

**Geoff Nunn & Associates**  
**Australia's Leading Independent Remuneration Specialists**

# Remuneration Update

*Special Edition of the Productivity Commission Inquiry into Director and Executive Remuneration*



## Productivity Commission Review of Director and Executive Remuneration Gathers Pace

*In this issue of Remuneration Update we focus exclusively on the Productivity Commission Inquiry into Director and Executive Remuneration:*

**Key Topics Include:**

- The perspective and recommendations of various stakeholder groups.
- Issues and concerns with the current model of executive remuneration in Australia.
- The widening gap between CEO and average worker earnings.
- Issues of corporate governance and effectiveness of the current regulatory environment..
- Effectiveness of existing STI and LTI arrangements.

In March 2009 the Federal Government announced an inquiry into the "Regulation of Director and Executive Remuneration in Australia". The Inquiry specifically relates to directors and executives employed in companies subject to the *Corporations Act 2001 (Cwlth)*.

The Inquiry was initiated largely in response to perceived excesses in Director and Executive Remuneration in Australia, particularly amongst some large listed companies over the past 10 years.

The review is headed by Productivity Commission Chairman Gary Banks, together with Commissioner, Robert Fitzgerald and Associate Commissioner, Professor Allan Fels.

Specifically the Inquiry is to consider:

- Trends in director and executive remuneration in Australia and internationally (TOR 1).
- The effectiveness of the existing framework for the oversight, accountability and transparency of director and executive remuneration practices (TOR 2).
- The role of institutional and retail shareholders in the development, setting, reporting and consideration of remuneration practices (TOR 3).
- Any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community (TOR 4).
- The effectiveness of the international responses to remuneration issues arising from the global financial crisis (TOR 5).

At the time of writing the Productivity had received 105 submissions from interested parties and held four public forums (two in Melbourne and two in Sydney) to canvas views.

The Commission is due to report in December, 2009 with preliminary findings in September.

In this edition of Remuneration Update we will review the Commission's progress to date, examine the content of some of the submissions and offer some evaluative comment.

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In April, 2009 Gary Banks held a media briefing to outline the rationale behind the conduct of the Inquiry.

He specifically cites public concern over the size of executive remuneration packages and termination payments at a time when corporate performance has been declining. In particular he mentions cases where levels of executive remuneration appears high whilst the company has been receiving Federal financial assistance.

According to Banks average CEO remuneration has doubled since 2000 whilst aver-

age weekly earning have only risen 30%, thus widening the gap between CEO pay and ordinary workers remuneration.

The Inquiry is not primarily concerned about the quantum of executive remuneration. Rather it is to ensure that appropriate corporate governance arrangements are in place and that these support alignment of executive and shareholder and other stakeholder interests.

Banks notes that the rise in share based and other forms of incentives has been considerable over this period.

The Inquiry will be focused on examining the relationship between executive remuneration arrangements and corporate performance. That is, do existing strategies support reward for performance? Do they encourage a long term view of performance or do they encourage short term thinking and excessive risk taking.

The primary concern is that of corporate governance and the effectiveness of the existing framework.



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## Four Different Perspectives

In this Edition of Remuneration Update we will examine four different perspectives on Director and Executive Remuneration. Each is derived from submissions to the Productivity Commission Inquiry as follows:

- Remuneration Consultants
- Corporate Sector
- Industry Associations
- Trade Unions

Not surprisingly the perspective of these four groups differs.

### REMUNERATION CONSULTANTS



Submissions to the Inquiry were received from Mercer, HayGroup, Guerdon & Associates and a number of other consulting organisations.

Most consulting firms take the perspective that the international, rather than the domestic market is responsible for setting executive remuneration levels amongst the top corporates. They argue that these companies seek to attract from a select group of highly capable and mobile executives who move between countries seeking opportunity. Rates are influenced upward primarily by the US and other developed markets, such as the UK, Hong Kong and Singapore. In comparison to executive rates offered in these countries Australian executive packages are modest.

Some argue that the level of remuneration offered by our larger listed companies in Australia are comparable to that offered by local heads of international subsidiaries operating in this country and locally owned non-listed companies.

Remuneration consultants generally support current disclosure requirements (CLERP 9) however some have noted the performance conditions relating to short term incentive

payments have been either not covered in remuneration reports or only partially covered. Some argue that reporting and costing of equity based long term incentive plans requires simplification. All argue that the current role of the non-binding shareholder vote is appropriate.

One consulting firm expressed concern that the proportion of CEO reward allocated to Short Term Incentives was too high. Often making up the most significant component of the CEO's total package. This they argued, placed emphasis on short term results rather than longer term strategic goals.

They argue that the CEO's role is primarily about achievement of the organisation's long term strategic objectives. In particular, sustainable shareholder value. Long term incentives should be determined over a multi-year period. However, Boards need to be conscious of the fact that equity markets are volatile and that other factors (outside of Board, CEO and Executive performance) impact on shareholder returns.

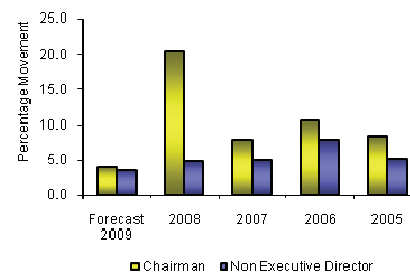
All affirm that it is critical for Boards and Board Remuneration Committees to ensure that:

- All Directors are skilled in the management of executive remuneration, monitoring corporate and individual performance and ensuring that there is alignment between the interests of various stakeholder groups and executive remuneration strategy.
- Directors are aware of and skilled at carrying out their legal and compliance obligations with regard to executive remuneration.
- Directors seek independent advice on all aspects of executive remuneration from qualified and experienced advisors. Advice should be tested. In many instances it is appropriate to seek advice from a range of sources.

Most remuneration consultants argue against increased regulation of director and executive remuneration. In particular they argue that increased regulation can have unintended consequences. Each organisation's circumstances are different. This requires Boards to exercise discretion in the management of executive remuneration. Tightly prescribed regulatory frameworks limit discretion and may lead to undesirable outcomes.

Interestingly remuneration consultant submissions are largely silent on the key issue of non-executive director (NED) remuneration. Whilst it is true that the level and structure of NED remuneration has not received the level of publicity or scrutiny in recent press or regular interest as has executive remuneration, it is none-the less, a core component of remuneration strategy.

The growth in NED remuneration has been patchy over the past few years as indicated below<sup>1</sup>:



In our view the question of non-executive director remuneration is pivotal, especially considering the risks associated with this role. We would like to see consultants and the Commission devote some attention to this key issue.

### References

1. Top 500 Report. 2006, 2005 and 2004 - Remuneration Planning Corporation.  
Top 500 Report. 2006, 2007, 2009 - Corporate Remuneration Advisors.



## The Corporate Sector Perspective

*Submissions to the Inquiry were received from a number of major Australian listed companies. These include BHP Billiton, Bluescope Steel, Wesfarmers, Origin Energy and the Macquarie Group.*

*Commentary was varied and we have endeavored to summarise some of the key points below.*

**BHP Billiton** opened its submission with a strong argument in favour of the existing regulatory framework for director and executive remuneration. They assert that the non-binding vote on adoption of the remuneration report, introduced in 2004, has proved to be a very effective control mechanism for regulating excesses in executive remuneration. The Chairman, Mr Argus states that:

“There are now many examples of companies changing their remuneration practices either following a high “Against” vote on the Remuneration Report, or even prior to the vote – in recognition of shareholder and governance advisor concerns voiced in the lead-up to the AGM. It has been a catalyst in prompting greater consultation by companies and significantly enhanced engagement by shareholders.”

*BHP Billiton Submission to the Productivity Commission Inquiry into the Regulation of Director and Executive Remuneration in Australia. 29 May 2009.*

Mr Argus goes on to outline the structure of the CEO's package (27% FAR, 20% STI and 53% LTI) and emphasises that both at risk components are contingent upon rigorous and broadly based performance measures.

In their “Executive Summary” **Origin Energy** draws clear links between Australia's economic prosperity and individual company's capacity to attract the best executive and specialist talent.

They argue that a tightly regulated and overly prescriptive approach to executive remuneration would restrict capacity to attract the best talent, with potential long term economic consequences.

They further argue that the current regulatory framework in Australia has served the nation well. In particular the shareholder non-binding vote on director and executive -

remuneration. We have not seen the excesses of other countries. This has positioned Australia well to meet the challenges of the Global Financial Crisis and to accelerate our recovery from its negative consequences.

They further argue, with some considerable merit, that the nature of their business requires specialist technical expertise in certain areas (such as oil and gas executives and petroleum engineers). The current activity in coal seam gas (CSG) has resulted in a shortage of such personnel in Australia and therefore competitive international rates need to be offered to attract the executives and specialists with the right level of expertise.

This argument has been well understood by resource (and engineering based) companies in Australia for a long time. Local and off shore operations have historically been staffed by a mixture of local and expatriate personnel. Australia's capacity to provide the mix of technical and international expertise in these areas is limited and requires these companies to offer competitive international rates.

The **Macquarie Group** comes out strongly in favour of retaining existing governance arrangements. Specifically they argue that Australia should<sup>1</sup>:

- Maintain primary responsibility for setting executive remuneration with the Board of Directors.
- Retain strong remuneration disclosure.
- Retain non-binding vote.
- Retain shareholder's right to retain a cap on non-executive director remuneration.

Macquarie go on to argue cogently that risk should be factored into executive remuneration strategy and rewards consider the overall financial health of the organisation.

They argue that reward should be linked to “Controllable Drivers of Performance” and that caution should be exercised when using meas-

ures such as Total Shareholder Return which is influenced by factors outside of the control of executives.

Wesfarmers Limited provide an insightful explanation of how they reviewed executive remuneration strategy following a “no” vote on its remuneration report at the 2008 AGM. To quote:

“Wesfarmers has taken the ‘no’ vote seriously and is addressing a number of issues that were subject to criticism in the 2008 report, particularly around disclosure around hurdles for the Group Managing Director's Long Term Incentive (LTI). Wesfarmers has also moved to freeze Fixed Annual Remuneration (FAR) for its most senior executives at 2008 levels while reducing the amount of short term incentives<sup>2</sup>.”

The Wesfarmers submission makes the point that any restrictive changes to the regulatory environment regarding executive remuneration are likely impact primarily on listed companies. This may restrict their capacity to attract and retain the best talent. Particularly if unlisted private companies do not face the same regulatory restriction. This may negatively impact on financial performance with a potential flow on to superannuation investments. That is, a significant percentage of Australian superannuation fund investments are with Australian listed companies.

In summary large corporate” submissions indicate that, in their view, Australia is well served by the existing regulatory framework and there is no requirement for wholesale change.

### References

1. *Inquiry Into Executive Remuneration. Macquarie Group. 29th May, 2009*
2. *Submission to the Productivity Commission Inquiry on Executive Remuneration. Wesfarmers Limited. 28th May, 2009.*

## The Industry, Investor and Professional Association Perspective

Submissions were received by a number of Industry and Investor Associations and Professional Bodies including the Australian Chamber of Commerce and Industry (ACCI), the Australian Compliance Institute, the Australian Shareholders Association (ASA), the Australian Human Resources Institute (AHRI) and the Chartered Institute of Secretaries (CSA).

**The Australian Chamber of Commerce and Industry** advises the commission to be cautious about a regulatory response to what is essentially a market driven phenomenon. They assert that unlike general salaries and wages, executive remuneration fluctuates upward and downward depending upon financial circumstances.

The ACCI assert that there are a number of sectors and professions where earnings exceed those of senior executives including sports, entertainment, medical and legal. *Whilst this is certainly true of some in these professions it tends to be limited to the upper echelon. Those operating in this space tend to have a limited earning opportunity in term of number of years or are business owners, and as such have greater risk exposure.*

The ACCI makes a very valid point regarding the quantum of executive remuneration. To quote:

"It is not unusual for an executive to relocate, expend costs and leave an otherwise stable position to join a new firm. It is also not uncommon in the case of buyouts, restructures or mergers/acquisitions for an executive's position to be terminated before their term has expired. This is why executives are remunerated for a legitimate amount of *operational* risk. It must be recognized that executives are also remunerated for a high degree of *legal* risk, in that Australian laws extend to personal legal liability (for civil and criminal offences, carrying terms of imprisonment) to may company officers who exercise control over company affairs"<sup>1</sup>.

The **Australian Compliance Institute**, not surprisingly, focuses on issues of risk and compliance. The key element of their submission is the recommendation that risk and compliance KPIs be mandatory for all ASX Top 200 companies and Financial Service licence holders.

They propose a very direct linkage between these KPIs and bonus payments such that should KPIs not be met, no incentives of any sort would be payable. Further they propose that that AS/NZ 3806 and AS/NZ 4360 be mandated as benchmarking tools for the companies mentioned above.

In the "Definition and Scope" of its submission the **Australian Shareholders Association** makes the key point that whilst it accepts Total Shareholder Return (TSR) is a valid external measure of corporate performance, it is not able to differentiate external influences. And therefore should be used in tandem with other measure of corporate performance when linking to the at risk component of executive remuneration.

The ASA assert that international competition is driving higher levels of executive remuneration is somewhat overstated as the number of overseas CEOs of Australian companies is limited. Effective succession planning, they suggest, is the key to ensuring that appropriate local candidates are available and ready when the opportunity arises.

The ASA strongly asserts that current levels of executive remuneration in the top listed companies is unsustainable for the following reasons:

- Equity incentive schemes which reward 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 3 years or in some cases less<sup>2</sup>.

Amongst other recommendations the ASA proposes that a 75% vote threshold be applied before the remuneration report is accepted. Should the remuneration report not be accepted then the chair of the remuneration committee should automatically face re-election at the next AGM.

The **Australian Human Resource Institute** submission provides a precise background overview of the circumstances which led to the current GFC.

AHRI recommends retention of the current three tiered structure (FAR, STI and LTI) for major listed companies in Australia. Amongst other recommendations AHRI suggests embedding the principal of one-level removed overview of all remuneration decisions in policy to be incorporated into a self regulating code of remuneration practice (similar to ASX Principle 9).

AHRI views are mixed as to whether the shareholder vote on the remuneration report should be binding. They suggest a compromise position where prospective executive remuneration strategy for the next five years is subject to a binding vote. However no prospective decisions should impact on existing contractual provisions.

The **Chartered Institute of Secretaries** make a strong recommendation that:

"On the issue of remuneration, CSA strongly believes that directors should have the responsibility to determine executive remuneration, as boards are best placed to take into account the financial and operational circumstances of the company, which may shift year to year, when assessing remuneration structures. That is, CSA is of the view that boards should retain the discretion to determine the quantum, short-term incentives, long-term incentives, performance hurdles and other parameters used in determining remuneration structures."<sup>3</sup>

The overall view from industry, investor and professional associations appears to be that Australia is well served by the existing regulatory frameworks surrounding executive remuneration. Changes proposed are in the form of fine tuning rather than radical reform.

### References

1. *Regulation of Director and Executive Remuneration in Australia. ACCI. 28th May, 2009*
2. *Submission to the Productivity Commission Inquiry on Regulation of Director and Executive Remuneration in Australia. ASA. 29th May, 2009.*
3. *Regulation of Director and Executive Remuneration in Australia. CSA. 29th May, 2009.*

## The Trade Union Perspective

Submissions were received by a number of Trade Unions. For the purposes of this review we have focused on the views of the three major unions on the Australian industrial relations landscape: The Australian Manufacturing Workers Union (AMWU), the Construction, Forestry, Mining and Energy Union of Australia (CFMEU) and the Finance Sector Union (FSU).

Not surprisingly these organisation offer a different to the organisations and groups whose views have previously been summarised.

The AMWU open their submission with a philosophical discussion between the different societal perspectives of labour and capital. They quickly move to a discussion of equity and relativity - of the disparity between the remuneration levels of corporate executives and those holding positions of similar size and accountability in the public sector.

The AMWU asserts that some Boards seek "messianic" CEOs as a way of satisfying the needs of shareholders and lifting the company to new levels of performance. Markets respond positively to such high profile appointments. However, often such CEOs fail to deliver on the promised performance returns to shareholders and only succeed in enhancing their own personal wealth. They quote the recent high profile case of the immediate past Telstra MD and CEO, Sol Trujillo:

"When Australians read that former Telstra boss, Sol Trujillo "picked up more than \$30 million over his nearly four years at the company as its shares slumped almost 38% they might rightly be angry—whether those Australians be Telstra workers struggling for job security and improved pay; customers facing painfully slow internet connections; or, investors who have seen their shares decline markedly in value. The high level of compensation the Telstra board saw fit to confer on Mr Trujillo only fans discontent in the community; and with no one person or institution being bigger or better than the community itself, it is proper for the community's representatives, viz., legislators, to intervene"<sup>1</sup>.

The AMWU makes a number of recommendations to the Commission including:

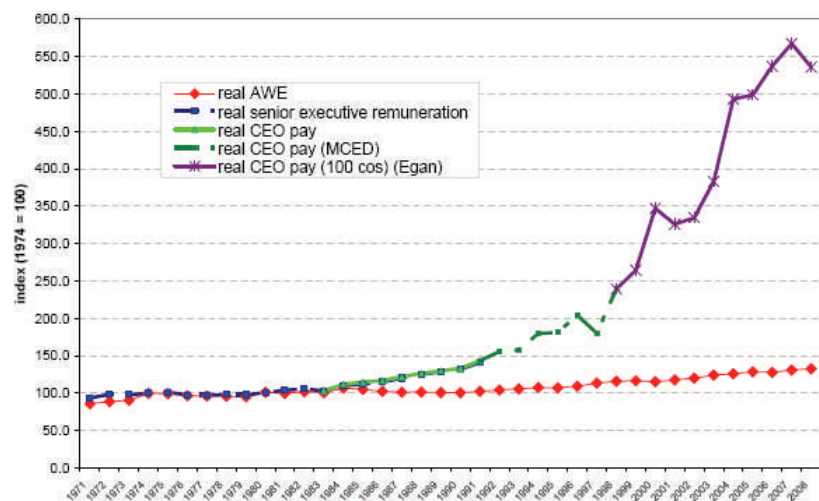
1. Making executive pay constraint a

a pre-condition for dealing with the government (at all levels: Federal, State and Local).

2. Use the tax system to penalize very high income earners.
3. Empower shareholders to vote down executive remuneration policy (make shareholder vote binding).

The CFMEU commence their submission with several graphical illustrations of how the gap between CEO remuneration and AWE has widened over the past 37 years. See below:

Figure 2: CEO pay series and AWE, indexes, Australia, 1971-2008



Sources: Egan 2009a, Kryger 1999, Noble Lowndes Cullen Egan Dell 1992, Australian Bureau of Statistics 6302.0, 6401.0.

They assert that between 1990 and 2005 adult weekly earnings increased 85% while Top 100 CEO remuneration increased 564%. The content of the CFMEU submission is made up of various statistics supporting their contention that executive remuneration has grown out of all proportion to Average Weekly Earning and that this imbalance needs to be addressed.

The CFMEU close their submission with recommendations similar to the AMWU. The major variation is that they would make all STIs with LTIs redeemable five years after departure.

The FSU makes a number of precise recommendations primarily relating to perceived

remuneration excesses and risk taking within their sector. These include:

- The criteria that executives must meet to receive performance pay should be outlined in the remuneration report and divided into financial and non-financial measures;
- Short-term incentive payments to executives are irresponsible, and should be abolished or replaced by long-term incentive payments;
- Long-term incentives are an appropriate

way to recognise performance, but should be coupled with CSR obligations.

The FSU submission concludes with the recommendation that remuneration consultants "sign off" on the Remuneration Report in the same manner as auditors do with the financial report.

### References

1. *The Australian Manufacturers Workers' Union Submission to the Productivity Commission's Inquiry on Executive Remuneration in Australia.* 29th May, 2009
2. *CFMEU Submission to the Productivity Commission Review into the Regulation of Director and Executive Remuneration in Australia.* 15th June, 2009.
3. *Inquiry Into Executive Remuneration.* FSU. 29th May, 2009

## Concluding Comments

The submissions received from Remuneration Consultants, the Corporate Sector, Industry and Professional Associations are relatively consistent in their view. By and large they believe that the regulatory framework governing director and executive remuneration is robust and serves the interests of all stakeholders well. They are of the view that the majority of executives in Australia receive fair and equitable compensation based on both international and local market (as appropriate) conditions. Some acknowledge that there is scope for improvement in the setting, tracking and disclosure around performance measures. Other recommendations tend to be at the level of fine tuning rather than wholesale change.

The excesses that have been widely reported are limited in number and, where they have occurred, Boards are likely to have revised their approach to preclude recurrence.

The fact that Australia has fared relatively well in the Global Financial crisis, compared to other developed economies, is testament to the strength of our overall sound approach to corporate governance. Not to mention our very fortunate national advantage of being a natural resource abundant country.

Not surprisingly the Australian Shareholders Association and the Trade Unions are not as comfortable with existing arrangements. The ASA believes that current levels of executive remuneration in the top corporates is unsustainable and that a correction is required.

The Trade Unions similarly believe that the quantum of executive remuneration in the top companies is out of step with Australian core values of equality and fairness. They recommend strong measures including withholding government contracts to those companies which do not exercise constraint in executive remuneration.

No doubt the Productivity Commission's Draft report, due this month, will generate considerable discussion prior to the "Final" in December. In our view the Commission will opt for a minimal change approach. The AHRI concept of a more extensive and detailed self-regulatory code of remuneration practice has much merit and is likely to be well received.

The long term benefit of this Inquiry will be an increased awareness by boards of their responsibilities to all stakeholders to manage executive remuneration in a responsible manner. A self regulated Code of Practice and appropriate training via AICD resources will serve Australia well. We do not need another set of highly prescriptive government regulations and reporting requirements.

One day the issue of non-executive director remuneration will receive its due attention. It has not done so far in this Inquiry.

## About Geoff Nunn and Associates

Geoff Nunn & Associates was established in Melbourne, Australia in 1993. Since then, the Company has established a reputation for professionalism and quality service. Projects have been completed in over 900 organisations across Australia.

### Our Services

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- **Performance Based Incentives.**
- **Balanced Scorecard Performance System.**
- **Organisation Structuring and Design.**
- **Board Advisory.**

### Contacts

Geoff Nunn, Executive Director (03) 9629 6866  
Mobile 0418 595 107.  
email: [gtnunn@gna.net.au](mailto:gtnunn@gna.net.au)

Elizabeth Plant, Principal Consultant (03) 9629 6866.  
email [eplant@gna.net.au](mailto:eplant@gna.net.au)

Website [www.gna.net.au](http://www.gna.net.au)

Suite 912, 530 Little Collins Street  
Melbourne, Victoria, 3000, Australia  
Tel No 613 9629 6866  
Fax No 613 9629 6877



**GEOFF NUNN  
AND ASSOCIATES PTY LTD**

Independent Remuneration and Organisation Specialists