



Prudential Practice Guide

PPG 511 – Remuneration

28 May 2009

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About this guide

1. This prudential practice guide aims to assist institutions regulated by the Australian Prudential Regulation Authority (APRA) in considering and prudently managing the risks that may arise from their remuneration arrangements.
2. The information in this guide supports compliance with APRA's Governance Prudential Standards APS 510, LPS 510 and GPS 510, collectively referred to as the governance standards, which set out APRA's requirements in relation to remuneration. There is no equivalent prudential standard for the superannuation industry, so this guide does not apply to superannuation trustees. However, where appropriate, trustees may seek to apply the principles as a matter of prudent practice.
3. For the purposes of this guide, 'regulated institution' refers to an authorised deposit-taking institution (ADI), a general insurer or a life company (including a friendly society) regulated by APRA.
4. The guidance provided in this prudential practice guide conforms to the *FSF Principles of Sound Compensation Practices*, released on 2 April 2009. It is also consistent with, but not limited to, the requirements of the Corporations Act 2001 relating to disclosure, Principle 8 of the *ASX Corporate Governance Principles and Recommendations (2nd Edition)* and the guidelines published by the Australian Institute of Company Directors (AICD) in February 2009.
5. Not all of the practices outlined in this prudential practice guide will be relevant for every regulated institution and some aspects may vary depending upon the structure of the institution's business, including its size, complexity and risk profile.

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Introduction

1. In late 2008, the Financial Stability Forum (FSF), recently re-established as the Financial Stability Board, formed a Compensation Workstream Group, of which APRA was a participant. The work culminated in support by the Leaders of the G20 for the FSF's *Principles of Sound Compensation Practices*¹. APRA's requirements for remuneration in the governance standards are based on the FSF's principles (see Attachment), but have been adapted to reflect the regulatory framework in which APRA-regulated institutions operate.

Governance of remuneration arrangements

2. APRA's governance standards set out the minimum requirements that a regulated institution must satisfy in the interests of promoting strong and effective governance. Remuneration is a key aspect of any governance framework and needs to be properly considered in order to mitigate the risks that may arise from poorly designed remuneration arrangements.
3. The Board has ultimate responsibility for the sound and prudent management of a regulated institution, including remuneration arrangements. Whilst the governance standards require the establishment of a Board Remuneration Committee, the Board retains ultimate responsibility for remuneration. In dealing with matters relating to executive remuneration, the independent directors would be expected to ensure that executive directors are not placed in a position of actual or perceived conflict of interest.

Board Remuneration Committee

4. The governance standards require the Board to establish a Board Remuneration Committee to periodically review the Remuneration Policy and make recommendations to the Board. APRA may grant the institution approval under the governance standards not to have a Remuneration Committee, but only where the Board has alternate arrangements in place that achieve the same outcome.
5. The Board Remuneration Committee is also required to review and make recommendations to the Board on the remuneration of executives, including the amount of their remuneration. This reflects the fundamental principle of good corporate governance that executives should not be permitted to set their own remuneration.
6. The governance standards require the Board Remuneration Committee to periodically review the Remuneration Policy, so as to ensure that it remains current and appropriate for its intended purpose. As part of this review, the Remuneration Committee would be expected to identify material deviations of remuneration outcomes from the intent of its policy. The Remuneration Committee would also be expected to identify unreasonable or undesirable outcomes that flow from policy limitations, such as imprecise risk or profit measures.
7. To assist the Remuneration Committee to undertake the review, the regulated institution would be expected to maintain proper records of remuneration arrangements. These records are particularly relevant for deferred components which may extend over a number of years from the time they are provisionally awarded through to the time they vest.

¹ <http://www.financialstabilityboard.org/>

8. It is important that such periodic reviews extend to persons at all levels of the regulated institution who receive performance-related remuneration. Large numbers of lower-level employees with material financial incentives can take actions that are individually insignificant but collectively can be detrimental to the regulated institution.
9. The governance standards do not prescribe a minimum review period but APRA would generally expect a review to be undertaken at least every three years.
10. The governance standards require that the Board Remuneration Committee have the necessary experience and expertise to deal with these issues and perform its duties. The Remuneration Committee may need to supplement its expertise by obtaining appropriate expert advice. APRA expects that the Remuneration Committee, in performing its duties, will seek information and advice from relevant internal parties including, but not limited to, those responsible for risk management, human resource management and internal audit.

Use of external consultants

11. When the Board Remuneration Committee engages expert advisers, the governance standards require that the advice be commissioned by, and provided directly to, the Remuneration Committee, independently of management. In this regard, lawyers or other parties negotiating contracts or employment terms on behalf of the regulated institution are expected to receive instructions solely from the Remuneration Committee and provide advice solely to the Remuneration Committee.
12. Where APRA has granted the institution approval under the governance standards not to have a Remuneration Committee, the Board itself would be expected to engage and instruct the expert advisers.

Remuneration Policy

13. The governance standards require the Board to have in place a Remuneration Policy. Large, complex and publicly listed regulated institutions are likely to need a more comprehensive Remuneration Policy than smaller, less complex regulated institutions. A regulated institution is able to utilise a group Remuneration Policy provided that the group policy as a whole meets the requirements of the governance standards.
14. The governance standards require that the Remuneration Policy cover all employees and agents, whether or not they are employees of the regulated institution, whose actions could put the institution's financial soundness at risk. In this regard, APRA has identified three groups for the purposes of the Remuneration Policy:
 - (a) The first group is 'responsible persons', defined in APRA's 'fit and proper' prudential standard² to include directors, executives and senior managers who make or participate in making decisions that affect the whole, or a substantial part, of the business of the regulated institution. The governance standards exclude non-executive directors from this first group. Appointed Auditors, responsible auditors, external Appointed Actuaries (where relevant) and Reviewing Actuaries (where relevant) of the regulated institution are also defined to be 'responsible persons' but are excluded from this first group.
 - (b) The second group are risk and financial control personnel (including risk management, compliance, internal audit, financial control and actuarial control personnel). The remuneration of such personnel requires special attention because of the potential conflict between their own interests and the interests of executives and others whose financial and risk performance they are required to oversee. This group is discussed separately below.

² refer APS 520 Fit and Proper, GPS 520 Fit and Proper, LPS 520 Fit and Proper

- (c) The third group are those persons who receive a significant proportion of performance-based remuneration through bonuses, commissions and the like. These persons may not individually be able to put the institution at risk but they may collectively pose a threat to the soundness of the institution. APRA envisages that such persons would typically include but not be limited to financial market traders, other transaction-oriented staff and commissioned sales personnel and agents.
15. It is conceivable that senior risk and financial control personnel are also responsible persons, and are therefore members of both the first and second groups. The Board must ensure that the requirements in the governance standards for each group are applied to such persons.
 16. A regulated institution may extend its Remuneration Policy to a wider range of persons than the minimum coverage required by the governance standards. Additionally, the governance standards enable APRA to designate certain people or classes of people who must be covered by the policy.

Risk and financial control personnel

17. Risk measures and risk judgments play a key role in the risk adjustment of remuneration, as do the accuracy and reliability of measures of profit and loss. Risk and financial control personnel are usually relied upon to ensure the integrity of these measures. Hence, APRA would expect the regulated institution's risk management personnel to play a role in the design and operation of the remuneration arrangements.
18. The governance standards require that risk and financial control personnel are remunerated in a manner that is independent of the business areas they oversee. The Remuneration Policy would be expected to ensure that the remuneration of such persons is not influenced by either the personnel or performance of those business areas due to the conflicts of interest that may arise.
19. Regulated institutions would be expected to ensure that the total remuneration packages offered to financial and risk control personnel are sufficient to attract and retain staff with the skills, knowledge and expertise to discharge those functions. For such personnel, an appropriate remuneration arrangement is likely to feature a higher proportion of fixed salary to performance-based remuneration than would be the case for personnel with profit centre responsibility.

Adjusting remuneration for risk

20. Regulated institutions have risk management frameworks in place to assess their risk appetites and to identify and manage the risks associated with their business activities. Generally speaking, if the risk management framework is strong and effective, the risk-taking incentives provided by remuneration systems are mitigated and would be more likely to remain within the institution's risk appetite.
21. Noting that controls are not always perfect and may be undermined by poorly designed remuneration arrangements, the governance standards require that, in rewarding individual performance, the Remuneration Policy be designed to encourage behaviour that supports the risk management framework of the regulated institution.
22. In designing remuneration arrangements, the Board Remuneration Committee will need to consider, among other matters:
 - the balance between fixed (salary) and at-risk (performance-based) components of remuneration. Performance-based components include short-term and longer-term incentive remuneration, payable with or without deferral; and
 - whether cash or equity-related payments are used and, in each case, the terms of the entitlements including vesting and deferral arrangements.
23. These matters are discussed further in the following sections.

Measuring performance

24. Current practice often fails to adjust for risk when setting performance targets and measuring actual performance for remuneration purposes.
25. A number of techniques are available to adjust profits for risk. The Board would be expected to choose the techniques most appropriate to the circumstances of the regulated institution. Whichever techniques are chosen, the full range of identifiable risks will need to be covered.
26. Measuring performance and adjusting for risk relies on the accuracy and relevance of the measures used to assess financial results. The measurement and allocation of performance-based remuneration based on accounting standards would generally be the starting point for financial measures of performance for remuneration purposes. However, some components of profit and value measures, e.g. changes in asset values where a regulated institution's assets are marked to market, or changes to the surplus or deficit in an institution's defined benefit superannuation fund, may be outside the control of individuals and so may need to be excluded or modified in making remuneration assessments. Where the institution makes adjustments to the statutory accounts for these purposes, the adjustments would be expected to be properly documented and substantiated.
27. Financial measures of performance that are based mainly on revenue, volume or market share growth may provide an incentive for employees to pay insufficient regard to the quality of business undertaken or services provided, or to their appropriateness for the client. Such measures can be at the product, portfolio or corporate level.
28. Measuring performance by some version of profits or earnings may be appropriate in many cases but effective remuneration calculations will include adjustments for risk, including future risks not adequately captured by accounting profits. The latter is discussed in the following section.
29. Whilst performance measures are generally related to an institution's own performance, some measures rely on performance relative to others, most commonly through relative total shareholder return (TSR). APRA would expect Boards adopting such an approach to do so only after careful consideration of its appropriateness, especially in periods when absolute returns are low or negative.
30. The level of performance-based remuneration would be expected to reflect the levels of risk to which the regulated institution is exposed by an individual in performing his or her role. For example, it would not be prudent practice to remunerate, in the same manner, two employees who generate the same profit but assume different amounts of risk on behalf of the institution. APRA would also expect performance-based remuneration to be reduced or eliminated where the individual has been found to have exposed the institution to risk beyond its risk appetite.
31. Poor performance in non-financial measures or other behaviours contrary to the regulated institution's values can pose significant risks for institutions. It is important for institutions to recognise and adjust remuneration for non-financial measures, such as compliance with risk management and internal audit frameworks, management of staff, adherence to corporate values and displaying good corporate citizenship. Performance against risk-related non-financial measures may be identified through various mechanisms, e.g. the nature of internal or external audit findings, risk management assessments including any compliance breaches, unexpected taxation or litigation consequences or administrative, civil or criminal actions taken against the institution.
32. Adverse performance by an individual in these areas would usually be reflected in reductions to, or elimination of, any performance-based remuneration.

Using capital to adjust financial performance measures for risk

33. At the product or portfolio level, prudent decisions generally correspond to sound business practices aimed at generating a continuing profit stream or at enhancing the value of the product or portfolio from year to year. Similarly, at the corporate level, prudent decisions generally correspond to business plans and corporate initiatives that are aimed at generating a continuing profit stream or enhancing the value of the business from year to year.
34. Profits and value enhancements can be risk-adjusted in various ways. One such method that APRA expects regulated institutions to apply, irrespective of other techniques that may also be adopted, is for profit to be measured net of the cost of capital employed in supporting the relevant product, portfolio or business. The basis for this approach is that the level of capital employed should reflect the level of risk associated with the product, portfolio or business and the cost of that capital is as much a business expense as employee expenses, IT costs and other business expenses. APRA would therefore expect Boards to recognise that:
 - profits are most usefully measured relative to a reference return on the amount of capital supporting the product, portfolio or business;
 - the amount of capital should reflect the risks associated with the product, portfolio or business; and
 - the amount of capital can generally be ascertained by making an allocation of capital through an economic capital model (ECM)³ or, in the absence of such a model, by reference to some other capital allocation method, such as regulatory capital.

Retrospective adjustments to performance-based remuneration

35. The governance standards require that the design of remuneration arrangements takes account of the risks in the regulated institution's business activities and allows time for outcomes of those business activities to be measured reliably. This means that performance-based remuneration should be 'at risk' until performance of the individual can be validated.
36. Measuring performance-based remuneration after the event, with the benefit of hindsight, allows Boards and regulated institutions to assess the consequences of the risks to which the institution has been exposed. This is particularly relevant where there are uncertainties in the measures applicable to the period in which business is written or generated (e.g. assessing the quality of loans written during the current year).
37. Performance measurement in such cases is best deferred. The deferral period may be months or years, depending on the portfolio or the business. If there is no deferral, a margin for uncertainty might well be incorporated into performance measurement.
38. For business activities that have strong controls in place and have well understood risks, it may be the case that performance can be reliably measured immediately.
39. As already noted above, one approach to allow for the time necessary to measure performance reliably is to defer some or all of the allocated performance-based remuneration, with validation of performance and risk outcomes at the end of the deferral period. It is the Board's responsibility to determine the amounts deferred, the length of the deferral periods and any associated vesting arrangements.

³ ECMs have been developed by a number of ADIs over recent years, in the context of the 'advanced' approaches available under the Basel II Framework in Australia. APRA also requires general insurers that seek approval to use the internal-model approach to demonstrate that the ECM plays an integral role in the insurer's management and decision-making processes, and that this use is embedded in the insurer's operations.

40. A regulated institution may elect to allocate interest on cash components or dividends on equity components that have been deferred. Consistent with the intent of deferral, the vesting of such allocations would be expected to occur when the performance-based remuneration is validated. In addition, an institution may permit the partial vesting of an amount to cover taxation obligations of the employee arising from the deferred component. APRA expects all such arrangements to be adequately documented in the Remuneration Policy and to be consistent with the governance standards.
41. Where adverse outcomes that arise during any deferral period lessen the original assessment of the performance generating the deferred allocation, the governance standards require that the Remuneration Policy provide for and enable the Board to reduce or eliminate payment of performance-based remuneration. Although the deferral of equity components exposes employees to losses in the event of poor share price performance it is APRA's view that this is generally not sufficient on its own to offset risk-taking incentives.
42. Some business lines require many years of exposure before all risks have materialised. Long deferral periods, however, reduce the effectiveness of employee incentive arrangements. Hence, the Remuneration Policy needs to strike a reasonable balance between providing effective incentives and validating the performance measures over a deferral period.
43. In general, it is desirable to set performance thresholds and targets prior to the start of any performance period. It is also desirable not to re-set performance-based remuneration components involving performance hurdles, strike prices and the like due to company, industry, economic or share market adverse performance unless there are exceptional circumstances and explicit support from the Remuneration Committee and the Board.

44. It would not be prudent practice for all deferred payments to automatically vest upon an employee leaving a regulated institution.

Adjusting for performance outcomes of the whole entity

45. Performance-based remuneration arrangements are typically structured to recognise individual performance and contributions to outcomes at both the business unit and whole-of-entity level.
46. There can be a conflict, real or apparent, between rewarding individuals and business units that perform well when the regulated institution as a whole, or a relevant large business unit within it, fails to perform well. The remuneration arrangements need to be structured in a manner that copes with uneven performance across the institution.
47. The governance standards require that the Remuneration Policy provide for and enable the Board to reduce or eliminate payment of performance-based remuneration where such actions are necessary to protect the financial soundness of the regulated institution. The exercise of such discretion may be appropriate when the institution is experiencing, for example, poor or declining profitability, difficulty in meeting prudential capital requirements or reliance upon public sector capital injections.

Fixed and variable remuneration components

48. The overall remuneration structure, including the balance and selection of components of remuneration, would be expected to promote a culture and working environment that attract and retain the types of staff that suit the regulated institution's risk appetite.
49. One aspect to consider is the balance between base (or fixed) pay and performance-based (or variable) components. Components of base pay are usually base salary, statutory superannuation and retirement benefits, and perhaps reimbursement of some kinds of expenses.

50. It is desirable that base pay be a sufficient proportion of total remuneration to enable the Board to make performance-based components truly discretionary. Boards will need to seek a balance in their Remuneration Policy between offering incentives for good performance and avoiding incentives for an individual to take risks that are outside the regulated institution's risk appetite to attempt to improve his or her remuneration.

Other considerations for executive remuneration

51. Some executives are able to make decisions that materially influence the long-term financial soundness of the regulated institution. Accordingly, it is sound practice to structure the components of performance-based remuneration in a way that aligns financial incentives for these executives with the long-term successful stewardship of the institution.

Equity-related components

52. Equity-related benefits for executives can be useful as performance rewards for the obvious reason that a personal stake in the regulated institution's equity can increase the incentives for an executive to preserve and enhance shareholder value. However, it is also clear that share prices are affected by many factors that are beyond the influence or control of executives.

53. Particular attention should be given to the length of the deferral periods of equity-related remuneration components to ensure executives maintain a long-term view, even when approaching the end of their employment contracts. These considerations indicate the need for a thorough risk-oriented assessment by the Board Remuneration Committee of all equity-related remuneration components.

54. Equity options in performance-based remuneration have their place but need to be considered carefully because they have the potential to generate more extreme incentives than an equivalent dollar amount of ordinary shares. They generally represent a one-sided incentive that can generate very high payments to executives when share prices rise, representing a geared return relative to shareholders. On the other hand, when share prices fall and the option value becomes zero, shareholders may suffer losses whereas the executive granted options may have no further downside risk.

55. The use of equity-related components and any other associated benefits to the executive should be transparent and clearly aligned with the intent of the Remuneration Policy. For example, granting options with a low exercise price relative to the market price at time of issuance or allowing executives to use cash bonuses to purchase equity at below-market prices provide a windfall benefit to executives. Such arrangements are equivalent to base salary payments being hidden within the remuneration structures. Such payments should generally not be viewed as being performance related and may undermine the effectiveness of using equity components to preserve and enhance shareholder value.

56. The pressure upon executives to engage in risky behaviour is materially increased if the remuneration arrangements are such that a fall in the share price creates an incentive for the executive to attempt to restore the institution's share price in order to protect his or her personal financial position. Examples of such arrangements include some leveraged equity ownership arrangements, such as partly paid shares or shares funded by a company-arranged loan.

Incoming and terminating payments

57. Guaranteed payments to terminating executives, such as 'golden parachute' arrangements, are generally inconsistent with prudent practice. Such arrangements may expose the regulated institution to considerable risk. For example, an executive could decide it is worth taking large risks with the institution's financial position in the knowledge that success would lead to large performance-based payments and failure will lead to large termination payments.
58. Similarly, guaranteed payments beyond normal remuneration for incoming executives or other staff are generally inconsistent with prudent practice. With APRA's prudential requirements on remuneration in operation, it will be incumbent on regulated institutions to undertake due diligence on the previous remuneration of incoming executives and to take the results into account in establishing the new remuneration package.

Hedging equity exposure

59. The Corporations Act was amended in 2007 to require Boards to disclose their policies on executives limiting their exposure to financial risk regarding equity (and equity options) and on the mechanism used by the company to enforce this policy.
60. To strengthen this requirement for regulated institutions, the governance standards prohibit responsible persons from hedging their equity exposure to the regulated institution. The standards also require that the Remuneration Policy set out the actions that would be taken where a person is found to have breached this requirement.
61. An executive may contemplate taking excessive risks near the end of his or her employment with the regulated institution if the option is available to hedge deferred equity exposures upon leaving the institution. Boards would be expected to consider this risk in establishing their remuneration arrangements.

62. In this regard, the governance standards only apply to 'responsible persons', being generally the senior executive cadre. The Board of a regulated institution would be expected to consider whether the anti-hedging policy were appropriate for other staff who receive equity-related benefits as part of their remuneration.

Perquisites and fringe benefits

63. Most regulated institutions offer some perquisites or fringe benefits to their staff. Whilst there is nothing inherently imprudent about this practice, such arrangements may raise concerns when they comprise a substantial share of an executive's total remuneration, or when they are unusually large or generous.
64. Prudent practice would be for material perquisite arrangements, for both current and former executives, to be detailed in the Remuneration Policy.

Attachment

FSF principles for sound compensation practices⁴

Effective governance of compensation	
Principle 1	The firm's board of directors must actively oversee the compensation system's design and operation.
Principle 2	The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended
Principle 3	Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.
Effective alignment of compensation with prudent risk taking	
Principle 4	Compensation must be adjusted for all types of risk.
Principle 5	Compensation outcomes must be symmetric with risk outcomes.
Principle 6	Compensation payout schedules must be sensitive to the time horizon of risks.
Principle 7	The mix of cash, equity and other forms of compensation must be consistent with risk alignment.
Effective supervisory oversight and engagement by stakeholders	
Principle 8	Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
Principle 9	Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

⁴ <http://www.financialstabilityboard.org/>



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