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29 May 2009

Mercer's Submission to the Productivity Commission on the Executive Remuneration Inquiry

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Executive Pay is a Public Issue

CEO remuneration remains a troublesome issue confronting boards, shareholders and the broader community.[1] From the community's perspective CEO pay is generally regarded as excessive. At the more populist level CEOs are seen as determining their own remuneration to be rubber stamped by acquiescent remuneration committees and boards. A more tempered perspective focuses on three issues: the level and rate of increase in pay, particularly in comparison with average weekly earnings; a perceived lack of transparency in the remuneration determination process; and an apparent disconnect between CEO pay and company performance. These are the most commonly reported issues in the media and they underlie the popular view that CEO pay is out of control.

At the other end of the continuum are the directors who make the pay decisions. These directors, particularly members of board remuneration committees, have a very concrete problem to resolve: how much should we pay our CEO? The dilemma facing these directors is that there is no obvious 'right' answer to the question of how much to pay an individual CEO. Not only is the 'right' answer not obvious, but the outcome needs to be seen as equitable and fair by the CEO, appropriate in level and structure in the view of major shareholders, and be deemed 'reasonable' in terms of the requirements of the Corporations Act. Ultimately, disclosure requirements mean that the remuneration outcome is freely available to the public and that shareholders have the opportunity to voice their views at the annual general meeting by voting against the board's CEO pay proposal.

Mercer's submission presents four perspectives on the pay determination process. First, we describe the characteristics of the Australian CEO labour market and the impact that individual transactions can have on market norms. Second, we use interview data to illustrate the reliance that directors place on market data to reach their decisions. Next we provide a brief outline of the role played by external consultants in advising remuneration committees to enable them to reach decisions consistent with the company's business objectives, the interests of the shareholders and the governance requirements. Our submission concludes with Mercer's perspective on the the Terms of Reference outlined by the Productivity Commission in its Issue Paper.

[1] Remuneration strategies in Australian organisations typically follow the premise that the pay structure of the CEO's direct reports will mirror the CEO's pay structure to promote alignment of goals and objectives for the executive team. Consequently, the CEO's pay structure influenced the remuneration of key executives.

Characteristics of the Australian CEO & Executive Pay Market

The 1990s represent a turning point in the level and structure of Australian CEO pay. This decade saw a series of high profile Americans, appointed on U.S. styles of pay, to lead Australian companies. The recruitment of people such as Bob Joss to Westpac Bank in 1990, Frank Blount (Telstra 1992), George Trumble (AMP 1994) and Paul Anderson (BHP 1998) were significant for Australian CEO remuneration for two reasons. First, these appointments introduced levels of pay well beyond Australian market norms at the time. For example, the fixed salary paid to Bob Joss on his appointment to Westpac was almost as much as the combined salaries of the CEOs at the other three major banks[2]. Second, a significant portion of their remuneration comprised long-term equity awards, typically in the form of options, a relatively new concept in Australia at that time. Consequently, these high profile appointments were influential in the subsequent widespread adoption of equity-based incentive remuneration systems by Australian corporations during the 1990s. For example, the median percentage of the long-term incentive component of a benchmark of Australian CEO remuneration packages increased from 6.3 percent of total remuneration to 32 per cent over the period 1987 to 2000 and the total performance component of pay (i.e. short and long-term incentives) rose from 9.5 per cent to forty-seven per cent[3].

These appointments, and their subsequent impact on the level and structure of CEO pay, illustrate three features of the Australian pay market. First, it is a small market with relatively few transactions. Second, it is a closed market in that available opportunities are generally restricted to a narrow set of candidates perceived as eligible, particularly with regard to large and medium sized CEO roles. Third, and given the requirements for disclosure, it is an increasingly informationally efficient market.

The combined effect of these three characteristics results in a market that operates in a qualitatively different way from a traditional labour market. Traditional labour markets are characterised as being open to a broad range of employment opportunities, with a large number of simultaneous and independent transactions, and where no one transaction affects the market as a whole. Such a market allows that all participants will find work at a given ‘going rate’ of pay.

In contrast to the traditional labour market, the CEO pay market is capable of being directly influenced by any one or more transactions. This is because disclosure requirements maintain the information efficiency of CEO pay details in the public arena. By way of example, academic research indicates three effects resulting from CEO pay disclosure: first, it forces lower paying firms to better align with market averages to meet the ‘going rate’ expectations of candidate or incumbent CEOs; second, it prompts some firms to move to an identified position of market leadership; and third, there is a consistent tendency noted for companies to increase the

[2] D. Nason (2006) Bob Joss now bats for the other team’ *The Australian – Business* 9 October, p.3.

[3] G. O’Neill & A. Berry (2002) ‘Remuneration of Australian executives: A practitioner review’ *Asia Pacific Journal of Human Resources*, vol. 40, no. 2, pp. 257-65. Mr. O’Neill is now employed by Mercer.

weighting on performance-based pay[4]. The first two of these effects, moving to the market average and taking a position of leadership, inevitably increase the fixed component of pay while the third contributes to a lift in total CEO remuneration.

Directors' Perspectives on CEO Pay Determination

The sole guidance that boards have in addressing the issue of how much to pay their CEO is found in Section 211 of the Commonwealth Corporations Act. This section requires that shareholder approval is not needed for the remuneration of an officer of the company provided it is deemed 'reasonable' in terms of the circumstances of the company and the circumstances of the individual. Beyond this governance requirement boards need to exercise their discretion in determining CEO pay and their decision will be informed by a range of internal and external considerations. This section of our submission draws from interviews conducted with board chairs and remuneration committee members to describe the various issues and dilemmas these directors face as they exercise their discretion to make a determination of CEO pay.[5]

Reality of the Market

The notion that the external CEO pay market acts as a proxy for a centralised pricing mechanism for CEOs is a unanimously accepted reality for all interviewees. They define this market in terms of the aggregated remuneration information available from the detail disclosed in company annual reports, surveys of comparative chief executive remuneration data provided by specialist consulting firms and formal and informal data provided by executive search firms. This broad market then provides the basis for further segmentation to define more precise comparator groups appropriate to their respective company's context in terms of issues such as firm size, industry, international reach and comparative performance ranking.

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[4] See for example P. Gélinas and M. Magnan 2004, 'Increased compensation costs: An externality of mandatory executive compensation disclosure', paper presented to Administrative Sciences Association of Canada, Quebec, June 5-8 and Y. Park *et al* 2001 'Executive pay and the disclosure environment: Canadian evidence', *The Journal of Financial Research*, vol. 24, no. 3, pp. 257-65.

[5] The quotations used in this section comprise part of the data collected by Graham O'Neill, an executive remuneration principal with Mercer as part of the research for his doctoral dissertation, *The Determination of CEO Pay: An Australian Boardroom Perspective*. The quotations are representative of interview comments from a series of in-depth interviews with board chairs, remuneration committee chairs and committee members of leading Australian public corporations. Consistent with university ethics requirements, interview participation was on the basis of anonymity and confidentiality. At the time of the interviews these directors represented 36 Australian and three overseas public companies. Four of the Australian companies were ranked in the top ten ASX listed corporations by market capitalisation and fourteen in the top fifty.

I think in the last few years particularly [we've] begun to remunerate our CEOs far more than I think is appropriate and I don't see any easy way out of that because it's a market issue to recruit and retain the sort of quality of person you want to run a major publicly listed company. Directors have very limited room to do anything about that (Interview #7: board chair).

There is a thing called the market and at the end of the day, if you want to go out and get somebody who is going to turn around your company or take it to the next stage of growth, then you are having to buy that person on the market (#1: remuneration committee member).

There is further unanimous agreement regarding the reliance on market data in formulating CEO pay determinations. Market levels of pay are typically described as providing 'boundaries', 'direction', 'guidance' and 'roadmaps' for remuneration committees to work within.

There would be a sense of what the market is and we would be aware of that and evidence supporting that would be part of what was presented. So you would be making a decision in the knowledge of the competitive situation for an individual, you would also be looking at what reasonable people would say you ought to be doing based on where the market is. This is what you are confronting, this is reality, and you wouldn't want to argue about that (#2: board chair).

You know, it's not up to me to determine what the market does, but I can give you an assurance that we take market soundings and that we pay, and we'll tell you now in our annual reports, we pay relative to the market average and you as shareholders mightn't like it, I as a person mightn't like it, but that's my defence (#12: board chair).

The Impact of Globalisation

The interviewees are also unanimous in their views on globalisation as a key force driving the market. While many participants linked the impact of globalisation with overseas executives recruited to Australian firms, others also saw it as a reflection of the international mobility of Australian executives and the growing internationalisation of Australian business. This internationalisation of business has in turn created further pressure on the Australian market to match overseas remuneration packages.

The truth is there is a shortage of talent around the world and unless you compete at global remuneration rates you are not going to attract the talent to run the companies. The local talent is going to be attracted off shore (#7).

US CEOs come to Australia and up the expectations of equity within this market. Australian CEOs see that these people don't walk on water, and ask so why aren't we paid at similar rates? (#14: remuneration committee chair).

Disclosure Requirements

Disclosure requirements are also seen as adding to the ratcheting-up effect of CEO remuneration. Directors take for granted that CEOs compare their own pay relative to peers, thus providing a further avenue for CEOs to establish their respective expectations and negotiating stances. Similarly, remuneration committee members use the data to benchmark their chief executives and make their own assessments of appropriate external relativities.

I think disclosure was intended for the best of reasons, to make shareholders informed, to prove who was being paid what. I think the unintended consequence of that has been that it has contributed hugely to escalation in executive pay (#2).

So you're driven by the marketplace and the fact that everyone is required to disclose remuneration arrangements in reasonable detail. You know, everyone is fully informed as to what the market place is for Chief Executives (#9: remuneration committee member).

Attracting, Retaining and Motivating the 'Right' CEO

The need to attract, retain and motivate a CEO might sound like a cliché to some, but for remuneration committee members the need is central to their deliberations determining CEO pay. Interviewees have a unanimously shared view of the importance of the CEO role and its contribution to the success of the company. Comments focused on three key aspects of the CEO's role. First, as leader, the CEO directly influences business decisions, resource allocation and operational practices that determine financial outcomes for the firm. Second, the CEO is the external face of the company responsible for maintaining the confidence of shareholders and the investment community in the strategic direction and operational capacity of the company while also serving the internal role of maintaining effective relationships between the board and management. Third, the CEO defines the structure, values and culture of the company.

Remuneration committee members believe that there is a shortage of talented executives capable of filling this multi-faceted CEO role, and those executives who have the capability to lead are well aware of the value they bring.

You have got to assume here that many are called but fewer are chosen. All sorts of people want to be CEOs, but the ones that you want, the really good ones, believe me are quite scarce. They are like top sports people, they are not around. Now lots of people would love to play, but they are not all of the calibre that you want (#2).

Nowadays they're more mobile. They're prepared to take a board on and say, well, look, I'd be very unhappy. Then you've got to face up to the fact do you want an unhappy CEO who can be really awkward around the whole place and alter the whole culture (#11: Board chair).

The CEO's expectations regarding remuneration can be a significant factor underlying the relationship between the CEO and the board. One director illustrated the positive side of this relationship with reference to an overseas CEO appointee:

He's probably one of the real quality CEOs in the world and we got him, in international terms, pretty cheaply. Now he was prepared to tie a lot of his remuneration into long-term incentives and I applaud him for that. So he was prepared to put his strategy on the line and at risk (#10: Board chair).

The Need to 'Strike a Balance'

Directors are challenged to find a balance. The result is a judgemental process that aims to meet the needs of the company to secure and retain the best available CEO and, in doing so, provide an outcome that is seen as credible and defensible to major stakeholders. The notion of 'striking a balance', a consistently recurring theme in all interviews, is illustrated in the following interview extracts:

The first thing that comes to mind is making sure that the pay of the CEO balances two things. One, being defensible in terms of being able to explain it to the various stakeholders, and those stakeholders differ, so balancing the defensibility of the CEO's pay with being able to attract the sort of person that we need and giving them a sense that they are being fairly recognised for what they do, for the value that they add and that they are basically happy, they are not unhappy with the way they are being paid (#1).

I think the board felt a bit uncomfortable with the overall quantum and negotiated it down, so that's my view, an unintended consequence perhaps of the scheme. I think the board did a good job in that regard. Bringing it into line with expectations in the market place of what is reasonable and that is something that's quite subjective (#9).

The Role of the Executive Remuneration Consultant

The remuneration committee is responsible for developing recommendations on the appropriate level and structure of CEO and senior executive pay for board approval. It is our experience that the remuneration committees of Australian companies typically meet between four and six times a year: furthermore, committee members generally lack the time and depth of technical knowledge to be deeply involved in the fine detail of remuneration design. For these reasons committees rely largely on the expertise of external consultants to assist in developing senior executive remuneration plans.

Mercer executive remuneration principals provide advice on the design and implementation of executive pay programmes in support of aligning executive performance with the company's business strategy and shareholder interests. These principals fulfil two primary roles in relation to the work of the committee: first they assist the committee to establish an overall philosophy of executive pay as a platform for specific programme design; and second they provide objective and expert analysis, advice and information to support the committee in its decision-making. Inherent in both these roles is the need to work with the committee to help directors understand the choices available to them, as well as the taxation, accounting, disclosure, regulatory and human resource implications of those choices. Ultimately, our advice is formed and provided within the context of 'reasonableness' as set out in Section 211 of the Corporations Act.

In 2005 Mercer developed and implemented global business standards for managing our business and any potential conflicts of interest that may be present in advising boards of directors on CEO and executive remuneration issues. These global business standards, which are revised periodically, are the central internal governing document for Mercer's executive remuneration consulting business. We believe that these standards enhance transparency and establish a framework that allows Mercer executive remuneration consultants to provide high-quality, unbiased advice to remuneration committees.

Mercer's Perspective on CEO Pay Determination

Based on our experience gained from working directly with boards and remuneration committees from a wide cross section of Australian companies, we do not believe that directors are 'captured' by entrenched and powerful CEOs, or that acquiescent committees rubber-stamp CEO and senior executive pay plans. To the contrary, our experience is that the overwhelming majority of non-executive directors approach their fiduciary responsibility for determining CEO pay seriously and that they act with diligence and integrity to reach an outcome that best meets the interests of shareholders. Most boards have robust and transparent processes to review CEO pay, evaluate CEO performance and ensure a link between pay and performance.

We believe that any gap between what the community expects boards to achieve with regard to CEO pay, and what boards actually achieve, is not a performance gap on the part of boards, but an expectations gap concerning what boards can reasonably be expected to achieve, given the nature of the CEO pay market, the availability of CEO pay data and the need to compete for talent in a global market. As the commission reviews issues of transparency related to the determination process, it is important to acknowledge that increased transparency may not necessarily close the expectations gap but if history repeats itself, may well contribute to further CEO pay increases.

The Current Environment

Mercer believes that it is important to differentiate the Australian executive remuneration environment from what has occurred in North America (and to a lesser extent in Europe). Solutions proposed to address egregious examples in these regions would in most cases, not be appropriate for the Australian market.

Mercer's global executive remuneration database shows that in 2008, 144 of the top 200 US corporations (72%) were led by a CEO who is also board chair. From an a priori perspective, the predominance of the CEO/chair duality is used to infer that the power and authority vested in CEOs results in undue influence over corporate boards. To attribute increased remuneration levels for Australian CEOs to a similar 'board capture' notion is indeed a long bow, particularly when one notes that only 12 of the top 150 Australian companies' (8%) have CEOs who also serve as board chair or deputy chair.

In addition, we believe it is important to note that in the US, senior executives have a higher proportion of total remuneration paid in the form of incentives than in the Australia. Options remain the most common vehicle for delivering long-term incentive based pay and are generally linked to tenure rather than performance. This is in direct contrast to Australia where the majority of long-term incentives are linked to future performance of the organisation.

We believe that Australia's existing corporate governance and legislative framework provides a robust set of checks and balances that has allowed Australia to avoid the large corporate failures experienced in the US. The role of excessive executive pay and aggressive incentive arrangements considered by many to have contributed to the global financial crisis have not been prevalent in Australian organisations. We believe this can be attributed to the higher level of accountability and transparency that is a direct result of existing legislation, guidelines and disclosure requirements which allow shareholders to vote on certain elements of executive equity plans and express their opinion on remuneration through the non-binding vote on the remuneration report.

Recommended Outcomes

Mercer believes the review of executive remuneration is one of the critical elements Australian corporations must address as they look for ways to adapt and respond to the current economic situation. We welcome the government's response to community concerns by providing a thorough review by a body such as the Productivity Commission.

We have already seen a number of companies respond to pressure from the community, market and shareholders to further improve remuneration frameworks to ensure pay levels are reasonable and incentives aligned to the business strategy and performance expectations. We believe this illustrates the effectiveness of the self regulatory nature of the current system and reinforces the fact that a sweeping overhaul is not required.

Mercer favours a principle-based approach that would provide boards with a set of guidelines to assist them in understanding the expectations of government and regulators and a consistent framework within which they can undertake the difficult task of developing executive remuneration in a way that is globally competitive, commercial and aligned to the interests of stakeholders.

Mercer is concerned that prescriptive legislation that mirrors international responses to events overseas and seeks to address the limited examples of excess in Australia will have unintended consequences. Such legislative action limits the ability of boards to provide flexible, innovative solutions to recruit and retain the high calibre of executive talent that has been a cornerstone of Australia's current strong financial position.

In response to the issued raised by the Productivity Commission in its paper, Mercer submits the following points:

- **Trends in levels and types of remuneration in Australia and internationally.**

Mercer agrees with the principle endorsed by the G20 Working Group on this issue as outlined in their final report on recommendations to strengthen international regulatory standards and enhance transparency in global financial markets. We feel that this approach is appropriate to the broader business community beyond just financial services.

> *In general, it is not intended, however, that national authorities or prudential supervisors would prescribe particular designs or levels of compensation. Since financial firms differ in goals, activities and culture, and since there is also a wide range of employees within a firm, any compensation system must work in concert with other management tools to promote prudent risk taking.*[6]

- **Effectiveness of the existing framework for the oversight accountability and transparency of remuneration practices in Australia.**

As discussed above, Mercer feels that Australia's existing system provides a robust and effective framework that has allowed Australia to avoid some of the excessive remuneration practices that have occurred overseas. However, Mercer is concerned that current disclosure requirements are not representative of the actual remuneration received by executives because there is no requirement for companies to provide detail on target incentives and actual incentives vested.

Mercer encourages the Productivity Commission to consider including this requirement in the disclosure rules and would be happy to provide further detail on how disclosure of incentive arrangements could be presented with more accuracy.

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[6] G20 Working Group 1
Enhancing Sound Regulation and
Strengthening Transparency, Final Report, March 25, 2009

In this aspect, we may benefit from steps taken in the US to centralize the rules for disclosure and clearly define aspects to be covered as well as the oversight authority. In July 2006, the US Securities and Exchange Commission adopted more rigorous standards to its pay disclosure requirements, to capture the increasing complexity of executive compensation arrangements and clarify remuneration intent and strategy. The most notable change to disclosure is the inclusion of the Compensation Disclosure and Analysis (CD&A) section, which requires explanation of the company's compensation objectives, policies, and rationale for the method and magnitude of pay delivered to senior executives.

Significant changes were also made to equity compensation reporting, to help investors better understand the intended and actual value of share-based awards to executives. In addition to more stringent disclosure on stock option grant practices in the CD&A, and the inclusion of the company cost of equity awards in the Summary Compensation Table (SCT), the new requirements also provide for further disclosure of outstanding equity awards. Companies must now disclose in clear tabular form the value of all outstanding equity awards at year-end and the amounts each executive realised on option exercises and stock award vests during the year. While improved equity and "bottom line" total compensation disclosure is seen as helpful insight to executive pay, investors were disappointed that the SCT value of equity is provided as "company cost" rather than grant date fair value, thus not necessarily reflective of intended or actual pay.

- **The role of institutional and retail shareholders in the development, setting, reporting and consideration of remuneration practices.**

Mercer believes that the input of institutional and retail shareholders is an important element of developing remuneration policies and we encourage our clients to engage with these key stakeholders whenever developing or making substantial changes to their remuneration practices. The non-binding vote on the remuneration report has allowed shareholders to express their views on executive remuneration and we believe has provided a higher level of accountability and transparency that has moved boards to look to better align remuneration practices since its introduction. However, we think it important that the Productivity Commission also consider the conflicting pressure boards are under from institutional and retail shareholders to meet analyst expectations of performance that were increasingly aggressive during the recent economic boom and placed additional pressure on boards to recruit and retain executive talent and drive them to superior performance through the use of incentive based compensation.

- **Mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community.**

Again, Mercer is in agreement with the recommendations of the G20 working group on the role of compensation schemes and alignment with an organisation's risk profile and believe that this approach should be adopted across other industry sectors.

Large financial institutions should ensure that their compensation frameworks are consistent with their long-term goals and with prudent risk-taking. As such, the Boards of Directors of financial institutions should set clear lines of responsibility and accountability throughout their organizations to ensure that the design and operation of its remuneration system supports the firm's goals, including its overall risk tolerance. Shareholders may have a role in this process. Boards should also ensure there are appropriate mechanisms for monitoring remuneration schemes.

Mercer advises companies to adopt a balanced approach to remuneration that includes cash, equity (where appropriate) and non-financial elements of reward and aligns to the organisation's business strategy, risk profile and performance timeline. We provide further detail on Mercer's balance approach to executive remuneration in the attachment.

- **The effectiveness of the international responses to remuneration issues arising from the global financial crisis and their potential applicability to Australian circumstances.**

Mercer encourages the Productivity Commission to consider the Australian environment as discussed above before adopting international responses that were designed to address specific problems in those jurisdictions, such as the TARP provisions. There are many examples of the unintended consequences of legislation that created more problems than solutions such as the impact of introducing Section 162M of the US Internal Revenue Code that limited deductions for fixed pay and drove up the leverage of at risk pay in the US.

- **Interaction with the Australia's Future Tax System Review and the Australian Prudential Regulation Authority review.**

Mercer is concerned that recent announcements regarding changes to legislation governing termination payments and employee share schemes appear to have been made without consideration of the objectives of the Productivity Commission's review. In particular, the conflicting aims of promoting more alignment of executives and shareholders through the use of deferred bonuses and equity over longer timeframes with legislation that would potentially treat unvested equity as excess termination payments subject to penalties or tax equity in the year of grant when still subject to vesting conditions and/or sales restrictions.

Mercer believes that the finalisation of any such proposed legislation should be deferred until the Productivity Commission has finalised their recommendations to government such that changes to the Corporations Act and the Tax Act are consistent with the Productivity Commissions' findings.

- **The following recommendations are proposed to strengthen the existing framework governing Australian executive remuneration practices:**

  - A set of consistent, principles-based guidelines that boards can follow when developing remuneration policy;
  - Clearer and more consistent disclosure requirements focusing on incentive target levels as well as payout/vesting levels for both short and long term incentives;
  - Consistency with Corporations Act and Tax Act and APRA's review.