

Business  
Council of  
Australia



# **Business Council of Australia**

**Submission to**

**Productivity Commission Inquiry**

**on**

**Director and Executive Remuneration in Australia**

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# Table of Contents

<b>Foreword</b> .....	<b>3</b>
<b>Introduction</b> .....	<b>3</b>
<b>The market for skills is increasingly global</b> .....	<b>5</b>
<b>Challenges facing CEOs in Australia</b> .....	<b>8</b>
<b>Setting executive remuneration in practice</b> .....	<b>11</b>
Market Transparency .....	11
Role of the board .....	11
Board capture .....	12
Pay structure and performance .....	13
Achieving alignment.....	14
Longer horizons .....	15
The timeline of pay and performance .....	16
Termination payments .....	16
<b>Setting remuneration – the regulatory and reporting backdrop</b> .....	<b>18</b>
<b>The issue of systemic risk</b> .....	<b>20</b>
<b>More regulation is not the answer</b> .....	<b>21</b>
<b>The way forward</b> .....	<b>22</b>
<b>The role of this inquiry</b> .....	<b>24</b>

## Foreword

The Business Council of Australia represents the chief executives of over 100 of Australia's leading companies. On behalf of its members, the BCA develops and advocates public policy reforms that seek to position Australia as a strong and vibrant economy and society. Our member companies are very large businesses; they account for significant domestic sales and economic activity, a substantial share of Australia's trade and investment flows, and collectively employ nearly 1 million people domestically.

The BCA welcomes the opportunity to provide a submission to the Productivity Commission Inquiry into the Regulation of Director and Executive Remuneration in Australia and acknowledges the time taken by the review team to consult directly with our members and the chairmen of BCA member companies.

## Introduction

The global financial crisis (GFC) has brought renewed scrutiny of executive remuneration, although concerns regarding trends in executive remuneration are not new.

As in the past, a key focus of the current debate is the amount of remuneration paid to executives relative to the pay of average wage and salary earners. But significant attention is also paid to circumstances where companies have underperformed or failed and there appears to have been little link between executive pay and performance. In addition to these issues, the GFC has raised questions about the role of remuneration structures in rewarding excessive and unsustainable risk taking that has economy-wide consequences.

It is interesting to observe that the tone of the debate on executive remuneration in Australia appears similar to that in many other countries, notwithstanding the fact that the performance of the Australian economy and its businesses has continued to be among the best in the world.

The BCA believes there are important issues which deserve more attention and that there is a need to promote a wider understanding of the drivers of executive remuneration and company performance.

This is particularly important because the nature of the public debate on executive remuneration continues to damage perceptions of corporate Australia. Now more than ever we should be focusing on the strengths of Australia's businesses and how a relatively well-placed corporate sector can capture new and emerging opportunities and support economic recovery.

At the outset it is also important to recognise that the executive pay debate in this country is essentially focused on the remuneration paid to those CEOs and other senior executives who lead Australia's large publicly listed companies. This is because only listed companies are legally required to report on the pay of their senior managers; neither private companies nor subsidiaries of large multinationals operating in Australia face comparable reporting requirements despite paying at similar levels. Given the relatively small size of the majority of these listed companies, scrutiny and debate actually focuses on a much smaller number of executives typically employed by Australia's larger public companies (ASX100), including many of the companies that make up the BCA.

As in other inquiries, the Productivity Commission has an important role to play in ensuring that public debate and any potential policy decisions are based on a thorough understanding of the facts and an objective assessment of the potential costs and adverse implications of adopting politically motivated regulatory and/or policy responses.

The objective of this submission is to contribute to a broader understanding of the factors determining and driving executive remuneration, the strength of the requirements already in place in terms of regulation and reporting of executive remuneration, and the potential adverse and unintended consequences that could flow from the introduction of additional regulation in this area. Many of these broader observations are reinforced by the more specific and detailed submissions made to the inquiry by individual BCA member companies.

## The market for skills is increasingly global

As Australia has become more integrated with the global economy executive pay has been increasingly influenced by global benchmarks. Australian corporations require a wide range of skills and talent to successfully lead businesses in a global economy and they compete globally for them. This has implications for the quantum and rate of growth of executive pay as well as arguments that executive pay should be regulated at a level or rate below competitive global benchmarks.

Like the markets for goods, services and capital, the market for labour and skills has become increasingly global. This reflects a wide range of factors including advances in transport and communication technologies, growth in the services sector everywhere, the rising importance of skills and ‘human resources’ in driving innovation and productivity (i.e. competitiveness), and the rapid growth of significant developing economies.

The global recession will no doubt adversely impact global labour mobility temporarily, but over time the competition for skills and ‘talent’ will intensify as technological progress reinforces a global marketplace and population ageing in the advanced economies reduces the talent pool.

While senior executives in many of the BCA’s member companies are Australian, a significant number are not, and the majority who are Australian have had international experience at some stage in their careers. Most large listed company boards will proactively consider overseas candidates, including Australians currently working overseas, when looking to fill senior executive positions – with some findings suggesting that Australia’s larger listed companies source almost 20 per cent of their executives from offshore.<sup>1</sup>

These are significant considerations, but recruitment is only part of the story. The global market for skills also presents significant challenges in terms of retention for businesses operating in Australia.

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<sup>1</sup> M. Robinson, ‘Hold the Remuneration Horses Until PC Report’, *The Australian Financial Review*, 26 June 2009.

There are a significant number of Australians moving and living overseas. Emigration is more often than not driven by work considerations (typically pay and opportunity) and Australia's emigrants are typically highly educated, highly skilled and highly paid.<sup>2</sup> While often emigrants are relatively young, the demand for experience has also seen stronger growth in emigration among older, more experienced professionals to regions such as Asia. The global recession will no doubt put a dent in these trends, but they can be expected to remerge as the global economy recovers.

International opportunities are now considered routine for careers in multinational corporations, and within the professional services, resources and financial sectors, to name a few. In this environment, all businesses and sectors must offer attractive incentives to secure and retain talented executives and potential up-and-coming business leaders.

Australian companies seeking to attract and retain skilled workers must offer globally competitive conditions and remuneration packages – in terms of structure and quantum – from the CEO down. In most companies the CEO's pay sets the benchmark for other executive salaries within the company. Paying the CEO less would mean publicly listed companies may not be able to pay the levels required to attract the most capable senior managers. It is frequently these managers who are the most vulnerable to change of jobs. It is not just the quantum, but also structure of CEO remuneration and the nature of performance benchmarks that filters down the ranks. In other words, restrictions on executive remuneration will typically have significant flow-on effects.

The visibility of CEO pay makes it an obvious focus of public concern regarding growing inequalities with average wages and incomes. But it is interesting to note that recent research by the IMF has concluded that the main factor driving the worldwide phenomenon of rising income equality has been technological change and the commensurate increasing premium on higher skills.<sup>3</sup> Although technological progress, coupled with trade and financial openness, has increased relative inequality, it has been positive for all income groups in an absolute sense. In other words, the same drivers that

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<sup>2</sup> G. Hugo, D. Rudd and K. Harris, *Australia's Diaspora: Its Size, Nature and Policy Implications*, CEDA Information Paper No. 80, December 2003.

<sup>3</sup> F. Jaumotte, S. Lall and C. Papageorgiou, *Rising Income Inequality: Technology, or Trade and Financial Globalization*, IMF Working Paper WP/08/185, 2008, at [www.imf.org](http://www.imf.org).

have contributed to rising executive remuneration have also contributed to rising national incomes and wealth more broadly over time.

### **The Role of a Public Company**

The listed company provides an effective mechanism to aggregate large amounts of capital for investment, to efficiently allocate and manage risk, accumulate expertise and knowledge and minimise the costs of doing business.

All these attributes provide the foundation for a modern economy like Australia's. At the same time, changes have occurred in the last 20 years that have fundamentally altered the environment in which Australian corporations and their senior managers operate. These include financial deregulation, the end of government-sponsored protectionism through across-the-board tariff reductions, major tax reform and workplace relations changes.

These changes have all led to a global and more competitive business environment, as well as increasing complexity in the operations and demands on Australian corporations. With market opportunities limited by Australia's small domestic market many have expanded their operations offshore. In turn, this has led to a rapid increase in responsibilities of and demands on the CEOs and senior management.

One of the more far-reaching changes during this time has been the significant increase in ownership (through direct shareholding) by ordinary Australians of publicly listed companies and by professional foreign investors holding Australian stocks as part of their global portfolios.

Collectively, Australia's more than 2000 listed companies, and by extension their senior management, are responsible for the management and growth of over \$1 trillion in shareholder and investment wealth.

Source: Excerpted from the BCA publication, *Principles of Executive Remuneration*, 2004. Data on Australia's listed companies (paragraph 6) is sourced from [www.asx.com.au](http://www.asx.com.au).

## Challenges facing CEOs in Australia

There is little doubt that globalisation, technological advance, financial innovation and the increasing scale of large businesses have made executive roles more complex and challenging. Australian executives are not alone in this respect. But some of Australia's unique circumstances do create additional challenges and complexities.

### **The Role of the Listed Company CEO**

The role of a listed company CEO involves leading a team, responsible through the board to the shareholders, to safeguard and grow shareholder value within the regulatory, statutory and ethical requirements of the markets and communities in which the corporation operates.

In order to manage shareholder capital and deliver competitive returns, the typical CEO has four sets of accountabilities, namely:

- Those that relate directly to achieving the commercial and financial objectives of the company.
- Those that relate to the internal structure and organisational capability required to meet these objectives.
- Those that define the professional, regulatory and ethical relationships required to protect and grow company value.
- Those that influence its relationship and standing within the wider community.

The defining characteristic of the CEO position is that the scope and size of the role and its accountabilities require significant personal latitude, judgement and responsibility. The complex mix of skills required to succeed as a public-company CEO are often poorly understood in the public domain despite the presence of ample evidence pointing to the very public and often stark divergence in the performance of corporations during the



tenure of different CEOs.

Over the past 20 years, as Australia has internationalised its economy, the structure and role of major corporations has changed markedly. So has the complexity, expectations of and risks associated with the role of the CEO and senior managers.

The opening of the Australian economy to international markets has provided many companies and their shareholders with additional sources of revenue and profit. At the same time, it has exposed Australian firms to an unprecedented level of competition and risk.

The Booz & Co CEO Turnover Study in 2007 notes for example that 'being relatively small and isolated, Australia's economy is structurally quite different from many other OECD markets.'<sup>4</sup> One issue highlighted includes the need to pursue more aggressive, usually offshore, growth strategies to compensate for the lack of domestic scale and the challenges of competing in global capital markets. As a result, Booz & Co concluded that executives in Australia are more likely to be confronted with additional commercial risks associated with operating in geographically and culturally diverse locations, coupled with the logistical difficulties of differing time zones, managing over long distances and frequent long distance travel. Anecdotally, the typical BCA member now spends considerable time travelling overseas either to manage offshore operations and/or as part of global investor roadshows. In sum, the CEOs of Australian-listed companies with overseas operations must manage the political, social, regulatory and market risks in each market and their implications for the company's business strategy.

This is compounded by the excessive burden associated with an overlapping federal–state regulatory system that is well out of proportion to the size of our domestic economy.

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<sup>4</sup> Booz & Company, *CEO Turnover Study 2007 – The Performance Paradox*, 2007, p. 6.

While the roles of listed and non-listed company CEOs in Australia share many common responsibilities, it is also worth noting that some performance-driven responsibilities for listed corporations have greater emphasis. This includes:

- expectations that publicly listed companies play a role in financial security for many Australians, particularly retirees; and
- relatively high rates of share ownership, which means greater public awareness and interest in issues related to corporate performance and governance, which in turn are tied to perceptions of the performance of the CEO.
  - Anecdotally, many CEOs, particularly those with overseas experience, remark on the degree of public examination of their performance and remuneration in Australia compared with elsewhere.

The BCA believes that these performance expectations have been a major driver of greater employment risk for CEOs.

The Booz & Co 2007 Turnover Study found that:

- Australian CEO turnover in 2007 was 18 per cent, the highest since they commenced the Australian study and an increase of 60 per cent since 2000.
- CEO turnover in Australia was among the highest in the world, and well above the 2007 global average of 13.8 per cent.
- CEO tenure in Australia dipped to 5.7 years, significantly lower than the global average of 8 years.

The Booz 2007 study also reported an increase in recent years in the proportion of first-time CEOs among all departing CEOs in Australia.

It is interesting to note that merger activity plays a large role in Australian departures, which supports the view that pursuit of scale and growth is a key issue/challenge in a small market.

The overriding conclusion from the Booz & Co research is that executive retention is the key issue looming for Australian boards in the future.

## **Setting executive remuneration in practice**

### **MARKET TRANSPARENCY**

Current disclosure rules require locally listed companies to provide full details of CEO and selected senior management remuneration to be made public in their annual remuneration reports. As a result, CEO recruitment and ongoing remuneration operates in an informed transparent market where comparable benchmarks are readily available. The widespread use of global job sizing methodology and the participation of the local arms of multinationals in the various local and global remuneration surveys also permits local remuneration to be benchmarked against international practice.

### **ROLE OF THE BOARD**

Selecting a CEO and deliberations about executive pay are the responsibilities of the company board.

The trends and challenges noted above are one aspect of the deliberations that boards face when agreeing to executive appointments and remuneration packages, but there are many others. These deliberations are complex and require boards to exercise their best judgement based on the information available to them, and their own skills and experience. No two CEO jobs are the same and no two CEOs are the same. Different candidates will bring different strengths, skills and experience, and likewise will have different expectations about the quantum and structure of their remuneration.

Larger companies will also likely have a specialised remuneration committee as a sub-committee of the board with responsibility for more detailed investigation of remuneration levels. Best practice requires that this committee is comprised solely of independent

directors. In making decisions on remuneration, many boards will be guided by the recommendations of the remuneration committee.<sup>5</sup>

While boards can and do also seek external expert advice, it is clear that the ultimate responsibility for CEO selection and remuneration rests entirely with the board.

## **BOARD CAPTURE**

Some have argued that the growth in executive pay reflects the fact that CEOs are able to ‘capture’ boards and ‘skim’ remuneration in excess of what they deserve.<sup>6</sup> But in addition to the legal and regulatory requirements placed on companies, there are powerful incentives for boards not to pay executives more than they need to.

Given the scrutiny and levels of disclosure that now operate, boards that award excessive amounts of remuneration run the risk market and public criticism, resulting in damage to personal and company reputations.

Remuneration is a business cost, and competitive forces require boards to examine all costs carefully. While pay to senior executives may account for a relatively small share of a large company’s total cost, excessive remuneration, or remuneration that rewards underperformance, represents a highly public, uncompetitive cost structure.

Many of the recent decisions by major listed companies to freeze or cut executive remuneration can be taken as evidence that consideration is being given to concerns about both cost and reputation in a difficult economic climate.

The relatively short and declining CEO tenure observed in recent years also casts doubt on the extent of ‘board capture’ in Australia.

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<sup>5</sup> The issue of independence which is not always straightforward is addressed in Principle 2 of the ASX Corporate Governance Principles and Recommendations (Second Edition August 2007).

<sup>6</sup> See for example L. Bebchuck, and J. Fried, ‘Executive Compensation is an Agency Problem’, *Journal of Economic Perspectives*, 2003, 17 (3), pp. 71–92.

## **PAY STRUCTURE AND PERFORMANCE**

Executive remuneration is structured differently from the pay of average workers. This reflects:

- Competition for skills and experience in an increasingly global market.
- The relatively small pool of potential applicants that have the requisite skills and track-record to manage the complexity of leading a major firm, employing thousands of people in an international environment.
- A clear public link from the performance of the individual to the performance of the company.
- The risks and uncertainties associated with tenure and the typical public scrutiny of exits, be they forced or otherwise.

While the quantum of CEO pay appears to be at the heart of community anxiety, the most important issue from the BCA's perspective is closely and clearly aligning executive remuneration to sustained company performance. If this is achieved then executive interests are aligned with shareholders' interests and the likelihood of systemic risks or market failures (for example those that might stem from excessive and unsustainable risk taking) is also minimised.

As with any commercial negotiation, the amount and structure of remuneration will reflect the risk–return trade-off – the greater the risks, the higher the pay. Within this context and against the backdrop of the broader market considerations discussed above, a company board has to decide four key issues:

- The split between fixed and performance-based (or 'at risk') pay.
- Within performance-based pay, the split between long-term and short-term incentives.
- The nature of performance hurdles or benchmarks.
- The payout costs and conditions associated with termination.

While some have argued, on the basis of simplicity, for a return to a greater proportion of fixed pay, it is hard to see how this achieves a strong alignment with shareholder interests.<sup>7</sup>

## **ACHIEVING ALIGNMENT**

The ongoing debate therefore continues to centre on how to better link an executive's variable or 'at risk' remuneration clearly and closely to those factors that drive shareholder returns and which executives have the ability to directly impact. This is not easy or straightforward.

Even the definition of the 'shareholder' poses challenges. Many companies have very fluid share registers with shareholders trading in and out of the stock at different times. A shareholder who buys into a company at a cyclical low may well be pleased when the stock price rises but for a longer-term holder this may simply mean the recovery of a portion of their previous losses.

In reality, each company has its own strategy and specific operating objectives, and these will differ and evolve over time. Often, important aspects of a company strategy will rely on the achievement of key qualitative outcomes that are inherently difficult to objectively measure and report.

If variable pay is to be closely aligned to real drivers of company performance over time, a greater diversity and indeed complexity of measures and targets is required within and across companies. This should not be surprising. Large companies are complex as are the vast majority of contracts that relate to their operation. This raises the very vexed issue of how to ensure there is clarity around performance incentives/hurdles and a broad understanding of remuneration priorities, strategies and outcomes.

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<sup>7</sup> Unless this base pay is delivered in the form of restricted stock, but delivery of restricted stock as part of base pay, rather than as a variable component subject to some form of performance criteria as is currently the case in many CEO remuneration packages, does not seem logical.

Experience shows that efforts to use common and more widely understood metrics (such as total shareholder return or relative total shareholder return) do not always produce the desired results. For example, as share prices have fallen, using measures such as relative total shareholder return as a performance benchmark may in fact reward volatility and market ‘catch-up’ rather than the management out-performance. But in a rising market, relative total shareholder return is seen as being superior to total shareholder return, which simply rewards all for market momentum.

Given the various complexities in determining superior performance, there is a strong case to be made for the use of board discretion in determining the quantum of at-risk payments.

## **LONGER HORIZONS**

The role of excessive, short-term risk taking in the GFC has also brought more focus to an already emerging trend: a greater emphasis on remuneration strategies that target and relate to long-term company performance.

Australian remuneration practices have followed this trend. Recent research by PricewaterhouseCoopers shows that there is a clear focus on long-term incentives (LTI) in the remuneration strategies of Australian companies.<sup>8</sup> In 2008, 39 per cent of the actual remuneration of ASX 100 CEOs comprised long-term incentives and it is the LTI component of CEO remuneration that is substantially responsible for the higher pay of CEOs among the largest 25 companies compared with the rest of the ASX 100.

In creating an alignment with shareholder interests it is probably most meaningful to consider the total stock holding that a CEO might amass over his or her term in the job rather than focus on the amount that might be awarded in any one performance period. Most successful CEOs will quickly build a relatively large stock holding in the companies they manage. As such they will have a strong vested interest in the value of that stock.

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<sup>8</sup> Pricewaterhouse Coopers, *Executive Remuneration: Fit for the Future?*, 2009.

To the extent that the majority of shareholders (though not all) are long-term investors, this should provide more confidence regarding the alignment of executive remuneration with shareholder interests in Australia's large listed companies.

## **THE TIMELINE OF PAY AND PERFORMANCE**

Finally, in assessing remuneration outcomes and practices it is important to ensure that reported pay is compared with performance over the period for which that remuneration is being paid. Not all contracts are or will be well structured, but in the current environment it is important to note that sometimes, while it appears that poor performance is being rewarded, that may not be the case.

Performance payments occur in arrears – often well after performance has been recorded. And, more generally, the publication of remuneration reports lags company performance. This means at present, against the backdrop of more recent share price falls, attention is focused on pay outcomes that reflect performance in 2008 (and earlier). Many companies delivered strong results for much of that year and continue to manage relatively well the impacts of an unprecedented global recession.

Likewise, as has been observed by others, what tends to be reported in the media is booked or expected values of pay at risk and not actual payments. In falling markets, typically this approach significantly, overstates actual remuneration. This can lead to a misleading coincidence of inflated perceptions of pay as market performance deteriorates.

All of this serves to diminish the clarity of public discussion of executive remuneration.

## **TERMINATION PAYMENTS**

In considering the appropriateness of termination payments it is important to bear in mind the nature of the termination. Is it for poor performance or for some other non-performance related reason, e.g. the executive has reached retirement age or the company has been acquired? This is germane to the extent that for terminations not related to poor performance it is not uncommon for CEOs to receive a pro-rata amount for performance hurdles already achieved.



The most controversial aspect of the executive pay debate is when some apparently ‘failed’ CEOs receive large payouts.

CEO jobs are risky and uncertain and as noted above are characterised by relatively short tenure in Australia. Employment agreements for CEOs and other senior executives typically provide for termination with very little notice. In most cases other than ‘for cause’, it is common for contracts to provide for a maximum payment of 12 months pay in the event of termination by the company.

When a board decides a CEO is not delivering acceptable results, it is in everyone’s best interests to encourage the CEO, through mutual agreement, to leave sooner rather than later. Protracted poor performance or public contractual disputes can be damaging to the business, including important commercial factors such as public reputation, client relationships and staff morale. This means compensation for the risk of early termination is a priority issue in contract negotiations.

The Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 has been introduced into parliament, less than a month after the submissions on the exposure draft legislation were due.

The BCA is concerned that under these laws, boards will find it more difficult to manage termination arrangements not least because of the breadth of their application and the details of the definition of what constitutes a termination benefit.

Much of the detail of what amounts to a ‘termination benefit’ has been left unclear because the regulations have not been finalised. There has also been no explanation of why the laws apply to potentially hundreds of ‘key executives’, including overseas executives. This has the potential to distort the executive employment market away from the listed sector in Australia, and to create significant unintended consequences for the wider economy.

The BCA considers that this issue should have been dealt with through this inquiry, rather than through legislation quickly drafted with little consultation.

## Setting remuneration – the regulatory and reporting backdrop

In Australia there are explicit, statutory requirements and guidelines that provide a clear framework for board decision-making on and disclosure and governance of executive pay.

These requirements and guidelines demonstrate there is already in place a robust framework for regulating executive pay, which still provides boards with the scope to structure executive pay according to their companies' needs.

The Corporations Act has two sections that relate directly to the board's accountability for executive pay.

- Section 211 requires that remuneration paid to an employee of a public company must be deemed 'reasonable'.
- Section 300A of the Act requires that the annual directors' report include an explanation of the board's policy for determining the 'nature and amount' of pay to directors and executives. The board is also required to show the relationship between this policy and the company's performance and to provide details of pay for each board director and each of the named five highest paid executives.

The Australian Securities Exchange Corporate Governance Principles and Recommendations directly address issues of executive remuneration in Principle 8.<sup>9</sup> This principle is meant to encourage companies to ensure that executive pay has a defined relationship to individual and company performance. It also emphasises important governance structures including that boards should establish a remuneration committee, chaired by and comprising a majority of, independent directors. Companies are required to comment in their annual report on how Principle 8 has been applied (or why it has not been adopted) in the reporting year. Disclosures about executive remuneration are expected to be 'understood by investors'.

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<sup>9</sup> Principles are regularly reviewed and were comprehensively revised in 2007. =

In addition, a non-binding shareholder vote on the remuneration report of the board was adopted in 2004. In practice the vote has worked well and provides a means for shareholders to convey clearly to the board their views on executive remuneration policies.

It is interesting to note that based on a recent PwC analysis, it can be argued that there is not a high degree of dissatisfaction regarding executive remuneration among shareholders in ASX 100 companies. The PwC research found that for fiscal year 2008:

- Only 12 per cent of companies had a 'no' vote exceeding 20 per cent on remuneration report resolutions.
- Only 10 per cent of companies had a 'no' vote exceeding 20 per cent on CEO equity grant resolutions.
- Only 7 per cent of companies had a 'no' vote exceeding 20 per cent on non-executive directors fee pool increase resolutions.

These figures suggest that the remuneration strategies of Australia's largest listed companies generally receive broad support from shareholders.

In electing directors, shareholders of course have the ultimate say in who determines executive remuneration in the company.

The BCA considers that these existing regulatory and reporting arrangements are working well and provide more than adequate assurances regarding the integrity and appropriateness of the remuneration strategies being adopted by the majority of large listed companies in Australia.

This view is reinforced by the finding that Australia's corporate governance arrangements were ranked equal fourth in the world in 2008 as reported in the Australian Institute of Company Directors (AICD) submission to this inquiry.<sup>10</sup>

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<sup>10</sup> Submission by the Australian Institute of Company Directors to the Productivity Commission in response to the issues paper on Regulation of Director and Executive Remuneration in Australia.

Furthermore, these requirements are complemented by a wide variety of voluntary codes that provide advice and guidance to companies on appropriate principles of remuneration from the perspective of a range of stakeholders.

## The issue of systemic risk

Against the backdrop of the GFC there is now a consensus that poorly structured remuneration in the financial sector contributed to excessive risk taking, which generated adverse consequences well beyond the reach of the companies/industry concerned. Such experience does suggest the need to consider whether and how regulation can help to reduce systemic risks of this nature.

The Financial Stability Forum has commented that:

‘Compensation practices at large financial institutions are one among many factors that contributed to the financial crisis that began in 2007. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms. Such incentives amplified the excessive risk taking that destabilised the global financial system.’

FSF Principles for Sound Compensation Practices, 2 April 2009, see. [www.financialstabilityboard.org](http://www.financialstabilityboard.org)

In the Australian context, however, it is worth noting that:

- We have not experienced the systemic failures associated with excessive risk taking observed in other markets such as the United States and United Kingdom. In fact, it is important to acknowledge how well Australia’s banking and financial sector and companies have performed relative to their international peers over the course of the GFC.
- Where high risk business models have failed, executives have suffered significant losses related to the proportion of equity remuneration.
- As noted earlier, a significant share of executive remuneration among large listed firms in Australia already reflects long-term incentives.

The BCA notes that the federal government has requested that the Australian Prudential Regulation Authority (APRA) develop a template that links capital adequacy requirements to executive remuneration in order to limit excessive risk taking in financial institutions. To be clear, APRA's 'interest is related to the management of risk'.<sup>11</sup>

The BCA does not believe a case exists for action along these lines – that is, systemic risk management – to be taken outside of the financial sector.

## **More regulation is not the answer**

The BCA does not believe that evidence has been provided to suggest there is a consistent, widespread or systemic failure in regard to executive remuneration outcomes for large listed companies in Australia – that is, those companies that are the focus of this inquiry.

Against this backdrop, the adoption of additional regulation is highly likely to produce adverse and unintended consequences for no benefit.

In the face of competition from global and unlisted companies, additional regulation of executive pay will limit the ability of listed companies to attract and retain skilled and experienced executives, including in particular successful/experienced 'risk takers' who drive innovation and competitiveness.

The market for executive management works as a total market. Increasing the regulatory demands and expectations on public companies risks creating restraints and distortions on listed companies while allowing a significant part of the market (non-listed companies) to operate in a relatively unfettered and a non-transparent way.

Additional regulation could also limit the capacity of boards to adopt the incentive structures most likely to deliver strong performance relative to the company's business strategies and objectives. Somewhat ironically, boards may end up feeling less responsible for performance.

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<sup>11</sup> Refer to the speech given by John Trowbridge, Executive Member APRA, 'Executive Remuneration: The Regulatory Debate', 16 March 2009, p. 6, available at [www.apra.gov.au](http://www.apra.gov.au).

In the end, excessive and unnecessary regulation of executive pay will weigh on company performance and shareholder returns, job creation, tax revenues, productivity, export performance, economic activity and contribute to higher prices. In addition, it is likely to make it harder for publicly listed companies to attract capital, including from foreign shareholders, and will increase the attractiveness of ‘going private’.

As a result, we risk losing our valuable and experienced executive talent from our listed companies, and this is not a result we believe is desirable either for companies, their employees or shareholders.

While the BCA considers that a case has not been made for additional regulation of executive pay, it is also worth highlighting that many of the most talked-about remedies have not worked in practice and/or will prove unworkable. For example:

- It is widely acknowledged that limiting the tax deductibility of pay in the United States simply led to other forms of remuneration being paid (namely options).
- Binding shareholder votes on remuneration are likely to prove unworkable. In conducting negotiations, boards will not be able to provide any certainty in contract negotiation. It is also unclear how agreement could be reached in a shareholder meeting environment on the complex details of an executive remuneration package and contract.

## **The way forward**

Executive remuneration policies and practices have and should continue to evolve and be improved upon in Australia. But adopting simplistic one-size fits all approaches and interventions will not contribute to that objective. Such an approach will serve only to erode the competitiveness of Australian listed companies and undermine company and broader economic performance in Australia.

In pursuing better remuneration practices and outcomes, the BCA believes that effective, company-specific approaches need to be supported and highlighted. The aim should be to continue to strive for and encourage the strongest possible focus on remuneration packages that clearly align pay to company-specific strategies and objectives and those outcomes that are able to be directly impacted by executives.

In practice, this may well lead to greater complexity and diversity in remuneration strategies and outcomes. This flies in the face of calls for greater simplicity in remuneration structures and reporting. Serious consideration needs to be given to whether the pursuit of less complexity for the sake of greater ‘understanding’ – but at the potential cost of better outcomes – is a more desirable outcome.

The challenge for boards will be to ensure that remuneration strategies and goals are well communicated and as transparent as possible. Shareholders need to be confident that the strategies being adopted are in their interests.

Improved communication and transparency also supports the promulgation of innovative and effective approaches to remuneration. For example, greater attention is now being paid to policies that defer the payment of ‘at-risk’ remuneration. This is likely to lead to greater adoption of such approaches, where and how they are relevant. This is a far better result than would occur under a more prescriptive approach.

The BCA acknowledges that concerns about executive pay have in part been a failing of Australia’s business community to effectively communicate the role and contribution of business to the economy and community; and the rationale for and structure of executive pay.

Despite the fundamental role of business in delivering economic growth and prosperity, and despite the deepening investment relationship between corporations and ordinary Australians, BCA research confirms that the role of big business in Australia, and the complex environment in which companies and executives operate, is not widely understood.

While many argue that greater transparency and reporting of executive remuneration has contributed to rising pay, there can be little doubt that public reporting of executive remuneration is here to stay.

The BCA considers that greater attention now needs to be directed towards more effectively engaging and communicating with shareholders and stakeholders about executive pay.

Boards need to very obviously ‘own’ remuneration strategies and outcomes, and business more broadly needs to show greater leadership and innovation in how it communicates and engages with shareholders and stakeholders on the issue of executive remuneration.

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For their part, if shareholders have genuine concerns about remuneration policies, they should make use of the options available to them to make these concerns known, including by voting against remuneration reports. As noted above, shareholder voting trends to date suggest a more benign view of executive remuneration than that which is portrayed in the media.

## The role of this inquiry

The BCA strongly encourages the Productivity Commission to focus its attention on its core role; helping governments to make *better* policies in the *long-term* interests of the Australian community.<sup>12</sup>

The BCA believes that policies that support and enable a productive, competitive, innovative business sector in Australia are very much in the community interest, while policies that work against this will come at a significant long-term cost.

Executives are globally mobile and Australia's large listed companies need to be able to compete on equal footing for skilled and experienced executives. Remuneration practices among Australia's large listed companies already reflect best practice well. For example, there is significant disclosure, a clear focus among large listed companies on long-term incentives in remuneration, and listed companies are required to report against good governance criteria including whether they have a remuneration committee comprised of a majority of independent directors.

The BCA therefore believes that any recommendations flowing from this inquiry should adopt a principles-based approach that will enable listed companies to adapt and respond in ways that best suit their company-specific circumstances and shareholder interests. Specifically, the inquiry should focus on reinforcing and promoting existing best practice governance and remuneration processes including:

- Clear board responsibility for remuneration strategies and outcomes.

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<sup>12</sup> Emphasis added by BCA.



- Existing best practice principles including the appointment of an independent chairman, and the establishment by the board a remuneration committee comprising a majority of independent directors, should be retained.
  
- Strong remuneration disclosure.
  - Efforts should be made to better promote and highlight ‘best practice’ features and remuneration reports.
  
  - Boards should be encouraged to report actual remuneration outcomes in remuneration reports rather than, or as well as, potential outcomes.
  
- The non-binding shareholder vote should be retained.
  - Shareholders unhappy with remuneration reporting and outcomes should exercise their vote.
  
  - Where a significant ‘no’ vote has been cast, boards should be encouraged to respond to shareholders in the following year’s annual report, if not sooner.

More prescriptive, regulatory responses should be avoided and where considered must be subject to rigorous cost–benefit analysis.

Finally, and more broadly, it is important that there is consistency in the approach taken by government and regulators to addressing the issue of executive remuneration. Since the beginning of 2009 no fewer than four separate policy actions and/or inquiries have been undertaken or initiated which have a direct bearing on executive remuneration. In addition to this inquiry are the development of the APRA framework, the changes to the taxation of employees share schemes announced in the federal Budget (and later amended), and the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009. In addition to the resources and time required to manage and engage with all four, this ‘multi-track’ approach creates a greater risk of unintended consequences or inconsistent approaches being adopted.