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# The Productivity Commission's executive pay inquiry: an update on the issues\*

Gary Banks  
Chairman, Productivity Commission

This inquiry came into being because of 'sticker shock' in the community about CEO pay and hefty payouts, at a time when company values have been plummeting and some firms have secured taxpayer funded assistance. There is also the G20's view that executive remuneration practices encouraged excessive risk taking, and actively contributed to failure in the financial sector which triggered the global financial crisis.

The depth of community concern was reflected in many of the early submissions we received, which describe executive remuneration and termination payments in terms such as unjustified, unfair, immoral, and obscene.

In announcing the inquiry, the Government referred to such concerns, declaring:

The Rudd Government is determined to ensure regulation of executive pay keeps pace with community expectations, particularly as job losses increase.

While the unease about executive pay is palpable, understanding whether or how government could assuage it without causing even bigger problems is not straightforward. That the Commission has been given the task — with nine months to investigate and analyse the issues — demonstrates that the Government is well aware of the risks of hasty intervention in this area. Like them or loathe them, large public companies and the executives who run them, play an integral role in the overall performance of the Australian economy, and any regulatory changes would need to avoid 'throwing out the baby with the bathwater'.

Central to the Commission's modus operandi are its extensive consultations and the reliance on a public draft report to test preliminary findings and recommendations well before formulating a final report. This can give government, and those potentially affected, some comfort that any recommendations by the Commission have been 'stress-tested' publicly, reducing the risk of unintended consequences.

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The consultation process has now been underway for two months and we have already learnt quite a lot from meetings with industry organisations, institutional and retail investors and their representative bodies, management and remuneration consultants, companies, business associations, trade unions and individuals. With the public hearings looming, and given the brevity of our initial Issues Paper, we thought that it would be useful to participants for us to share what we have been hearing in this initial sweep of consultations, which has brought some of the key questions, if not the answers, into clearer focus. This should also give further pointers to themes and issues that I and my fellow Commissioners, Robert Fitzgerald and Allan Fels, will be probing in the public hearings.

### **What has *really* been happening to executive remuneration?**

Our first task is fact finding. While we still have much data trawling to do, it is hardly a revelation to say that both executive and (non-executive) director remuneration have been increasing relatively rapidly — at least until last year — albeit with executive pay at much higher levels and increasing at a faster rate than for directors.

That said, it appears that media reports sometimes exaggerate amounts actually received. This is because they reflect the annual ‘booked’ or expected values of incentive pay arrangements, as well as deferred pay (as required under accounting standards). Admittedly the complexity of remuneration arrangements — which typically comprise both fixed and performance-based pay, with short and long-term dimensions to the latter, and all having multiple components — does not help public understanding. Amounts actually received over time depend on the executive reaching specified performance targets and, if equity based, the share price at the time of vesting. For example, one submission comments that a performance-based incentive (over three years) to its CEO of \$1.3 million reported in its 2007 annual report, will in fact be worth less than \$400 000, because only 25 per cent is likely to vest and the company’s share price has declined. (By the same token, I should add, sometimes actual payments have exceeded book values.)

This element of serendipity when payment is via shares or options can muddy the distinction between changes in CEO wealth and changes in remuneration. While annual returns from investments purchased from cash pay are not measured as executive remuneration, capital gains (or losses) derived from share-based incentive schemes are.

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*Australian data are limited*

Reasonably accurate information about *non-executive director* pay is generally available, with such directors normally receiving fixed salaries paid in cash or shares. However, information on the value of much incentive-based remuneration to executives is not. Even data on the ‘book’ values of options-based pay for Australian executives are limited to the ‘boom’ period since the introduction of disclosure requirements in 2003 — hardly a representative trend. We will clearly need to look at pay outcomes this year to see how well ‘at risk’ pay structures perform during the downturn.

The lack of Australian data contrasts with the comparatively abundant data available for the USA, and obviously limits our ability to replicate some of the empirical analysis undertaken there. Nonetheless, the domestic data series that are available should still allow cross-sectional, inter-sectoral and international comparisons, which might help us identify possible ‘problem’ areas. For example, are average data distorted by outliers? Is high remuneration mainly confined to firms of certain sizes or in particular industries?

On average, CEO remuneration appears to be significantly lower in Australia than in the USA. However, we understand this is attributable mainly to the much larger ‘performance’ pay in that country, than to base pay differences. There is also a perception that remuneration rates in Australia and other English-speaking economies exceed those in other comparable countries, though this needs empirical verification using PPP exchange rates.

While remuneration levels attract the headlines, most investors we have spoken to seem to focus more on whether pay *structures* give executives appropriate performance incentives. Subject to the measurement limitations about long-term incentive arrangements already noted, according to the Australian Council of Super Investors, fixed pay, short-term incentives (such as bonuses) and long-term incentives (usually shares or options) each accounted for roughly one third of total CEO remuneration in 2006-07. This compared with fixed pay representing nearly half of total remuneration in 2000, with short-term and long-term incentives each contributing a little over one quarter. It is notable that the use of options for long-term incentive remuneration is estimated to have declined from a peak of 20 per cent in 2001-02 — still low compared with the USA — to less than 10 per cent in 2006-07. Share options have generally been replaced by performance rights and deferred share programs.

Again though, there are some conceptually tricky measurement issues. To take one example, should the component of pay ‘at risk’ be measured *ex ante* or *ex post*? In

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the current economic environment, fixed salary will typically increase as a proportion of total executive remuneration simply because share prices are low, not necessarily because the *design* of pay structures has changed.

### **What *is* driving executive pay?**

Community sentiment about inequality or fairness cannot be ignored by governments, but neither should the national income consequences of any interventions. Government interventions to promote fairness can sometimes have perverse effects, including for those very groups whose interests are uppermost in governments' minds. Therefore, the full costs and benefits of any mooted intervention — both direct and, importantly, indirect — need to be carefully considered in advance.

The most elementary, but also most important, step on the path to good policy is identifying the problem. That means in this case understanding *why* executive pay has increased, and whether the drivers are symptomatic of systemic distortions — across business generally and over time — or merely sporadic aberrations.

So through discussions with various parties and our own research, we are trying to get a feel for how efficiently the market for executives is working — that is, to express it more starkly, whether pay outcomes broadly reflect executive performance and market needs, or whether executives invariably have the upper hand in negotiations with their boards and can subvert the interests of the firm for personal gain.

#### *Board capture and rent-skimming?*

This latter view — often referred to as the 'managerial power hypothesis' — suggests that with boards being unduly influenced or 'captured' by the CEO, the only constraint on executive pay is community and shareholder 'outrage'. The major proponents of this thesis, Professors Bebchuk and Fried from Harvard and Berkeley Law Schools respectively, claim that pay has increased to the extent it has because executives have been able to camouflage their earnings through the use of options and other share-based schemes, with boards complicit, ignorant or powerless to stop them.

This thesis has many supporters, who point to the exponential increase in CEO pay in the United States apparently unrelated to their performance. (Remuneration in the form of options or equity in the United States is far less likely to be required to meet performance hurdles than in Australia). But it also has its detractors, especially in

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the academic world, who argue that attributing pay increases to board capture does not sit easily with the evidence — for example, of improvements in governance over the same period.

We will be exploring the extent to which this classic ‘principal–agent’ problem applies in Australia. For one thing most people here would argue that corporate governance in Australia is much stronger than in the USA. For example:

- The boards of Australian companies generally have non-executive chairmen and ‘independent’ directors, whereas in the United States, around three-quarters of the top 200 companies combine the roles of CEO and chairman.
- Australian shareholders also elect directors and have an annual (non-binding) vote on the company’s remuneration report. It seems that they are increasingly using this leverage to influence remuneration levels and structures. The direct influence of shareholders in the United States appears to be far more limited.

Nonetheless, we have also heard a range of concerns about corporate governance as it is observed in practice in Australia — including alleged ‘clubbiness’ among a relatively small CEO and director pool, and the reliance of many boards on the advice of remuneration consultants who may in turn be reliant on the CEO for other, more lucrative consulting work, creating potential conflicts of interest.

Concerns have also been raised about the skill sets of some boards, and their capacity to comprehend all the implications of the complex arrangements devised or proposed by remuneration consultants and management. Are the boards of Australian public companies up to the mark when it comes to choosing the best CEOs and devising the most appropriate executive remuneration? Or are they too much in the thrall of management and consultants? These are threshold questions for this inquiry.

That said, somewhat surprisingly, a link between good governance and better corporate performance lacks robust empirical verification. This might simply reflect the difficulty of capturing something as subjective as ‘governance’ in observable metrics. It might also be an indication that there are other, possibly more important, drivers of corporate performance — not least product and capital market competition. On any assessment, the United States economy has done pretty well over many decades despite its apparently inferior corporate governance. Is having an omnipotent CEO-cum-chairman good for business, or has poor corporate governance finally caught up with corporate USA?

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### *Danger money?*

Another explanation we are hearing is that executives demand higher pay these days as recompense for perceived increases in job and possibly reputation risk. According to a Booz & Company study, Australian CEO tenure has averaged around 6 years since 2000, apparently dipping even lower recently, compared with 8 years globally.

As well as CEO jobs becoming more risky, some argue that ongoing intense media scrutiny and greater complexity of the operating environment have reduced the attraction of the CEO role for prospective candidates. Some have also suggested that today's global markets and international connections mean that working in the Southern Hemisphere has become a 24/7 proposition.

On the other side of the ledger, some argue that the cost of living is lower and the non-pecuniary benefits are higher in Australia. We need to probe these issues and get a feel for their significance.

### *Linking pay to company performance*

Increased use of performance-based pay in itself is likely to have increased headline remuneration numbers. It seems well-established in the literature that executives are generally risk-averse when it comes to their own remuneration. To provide a given 'certainty' equivalent, expected pay-offs if performance hurdles are met have to be larger to compensate for the risk of them not being met. Executives will also take into account the risks of being compelled to hold wealth in the form of their company's shares and options. For instance, one US study has estimated that CEOs discount the nominal value of their non-diversified portfolios by 25–50 per cent.

In other words, once there is a shift away from fixed pay, the (potential) cost of remuneration to the firm starts to exceed the value to the recipient. Firms will generally be prepared to pay this premium *provided* the incentive pay arrangements elicit better performance.

As noted, on average about two-thirds of executive remuneration in Australia has been linked to performance hurdles, such as (relative) Total Shareholder Return. North American academic studies, drawing on extensive time series data, provide some evidence of a link between increases in executive pay and company performance — executive pay is consistently found to increase by a couple of dollars for every \$1000 increase in company value. The few Australian studies in this area suffer from lack of good data, but the results are in a similar ball-park.

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Such ratios, though seemingly small, translate to big numbers in propitious economic times, as we have experienced until recently.

### *Signalling worth?*

There is a widely held view among company ‘insiders’ that public disclosure of executive remuneration has led to a ratcheting up of pay. While total payments to executives as a group have been made public for many years, since 1998 listed companies have been required to identify payments to *individual* executives and directors (and from 2003, place a reliable valuation on options).

Although it is more than likely that executives and boards had a reasonable idea of who was paid what prior to the 1998 disclosure requirement, it’s been put to us that *public* disclosure brought a new dimension and greatly changed the dynamic. Remuneration is a tangible indicator of an individual’s worth. So third party knowledge of relativities made these difficult to ignore for many executives. We have heard similar anecdotes from several CEOs, former CEOs and chairmen, involving an executive challenging his remuneration level by demanding whether he was really considered inferior to Joe Blow in rival company X?

From the company’s own perspective, low pay may connote a lesser capability than rivals or may lead it to become prey to head-hunters. Thus we are hearing that it is common for firms to seek to position their executives’ pay above the average for their comparator group. Among Garrison Keillor fans, this has become known as the Lake Wobegon effect, the place where “all the women are strong, all the men are good looking, and all the children are above average.” Does this ring true? If so, how significant a driver of remuneration increases has it been?

### *A war for talent?*

A large body of econometric literature from the United States and a much smaller instalment from Australia indicate a strong statistical relationship between firm size and CEO pay. Preliminary ‘eyeballing’ of the data indicates that CEOs of the top ten per cent of the S&P/ASX 300 listed companies (by market capitalisation) received an average base salary of more than \$2 million in 2007-08, compared with less than \$1.5 million for CEOs of companies in the second highest decile, plateauing at around \$0.5 million for the smallest 40 per cent.

One hypothesis is that as firms become larger and/or more complex, they are prepared to pay more to attract the most talented executives — the so-called ‘war for talent’. Professor Peter Swan from UNSW has recently analysed US data series

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dating back to the 1930s, and found that demand for ‘talent’, together with job risk, explain 85 per cent of increases in pay in that country. This relationship has been found to hold, notwithstanding the sharp acceleration in remuneration from the early 1980s and again in the 1990s — to the point where it looks like a structural break in the data.

We will also be exploring the extent to which Australian executives operate in a global market, and thus whether their ‘opportunity cost’ has been attuned to pay trends overseas, regardless of whether or not they actually move offshore. We have been hearing that in many industries (such as finance) there *is* an international labour market, and boards feel obliged to search overseas for executives even if eventually they select a local candidate. However, some dispute this, suggesting that for some industries there may be little interface — indeed, in mining it has been suggested that Australia dominates the global market and effectively sets the remuneration benchmark. We will be endeavouring to uncover more data on appointments of foreign executives as well as of Australians from abroad.

### *Are CEOs really as scarce as hens’ teeth?*

Of course, even if the demand for CEOs increased, their ‘price’ will only rise if their supply cannot be readily increased in response. If the supply of top executive services is indeed relatively ‘inelastic’ as some maintain, any increase in demand will bid up CEO pay significantly, even for less talented ones. This is known as a ‘contagion’ or ripple effect — as in other markets, it occurs because it is the transaction ‘at the margin’ that drives the market price.

Yet despite its importance, we have not yet managed to find much research on what distinguishes top CEO material. We have been hearing from some senior business figures that although experience (including, increasingly, international experience) and managerial competence are pre-requisites, ‘emotional intelligence’ and innate leadership qualities of a high order are also important. This raises a question about the extent to which new CEOs can be, and are being, ‘trained’ and ‘groomed’, and consequently whether the CEO ‘pool’ is likely to remain relatively scarce, even over the longer term. While there do not appear to be any visible entry barriers or mechanisms limiting competition in the CEO market, there may be more subtle forces at work. In the past, for example, religion, race, class or gender commonly conditioned one’s career options and progress. But do any such influences persist under the pressures of today’s more competitive business environment?



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### *Tax drivers?*

Finally, while taxation arrangements are unlikely to have affected the quantum of executive remuneration in Australia, they might have influenced remuneration structures and choice of pay ‘vehicle’. Before the announcement of the new tax regime for discounted shares and options, we hadn’t really been hearing that tax was driving share-based pay. But the reception to the changed arrangements announced in the budget suggests that tax may have been playing at least a facilitating role.

As you know, the changes were motivated by perceived ‘roting’ among some senior executives. But they had much wider, and apparently unintended, consequences, the rectification of which is currently the subject of a fast track review by the Treasury. Some have argued that it would be preferable for the status quo to be restored pending an assessment by the Productivity Commission in this broader inquiry. We will need to look at the outcomes of that review in any case, as equity-based remuneration has a specific mention in our Terms of Reference.

## **Some key considerations for policy**

### *Identifying the problem — continued*

Sorting through these various potential influences and assessing their relative importance are integral to our conclusions as to whether, in the jargon, there is a ‘policy-relevant problem’ and where the most prospective policy options might lie. We will be bringing to bear on this whatever statistical analysis the (limited) Australian data will support, as well as drawing on other empirical studies and qualitative evidence, including from submissions. It is already clear, however, that a fair element of judgement will be required, in which the Commission’s independent focus on economy-wide outcomes will come into play.

We may well find that there has been a mix of drivers, some broadly consistent with market forces and efficiency, others that suggest distortions. Our task then will be to assess which of these might involve systemic problems of sufficient magnitude to warrant intervention.

### *A public interest rationale for intervention?*

As noted in the Issues Paper, some question the rationale for policy intervention in this area, arguing that markets will self-correct in time. For example, if shareholders consider that they are not receiving an adequate return because of poor

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remuneration practices in a particular company, they can sell their shares. And if the company is performing poorly, it will lose market share, be taken over, possibly even bankrupted. Others would contest this.

Even if such ‘automatic’ mechanisms are operating, there may still be scope to make markets work better and to avert the pain of catastrophic failure by reducing what economists call ‘transaction costs’ — for example, through measures which improve accountability, transparency and information flows.

Importantly, in some sectors — the most obvious being finance — allowing bankruptcy could generate costly system-wide contagion effects. In these circumstances, action to preclude any remuneration practices that encouraged excessive risk taking and threatened firm viability would seem to be good policy if properly targeted and provided that it did not generate other (greater) costs. This of course is the policy space APRA and the GFS are concerned with at the moment.

#### *Aligning interests of executives, boards, shareholders and the wider community?*

Picking up on the principal–agent problem created by separation of management and ownership, and the impossibility of directly observing and measuring the contribution of the manager, a major part of our terms of reference is about exploring measures to strengthen the alignment of interests of executives and boards with those of shareholders — and indeed the wider community.

Obvious direct mechanisms for doing this include pay structures as well as governance arrangements. But there are also broader ‘environmental’ forces potentially promoting alignment of managerial and owner incentives and, ultimately wider economic efficiency, including competition in product and capital markets. There is also the ‘reputation’ of the executive. If executives value their professional reputation they might be expected to want to see strong corporate performance (although some might argue that failure doesn’t seem to dent reputation much and remuneration even less). There is also the role of shareholders. For example, some suggest that ‘block’ ownership (for example, through greater institutional shareholdings) is likely to promote better alignment of interests than dispersed ownership, although some have argued precisely the opposite, seeing institutional investors and corporations as being part of the same ‘club’.

A quite fundamental issue that has become more apparent to us during consultations, concerns the desirable level of shareholder influence on company policy. It seems generally accepted that the shareholder body — en masse and over time — ‘owns’ the company, in the sense that they have claim over the profit

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residual. By the same token, shareholders, whether individual or institutional, face ‘limited liability’ and can sell their interest in the company at any time.

Shareholders are a heterogeneous group. They can hold different and often quite divergent views about company strategy and policy, reflecting their different risk preferences and time horizons. Indeed, it’s been put to us that investors often are more focused on the short term than executives and boards, who need to make investment decisions with long-term pay offs.

The modern corporation emerged largely to circumvent problems created by divergent interests of asset owners and their competing claims for profits. Hence, the legal responsibility of executives and boards quite deliberately is to the *company* (which has a legal life of its own), not shareholders explicitly. So how much should company remuneration policy be driven by shareholders?

Another view put to us is that firms should heed the wishes of other stakeholders as well as shareholders, notably their employees and customers.

Moreover, the terms of reference also highlight the interests of the Australian community generally. Two aspects of this much wider perspective have been raised with us. One is the material well-being of the community, which can arguably be directly related to the efficient operation of firms and markets over time (‘what’s good for the corporation is good for the country’). The other, more difficult aspect, is the extent to which community norms and attitudes about executive pay are relevant to firm behaviour or public policies that shape it.

As indicated earlier, that aspect was invoked in announcing the inquiry. It is obviously a fraught area for any advisory body. Ultimately, interpreting and acting on perceived societal norms is a political call. Perhaps we can best assist by indicating the potential costs and benefits on economic grounds.

#### *‘Optimal’ compensation arrangements?*

The terms of reference also ask us to explore mechanisms that could better link executive remuneration with corporate performance, including (as noted) the role of equity-based payments and incentive schemes.

It’s probably fair to say that most of those we have spoken to want to see more emphasis on long-term incentives, aligned with shareholder value. A rule of thumb seems to be one-third fixed pay, one-third as short-term incentives and one-third as long-term incentives. We understand that many companies broadly conform with this (and the available data seem to support it), although some see scope for

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improvements such as longer periods for long-term incentives (at least three years, possibly five) as well as performance hurdles extending beyond retirement of the executive. There is also a strong view among investors that the relevant hurdle should be *relative* TSR, although this apparently simple metric relies on the selection of an appropriate comparator group, which can be difficult in our small market. Moreover, even relative TSR is at best an imperfect proxy for ‘unobservable’ executive productivity (as observed by APRA last week in its draft guidelines).

Despite misgivings among many of those we have talked to about the structure of executive remuneration and its relationship to performance, most are of the view that pay quantum, structure and vehicle should not be prescribed or, for that matter, proscribed.

One reason is simply that different companies have different needs. For example, we are hearing that while options-based pay is now seen as less appropriate for mature companies, it continues to play an important role for cash-constrained, start-up companies. Another is that constraining particular elements of remuneration packages can lead to break-outs elsewhere — the introduction of the \$1 million deduction cap for fixed pay in the United States is widely blamed for the massive shift to options-based pay in that country.

It’s yet to be seen if new arrangements in Australia for termination pay also lead to the ‘creative’ restructuring of packages, such as through higher base pay or sign-on bonuses (a dowry rather than divorce settlement). The scope for such break-outs might be contained by imposing an overall cap, as some are recommending, but would executives then shift to or remain in other countries or, closer to home, simply go to non-disclosing firms (where pay levels are often higher)?

Another reason given against prescription is that designing remuneration in practice is more art than science. Even in theory there appears to be no ‘optimal’ compensation design. It typically reveals itself for each company in an iterative and experimental fashion. Highly prescriptive and inflexible interventions could stymie this process and possibly set in concrete incentive arrangements that lead to bad outcomes. (One ex CEO of a major company tells the story of an incentive scheme that led to an executive temporarily closing the production unit for which he was responsible, in order to reduce outlays and thereby increase (very) short-term profits!)

The scope for unintended outcomes is obviously something exercising the mind of one former company chairman, who recently called for a return to cash salaries to reduce remuneration complexity and the associated scope for poorly designed

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packages with perverse incentive effects. Others have also questioned the impenetrable complexity of many incentive pay arrangements, notwithstanding the widely held view that pay should be linked to performance. Have companies got the balance roughly right or have they been susceptible to fad and fashion?

The Holy Grail of ‘optimal’ compensation is exercising the minds of Australian and international financial market regulators, who are seeking to ensure that pay arrangements for executives and other key personnel in financial institutions no longer encourage excessive risk taking. APRA released its draft standard and guidelines for consultation last week. In line with the Financial Stability Forum and G20 principles, APRA is proposing a principles-based rather than prescriptive approach to pay setting, albeit with a sector-specific requirement that remuneration be linked to risk taking, though how this will be implemented remains unclear. It is proposing a more prescriptive approach to governance arrangements, for example, requiring boards to regularly review remuneration policies and to establish remuneration committees composed of non-executive directors. We will need to consider the extent to which these principles would have wider application, beyond the finance sector.

### *Better governance arrangements?*

In line with their concerns about the risks of black letter regulation in this area, most groups we have spoken to, including shareholder groups, feel strongly that executive remuneration should remain the responsibility of the board of a public company. But many also see a need to improve board decision making, and a number of possible measures have been floated.

- One suggestion, motivated by concern at an apparently confined ‘Director’s Club’ — with the same familiar faces cropping up in various boardrooms — is simply to place regulatory limits on multiple appointments. It is argued that this could force current appointees to consider where they can add most value, encourage other potential candidates to emerge and step forward (including more women) and force companies and their shareholders (who, after all, have the final say on board appointments) to look more widely.
- It is also argued that, on the ‘supply side’, the pool of potential candidates for director positions has been diminished in recent years by regulations which have increased the legal and financial risks associated with the position. It has been further argued that this has also made incumbents too risk averse, and more inclined to seek and uncritically accept ‘expert’ advice, including from remuneration consultants.

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- The contribution of such consultants, and the nature of and degree of independence in their advice to boards, has also been a contentious issue. There are suggestions for greater disclosure and better processes around their use, as well as to improve the remuneration committee process and enhance the control of boards as a whole.
  - Remuneration reports are generally seen as a good thing in principle, but often poorly executed in practice. Even those with a close professional interest in these reports, such as remuneration consultants and proxy advisers, reportedly find them difficult to fathom.
  - There is fairly widespread agreement that remuneration reports need to be made less complex and more accessible (to directors as well as shareholders) and that they should explain clearly the company's remuneration philosophy. It has also been argued that the painstaking focus on the structure of packages has contributed to misperceptions as to the remuneration that executives actually receive. The inclusion of reporting of realised incentive pay is favoured by many.
  - While we have heard that there has been an increase in shareholder engagement with companies about remuneration policy, particularly at the top end, some argue that the non-binding vote could be strengthened. One suggestion, for example, is requiring an explanation from the board if remuneration is not changed following a vote against the remuneration report. Another suggestion is that where remuneration reports are rejected in successive years, some or all board members should stand for re-election at the next AGM. Most we have spoken to regard a binding vote on actual remuneration as impractical, because they say it would make remuneration setting very difficult and effectively stymie recruitment of executives. But some have argued for a binding vote on remuneration *policy*, which applies in some other countries.

Most such suggestions could be said to be at the margin of established governance responsibilities. That said, they could have significant ramifications and would need to be carefully thought through.

### *Regulatory constraints on pay outcomes*

However, some participants would go further and curtail board discretion more fundamentally, by imposing regulatory limits on the level and composition of executive remuneration. Such proposals draw on the perceived unacceptability to the public of current disparities, together with a view that there is no economic justification for them and thus little downside risk in outlawing certain components

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(like share options) or in imposing a cap on the absolute levels of executive pay or on differentials with other workers.

As suggested earlier, while such views may have support within the union movement or wider community, they imply a degree of systemic failure and of faith in prescriptive regulatory remedies that seem difficult to reconcile with what has been learnt thus far. Indeed, even the comparatively ‘mild’ recent initiative to require a shareholder vote on termination payments that exceed a year’s base remuneration has elicited widespread concern about adverse consequences ‘at the margin’, notwithstanding that the regulation broadly accords with convention. And as noted, the tax deductibility cap on base pay in the USA is widely blamed for the subsequent surge in the use of opaque pay vehicles (and in levels of pay) which are now seen as contributors to the Global Financial Crisis itself.

In any case, it would be difficult to legislate for practicable limits that meet community expectations. Surveys of retail investors have revealed that while they support the proposition that ‘CEOs deserve relatively high rates of pay’, their conception of ‘high’ is no more than \$500 000 per annum.

Is the case for regulatory limits on executive pay stronger when companies are ‘bailed out’ or ‘propped up’ by taxpayer funded government support? The sense of community outrage is certainly easier to sympathise with. And, as one hard-headed economist has remarked, if government support removes responsibility and risk, then perhaps the CEO effectively becomes a public servant, and should be paid as such! A practical problem in Australia is where to draw the boundaries, given the extensive public support to private enterprises in this country. For example, should we include auto industry executives?

More fundamentally, provided a bailout can be shown to be in the public interest (for example, because of possible contagion effects), are there risks in reducing the remuneration of the executives who ultimately must be relied upon to improve the company’s performance? If they are not the right people for the job, would it be preferable to make any assistance contingent on them being replaced?

## **Next steps**

So you can see that our initial round of informal consultations has left us with no shortage of interesting and important issues to explore in the public hearings! Our hearings commence in Sydney in two weeks’ time, followed by Melbourne and Brisbane. After the hearings, we will concentrate on preparing a draft report for circulation and comment towards the end of September. Meanwhile, I encourage

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you to get your submissions in as soon as you can, so that we can make best use of them in shaping the draft report.