Additional Comments by Senator Cameron

Wider issues concerning executive pay

Many of the submitters to this inquiry, particularly from business, their organisations and their associates in the legal and consulting professions have argued that executive termination payments cannot be looked at in isolation from executive pay generally; including base salaries, short and long term incentive payments stock options, and sign-on payments.

Professor David Peetz also submitted to the Committee:

> The issue of termination payments for executives cannot be sensibly analysed separate from the broader issue of executive remuneration, as these termination packages are explicitly or implicitly part of executives' overall remuneration packages.[1]

These submissions are not without merit and therefore it is appropriate to make some observations about executive pay generally.

The growth trajectory of executive pay

There is no doubt that the rate of growth in executive pay has far outstripped growth in average weekly earnings over the past 25 years.

In his submission, Professor Peetz shows that in the period from 1971-2008, CEO pay grew by 470 per cent compared to growth in real average weekly earnings of 54 per cent over the same period. But the truly spectacular divergence between growth in CEO pay and average weekly earnings has occurred since the mid-1980s with the period since 1997 showing rates of growth in executive pay running out of control.[2]

What this means in dollar terms is amply illustrated by the Australian Council of Super Investors Inc. who last October published a voluntary survey of CEO pay in the top 100 ASX-listed companies for 2007.

Eighty CEOs were included in the survey, the results of which were adjusted for the withdrawal of News Corporation from the ASX/S&P 100 index when it moved its headquarters to Delaware.

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1 Professor David Peetz, *Submission 15*, p 2.

2 Professor David Peetz, *Submission 15*, pp 2-5.

The survey found:

- Average fixed remuneration of the CEOs (excluding performance-based pay) increased from $888,407 in 2001 to $1,833,228 in 2007; an increase of 106.4%.
- Median fixed remuneration of the CEOs (excluding performance-based pay) increased from $780,975 in 2001 to $1,533,948 in 2007; an increase of 96.4%.
- The fixed remuneration of the highest paid CEO (excluding performance-based pay) increased from $2,650,565 in 2001 to $8,885,278 in 2007; an increase of 335%.
- Average short-term incentive payments to the CEOs increased from $769,125 in 2001 to $2,178,274 in 2007; an increase of 283%.
- Median short-term incentive payment to the CEOs increased from $377,936 in 2001 to1,334,200 in 2007; an increase of 353%.
- The highest short-term incentive payment to a CEO increased from $6,239,739 in 2001 to$25,615,987 in 2007; an increase of 410.5%.
- Average total remuneration (including all performance pay) paid to the CEOs increased from $2,450,513 in 2001 to $5,532,515 in 2007; an increase of 125.8%.
- Median total remuneration (including all performance pay) paid to the CEOs increased from $1,843,987 in 2001 to $4,168,554 in 2007; an increase of 126.6%.
- The total remuneration (including all performance pay) paid to the highest paid CEO in the sample increased from $11,682,638 in 2001 to $33,489,818 in 2007; an increase of 286%.[3]

Income inequality and social inequality

The supporters of the vast sums earned by corporate executives argue that the income inequality generated by them is of no consequence because the number of vastly wealthy individuals involved is a tiny fraction of the population. They are wrong.

It is risky drawing on American data as Australia is inherently different due to its market size, company size, market capitalisation and social safety net, nevertheless there is sufficient consistency in both the quantum of executive pay increases and the justifications advanced for them on both sides of the Pacific for some lessons to be learned and warnings to be heeded. Many Australians are enthusiastic adopters of American cultural practices and fashions, none apparently more so than Australia's corporate elite in relation to executive remuneration.

3 Australian Council of Super Investors Inc, *CEO Pay in the Top 100 Companies: 2007*, Research Paper, RiskMetrics, ISS Governance Services.

In a paper entitled *The Productivity to Paycheck Gap: What the Data Show*, after making all the necessary adjustments for non-wage labour costs including taxes and health care costs, Dean Baker of the Centre for Economic and Policy Research found that there is still a large gap between the rate of usable productivity growth and the rate of growth of hourly compensation for the typical worker. Over the period from 1973–2006, median hourly compensation rose by 20.1 per cent while usable productivity grew by 47.9 per cent. This indicates that there was still a very substantial upward redistribution from typical workers to profits and high paid workers.

If gains in American productivity had been shared evenly across the workforce, the typical American worker's income would be about 35 per cent higher than it was in the early 1970s on productivity grounds alone. What actually happened was that every worker whose income lay below roughly the 90th percentile of income distribution saw their income grow less than the average rate of income growth. Only those above the 90th percentile in income distribution saw above average income growth.[4]

But the truly spectacular gains went to a very small group indeed. At about the time Oliver Stone's film *Wall Street* was making it big at the box office, an American income of $400,000 a year would have put someone in the 99.9th percentile of income distribution. Since then, the income of the top tenth of a percent of income earners has increased seven-fold.

Apart from sports stars and celebrities, the ranks of the richest one in ten thousand in the United States are made up of corporate executives, rather than the industrial barons of old who actually owned factories and who might have employed these executives as their agents.

These growing inequalities would account for much of the widespread public outrage and opposition to excessive executive pay in Australia.

Rightly or wrongly, corporate leaders are afforded considerable status as opinion leaders in this country but in order to be taken seriously, they must be seen to be acting far more clearly in the public interest than in their own interest.

Extreme inequality is damaging to society. Where vast income inequality becomes normalised, if not internalised into the workings of a society, then social inequality is bound to follow in its trail. Social inequality results in social dislocation, alienation and eventually, a breakdown in social order.

The following exchange between Senator Eggleston and Professor Peetz seems to sum up the principal strains of thought on the connection between income inequality and social inequality:

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4 Baker, Dean, *The Productivity to Paycheck Gap: What the Data Show*, Centre for Economic and Policy Research, Washington, April 2007 (available at http://www.cepr.net/index.php/publications/reports/the-productivity-to-paycheck-gap-what-the-data-show).

> Senator EGGLESTON—They do, indeed. And it would be very interesting to know what the level of pay is for the chief executives of Nokia, Saab and so on. I am sure you would find they are comparable. You have raised this issue of the link between workers' pay and senior executives' pay. I suggest to you that in countries like China and Vietnam workers' pay is a lot less than chief executives' pay. But that is another point. You are only comparing work of pay in industrialised Western countries and not in countries where most things are made these days, and that is China, Vietnam and Third World countries—the new international division of labour, isn't it called? I just wonder why we think that as a society we have a right to seek to impose the views of government on the private affairs of a private company owned by private shareholders.
>
> Prof. Peetz—In a sense, this gets back to the question that was raised earlier about the social dysfunctionality of having high degrees of inequality. Do we really want a society where inequality is constantly growing? Why is that a good thing? It is one thing to say, 'Is it a good thing to have inequality?' or 'How much inequality should there be?', but it is another thing altogether to say, 'Should this inequality constantly get greater and greater?' I cannot see any good social reason why it should. Resources are basically being redirected away from ordinary people to a relatively small group.[5]

In the face of growing inequality it is incumbent upon the parliament to address the market failure that manifests itself in excessive executive remuneration by intervening in the public interest to ensure continuing support for our system of corporate governance, government and economy.

The role of remuneration consultants, comparative wage justice and pattern bargaining

During the course of this inquiry, the Committee received a considerable amount of evidence concerning the role of remuneration consultants in setting executive pay. Views about the role of remuneration consultants and whether their influence is a significant factor in the ratcheting up of executive pay varied widely.

The most benign view of the role of remuneration consultants came, predictably, from the consultants themselves and their clients.

During the hearing on 25 August 2009, Mr John Colvin, CEO of the Australian Institute of Company Directors offered this view following questioning by Senator Joyce:

> Senator JOYCE—Remuneration consultants—they are put up as putting some sort of arm's length between company directors and their pay. I was

5 *Proof Committee Hansard*, 25 August 2009, pp 15-16.

> looking at one of the previous submissions where they talked about evidence linking remuneration consultants to the upward racheting of pay of senior executives in the banking sector. And I can see the banking sector sitting at the back.
>
> Mr Colvin—I know who they are. But in terms of—
>
> Senator JOYCE—What are they?
>
> Mr Colvin—What are they? Well, they are a very valuable resource to directors who are trying to work out what the market is for particular positions. So they keep records and trawl through and do the scientific evidence basis for this, and they advise boards as to what those, if you like, comparable salaries, wages—
>
> Senator CAMERON—Comparative wage justice! Shock!
>
> Mr Colvin—Exactly. Comparative wage justice is just as strong at the top as it is anywhere else. So they provide that service and they provide boards, bearing in mind that boards—
>
> Senator JOYCE—Are they at arm's length? That is the question I am asking. To your knowledge, are they at arm's length?
>
> Mr Colvin—To my knowledge, when I was practicing in this area, they were at arm's length.[6]

During the hearing on 25 August 2009, representatives of the executive remuneration consultancy Guerdon Associates gave evidence to the Committee. During the course of that evidence, Mr Peter McAuley furnished the Committee with the following explanation of how they go about their work in advising boards on appropriate levels of remuneration:

> Senator CAMERON—You provide information to companies to help them establish and set the executive and director salaries. Is that correct?
>
> Mr McAuley—That is correct.
>
> Senator CAMERON—How do you do that?
>
> Mr McAuley—There are a number of facets to it. Clearly, the most basic element of it is determining overall remuneration levels or opportunity levels as in benchmarking the aggregate levels of pay but that is only one element. That is done by looking at the nature of the business and the fields in which it operates. We talk to directors of the business to understand the strategic and operational issues associated with that business, to look at the risks and the ability to retract and retain employees. We look at the industry and sector generally and sometimes more widely. We look at the levels of pay in that area and the size and scope of the roles within the business. More particularly, we look at the nature of the business. We look at whether it is a capital intensive business, whether it is a fast-moving consumer goods business and what the time horizon of performance is, if you like, for executives—some have very capital intensive decisions to make, it might

6 *Proof Committee Hansard*, 25 August 2009, p 45.

> be an energy type business, a resource business or something which has a totally different time horizon. In doing that, we would look at the long-term versus short-term mix. There will be decisions taken around what is the fixed pay level, what should be the opportunity for short-term annual operational and financial performance and what should be the long-term measure of performance.
>
> Senator CAMERON—So basically there is an element of comparative wage justice in there.
>
> Mr McAuley—That is probably a reasonable way to put it. It is also obviously impacted by competitiveness and availability of talent.[7]

Essentially what Mr McAuley describes is not in any way a scientific approach to determining executive pay but a simple but nonetheless effective comparative wages survey designed to ratchet up executive remuneration. It is pseudo-science pure and simple.

Ms Anne Byrne, CEO of the Australian Council of Super Investors, indicated to the Committee that the work of these consultants is less transparent than might be the case in an ideal world:

> Senator JOYCE—I am very interested in these remuneration consultants who seem to work hand in glove with boards. Do you think that creates a grey area in how executives are remunerated?
>
> Ms Byrne—We actually do not know who they are. We think boards should be required to tell shareholders who their remuneration consultant is. We know who they are generally—who are the consultants around—but we think that, as part of the disclosure, that should be a requirement. We have suggested that to the Productivity Commission. But they go to look for the best person for the job.
>
> Senator JOYCE—So there should be transparency about who the remuneration consultant is?
>
> Ms Byrne—Yes.[8]

The most telling criticism of remuneration consultants and their methods put before the inquiry was made by Professor Peetz in both his written submission and during his appearance at the hearing on 25 August 2009.

Professor Peetz described the methods by which executive remuneration is determined as "dual asymmetric pattern bargaining":

> The determination for remuneration of senior executives is characterised by what I call dual asymmetric pattern bargaining. It is pattern bargaining because it is based on reference to the patterns of pay of other executives, in particular through the device of remuneration surveys. It is dual asymmetric

7 *Proof Committee Hansard*, 25 August 2009, pp 59-60.

8 *Proof Committee Hansard*, 25 August 2009, p 28.

> pattern bargaining because of two key asymmetries. First, the pattern is asymmetric; it is not based on bringing participants up to a common mean, as in traditional pattern bargaining, but often to a position above the mean in a leapfrog pattern. Second, the bargaining itself is asymmetric as there is not an effective countervailing force at the bargaining table, as there is with wage bargaining for ordinary employees. I suppose I could add a third asymmetry: the movements upwards when times are good are generally not matched by equivalent movements downwards when times are bad—but that is in large part due to the first two asymmetries.

In his written submission to the inquiry, Professor Peetz describes the process of pay leapfrogging that arises from asymmetric pattern bargaining:

> To express it crudely, the process is something like this. Private sector executive salaries are typically set by a body like a board remuneration committee. These may include outsiders (that is, senior executives and directors from other corporations) but in Australia they are rarely fully independent of executive influence (Schwab 2009b, Shields, et al. 2003). Particularly in large corporations, this committee typically looks at the results of executive salary surveys undertaken by remuneration consultants, and takes advice from such consultants. The committee members, who identify and network with the senior executives under scrutiny, are easily persuaded that the company needs to pay above the average in order to retain such high calibre executives. Otherwise the company may under-perform and be under threat of takeover. So a large number of firms raise their salaries so that they are paying above the median (the middle of the market), and others paying below the median raise theirs to match the median. Another survey is then published. Companies see that the market rate has risen, and they have to readjust their executives' pay so that they are paying above (or at) the market median again.

Professor Peetz also drew the Committee's attention to the recent report of the House of Commons Treasury Committee, who looked at the role of remuneration consultants in the British banking industry during the course of its inquiry into the banking crisis. The evidence received by the Committee cast considerable doubt on the integrity and rigour of the advice received by corporate boards from remuneration consultants.

Mr Montagnon[9] accused remuneration consultants of having "contributed to the general ratchet in executive remuneration because they seem to have business models which require them to earn fees which require them, therefore, to modify packages every year which, therefore, requires the packages to go up". Mr Barber[10] also spoke of the "ratchet" effect telling us that it was remarkable how many remuneration consultants "are given remits which refer to a benchmark of the upper quartile. If

9 Peter Montagnon, Director of Investment Affairs, Association of British Insurers.

10 Secretary-General, Trades Union Congress.

endlessly, year after year after year, you are referred to the upper quartile, then that is an endless ratcheting and an ever-increasing gap with the rest of the workforce”.[11]

> We have received a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector. We have also received evidence about potential conflicts of interest where the same consultancy is advising both the company management and the remuneration committee. Both these charges are serious enough to warrant a closer and more detailed examination of the role of remuneration consultants in the remuneration process.[12]

How this works in practice in Australia is illustrated in Professor Peetz's submission dealing with where companies position their executive pay structures in the marketplace:

> Most relevant, however, was the question on how companies sought to pitch or 'position' their senior executives' pay. Results are shown in Figure 8. Nearly two thirds of companies had a policy of 'positioning' their executives’ pay above the median and 92 per cent claimed to set them around or above the median. The 65 per cent who pitch their executive pay above the median comprised 35 per cent who pitched between the median and the 75th percentile and 31 per cent who pitched at or above the 75th percentile. Only 2 per cent aimed to position their pay below the median. Of course, it is mathematically impossible for all companies to achieve the position they are seeking. By definition, 50 per cent of firms will be paying below the median, not 2 per cent. As virtually all firms attempt to position themselves at or above the median, senior executive remuneration will increase even in an environment of zero inflation and zero productivity gains. A similar pattern was seen in the USA at that time (Crystal 1991).[13]

This phenomenon is the Lake Wobegon effect, named for the fictional town of Lake Wobegon from the radio series *A Prairie Home Companion*, where, according to the presenter, American humourist Garrison Keillor, “all the women are strong, all the men are good-looking, and all the children are above average.” Applied in the boardroom and despite its pretence to scientific rigour it is a statistical fiction.

Executives effectively set their own pay

Much of the evidence before the Committee from those submitters who could be characterised as generally representing the interests of corporate executives and the status quo tended to explain the process of executive pay setting in abstract terms. The following exchange is a good example of the degree of abstraction involved:

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11 House of Commons Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City*, Ninth Report of Session 2008-09, 12 May 2009, p 32.

12 House of Commons Treasury Committee, Ninth Report of Session 2008-09, p 33.

13 Professor David Peetz, *Submission 15*, p 12.

> Senator CAMERON—Do you want me to give you the figures, and then can you comment? Executive salaries have increased from about 1986 through to about 2007 from a median of 100 to 550—a huge increase. The average earnings have gone from 100 to about 110. I just do not understand. What are these executives being paid for? Why is this huge gap appearing between average weekly earnings and these executives? Why?
>
> Mr Crone—One possible answer to that, and you are talking about the pace of the increase in executive salaries compared with the pace of increase in salaries lower down the chain, is perhaps that turnover and job tenure of the CEOs is a lot shorter I would imagine than for workers lower down, and perhaps the CEOs feel that they need to be compensated for that.[14]

And this:

> There is a certain pool of available talent out there, there is a certain demand for people to run these companies. You are trying to get the best and the brightest.[15]

And then this:

> Senator CAMERON—It used to be the captains of industry, the entrepreneurs, who set the business up and invested their money into an industry. The Henry Fords were the captains of industry. Now it is this managerial class who are coming in and demanding these returns without, as you say, the risk. Why shouldn't they simply receive a fair day's pay for a fair day's work? Why do they have to be linked to this culture that they should make gains disproportionate to their input? That is still the problem. Your system can still give them gains disproportionate to the rest of society, disproportionate to the rest of the workers in the company and disproportionate to what is a fair thing.
>
> Mr Mather—The question of what is fair in remuneration is a very, very difficult one, because it is in the eye of the beholder. We do favour the market. The market is allowing these executives to extract this rent from the owners of companies, and there is no doubt that there is a significant amount of stress associated with running a public company.
>
> Senator CAMERON—That is not the market. How do you define the market in that sense?
>
> Mr Mather—The market is the willingness to pay and there are the challenges of being an executive. Managing people, being the company spokesperson and navigating the political environment as well as the business environment is challenging.[16]

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14 Mr Peter Crone, Policy Director, Business Council of Australia, *Proof Committee Hansard*, 25 August 2009, p 5.

15 Mr Peter Crone, Policy Director, Business Council of Australia, *Proof Committee Hansard*, 25 August 2009, p 7.

16 Mr Erik Mather, Managing Director, Regnan Governance Research and Engagement Pty Ltd, *Proof Committee Hansard*, 25 August 2009, p 31.

These are idealised norms of executive talent. Once they are stripped away it isn't difficult to see why executive pay is less connected to questions of supply, demand, global talent pools and competition for talent than it is to power and fashion.

Neither the quality of executives nor the amount they should be paid are hard numbers. It is far harder to assess the abilities and productive capacity of a corporate CEO than it is a bricklayer by measuring how many bricks are laid in an hour, how square and how true.

Even to the extent that corporate boards correctly judge the talents of those who they recruit, the amounts they end up paying them depends almost entirely on what <u>other</u> companies are doing. Even corporate boards that aren't smitten with the idea of astronomically well paid executive superstars are forced to pay high salaries firstly just to attract talent and secondly because it is highly likely that the financial markets will cast a suspicious eye at a company that doesn't give the outward appearance of hiring a superstar where the evidence of superstar status is found not in the appointee's record or performance but in the size of their pay cheque.

To the extent that there is a market for executive talent and it is as abstract as the Committee is led to believe, who are the buyers? Who determines how good a CEO is and how much she should be paid to ward off other suitors? The answer of course is that corporate boards, largely selected on the recommendation of the CEO in consultation with other CEOs and former CEOs, hire remuneration consultants, chosen by the CEO, to determine what the CEO is worth. It is a situation conducive to the development of a very powerful Lake Wobegon effect.

What this suggests is that the dollar value of the executive class is dependant on a range of 'soft' factors such as social attitudes, political background and above all, networks.

This view is made strongly by the authors of *Pay Without Performance*, Lucien Bebchuk and Jessie Fried who argue that top executives in effect set their own pay and that neither the quality of the executive nor the marketplace for talent have any significant bearing. The only real constraint, they argue, are the “outrage costs” of excessive pay; a concern that excess will lead to a backlash among the general public, shareholders, workers and politicians.

Professor Peetz put the task of the Senate this way in his appearance before the committee:

> This bill is important not only for promoting good practice in executive termination payments. It is also important that the parliament send a signal that, like the community, it is no longer willing to welcome excess in executive remuneration generally. While sending signals will not in itself halt excessive remuneration, if parliament fails to pass this bill it will send exactly the wrong signal and we could expect a return in the near future to not only the excessive termination payments that characterised the recent

> past but also the excessive growth in executive remuneration generally that has been witnessed.[17]

The parliament is in a position to send a strong signal on behalf of the community that it is no longer willing to tolerate excessive payments to departing executives without the express approval of the owners of the company. To do otherwise will only further corrode public confidence in the integrity of those corporate leaders in whose hands the economic security of most ordinary citizens lies.

Conclusions and recommendations

The common theme throughout much of the evidence presented to the committee is that information about how executive pay generally and termination payments in particular are calculated is in short supply. The committee heard that the calculus involved is based on abstractions including notions about innate talent, a global executive labour market that may or may not exist, assumed rather than measured productivity, the possibility of losing one's job, complexity and so on. These abstract ideas about executive worth don't appear to stand up to much close scrutiny.

What has been consistently absent is hard evidence and hard numbers to support the claims for ever higher levels of executive remuneration and the termination benefits that inevitably follow when an executive ceases their employment. It seems absurd that in every other labour market segment there is hard evidence and hard data by which the relative dollar value of each occupation and profession can be assessed. That it is not the case when it comes to the termination benefits and other remuneration of senior corporate executives simply beggars belief given the vast amounts of money involved.

The principal object of the bill is improved accountability in relation to certain executive termination payments. The mechanism that the bill provides for doing so is widely supported by the majority of submitters to the inquiry. But the paucity of information about how these payments are arrived at and who has influenced the decision to award the benefit will in all likelihood bedevil shareholders faced with approving any given proposal before them. As indicated above by Ms Byrne on behalf of the Australian Council of Super Investors, no-one seems to know with any certainty just who has their finger in the pie.

It is my view that the scope of the information required to be provided to shareholders either in or accompanying the notice of the meeting at which the question is to be resolved should be extended to include a much wider range of information that will assist both retail and institutional shareholders to make more informed judgements about the merit or otherwise of a given termination payment.

17 Professor David Peetz, *Proof Committee Hansard*, 25 August 2009, p 12.

Recommendation

That the details of the benefit required to be set out in or accompany the notice of the general meeting to consider the resolution include, in addition to the matters already set out in section 200E(2) of the Act, the following:

- The manner in which the value of the benefit has been or will be calculated whether or not the benefit is a payment or otherwise and whether or not the value of the benefit is known at the time of the disclosure.
- Whether the remuneration package that forms the basis of the termination payment was set as a result of advice from an executive remuneration consultant or similar entity.
- The quantum of the termination payment expressed as a ratio of the executive's normal weekly salary.
- The nature and source of any and all advice received by the board or any board nominee in relation to the decision to award the benefit and the determination of the quantum of the benefit.
- If the decision to be approved by the general meeting is based on advice from an outside consultant or other "arm's length" entity, the value of any contracts for services for whatever purpose between the company and that entity.
- A schedule setting out the formula used for calculating termination and/or redundancy payments for each class of employees employed by the company.
- Whether or not the remuneration of the recipient of the termination payment, during the term of the recipient's employment with the company, was set at a level above or below the median remuneration of comparable employees in the industry or sector occupied by the company and by how much.
- A schedule setting out increases in the recipient's remuneration during the term of the recipient's employment with the company compared with movements over the same period in the company's turnover, profitability, productivity, returns to shareholders and capital investment.

Recommendation

That the Productivity Commission public inquiry into executive remuneration:

- Considers whether there have been any social and economic benefits as a result of the growth in executive remuneration over the past 25 years.
- Considers developing a range of key performance indicators against which increases in executive remuneration can be measured at a national, sector, and enterprise level and the indicators be published annually to facilitate improved decision-making on executive remuneration.
- Examines the role of executive remuneration consultants in facilitating spiralling growth in executive salaries including their role in promoting comparative wage

justice, positioning executive remuneration above the median and asymmetric pattern bargaining.

- Inquires into the apparent incapacity of many Australian company boards to contain executive remuneration to levels that do not undermine public confidence in Australia's system of corporate governance.
- Examines the evidence received by the committee to the effect that excessive executive remuneration is driven in large part by a shortage of "talent", and give consideration to the most efficient and effective means to increase the supply of labour in executive occupations as one initiative to reducing the unrealistic and unjustifiable cost of labour in executive occupations.

Senator Doug Cameron