



# Executive Remuneration The Regulatory Debate

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## Executive Remuneration - the Regulatory Debate

### Background

Executive remuneration has caught the eye and the ire of the community in the last year. It has drawn great interest from the public, from politicians and governments, from investors and shareholders, and from regulators, economists and other commentators.

For the public, executive remuneration is an easy target when share prices are falling and some executives are highly rewarded. There is public outrage at large payments to executives of loss-making businesses; and the public has a general sense of unease around the topic of executive remuneration.

Around the globe, politicians and governments are finding themselves not only responding to public concerns about executive remuneration. They also believe that unreasonable things have happened that have contributed to the global financial crisis and the economic downturn in which we now find ourselves. They are rightly concerned at excessive risk-taking, conflicts of interest and apparent examples of individual greed taking priority over the interests of shareholders and customers.

Investors and shareholders have become concerned that executive remuneration arrangements have contributed to risk-taking that has undermined the quality of corporate decisions and strategy, creating conflicts of interest and compromising shareholders.

Regulators need to analyse this debate and the associated circumstances, and to influence where they can the actions of boards of companies, in order to create more appropriate and better balanced remuneration arrangements. In APRA's case, there is the possibility of influencing directly the boards of financial institutions which are regulated by APRA, namely banks, building societies, credit unions, insurance companies and friendly societies, and also superannuation fund trustees.

### The Executive Remuneration Debate

The purpose of this presentation is not to put on the table APRA's proposed approach to executive remuneration, which will be explained in depth in a discussion paper to be issued in the next few weeks, but rather to explain the context of the executive remuneration debate generally and to position APRA's approach within the wider debate.

A good place to start is a chronology of recent publicly announced initiatives on executive remuneration -

Date	Initiative
25 Sep 2008	Prime Minister Rudd raised remuneration reform in an address to the UN assembly.
13 Oct 2008	FSA (UK) wrote to bank CEOs in the UK outlining good practice and poor practice in remuneration
15 Oct 2008	Prime Minister Rudd announced government concern at excessive risk-taking, asked APRA to explore
Nov 2008	APRA invited to join FSF workstream preparing for G20 leaders meeting on 2 April 2009
9 Dec 2008	APRA announced its approach -- see media release: <a href="http://www.apra.gov.au/media-releases/08_32.cfm">http://www.apra.gov.au/media-releases/08_32.cfm</a>
11 Feb 2009	AICD announced new guidelines on executive remuneration
18 Feb 2009	ASA released exposure draft on executive remuneration
27 Feb 2009	FSA (UK) released a draft code of practice for all regulated UK financial institutions
6 Mar 2009	CEBS announced draft principles on executive remuneration for European banks
12 Mar 2009	FSF issued a press release regarding the recommendations it would be making to the G20 meeting

The FSF press release followed a meeting of the Financial Stability Forum in London on 11 and 12 March in preparation for the G20 meeting on 2 April. The relevant section of its press release stated that "The FSF endorsed a set of principles that will reinforce **sound compensation practices** in the financial industry. The principles aim to ensure effective governance of compensation, alignment of compensation with prudent risk-taking, and effective supervisory oversight and stakeholder engagement in compensation."

The full FSF paper was scheduled to be released following the G20 leaders' meeting on 2 April.

Beyond the above table, it is notable also that section 300A of the Corporations Act, administered by ASIC, has required for some years that registered corporations in Australia make a set of disclosures on executive remuneration. In addition, the Australian Securities Exchange (ASX) has had disclosure guidelines in place for some time regarding executive remuneration in listed companies.

So who are all the agencies referred to above and what are their interests in executive remuneration?

There are several existing players -

ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
AICD	Australian Institute of Company Directors
ASA	Australian Shareholders' Association

and some new ones -

APRA	Australian Prudential Regulation Authority
FSF	Financial Stability Forum
FSA	Financial Services Authority (UK)
CEBS	Committee of European Banking Supervisors

The existing players have generally been obliged to rely on disclosure of remuneration arrangements. There are, however, major constraints on disclosure and the results have been mixed. Often we see form prevailing over substance, because compliance with disclosures gives limited assurance regarding the effectiveness of incentive arrangements from a shareholder and customer viewpoint.

The new players are predominantly prudential regulators and in most cases they have the power to go beyond disclosure. Prudential regulators can use principles-based approaches rather than the prescription required in most disclosure regimes, and they can oblige compliance with both the intent and the substance of the prudential requirements. This is certainly the position in APRA's case.

### **APRA's Modus Operandi**

It is useful here to explain how APRA operates. Our primary requirements for financial institutions relate to capital, risk management and governance, supported by regular financial reporting. This is the essence of APRA's **regulation**. Regarding governance, APRA requires that each company's board accept responsibility for the actions and performance of the company. Generally boards accept and indeed are supportive of APRA's requirements. APRA can take various actions if the board is not playing the game, especially if we believe that the company's risk profile is high.

APRA also engages in **active supervision** of financial institutions. We undertake regular prudential reviews, whereby teams of APRA supervisors review closely the operations of each regulated institution. When we observe high or increasing risk, we increase the intensity of supervision. APRA has the resources to operate this way, on the basis that prevention (before trouble occurs) is better than punishment after the horse has bolted.

It should be evident from this description that APRA's modus operandi is to let companies work out their own approach, within the ambit of APRA's prudential standards, and for APRA then to challenge any company which is not, in APRA's opinion, operating appropriately.

## Ten Dimensions of the Debate

With this background we can now make sense of the full field of executive remuneration, the range of players and the initiatives they are taking.

The table below identifies ten dimensions of executive remuneration. It illustrates the range of possibilities available to regulators for each dimension. It also shows the direction that APRA will be taking when we introduce prudential requirements on financial institutions later this year.

Executive Remuneration - Ten Dimensions				
Dimension	Range of possibilities			
1. Application	All corps	Listed corps	All prud regulated*	Regulated banks
2. Scope	Senior executives		All significant staff*	
3. Emphasis	Structure*	Quantum	Structure & quantum	
4. Format	Legal prescription	Guidance	Prudential principles*	
5. Accountability	Disclosure	Non-binding vote	Supervisory*	
6. Governance	Bd/rem cttee*	Strict on independence etc*	Board discretion	
7. Components	Fixed*	STI payments*	LTI payments*	
8. Risk adjustment	Requirement*	Guidance	No guidance	
9. Time horizon	One year	Multi-year*	Deferred payment*	Deferred vesting*
10. Performance measurement	Guidance*		No guidance	

*\*APRA's direction*

By way of explanation, the first six of these dimensions relate to different attributes of the remuneration regime, whereas the last four relate directly to the structure of the remuneration arrangements themselves -

### Attributes of remuneration regimes

#### 1. Application

APRA's requirements will apply to prudentially regulated institutions only. By way of contrast, as already noted, ASIC's requirements apply to all registered corporations and the ASX requirements apply to all listed corporations.

#### 2. Scope

Within each regulated institution, APRA will take an interest in all personnel whose decisions can have a material effect on the financial performance of the

organisation. It will therefore cover senior executives and may also cover some or all sales staff, traders and other personnel.

Other regimes may have a more restrictive scope, for example senior executives only.

### **3. Emphasis**

APRA's emphasis will be on the structure of remuneration rather than on its quantum. Our interest is related to the management of risk and we are keen to see that incentive payments do not encourage excessive or inappropriate risk taking by executives.

APRA does not see itself as the guardian of any public assessment of whether pay levels themselves in some organisations are judged to be too high.

### **4. Format**

As already explained, APRA and other prudential regulators have the ability to hold company boards directly accountable for their remuneration arrangements. Accordingly we can operate by applying enforceable prudential principles.

Some other agencies, for example ASIC and ASX, need to rely primarily on compliance with regulatory prescription, while others such as the AICD and ASA are not in a position to go beyond published guidance.

### **5. Accountability**

Accountability under APRA's prudential approach will be through our supervisors actively reviewing each institution's remuneration arrangements.

By comparison, accountability under the Corporations Act (administered by ASIC) is based on compliance with disclosure requirements and for the ASX it is a combination of disclosure and non-binding shareholder votes.

### **6. Governance**

APRA will be requiring each company's board and remuneration committee to govern the remuneration practices of the company. APRA already has various standards around the competence and independence of the board and will be extending these standards into the remuneration domain.

In other regimes it is usually not possible to hold the board directly responsible in this way, thereby leaving the board with greater discretion as to how it conducts the remuneration affairs of the company.

## Remuneration Structure

### 7. Components

Remuneration can usually be subdivided into three elements, namely fixed pay, short term incentive payments (STI) and long term incentive payments (LTI). APRA will be taking an interest in all three.

### 8. Risk adjustment

APRA will be requiring incentive payments to be adjusted for risk. Such adjustments have not generally been required by regulators or other agencies in the past. Indeed rarely has there been any guidance on, let alone obligation for, risk adjustments.

The absence of risk adjustments, especially for some of the more extreme examples of high remuneration in the US and UK in recent times, is often seen to be both a failing of the remuneration structure and a direct contribution to the global financial crisis.

### 9. Time horizon

Extending the calculation of incentive payments over multi-year periods, and deferring bonus payments and the vesting of bonuses for several years, is usually a sound and transparent technique for making risk adjustments.

APRA will generally be expecting eligibility for and assessment of bonus payments to go beyond one year.

### 10. Performance measurement

Performance measurement refers to the form and the metrics of incentive or bonus calculations. APRA will be offering some guidance around such matters as rewards in the form of cash, shares, share options and the like. We will also be offering some guidance on calculation methods, which can range from simple percentages of fixed pay to complicated formulae based on various measures of profitability and economic value added or economic capital models.

The first distinguishing feature of prudential regimes is their opportunity to go beyond the disclosure approach and to use their supervisory powers to hold company boards directly accountable for executive remuneration.

The second distinguishing feature is that their application is limited to regulated financial institutions. Given, however, the accountability inherent in APRA's approach, we can expect quite some community and corporate interest in how influential this regime might be on boards of Australian companies that are not prudentially regulated.

This tour of the executive remuneration field is intended to offer some understanding of the overall debate, while also positioning the approach that APRA and other prudential regulators can be expected to take in this arena in the future.