

# Coalition Senators' Additional Comments

”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.”<sup>1</sup>

## Introduction

Coalition senators broadly support the objective of the government’s terminations payments amendment to the corporations law. However we are concerned about legislative overreach and that the parliament’s intervention in the corporate sphere will introduce distortion – to the alignment with shareholder interests, and to executive recruitment, remuneration and retention, among other considerations.

In giving our support, we acknowledge the argument of witnesses to the inquiry (ACSI, Prof Peetz) that there is merit in the parliament sending a “signal” to corporations that they are answerable to shareholders. Termination payments made to departing executives are appropriations of shareholder wealth.

But we are aware that:

- this legislation is a kneejerk reaction to appease public opposition to *ex gratia* payments made to executives to remove them from office;
- the government is acting after the event insofar as companies are already reviewing their policies in this area , in response to community outrage, consultation with shareholder groups and governance consultants;
- there is a downward trend in executive payouts in the last 5 years (Hay Group) or reduction this year (Prof Peetz) in any case;
- there are reported instances of perceived excessive termination payments, but we recognise these decisions are matters for boards, and are generally taken for sound reasons; and
- the legislation pre-empts the report by the Productivity Commission into executive remuneration and is typical of the rushed approach of the Rudd government.

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1 Gary Banks, Chairman, Productivity Commission, update on the executive pay inquiry to FINSIA, June 2009

## **Strong corporate governance in Australia**

Coalition senators have confidence in Australia's corporate framework and the capacity of boards to respond to community concerns. We are rightly cautious about this wholesale interference in the decisions of boards. We noted with satisfaction the ACSI study finding that most companies have policies in place which would deliver termination payments around the bill's proposed base pay threshold to executives departing now.

There is good evidence that the vast majority of large listed companies – the same group with the high profile headline offenders – are self-regulating on this issue, whether that be in response to cyclical changes, cash constraints, or other drivers such as community or shareholder outrage.

Coalition senators recognise the particular importance of oversight of executive remuneration packages in the banking and insurance sectors because of the potential for executives to chase the rewards of short-term risks at the cost of financial stability.

## **Adverse effects/unintended consequences**

Having expressed our broad support for the signal effect of the bill, coalition senators are concerned that the government's bill may have unhelpful consequences for our corporate sector and protest that the legislation has been introduced before the Productivity Commission report into executive remuneration has been released. Coalition senators regard this as a further example of the unseemly haste the Rudd government has demonstrated on a number of issues, including the youth allowance backdown.

Coalition senators share the view of many that presented or submitted evidence to the inquiry that the bill has elements of regulatory overreach. We observe that in its rush to legislate in the area of executive termination payments, the government has foregone a Regulatory Impact Statement on this bill at its own peril.

The overreach features of the bill include:

- The scope of the provisions is broadened to include unlisted companies
- The lower threshold of provisions will capture middle managers serving as directors
- The definition of termination payment is broadened and there is concern it will catch genuine retirement of long-serving director employees, redundancies, deaths in office
- Anticipated impact on departing executives, particularly international recruitment and impact on firms operating internationally
- Expected compliance costs, a burden particularly for unlisted companies
- Anticipated difficulty securing senior managerial employees to sit on boards of overseas subsidiary companies

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## ***Distortion***

Coalition senators foresee possible distortion arising in executive remuneration as new recruits negotiate packages around the revised shareholder-approval-required framework, producing what a number of witnesses to the Inquiry referred to in terms of the “(squeezing the)balloon effect”, that is, the shifting or re-weighting of remuneration components to achieve certainty or optimisation for the executive. The phenomenon is predicted to give rise to distortions variously described by witnesses as golden hello payments, frontloading, sign-on bonuses; these distortions are in addition to the expected increases in base salary.

Treasury gave evidence that any “squeezing the balloon” effect will be transparent in remuneration reporting, which is subject to non-binding shareholder vote, however, this will apply only to listed companies.

There is also the real possibility that companies may in fact face higher remuneration costs as a result of this legislation. This is because, if frontloading occurs, the sign-on payment is handed over with certainty whereas a contingent termination payment is not necessarily drawn down.

The legislation threatens to disturb the alignment of the interests of shareholders and directors. This is contrary to the aims of shareholder groups who argue against any disconnect between executive stakeholders sharing in the pain and the upside with shareholders. This misalignment occurs because the current form of the Bill may encourage executives to move away from incentive-based remuneration.

By adopting base salary in place of total remuneration as the threshold for shareholder approval, the amendment to the legislation will likely shift senior executives away from short and long-term pay incentives in favour of maximising base salary which will lead to an unintended distortion.

Executives are expected to prefer the certainty of a contracted fixed salary over the uncertainty of termination benefits that may be subject to a shareholder vote.

## **Unresolved issues**

On the basis of the evidence presented, Coalition senators felt there are a number of issues requiring clarification or further scrutiny:

- The application to all companies, not just listed ones
- The scope of “key management personnel”
- The definition of base salary awaited in the regulations
- The definition of termination benefit awaited in the regulations
- The role of institutional investors in shareholder voting on termination payments
- The treatment of superannuation

- The treatment of statutory entitlements
- The average (over three years) annual base salary calculation
- The pro-rata limit for service of less than 12 months
- The treatment of voluntary out of court settlements

## **Conclusions**

Coalition senators of course concur with the recommendation (3.124) that the draft bill be altered to permit shareholders to vote on a specific amount (over the threshold, in cases where it has been tripped). This oversight in the framing of the bill is cause for reflection on the government's undue haste to intervene in this area.

Evidence to the senate inquiry has highlighted once again that the government is legislating on the run, referring matters to this Committee before consultations on the all-important regulations are complete with the result that witnesses are forced to speculate on the content of legislation.

Once again as is seemingly become common practice in the Rudd government, this legislation is a bare skeleton of the main provisions with the key questions yet to be revealed in the regulations.

Coalition senators question the Rudd government's sense in announcing on the same day, a Productivity Commission investigation into executive remuneration, and at the same time, announcing how they will legislate on termination payments – jumping ahead of any Productivity Commission finding.

Given the Productivity Commission is due to present a final report by December 2009, surely it would be preferable to have the benefit of its analysis before any legislation is proposed?

We note that, in spite of this inquiry being limited to the terminations payment bill, many of the submissions, the evidence of many witnesses, the chair's report to which these comments append, and the questioning of Senator Cameron and others, all extended to the broader question of executive pay. In view of this and with reference to the quote of Productivity Commission chairman Gary Banks at the head of these comments, coalition senators are at a loss to understand why the government is rushing this legislation through the parliament.

Finally, Coalition senators welcome the focus this issue has received from APRA following the G20 meeting of world leaders in April 2009 and support APRA in the development of its guidelines for the setting of remuneration for executives of ADIs.

## **Recommendation**

Coalition senators are of the opinion that there are sound reasons to await the final report of the Productivity Commission in December 2009 before enacting legislation on termination payments.

Similarly there are reasons to await the release of APRA standards due shortly.

Coalition senators accept the prevailing sentiment that the present threshold is high by international comparisons and indications. We heard a divergence of views on an optimal threshold.

Coalition senators consider that, in the first place, there is a case for adopting total remuneration rather than base or fixed pay as the threshold, on the argument that there will be less squeezing of the balloon distortion.

Coalition senators favour a multiple of total remuneration of one to three on the grounds that we think the regulations in this area should be designed to capture the extreme cases and not the 50-60 per cent of cases of termination payments that Treasury has in its sights.

Finally, coalition senators are of the opinion that the provisions in the bill should apply only to executives in the remuneration report. There is no cause for government to intervene elsewhere than in listed companies.

**Senator Alan Eggleston**

**Deputy Chair**

**Senator Barnaby Joyce**

**Senator David Bushby**

