-fits-all approach. There are, however, complex and difficult issues in negotiating remuneration and setting parameters, and applying existing contracts. Boards need to consider not only addressing current conditions, but also the effect when good times return, as they inevitably will. I am reminded of the quote from Sun Tzu who wrote *The Art of War*: "In peace prepare for war, in war prepare for peace".

The changed market circumstances provide an ideal opportunity for a complete rethink on senior executive remuneration. With this in mind, AICD is embarking on a program to increase awareness of the issues associated with executive remuneration and the need for appropriate shareholder engagement, with a particular focus on director education. We will be asking whether the current approach is the most appropriate, or whether a new paradigm – including a possible return to some old ones – may be preferable for some companies.

A handwritten signature in black ink, appearing to read 'John H C Colvin', written in a cursive style.

John H C Colvin FAICD
CEO, Australian Institute
of Company Directors