## Executive Remuneration: opinion piece by Gary Banks, Chairman, Productivity Commission

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Has the Productivity Commission's final report on executive remuneration been 'watered down'? Was the Commission 'leaned on'? The answers to these questions, which have featured in media commentary since the final report was released, are 'not really' and 'absolutely not'.

To start with, those insinuating that the Government, or big business, somehow exerted influence to change the recommendations from what they would otherwise have been, ignore the Productivity Commission's track record. The Commission has a history of calling it as it sees it, without fear or favour, in the interests of the community. Indeed, its processes were originally conceived (going back to Whitlam's Industries Assistance Commission) for it to do just that.

The Commission also has a track record of modifying its recommendations in the light of public feedback. That is what our draft reports are for. Those preliminary proposals that pass scrutiny we keep; those that don't, we modify or drop. In this case, we made changes to 13 of the original 15 recommendations, and added two more.

Most changes were 'fine tuning', with a couple being more substantial. However, they have not been 'watered down' in the crucial sense of weakening the principles behind them or their potential to produce better outcomes. Rather, from this perspective, I consider the package of recommendations to have been *strengthened*, by addressing problems in a more targeted way that poses fewer risks or costs. This reflects our key finding that, despite some problems, there have not been widespread failures in remuneration-setting in Australia, nor significant impacts on efficiency.

The Commission's changes to its '2 strikes rule' exemplify that approach. This regulatory innovation was proposed in the draft report as a means of giving shareholders more leverage over the minority of boards that were not 'listening', without supplanting their role in setting pay. That remains our intent. However it became apparent that if a second significant 'no' vote on the remuneration report led directly to a board spill, institutional investors would become reluctant to cast a 'no' vote that they felt could end up destabilising the company and threatening its share price, defeating the purpose of the provision.

Under the Commission's reformulation, shareholders can express their opinion about the company's remuneration policies in the knowledge that a second no vote above 25 per cent would trigger a separate (majority) resolution to spill the board, but not a spill itself. Even where shareholders are unhappy with a company's remuneration report, they typically vote in favour of board members seeking re-election. So this new instrument is only likely to be invoked against the worst-performing boards, while signalling more strongly to all that listening to shareholders matters.

Shareholders' 'say on pay' would be elevated further by our recommendation to preclude executives and board members from voting on remuneration reports (or the associated re-election resolution). Some see this as unfairly disenfranchising director shareholders. But we consider it is justified to exclude directors from an advisory vote on what, after all, is their report — though our final recommendations no longer extend to 'associates'.

We have also held fast to recommendations to enhance the independence of board remuneration committees and reduce the scope for executive influence. Acknowledging the practical difficulties for smaller companies, we have now proposed that requirements be implemented on an 'if not, why not' basis, but that the exclusion of executives from these committees be mandated for the ASX 300. We also would make it harder for remuneration consultants to have divided loyalties.

Some have suggested that the report could have done more to ensure a longer-term focus for remuneration. We agree that having 'skin in the game', through equity-based incentives, is important for aligning executives' interests with shareholders. How this is best achieved is ultimately for boards to decide. But we have made two recommendations that would help. One is to amend the tax laws to remove the obstacle to deferred equity payments after a CEO's departure from a company. Another is to ban the hedging of equity-based remuneration, to maintain their 'at risk' character.

Further, we resisted making on-market equity purchases for remuneration purposes subject to shareholder approval. Those who persist in seeing this as a 'loophole' appear to be reinventing history. In practice, a distinction has always been made between new share issues that would dilute existing shareholders' interests and on-market purchases which would not. Subjecting both to a binding vote could deter the use of equity instruments and end up disadvantaging shareholders.

One area of universal agreement is the need to improve the informational content and accessibility of remuneration reports. Our recommendations would help shareholders understand what executives are actually being paid and why. That most boards have failed to do this is indicative of a wider communication failure which has contributed to public angst about executive pay.

This has been compounded by perceptions of a 'directors club'. The low (and declining) representation of women on boards seems hard to justify, and the Commission supports proposals for companies to set their own gender objectives and disclose progress, as well as explaining board composition generally. We have also held to our view that if boards believe they need to invoke the 'no vacancy rule' in the face of 'outside' nominations at AGMs, they should at least seek the approval of shareholders. Our revised recommendation should minimise any impacts on board flexibility.

Does all this elevate executive pay unduly above other corporate issues? The package of reforms would certainly make some boards give more attention to remuneration and to shareholders' concerns than in the past. But that is justified in the Commission's view and should complement, not detract from, their other responsibilities.

The final reform package is a measured and proportionate one. Clearly it will not, and should not, stop our top executives from earning high salaries. But it should reduce the scope for anomalies or economically inefficient outcomes, and promote greater trust in corporate Australia.

*Gary Banks is Chairman of the Productivity Commission and headed its inquiry into executive remuneration.*