# DRAFT PRUDENTIAL STANDARDS CPS 511

## SUBMISSION TO THE AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

23 October 2019

# EXECUTIVE SUMMARY

## Introduction

1. ANZ thanks the Australian Prudential Regulation Authority (**APRA**) for the opportunity to comment on the Discussion Paper *Strengthening Prudential Requirements for Remuneration* (**Discussion Paper**) and the accompanying proposed Prudential Standard CPS 511 (**CPS 511**). All references to paragraphs and defined terms in this submission are to those of CPS 511 unless otherwise indicated.

2. We welcome the Discussion Paper and CPS 511 as important steps towards better remuneration practices through the financial services industry. ANZ agrees that remuneration practices can support better governance, executive accountability and customer outcomes. We endorse the points made in the Discussion Paper that the new standard will provide clear expectations against which supervisors can assess regulated entities, and remuneration practices play an important role in the effective management of all risks.

3. Since the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (**Royal Commission**), we have announced wide-ranging reforms to our remuneration.[i] These include replacing bonuses for the vast majority of employees based on their individual performance with an incentive based on the overall performance of the ANZ Group. From 1 October 2019, the only variable remuneration most ANZ employees receive will be in the form of a 'Group Performance Dividend'. This dividend is based on the bank's performance from the perspectives of risk and reputation, financial, customer and people. We believe that these reforms position us well to meet CPS 511's requirements with respect to remuneration in general.

4. To assist APRA in finalising CPS 511 and achieving its policy objectives, we have set out below some comments on the draft standard. These comments are directed towards improving the implementation of the standard. They are made within the context of our overall support for strengthened requirements for remuneration. The comments are organised into:

    - First, our key points on CPS 511;
    - Second, to the extent not addressed by these points, specific responses to the ten consultation questions that APRA poses on page 43 of the Discussion Paper; and
    - Third, some further observations on the drafting of CPS 511.

5. Our key points are summarised below. We set these points out in more detail in the section that follows the summary.

## Role of the Board

- **To preserve their independence and responsibility, Boards should follow the recommendations of the triennial reviews on an 'if not why not' basis**

6. We largely agree with the proposed role of the Board and Board Remuneration Committee (**BRC**). However, it is important that the BRC retains discretion in responding to the three-yearly reviews of the remuneration framework. This could occur by the BRC justifying to the Board and letting APRA know why it has not followed any recommendations of a review (an 'if not why not' approach).

## Competitive balance

- **The proposed deferral and clawback requirements may make Australian (and New Zealand) banking (and financial services) less attractive for executives**
- **CPS 511 should apply, in full, to all APRA-regulated entities**

7. Based on feedback from external recruiters, we are concerned that the proposals, particularly for deferral and clawback, may make Australian (and New Zealand) banking less attractive for the people we need to help it be well managed and innovative. Modern banking relies on people who can work in a range of industries and jurisdictions. We need to hire more people with skills, like technology and finance, who can work in a range of sectors. As a bank with a strong international focus, we are also acutely conscious that we need to attract people in offshore jurisdictions, like Singapore and Hong Kong. Executives will understandably prefer employers who can offer remuneration without long deferral terms. CPS 511 should be calibrated to achieve its policy goals while minimising the disincentive of working for Australian (and New Zealand) banks.

8. We also believe that all APRA regulated institutions should apply CPS 511 in full. First, the protections that CPS 511 offers should be available to all customers. Second, without a uniform application of the standard across the APRA regulated population, institutions that are not 'significant financial institutions' may be preferred by employees. This is because they do not need to impose long deferral and clawback periods. This would be detrimental to the ability of other institutions to attract the best talent. In short, we are concerned that the proposed distinction could expose some customers to the effects of less stringent remuneration practices, defeating the purpose of the proposal and would create a competitive imbalance across the APRA population.

## Deferral and clawback of remuneration

- **The deferral and clawback periods, of up to eleven years cumulatively, are too long. They will reduce the ability of variable remuneration to positively influence behaviour**
- **We would recommend a shorter cumulative period (up to seven years):**
    - **For executive accountable persons (rather than senior managers):**
        - **A four year deferral period with no pro rata vesting; and**
        - **A three year clawback period for variable remuneration after vesting allowing for recovery in cases of egregious misconduct**
    - **For highly-paid material risk takers:**
        - **A principle that entities need to appropriately defer variable remuneration to ensure they can adjust remuneration outcomes over a sufficient period; or**
        - **If APRA wishes to prescribe deferral and clawback requirements for these people, our proposal for executive accountable persons but with pro rata vesting after one year**
- **Clawback should be made more effective by APRA mandating that entities need to contractually require individuals to retain either any paid variable remuneration or assets equivalent to its worth as assessed on the date of vesting through the clawback period**
- **Entities should be expected to apply malus or clawback when they judge that either form of adjustment is an appropriate response to the relevant event or conduct**

9. We understand the reasons for the proposed deferral and clawback arrangements. However, the period over which they apply appears excessive. Losing the benefit of variable pay for that long may mean individuals so discount its value that it has little impact on their decisions. This seems antithetical to APRA's objectives. We would also prefer that APRA rationalise the definitions applying to individuals by using the concept of 'accountable persons' (**AP**s) under the Banking Executive Accountability Regime (**BEAR**) rather than 'senior manager'.

10. Further, rather than predefined triggers being the predicates for malus and clawback, entities should be expected to apply them when they judge that either form of adjustment is an appropriate response to the relevant event or conduct. Clawback would be appropriate in cases of egregious misconduct. We also note that clawback is fundamentally different from malus. There are significant impediments to its successful use as a remuneration adjustment mechanism.

11. Because of these points, the deferral and clawback requirements should be:

    - For executive APs (or their equivalent in non-ADI APRA-regulated entities):
        - A four year deferral period (consistent with BEAR); and

    - A three year clawback period after the vesting of variable remuneration during which entities could take reasonable steps to recover the remuneration when it is a proportionate response (i.e. in cases of egregious misconduct)

- For highly-paid material risk-takers (**MRT**s):

    - A principle that entities need to appropriately defer variable remuneration to ensure they can adjust remuneration outcomes over a sufficient period having regard to the financial and non-financial risks to which the MRTs can expose the entity; or

    - If APRA wishes to prescribe deferral and clawback standards for these people, our proposal for executive APs but with pro rata vesting after one year

12. APRA could consider making clawback more effective by requiring entities to seek contractual undertakings from individuals that they will retain through the clawback period either any paid variable remuneration or assets equivalent to its worth as assessed on the date of vesting.

## Financial and non-financial performance measures

- **Instead of a hard cap on financial performance measures, APRA should set a principle that entities must limit the impact of such measures by adjusting variable remuneration for non-financial risk, that is, they must achieve a balance between financial and non-financial measures. This could occur, at the entity's discretion, through:**
    - **Board and management discretion;**
    - **Modifiers such as consideration of an individual's behaviour; and/or**
    - **Non-financial performance measures**
- **The efficacy of this principle-based approach should be assessed in the review of CPS 511 that APRA intends to conduct in three years from commencement**
- **If APRA keeps a cap on financial performance measures, it should apply to long term incentive (LTI) hurdles only and be set at 75% of the hurdles**
    - **Other variable remuneration should be subject to the principle above**
- **If APRA applies the cap more broadly, it should be 75% and apply to each of (a) the individual's performance assessment measures and (b) any LTI hurdles**
- **Total shareholder return reflects a range of factors including investors' judgement about the prospects of a company. It is not a purely financial measure**

13. Board and management discretion, other modifiers, such as behaviour assessments, and non-financial performance measures, can all limit the impact of financial performance measures on remuneration outcomes. Instead of a cap on financial performance measures, we would encourage APRA to set a principle that entities must limit the

influence of financial performance measures by requiring that variable remuneration structures and outcomes take into account non-financial risks. This could occur through mechanisms adopted at the entity's discretion. This would ensure that entities remain responsible for pay outcomes as well as giving APRA comfort that financial performance measures have a limited impact.

14. The main reason we would prefer this principle is that a cap on financial performance measures will be difficult to apply to remuneration processes that have multiple parts. For example, we (a) determine a group bonus pool using a range of determinates, including Board discretion (b) assess individual performance based on a range of measures and, then, (c) if applicable, grant LTI performance rights subject to hurdles to be assessed four years from the date of grant. See Diagram 3 below. It is unclear how the cap would be calculated across these multiple parts.

15. If APRA proceeds with a cap on financial performance measures, we would ask that it (a) applies to the hurdles attaching to LTIs only and (b) is calibrated at 75% to reflect the utility of, and stakeholder expectations concerning, existing financial performance hurdles and the challenges of identifying useful non-financial measures. We note that 75% is within the range of 50% - 75% weightings for financial metrics described by APRA as better international practice. Other variable remuneration would be subject to the principle we propose above. If APRA wants the cap to operate more broadly, the 75% cap should apply to (a) the measures used to assess an individual's performance and (b) any LTI hurdles.

16. We also disagree that total shareholder return (**TSR**) is a purely financial measure. Share performance reflects a range of drivers including investors' judgement of how well managed a company is, its exposure to regulatory action and its success in serving customers.

## Start date

- **CPS 511 should apply from an entity's financial year that commences on or after 1 July 2021**

17. To allow entities to prepare for the changes of CPS 511, it should apply to them from the beginning of the first full financial year that starts on or after the standard's commencement on 1 July 2021. If entities must have CPS 511-compliant remuneration arrangements on 1 July 2021, regardless of when their financial year starts, then some entities may need to start complying with the standard when their financial years begin in 2020.

18. For ANZ, this would mean the difference between compliance from 1 October 2020 rather than from 1 October 2021. If APRA finalises CPS 511 and any associated guidance in the

first quarter of 2020, an effective start date of 1 October 2020 would mean that we would have roughly seven months to design and implement new remuneration arrangements and governance processes. We do not believe this will be sufficient time. We note that it took approximately two years to design and implement the remuneration changes we refer to in paragraph 2. If the standard and guidance were finalised after the first quarter of 2020, the implementation challenge would be even more significant.

## Conclusion

19. While some of these points indicate that we have different views from APRA on aspects of CPS 511, these differences need to be understood within our broad support for APRA's policy aims. Indeed, there is much within CPS 511 that we support. Once again, we thank APRA for opportunity to comment on CPS 511. We would be happy to answer any questions APRA has on this submission.

# KEY POINTS

## Role of the Board and Board Remuneration Committee

- **To preserve their independence and responsibility, Boards should follow the recommendations of the triennial reviews on an 'if not why not' basis**

### General comment

20. We largely agree with the vision that CPS 511 sets out for the role of the Board in overseeing and approving remuneration. We would note, however, two general points on this topic.

21. First, it is important that Boards are ultimately accountable for remuneration. APRA's standard should not be so prescriptive that it allows Boards to replace their responsibility to shareholders and other stakeholders with a compliance approach. We do not understand this to be APRA's intent. However, this imperative should govern the calibration of APRA's standards, particularly in respect of deferral, malus, clawback and in ensuring non-financial risks are reflected in the remuneration framework (as discussed below). Adopting a more principles based approach to these topics would allow, and indeed encourage, Boards to remain responsible for their entity's remuneration arrangements.

22. Second, if the Board becomes too enmeshed in the remuneration arrangements, particularly through approving outcomes, then it will lose its ability to challenge and hold management to account. It is critical that the role of management in setting and administering the remuneration arrangements for ADIs is kept distinct from the Board's role in overseeing the activities of management. The maintenance of this distinction underpins good governance.

23. Under the auspices of these general comments, we have two points for APRA on its proposals for the role of the Board and the BRC.  These concern:

    - The BRC's response to the recommendations of the triennial reviews; and
    - The approval of remuneration outcomes.

### Triennial reviews

24. The language in para 35 concerning the BRC's response to the recommendations of the triennial reviews indicates that the BRC must follow the recommendations. We would be concerned if para 35 could be read as requiring the BRC to abdicate its decision making responsibility and replace it with the views of the independent reviewer.

25. We would strongly prefer that, where the BRC disagrees with a recommendation, then it needs to explain why to the Board and, where applicable, how in its view the concern behind the recommendation could be addressed more effectively through other action. This would mean that the BRC could follow the recommendations on an 'if not, why not' basis. The BRC's views could be provided to APRA. This would allow the BRC to act according to its view of the best interests of the entity's shareholders while also giving APRA comfort that the review's recommendations have appropriate compulsive force.

### Approval of remuneration outcomes

26. The effect of paras 48 and 50 is that the BRC must assess and make recommendations concerning, and the Board must approve, variable remuneration outcomes for senior managers and highly-paid MRTs individually and for other MRTs and risk and financial control personnel collectively. An MRT is someone whose activities have a material potential impact on the entity's risk profile, performance and long-term soundness. The threshold for being 'highly-paid' is fixed remuneration plus maximum potential variable remuneration being equal to or above $1 million.

27. We agree with the policy intent behind this expectation of the BRC and the Board. Subject to replacing 'senior managers' with 'APs' (consistent with our views on deferral and clawback below), it is appropriate that these bodies exercise oversight and approval of the remuneration outcomes of employees who are so important to the entity. This view on the role of the Board and BRC is predicated, however, upon the understanding that an entity's MRTs will largely be those who are now captured by paragraph 57(c) of CPS 510 (noting the difference concerning individual and collective actions across the two definitions). If the cohort of highly-paid MRTs were larger, then the Board and BRC may be asked to review pay arrangements and outcomes for more individuals than is appropriate. At this point, the delineation between Board and management would be challenged as the Board would be reviewing the pay outcomes of a large group of people.

28. Beyond this broad point, we have two clarifications to ask of APRA on this topic.

29. First, it would be useful if there were greater clarity on which employees are considered to be in 'financial control' roles (see para 48(c)). Taken broadly, this could mean all people working in the Finance function of an entity. However, if APRA means a specific subset of the people within this function, it would be worthwhile identifying these people through a more targeted definition.

30. Second, we would ask APRA to provide additional clarity on what it means by the Board 'approving' the variable remuneration outcomes (see para 50). We assume that 'collective' approval is the approval of the pool of remuneration available to the relevant

groups of employees. If it were anything different, we would appreciate APRA making this clear.

## Competitive balance

- **The proposed deferral and clawback requirements may make Australian (and New Zealand) banking (and financial services) less attractive for executives**
- **Existing employees may be reluctant to move into roles that are subject to the deferral and clawback requirements**
- **CPS 511 should apply, in full, to all APRA-regulated entities**

### Competition for talent

31. As we discuss below, CPS 511 proposes restrictions on when people are paid their variable remuneration. Remuneration that is subject to these restrictions will be less attractive than remuneration that is not. Based on feedback from external recruiters, we anticipate that we will be disadvantaged in hiring and keeping executives because others will be able to offer packages with more attractive deferral and clawback arrangements. We are concerned about the impact this will have on both the quality of Australian (and New Zealand) banking and our ability to compete commercially with entities not subject to CPS 511. There are four groups of employers that we are concerned will have an advantage over us.

32. First, ANZ operates internationally, including through the Asia-Pacific with a significant presence in Hong Kong and Singapore. In offshore jurisdictions, we need to recruit and retain executives who would be highly-paid MRTs. We expect we will have trouble competing for executives with other banks in these jurisdictions which are not subject to regulatory requirements akin to CPS 511.

33. Second, we, like other banks, are increasingly hiring people with non-financial skills, such as those concerning technology, risk and compliance, finance, marketing and operations. These people are able to work in a range of industries.[ii] Like executives in offshore jurisdictions, these people could view Australian (and New Zealand) banking as less attractive because of CPS 511. They may prefer to work in other industries or in the financial sector that is not regulated by APRA.

34. Third, we face greater competition from non-bank financial service providers, such as credit providers, fintechs and large technology firms. If these providers can pay on more attractive terms, then they may be able to enlist the services of more talented individuals. This will give them a competitive advantage. We note that those entities will be attempting to serve the same customers as banks but will be able to do so without customers benefiting from regulated remuneration standards.

35. Fourth, because APRA-regulated entities that are not significant financial institutions would not need to apply the deferral and clawback requirements, individuals may prefer to work for them rather than entities that are. Again, this could give them a competitive advantage.

36. The effect of CPS 511's changes will only become clear over time. Importantly, the changes will likely occur within an environment in which other regulatory and industry dynamics are significantly changing the Australian financial services market. We would be concerned if particular elements of the market benefited competitively from regulatory initiatives without adequate public policy justification. We believe the competitive imbalance arising from CPS 511 could be addressed through the appropriate calibration of the deferral and clawback arrangements and through the removal of the distinction between significant financial institutions and other APRA-regulated entities, both as discussed below.

### Internal mobility

37. Related to banking's ability to compete for talent with other employers, we can envisage that some existing employees would decline to take up positions that were either senior manager or highly-paid MRT roles because of the disincentive posed by the deferral and clawback requirements. This may impact banking's ability to move people internally to positions where they could best help the organisation. Again, this could be addressed through the appropriate calibration of the deferral and clawback requirements.

### Equal application across APRA population

38. In addition to entities that are not significant financial institutions having an advantage in hiring talent, we wonder whether it is appropriate that the customers of some institutions benefit from CPS 511's requirements while others may not, particularly where this may not be clear to those customers.

39. An alternative approach may be to only allow ADIs with restricted licences to follow the standards as currently proposed for ADIs with less than $15 billion in assets. This would be appropriate as ADIs with restricted licences are clearly in start-up mode and may need flexibility with their remuneration arrangements.

## Deferral and clawback – appropriate structure

- **The deferral and clawback periods, of up to eleven years cumulatively, are too long. They will reduce the ability of variable remuneration to positively influence behaviour**
- **We would recommend a shorter cumulative period (up to seven years):**
  - **For executive accountable persons (rather than senior managers):**
    - **A four year deferral period with no pro rata vesting; and**
    - **A three year clawback period for variable remuneration after vesting allowing for recovery in cases of egregious misconduct**
  - **For highly-paid MRTs:**
    - **A principle that entities need to appropriately defer variable remuneration to ensure they can adjust remuneration outcomes over a sufficient period; or**
    - **If APRA wishes to prescribe deferral and clawback requirements for these people, our proposal for executive accountable persons but with pro rata vesting commencing after one year**
- **Clawback should be made more effective by APRA mandating that entities need to contractually require individuals to retain either any paid variable remuneration or assets equivalent to its worth as assessed on the date of vesting through the clawback period**
- **Entities should be expected to apply malus or clawback when they judge that either form of adjustment is an appropriate response to the relevant event or conduct**

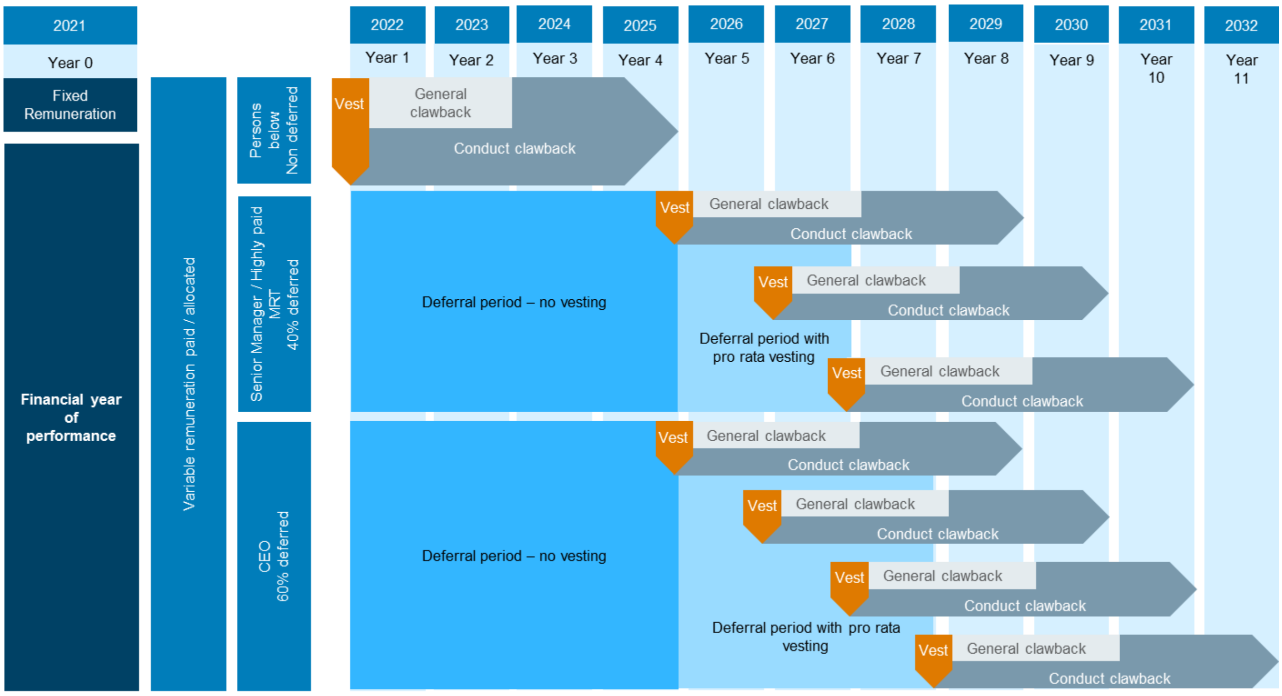
### Introduction

40. Paragraphs 53 and 54, together with para 57, set out the quantum and time periods over which variable remuneration must be deferred, vested and then available for clawback. For CEOs, 60% of total variable remuneration must be deferred for at least seven years from inception, with vesting to occur from four years after inception and no faster than on a pro-rata basis. Other senior managers and highly-paid MRTs are subject to a similar deferral structure with respect to 40% of their total variable remuneration and over a six year total deferral period. The clawback requirements are that any variable remuneration (not simply the deferred component) must be available for clawback:

    - For two years after payment or vesting; and
    - In circumstances where the person is under investigation, for at least four years from the date of payment or vesting.

41. The effect of the proposed provisions is set out in Diagram 1 below.

## Diagram 1




42. This proposal rests heavily on the remuneration mechanisms of the deferred vesting of awarded variable remuneration, the potential application of malus to the deferred remuneration and the ability of entities to claw back variable remuneration once it has vested (whether deferred or not).

- **Deferral** of remuneration involves an entity awarding an individual an amount of cash or shares for performance in year 0 but not transferring legal ownership of that cash or those shares until a subsequent year (in Diagram 1, from year 4 onwards)

- In the period between awarding the remuneration and it vesting, entities could apply **malus** to the entitlement of the individual. This would involve the entity reducing that entitlement, including to nothing (when contractually entitled to).

- When the legal ownership of the cash or shares is transferred from the entity to the individual it is said to '**vest**' in the individual. Vesting can occur on a 'pro rata' basis which means that the shares are transferred to the individual over a period of time on a proportionate basis (e.g. 25% of an entitlement each year for four years)

- **Clawback** would only become relevant once the individual is the legal owner of the remuneration. It would involve the entity asking the individual to return all or part of the paid remuneration (or its worth). If the individual refused, then the entity would need to sue the individual for the remuneration's return. If a court upheld the entity's claim then the entity would need to enforce the judgment against the individual. This could be problematic if the individual had dissipated or transferred their assets. If this were the case, then entities would only be able to seek a judgment against the individual for the unpaid debt.

43. We have several concerns with the proposed deferral and clawback arrangements set out in CPS 511. These go to the:

- **Duration** of the deferral and clawback periods;
- Ability to use **clawback**; and
- **Individuals who are subject** to the proposed requirements.

After we explain these concerns, we propose an **alternative** for APRA's consideration.

44. Before setting out these concerns, we would observe that CPS 511, as proposed, could see remuneration moving towards fixed pay and away from variable. While there are benefits to both types of pay, a reduction in variable remuneration would mean it would play less of a role in incentivising behaviour that various stakeholders believe is beneficial.

**Duration – Decreased influence on conduct**

45. One of our key concerns with the proposals on deferral and clawback is that they will significantly diminish the value of variable remuneration as an incentive on behaviour.[iii] Variable pay available so far from the behaviour that earns it and made subject to intervening contingencies may be discounted by employees to such an extent that the present value of the pay will figure little in their decision making. If employees perceive that the point and prospect of receiving the pay is remote, then its incentive value will likely be slight and thus decoupled from their behaviour. This would seem antithetical to APRA's policy intent of using remuneration to encourage better conduct.

**Duration – Intervening actions**

46. Because of the duration of the vesting period, it is possible that (a) the variables which determine whether any vesting hurdles have been cleared and (b) the value of any deferred equity when received will both come under the influence of an executive's successor. ANZ has estimated that the average tenure of a major bank senior executive in a particular role is between 2.5 and 3.5 years. If this average held, a particular position might be held by four individuals over a ten year senior manager deferral and clawback period.

47. For example, if a senior manager moves to a different role in the second year of a six year deferral period, whether the applicable performance measures clear the vesting hurdle

could be determined by the actions of the person's successors. Of course, this issue occurs with all deferred remuneration. However, the concern becomes more acute with longer deferral periods, particularly as those longer periods may allow a complete change of strategy or management personnel. Further, as we note below, as non-financial performance measures are introduced into the mix, there is greater chance that these may reflect a business focus that becomes deemphasised over time.

#### Duration – Misalignment between CEO and senior managers

48. Under CPS 511, there are different periods of deferral for the CEO and for other senior managers. We are concerned that this could lead to a situation where, if an event occurred for which both the CEO and a senior manager were responsible, malus or clawback may be available in respect of the former's variable remuneration but not the latter's. This could leave the CEO and the Board without the ability to use these mechanisms to hold senior managers to account.

#### Duration – Tax implications

49. We note that Australian tax laws currently require individuals to pay income tax on awarded shares when they cease employment with the awarding employer, regardless of when the shares will vest. This means that individuals need to pay tax on amounts that they cannot realise through the sale of shares until the deferral period ends. By significantly extending the deferral period, this means that affected individuals will need to pay tax on shares that they may not be able to realise for up to six or seven years.

#### Duration – Utility of longer periods

50. We appreciate the policy rationale behind adequate deferral and clawback periods. Instances of misconduct examined or raised in the Royal Commission took, on occasion, some time to come to light. However, in considering the appropriate calibration of those periods, it may be worthwhile considering other regulatory and industry initiatives directed at uncovering issues more quickly. If these work, then substantially longer deferral and clawback periods may not be needed.

51. For example, the Government has indicated that it will introduce laws into Parliament by 30 June 2020 to amend the breach reporting requirements. These amendments should (a) make it clearer when significant breaches of the financial services laws need to be reported to ASIC and (b) introduce breach reporting obligations under the credit laws. Further, some ADIs are pursuing simplification strategies with the intent, in part, of being able to identify and fix failures more quickly. We would also note that the impact of BEAR, which has its own breach reporting framework, is yet to be fully understood.

52. If these factors mean that there is less time between the occurrence of an event meriting remuneration adjustment and its discovery, then APRA may like to consider the

appropriate period over which remuneration is deferred and may be clawed back to ensure that events are reflected in pay outcomes.

53. We would also note that because longer deferral and clawback periods would give entities more time to adjust remuneration, they may, perversely, allow entities to be less inquisitive about adverse events and prompt in taking action in respect of them. Shorter periods would force entities to ensure they can discover and respond to an executive's acts in a timely way.

54. We suggest that the proposed duration of deferral and clawback requirements should be considered in light of the general approach in law that applies to limitation periods for legal claims and the related policy considerations. For example, the *Fair Work Act 2009 (Cth)* limits claims in relation to contraventions of civil remedy provisions to six years and the *Corporations Act 2001 (Cth)* limits action for corporate misconduct to six years.[iv] The policy rationale for statutory limitation periods has been described as being to promote the public interest in settling disputes as quickly as possible; provide fairness to all parties; recognise the degradation of evidence over time; remove the risk of oppression where an action arises long after the relevant circumstances; and recognise the desirability of people being able to arrange their affairs on the basis that claims cannot be made against them after a certain time.[v]

### Clawback – Impediments to use

55. The ability to use clawback as an effective remuneration adjustment mechanism is, in our view, imperfect. We are not sure what steps, if any, APRA wishes entities to take to improve it. There are two issues that we can see with clawback.

56. First, as we noted above, the success of any action to recover a sum paid to another will ultimately be contingent on (a) the strength of the legal claim for the recovery and (b) the availability of assets to satisfy the claim. Because of these points, clawback is a fragile adjustment tool.

57. On point (a), clawback would (without further law reform) primarily be a contractual claim against an individual. This means that the individual would be entitled to contest it in court. Even if the employment contract were drawn up to allow the unilateral application of clawback, the entity's decision to exercise its contractual right could still be challenged by the individual. The ability to use clawback will, therefore, always be contingent on the ability of the entity to convince a court that they have an entitlement to recover the paid remuneration.

58. On point (b), even if the court recognises the entity's claim as valid, the individual's assets may have been dissipated or transferred to a third party. In this case, the entity would

only be able to seek a judgment against the individual for the unpaid debt. This, of course, may be an adverse outcome that individuals would seek to avoid. However, they may also be indifferent to this if they are in situation where clawback is being pursued against them.

59. Second, we note that s 325 of the *Fair Work Act 2009 (*Cth) (**FWA**) could impede clawback claims. This provides that an employer must not require an employee to pay to the employer an amount of the employee's money if:

- The requirement is unreasonable in the circumstances; and
- The payment is for the benefit of the employer.

60. This prohibition appears to prevent an employer from requiring an employee to repay that employee's vested variable remuneration where that requirement is unreasonable. While we are not aware of case law on when a requirement would be 'unreasonable', a requirement to repay an amount earned in respect of a period other than the period in which the alleged wrongdoing occurred, or where the employee had no personal responsibility for the alleged wrongdoing, could conceivably be unreasonable.

61. For these two reasons, we are concerned that CPS 511 places too much faith in clawback (at least as currently conceptualised). Clawback is fundamentally different from malus adjustments. Malus is effective because it can be applied unilaterally by the entity (when contractually entitled) before the remuneration has shifted into the hands of the individual (e.g. before it has vested). We note, however, ss 324 and 326 of the FWA may raise also problems with malus (these sections place prohibitions on when amounts that are 'payable' to employees can be deducted).

62. Respectfully, we are not sure what steps APRA expects entities to take to apply clawback or overcome its impediments to successful use. CPS 511 does not create any statutory entitlement of entities to claw back paid remuneration, nor does it override the FWA. Further, if the entity had the clear right to claim paid remuneration, there may be no assets available to satisfy the claim.

#### Clawback – Confidence in claim

63. Further to our prior point, we note that para 56 provides that '[v]ariable remuneration must only be awarded if an amount corresponding to it can be recovered from the person if the recovery is justified…'. Read strictly, this would prevent the payment of variable remuneration unless the entity was certain that their clawback mechanisms would be able to successfully recover the requisite amount.

64. In contrast, para 56 appears to differ from para 59 in how certain of success the clawback action must be. Paragraph 59 only requires that an entity take 'reasonable steps' to recover an amount. There is a significant difference between the ability to take 'reasonable steps' and the requirement that remuneration must only be awarded if an amount 'can' be recovered. Because of the impediments to using clawback, we would strongly suggest that the language in para 59 is preferable to the language in para 56.

#### Clawback – Net or gross remuneration

65. We are also unclear on if entities would be required to recover the pre-tax or post-tax variable remuneration. When para 56 requires that the amount must be recoverable, is this the gross amount paid by the entity or the net amount received by the individual, once taxation and any deductions have been applied? Further, if part of the variable remuneration is paid as superannuation, individuals may be unable to access that amount.

#### Subject individuals – Definitional categories

66. We are concerned about the number of definitions of individuals in the APRA regulatory regime. These include 'senior manager', 'accountable person' and 'responsible person'. To these existing categories, CPS 511 proposes adding 'material risk taker', although this draws on paragraph 57(c) in CPS 510.

67. To help simplify the regulatory regime, we wondered whether it would be better to use the BEAR concept of 'accountable person' in lieu of 'senior manager'. This would occur in both the Board approval provisions and the deferral and clawback provisions of CPS 511.

68. We appreciate that the BEAR currently only applies in respect of banks. However, the Royal Commission has recommended extending the BEAR to other APRA-regulated sectors. This extension may allow a rationalisation of the number of definitions that APRA's regulatory regime uses to categorise individuals. Rather than locking the use of 'senior manager' into another regulatory standard, APRA could commence the rationalisation with CPS 511.

#### Subject individuals – Calibrating deferral periods to seniority

69. CPS 511 treats senior managers (excluding the CEO) and other highly-paid MRTs as equivalent. In our view, these groups of people occupy different positions within entities. Senior managers will largely be the most senior executives that an entity has (for example the Chief Financial Officer). In contrast MRTs could be executives occupying positions one or two levels down from senior managers. Senior managers are likely to be APs while MRTs are not. We think the regime should provide for greater differentiation between MRTs and APs.

70. We note that the UK FCA regime applies significantly shorter deferral periods to staff members who are not performing a PRA-designated senior management function (three years or five years deferral with pro rata after one year) compared to staff who are (seven years deferral with pro rata vesting after three years). We believe that this differentiated approach would be useful to follow in Australia.

### Alternative structure

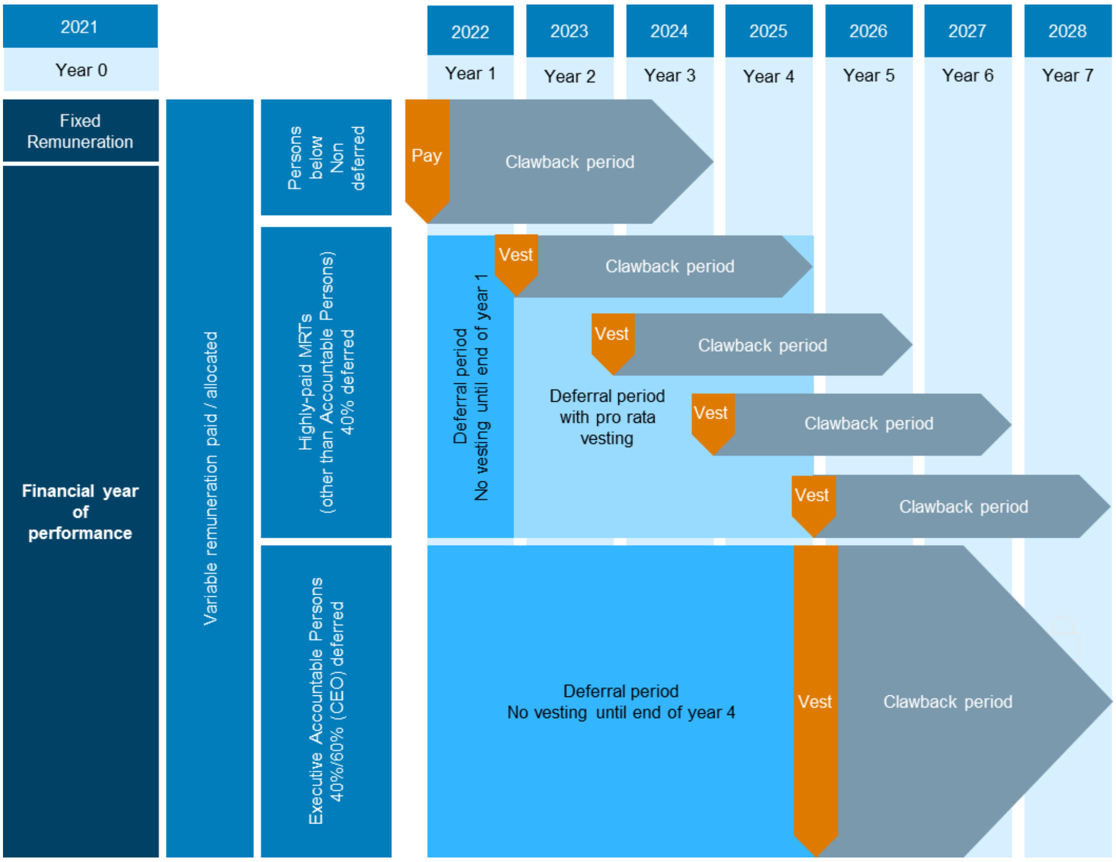
71. For these reasons, we believe the deferral and clawback arrangement be restructured as:

- For executive APs (or their equivalent in non-ADI APRA entities):
  - A four year deferral period (consistent with BEAR); and
  - A three year clawback period after the vesting of variable remuneration during which entities could take reasonable steps to recover paid variable remuneration when it is a proportionate response (i.e. in cases of egregious misconduct)
- For highly-paid MRTs:
  - A principle that entities need to appropriately defer variable remuneration to ensure they can adjust remuneration outcomes over a sufficient period having regard to the financial and non-financial risks to which the MRTs can expose the entity; or
  - If APRA wishes to prescribe deferral and clawback standards for these people, our proposal for executive accountable persons but with pro rata vesting commencing after one year

72. Clawback should be made more likely to succeed by APRA requiring entities to seek contractual undertakings from individuals that they will retain through the clawback period either any paid variable remuneration or assets equivalent to its worth as assessed on the date of vesting. The undertaking would (a) put individuals on notice that they are required to have assets available to meet a clawback claim and (b) give entities an additional contractual right to enforce, including potentially through specific performance.

73. Diagram 2 sets out what our proposal would look like if APRA were to accept it and prescribe deferral and clawback periods for highly-paid MRTs.

**Diagram 2**




74. We believe our recommendations would achieve APRA's policy aims of ensuring that entities can appropriately adjust variable remuneration outcomes for non-financial risks while also ensuring that CPS 511 does not significantly reduce the appeal of working in Australian financial services. The benefits of our recommendations are the following:

- **Greater link between conduct and pay** – by shortening the deferral periods, the present value of the deferred variable remuneration will be greater. This will help variable remuneration positively influence behaviour.

- **Alignment of CEO and other accountable persons –** because all executive APs, including the CEO, have the same deferral and clawback periods, adjustment will be available for both the CEO and his or her direct reports through the seven year period. This will remove the possibility that the CEO's pay could be adjusted but not his or her direct reports. We note that the CEO and the other executive APs would still be differentiated on the quantum of variable remuneration that is deferred (60% and 40% respectively).

- **Fewer disadvantages in competing for talent** – by either allowing entities to follow a principles-based deferral requirement for highly-paid MRTs and/or by reducing the mandatory deferral requirements, we think that the attractiveness of Australian banking will be less negatively impacted by CPS 511.

- **Maintains capacity to adjust pay appropriately** – the proposal retains the ability for an ADI to take action where adverse events surface up to seven years after the conduct occurred for executive APs or for an adequate period of time for highly-paid MRTs.
- **Remuneration standards that match entity's circumstances** – if APRA were to adopt a principles-based approach for deferral for highly-paid MRTs, entities could adopt remuneration practices that are appropriate to their individual circumstances. This would ensure Boards are responsible for pay.
- **Simpler clawback structure** – having one clawback period would be easier to understand than the two-part structure (general and then conduct-related) that is currently proposed in CPS 511.
- **More effective clawback structure** – while the clawback period in this proposal is shorter than the proposal currently in CPS 511, if APRA were to adopt the reform options above, entities would be more confident that they could exercise clawback when needed.
- **Rationalise definitions** – by using AP instead of 'senior manager', APRA can start the rationalisation of definitions concerning categories of individuals.

## Deferral and clawback – triggers

- **Entities should be expected to apply malus or clawback when they judge that either form of adjustment is an appropriate response to the relevant event or conduct**
  - **This will likely be when the individual is personally culpable for a failure**
- **Subject to Board discretion, clawback should only be pursued in cases of egregious misconduct**

### Introduction

75. Related to the appropriate structure of the deferral and clawback periods is when malus and clawback should be used. We have two observations and then a recommendation for APRA's consideration in this regard.

### Discretion in adjusting

76. We note that paras 45 and 59 appear drafted to compel entities to pursue malus and clawback if any of the listed triggers occur. In our experience of applying remuneration adjustment, we have found it useful to have broad discretion as to when and how adjustment occurs. In general, we think it would be preferable to apply:

- First, in-year adjustment to the variable remuneration being awarded to an individual;
- Second, malus to any unvested variable remuneration; and
- Third, in certain cases, clawback to paid remuneration.

However, even within this rough waterfall of mechanisms, it could still be appropriate to apply, for example, malus instead of an in-year adjustment. This may occur where the event meriting adjustment occurred in a prior year, there is sufficient unvested remuneration available for adjustment and the executive's current year behaviour is acceptable.

### Appropriate circumstances for use

77. We note there are different triggers that APRA expects for both malus and clawback (see paras 44 and 58 respectively). We had some concerns with how these triggers are articulated.

78. First, it is not clear to us that the triggers for either category of adjustment are always based in some form of personal culpability for an adverse event. In particular, the triggers in subparas 44(a), 44(c), 44(e) and 58(b) simply refer to an adverse event occurring without any apparent need for the relevant individual to have caused the event. In the other limbs of paras 44 and 58, it is possible to read into the trigger some form of individual culpability but this is not as clear as it could be. We would strongly argue that the triggers for malus and clawback should be referrable to something the individual has done or failed to do. Designing the triggers in this way would be consistent with the Financial Stability Board's (**FSB**) guidance on compensation tools.[vi]

79. One of the key reasons we are proposing the triggers should be more aligned with personal culpability (and thus accountability) is that we wish to foster a culture of owning up to, and learning from, mistakes. We are concerned that, if the triggers do not rest on personal culpability, executives may be less transparent about failures within their areas. Like the BEAR triggers that ask whether an executive has taken 'reasonable steps', the triggers for malus and clawback should not be enlivened simply for poor outcomes but for such outcomes due to malfeasance or which were preventable with due care and skill.

80. Second, we would ask APRA to exercise caution in requiring malus and clawback for reductions in profitability or for losses. It is part of business that some years will be better than others. If we automatically penalise executives for initiatives that fail, we will discourage risk taking and innovation. This is not appropriate. We would ask that any remuneration adjustment for adverse financial events only be required where the event

was unjustified in the sense that no reasonable business person would have taken the actions that led to it. The business judgement rule under section 180(2) of the *Corporations Act 2001* (Cth) may be an appropriate test to replicate.

81. Third, we think that greater distinction needs to be drawn between the triggers for malus and clawback. Clawback is likely to be pursued in cases of the most egregious misconduct. This is because clawback is a strong intervention in the life of an individual, there are significant impediments to its success, it is costly to pursue and, for these reasons, entities would likely make in-year adjustments and/or apply malus before attempting to claw back paid remuneration. For example, we do not think that clawback should be considered for *any* breach of a compliance obligation (as para 58(c)) currently contemplates). We would believe that clawback would be an appropriate option in cases of deliberate misconduct such as fraud, wilful dishonesty or other unlawful acts.

82. Fourth, even if the triggers set out in para 44 are appropriate grounds for the use of malus, there may be others that entities believe are appropriate.

### Principle for applying malus and clawback

83. Because of these points, we would strongly encourage APRA to allow entities the discretion in when and how they apply adjustment to remuneration. Instead of specific triggers for malus and clawback which, if met, mean that the mechanism must be used, APRA should adopt a principle that entities should be expected to apply malus or clawback when they judge that either form of adjustment is an appropriate response to the relevant event or conduct. For ANZ, clawback would be an appropriate response in cases of the most egregious misconduct.

84. This kind of principle would align well with the BEAR regime. Section 37E(1)(b) of the *Banking Act 1959* (Cth) (**Banking Act**) requires entities to make 'proportionate' adjustments to variable remuneration. We also believe that retaining discretion is consistent with the FSB's guidance on sound compensation practices.[vii] This kind of principle would also ensure that Boards remain ultimately accountable for variable remuneration outcomes.

## Financial and Non-Financial Performance Measures

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- **Instead of a hard cap on financial performance measures, APRA should set a principle that entities must limit the impact of such measures by adjusting variable remuneration for non-financial risk, that is, they must achieve a balance between financial and non-financial measures. This could occur, at the entity's discretion, through:**
  - **Board and management discretion;**
  - **Modifiers such as consideration of an individual's behaviour; and/or**
  - **Non-financial performance measures**
- **The efficacy of this principle-based approach should be assessed in the review of the prudential standard that APRA intends to conduct in three years from commencement**
- **If APRA keeps a cap on financial performance measures, it should apply to long term incentive (LTI) hurdles only and be set at 75% of the hurdles**
  - **Other variable remuneration should be subject to the principle above**
- **If APRA applies the cap more broadly, it should be 75% and apply to each of (a) the individual's performance assessment measures and (b) any LTI hurdles**
- **Total shareholder return reflects a range of factors including investors' judgement about the prospects of a company. It is not a purely financial measure**

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85. APRA is proposing that financial performance measures must not comprise more than 50% of the total measures used to allocate variable remuneration. Additionally, individual financial performance measures cannot be more than 25% of total measures. Financial performance measures include but are not limited to revenue, profit, value and share based measures, including total shareholder return (a metric that looks at the combined return to shareholders from dividends and share price changes). Excluded from financial performance measures would be any 'risk-adjusted' measures.

### Limiting the impact of financial performance measures

86. While we recognise the Royal Commission recommendation on limiting the use of financial performance measures in long term incentive arrangements, we also note that APRA has asked for feedback on other options to reflect non-financial risks in remuneration measures. In response to this request, we:

    - Provide some thoughts on how we allocate variable remuneration and the issues that could arise with applying a percentage cap on financial performance measures; then
    - Propose some alternatives to allow APRA to meet the Royal Commission's recommendation while avoiding some of the difficulties of applying a cap on the 'allocation' of variable remuneration.

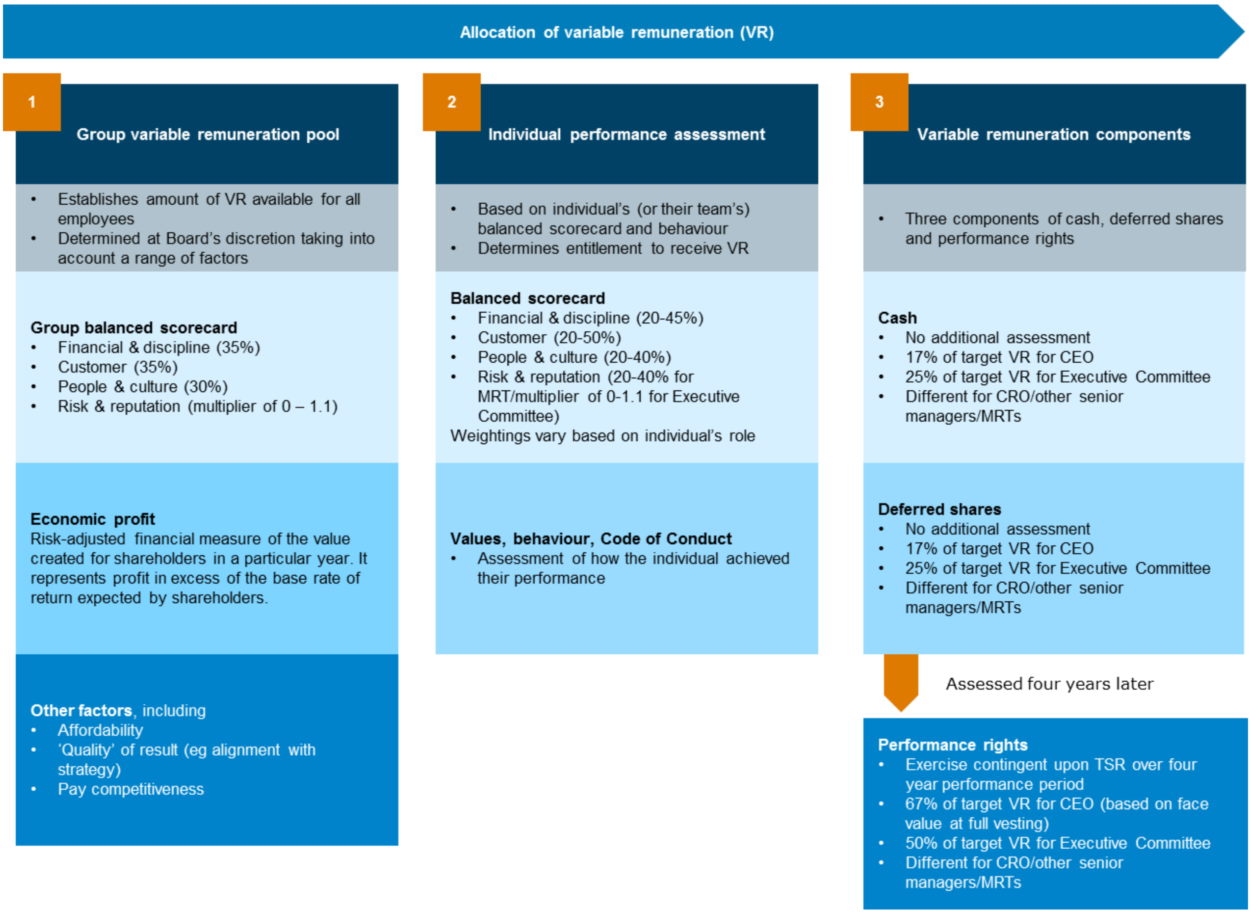
87. We currently follow a three-part process for determining whether, how much and what kind of variable remuneration a senior executive receives (see Diagram 3 which sets out

our FY19 practice). We note that this process may change and be different from the process followed by other entities.

88. The parts are:

- The determination of a group variable remuneration pool at the end of a financial year (part 1 of Diagram 3);
- The assessment of how an individual has performed at the end of the financial year and the determination of how much variable remuneration they will receive (part 2 of Diagram 3); and
- The award of the variable remuneration, which could be cash paid at the end of the financial year, the award of deferred shares that will be received over a number years and/or LTI performance rights exercisable four years after that award subject to performance hurdles that will be assessed over that four year period (part 3 of Diagram 3).[viii]

**Diagram 3**




89. As Diagram 3 makes clear, our process of allocating variable remuneration to our executives draws on a range of mechanisms that are applied over a period of time. The

mechanisms include scorecard measures, risk-adjusted economic profit, the behaviour of the executive, total shareholder return and Board discretion. These seek to ensure remuneration outcomes are aligned with the interests of our various stakeholders and are adjusted for non-financial risks.

90. Where entities use multiple part processes to allocate variable remuneration, we anticipate that it may be difficult to apply a simple cap on financial measures. For example:

- In part 1 in Diagram 3, the FY19 group balanced scorecard was weighted to 35% financials. However, the risk and reputation multiplier can completely override the impact of this performance measure (this would occur if the multiplier was set at 0%). In this sense, would we treat the multiplier as controlling 100% of the scorecard? Similarly, our economic profit, which is 'risk-adjusted' and thus not a financial measure, can also affect the pool size.[ix] We wonder how we should treat these overriding factors on the mix of more formulaic performance measures.

- Further in part 1, the pool determination is subject to the discretion of the Board. In this sense, performance measures can be inputs to a decision but are not used mechanistically to arrive at an outcome. How would we 'weight' performance measures if they are subject to the discretion of the decision maker?

- In part 3, we currently use TSR to assess whether the performance rights vest four years after their award. We would contend that this is not a purely financial measure. However, even if it were, we do not understand how we should take into account for the purposes of the cap the antecedent impacts of parts 1 and 2 on the entitlement of the executive to exercise the performance rights at part 3.

- Importantly, it is not clear how we apply the capping of performance measures when the process has multiple parts. Are we to apply the cap on each of parts 1, 2 and 3 of our process separately or do we need to somehow summate the measures? If we summate the measures, what is the basis for doing this?

91. Because of these issues, we would suggest that the cap on financial performance metrics, as proposed, would be difficult to implement. Instead of a cap, APRA could set a general principle that entities must limit the impact of financial performance measures on the allocation of variable remuneration by adjusting it for non-financial risks. This would allow entities to use a broad range of mechanisms to ensure that non-financial risks are appropriately reflected in remuneration outcomes. This would allow them to achieve a balance between financial and non-financial performance measures that are appropriate to an entity's situation and strategy. These mechanisms could include:

- The discretion of the Board and management;
- Assessments of whether the relevant executive has complied with an entity's behavioural values or been responsible for any non-financial risk failures; and
- Non-financial (or risk-adjusted) performance measures such as economic profit.

92. One of the key reasons for setting this kind of principle is to ensure the entity and its Board have ultimate accountability in how remuneration is allocated (as we discussed above). Under our proposed principle, an entity and its Board would need to be able to demonstrate that they have appropriately established remuneration arrangements that take into account non-financial risks. This kind of principle would also ensure that an entity can adopt remuneration that is appropriate for its commercial, risk and stakeholder circumstances.

**Calibration of cap on financial measures**

93. If APRA proceeds with a hard cap on financial measures, we would prefer that the cap:

    - Be 75% (rather than 50%); and
    - Apply only to the performance hurdles that must be cleared for long term remuneration to vest, consistent with the Royal Commission recommendation on this point (with the principle we set out above applicable to the remainder of the variable remuneration); or
    - If APRA wants the cap to operate more broadly, apply to:
        - The measures used to assess an individual's performance (ie the balanced scorecard measures in part 2 of Diagram 3); and
        - The performance hurdles that must be cleared for LTI to vest.

94. A cap of 75% is within the range of caps that APRA has identified in its Discussion Paper. We believe that this level appropriately reflects the role of financial metrics in the management of ADIs while still allowing non-financial measures to have a significantly determinative role in the variable remuneration paid to executives. It would also be more consistent with the expectations of our shareholders. Increasing the cap level would also recognise the challenges of developing adequate non-financial measures (see below). If the cap were increased, we would also ask that permissible weighting of individual measures also be increased (ie to 37.5%) or, more appropriately, removed.

95. We would also prefer that the cap apply only to LTI hurdles. This would accord with the Royal Commission's recommendation that concerned long term incentives. Importantly, applying the cap to this set of performance measures would make it easier to calculate the

required percentages. This is because discretion or other modifiers do not play a role in whether the LTI hurdles are cleared. We recognise that it would be important to ensure the other determinants of remuneration are also adjusted for non-financial risks. For that reason, APRA could apply the principle we describe above to the non-LTI components of variable remuneration.

96. If APRA wants the cap to apply more broadly, then we would suggest that it applies to the measures used to assess an individual's performance and, to the extent applicable, any LTI hurdles. The cap would need to apply to each point independently so that it could be calculated. If APRA applied the cap in this manner, we do not see the need to apply the principle we have articulated above to the other components of the variable remuneration.

### Total shareholder return

97. We note APRA's commentary on total shareholder return in the Discussion Paper. We would ask APRA to reconsider its view that total shareholder return is a purely financial metric. The share price of a company reflects not just its annual profit or loss but also how well managed it is; its exposure to risk; how well capitalised it is; and, over the long term, its ability to keep its customers satisfied. In these senses, the measure is risk-adjusted and reflective of non-financial determinants. We note that the UK FCA considers that profits can be risk-adjusted and that it contrasts profits with non-risk adjusted financial metrics such as revenue.[x]

### Non-financial performance measures

98. While we appreciate the policy basis for including non-financial performance measures within the remuneration structure, we are still considering which measures would be appropriate. This is particularly the case with respect to LTI hurdles that need to be assessed sometime after the year in which the remuneration was earned. This is because such measures would need to be:

- Adequately aligned with the long-term business plan of the entity
- Grounded in a methodology that is robust and independently verifiable
- Unable to be 'gamed' (or open to scepticism of gaming)

99. We have been thinking about the challenges in implementing these kinds of measures. These challenges include that an entity could change business strategy between the date of award and the date of assessment for LTI hurdle assessment so that the activity that the measure seeks to assess has become de-emphasised. This could particularly be a concern if there is a change of business leadership. The executive who agreed to the measure based on their then current business strategy could have left the entity and have

no influence over the business strategy that applies at the time of assessment of whether a hurdle has been cleared

100. The measures would also need to be capable of being disclosed to a sufficient degree to give external stakeholders comfort concerning the entitlement of executives to the variable remuneration but not reveal any commercially sensitive data or strategies. We also note that external stakeholders may find assessing performance measures that differ across institutions confusing. We wonder to what extent there will emerge an expectation that similar entities use similar non-financial performance measures.

101. Because of these issues, it would be preferable to either apply the principle we set out above or allow a higher cap of financial measures.  We would also welcome further guidance from APRA on what parameters are appropriate for non-financial measures. For example, is 'customer retention' a financial or non-financial measure?

# APRA'S QUESTIONS

## Remuneration framework

**Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework?**

102. Yes, this is an appropriate frequency.

**What areas of the proposed requirements most require further guidance?**

103. The areas that we believe most require further guidance are set out in this submission.

## Board oversight

**Are the proposed duties of the Board appropriate?**

**Are the proposed duties of the Board Remuneration Committee appropriate?**

104. See our comments commencing at paragraph 20 above.

## Remuneration design

**APRA is proposing that financial performance measures make up at least 50 per cent of variable remuneration measurement and individual financial performance measures are limited to 25 per cent. Is this an appropriate limit, if not what other options should APRA consider to ensure non-financial outcomes are reflected in remuneration?**

105. We have some concerns about this proposal. These are set out from paragraph 90.

**What would be the impacts of the proposed deferral and vesting requirements for SFIs? For ADIs, what would be the impact of implementing these requirements in addition to the BEAR requirements?**

106. As noted above from paragraph 31, we are concerned about the potential impact of the deferral and vesting requirements on our ability to attract and retain the people we need for senior manager and highly-paid MRT roles.

107. We note that para 55 sets the minimum amount of *total* variable remuneration at $50,000 before the deferral rules apply. This is different from s 37ED in the Banking Act. This section sets the threshold before deferral rules apply at $50,000 of *deferred* variable remuneration. For a CEO this means that *total* variable remuneration would need to be $83,333 or less for s 37ED to disapply the deferral provisions of BEAR. We would strongly prefer that CPS 511 matched BEAR.

**Would the proposals impact the industry's capacity to attract skilled executives and staff?**

108. Yes. See our comments from paragraph 31 above.

## Remuneration outcomes

**What practical hurdles are there to the effective use of clawback provisions and how could these be overcome? Would requirements for longer vesting where clawback is not preferred address these hurdles?**

109. For the reasons we set out from paragraph 54, we would not support longer vesting to overcome any issues with clawback.

**What transitional provisions may be necessary for particular components of the new standard or for particular types of regulated entities?**

110. The main transitional provision that we would encourage APRA to consider is that the requirements of CPS 511 apply from the start of the entity's financial year which commences on or after 1 July 2021. If entities are expected to have CPS 511 compliant remuneration arrangements in place on 1 July 2021, then they will need to make the changes from the start of the financial which commences before that date.

111. For ANZ, this would mean the difference between compliance from 1 October 2020 rather than from 1 October 2021. If APRA finalises CPS 511 and any associated guidance in the first quarter of 2020, an effective start date of 1 October 2020 would mean that we would have roughly seven months to design and implement new remuneration arrangements and governance processes. We do not believe this will be sufficient time. We note that it took approximately two years to design and implement the remuneration changes we refer to in paragraph 2. If the standard and guidance were finalised after the first quarter of 2020, the implementation challenge would be even more significant.

## Transparency

**What disclosures would encourage a market discipline in relation to remuneration practices?**

112. We note that we have already foreshadowed greater transparency on executive accountability at our ESG Investor briefing.[xi]

113. If APRA prescribes additional disclosure requirements, we would ask it to consider how disclosure could be made clearer and simpler. This may involve rationalising the requirements as additional fields are added to ensure that stakeholders can easily understand the disclosed information and focus on the most relevant metrics.

# COMMENTS ON SPECIFIC PARAGRAPHS OF CPS 511

## Paragraph 16

**Highly-paid material risk-taker**

114. We note the variable remuneration component of the $1m threshold in this definition is based on the 'maximum potential' variable remuneration available to an individual.

115. It may be more appropriate if this threshold were based on the actual variable remuneration that is proposed to be paid to the individual in the particular financial year. This is because some MRTs may not have a formal maximum potential set out in their remuneration arrangements. Further, there are individuals who could earn more than $1 million but who are unlikely to do so. Using 'actual remuneration' in lieu of 'maximum potential' would avoid capturing these individuals while still ensuring the policy has the intended scope of application.

116. We do note, however, that using the concept of 'maximum potential' allows entities to identify, in advance, those individuals who will be subject to the deferral, clawback and individual Board approval requirements. Further, by using 'maximum potential', there may be less year-to-year variation in who is 'highly paid'.

**Misconduct risk**

117. We agree with the intent of this definition but wondered whether it would help with its implementation if APRA could elaborate on the relevant 'ethical standards' which are being referred to in it (as different community members may legitimately support a range of different standards). Of course entities may adopt, like ANZ has, a set of ethical standards that they believe they should be held to account against. It may be that these adopted standards are the ones that this paragraph is referencing. We would note that such adopted ethics are often embedded in the internal standards that entities follow.

## Paragraph 19(d)

118. We note that this subparagraph appears to require a remuneration framework to apply to a person who is employed by a contractor. We do not understand how entities would be able to control the employment terms on which contractors pay their staff. Obviously, entities can set the terms on which they pay the contractor. The paragraph, however, appears to require entities to reach inside the contracting entity and control the pay arrangements that apply within them. This does not seem feasible.

119. We also note that the paragraph does not draw a distinction between the contractor's employees that are providing services to the entity and the contractor's other employees.

It purports to require the entity impose its remuneration framework on all of the contractor's employees. This drafting seems in excess of what is needed for the purposes of CPS 511.

120. We would prefer that APRA continues to use the drafting from para 58 of CPS 510 in lieu of the new drafting proposed by subparagraph 19(d) of CPS 511.

## Paragraph 20

121. We note that subparagraphs (a), (b) and (d) contain overlapping concepts. Specifically:

- It is not clear that the requirement in subparagraph (b) that the objectives must promote 'sustainable performance' adds much to the requirement in subparagraph (a) that the objectives align with the entity's 'business plan'; and
- The role of the remuneration in promoting adherence to the law is arguably evoked by the concepts of 'compliance obligations' in subparagraph (a), 'effective management of non-financial risk' in subparagraph (b) and 'misconduct risk' in subparagraph (d).

122. It may be neater if these objectives, for ADIs, were presented as a coherent taxonomy of alignment with:

- Long term business objectives of the entity;
- Management of financial and non-financial risk; and
- Adherence to legal and regulatory requirements.

## Paragraph 29

123. Paragraph 29 requires that the BRC 'obtain comprehensive reporting that will allow it to assess whether remuneration outcomes of all remuneration arrangements align with the entity's remuneration objectives'. This paragraph appears to require an assessment. We are not clear if this assessment is either of the assessments that need to be done under paras 33 and 34. We would be concerned if para 29 were introducing a third assessment. We believe that the assessments under paras 33 and 34 are sufficient.

124. We would also ask APRA to consider the potential overlap between para 29 and para 49. Paragraph 49 (concerning obtaining information to assess the appropriateness of outcomes for special role category employees) arguably injuncts the BRC to obtain a subset of the information that it would need to collect under para 29.

## Paragraph 36

125. Paragraph 36 concerns what the effectiveness review required under para 34 is to consider. We have the following points on this paragraph.

**Paragraph 36(a)**

126. We wondered whether the obligation to review the alignment between the entity's *remuneration objectives* and *remuneration framework* should, actually, be to review the alignment between the *objectives* and the *arrangements*. This is because under subparagraph 18(a) the *objectives* are part of the *framework* (ie they appear to be a subordinate concept not a controlling concept). It appears that under subparagraphs 18(b) and 37 the concepts that are to be aligned are the *arrangements* and the *objectives*.

**Paragraph 36(b)**

127. The annual effectiveness review of the remuneration framework is to consider whether '…the remuneration objectives, principles and structures are achieving their expected outcomes'. It is not clear from this what the 'remuneration structures' are as this is the first reference to the concept in the standard. Is this reference intended to be to the 'remuneration arrangements'?

128. We also note that this review requirement presupposes that the 'expected outcomes' of the remuneration objectives, principles and structures have been set out in advance. While this seems reasonable, we note that such outcomes are not otherwise mentioned in the standard. It would be useful to understand what role the Board and BRC will play in the establishment of these intended outcomes.

129. We also wondered whether the 'outcomes' referenced in subparagraph 36(b) are distinct from the 'remuneration outcomes' referenced in subparagraph 36(c).

130. It seems likely that the 'principles' that are referred to in this paragraph are those that are required by subparagraph 18(b). However, we wondered whether the drafting could be improved by making this clearer. If it is the principles from subparagraph 18(b) that are being assessed, we wondered whether, once subparagraph 36(a) is adjusted as we suggest above, subparagraph 36(a) would assess whether the principles are operating as intended. This is because the principles are intended to align the arrangements with the objectives. If the review in subparagraph 36(a) considers the degree of this alignment, that might consider whether the principles are working or not.

### Paragraph 36(e)

131. Is the alignment that is being assessed in this paragraph the adherence of the remuneration arrangements with the law (eg the *Fair Work Act 2009* (Cth)) or the promotion of individual and organisational conduct that is consistent with the law? Of course, the assessment could be against both. However, could this be made clear?

## Paragraph 37

132. Purely as an ordering matter, we wondered whether the points included under 'Remuneration Design' should be co-located with the points under 'Remuneration Framework'. Both sections concern the documentary artefacts that entities adopt to govern how they pay their staff. The standard may read more clearly if they were collapsed together or abutted to the other.

### Paragraph 37(a)

133. We wondered whether the reference to 'design tools' in this paragraph should be to 'mechanism' as the adjustments to variable remuneration will occur through the substantive elements of the arrangements rather than the aids by which those arrangements are designed.

### Paragraph 37(d)

134. This paragraph contemplates some form of assessment. Is this assessment a different assessment from those contemplated under paras 33 and 34 (and, possibly para 29)? Again, we would argue that the assessments required by paras 33 and 34 are sufficient.

135. It is also unclear whether the assessment contemplated by para 37(d) is something which needs to be ongoing or only at the point at which the arrangements are being 'designed' (which would, by definition, be antecedent to the operation of the arrangements).

## Paragraph 38

136. We are unclear what 'risk adjusted' means in para 38. Could APRA elaborate on this term?

## Paragraph 42

137. We wondered whether the list of conditions in this paragraph involve overlapping concepts. For example, subparagraph 42(d) requires that the payment meets the entity's remuneration objectives. By virtue of subparagraph 20, these must include the promotion of the entity's long-term soundness, the outcome which is repeated in subparagraph 42(a). As such, if subparagraph 42(d) is met, then by definition subparagraph 42(a) is also met.

## Paragraphs 53 and 54

138. Paragraphs 53 and 54 provide that '[v]esting of this [60/40] per cent may only occur after four years from the time of inception and no faster than on a pro-rata basis.' If APRA does not accept our alternative deferral arrangements, we would ask that it make clear that the initial vesting can occur at the end of the fourth year and then each subsequent year that makes up the seven as described.

## Paragraph 57(b)

139. We wondered whether the investigation referred to in this paragraph is to an investigation by the entity or by an external agency (or both). Could this possibly be made clear?

**ENDS**

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[i] ANZ 'ANZ reforms remuneration structure' (Media Release, 6 August 2019); available at: https://media.anz.com/posts/2019/08/anz-reforms-remuneration-structure?adobe_mc=MCMID%3D27006568842583272132769356075863816877%7CMCAID%3D2CD256ED052C6C03-400000C0A00006C8%7CMCORGID%3D67A216D751E567B20A490D4C%2540AdobeOrg%7CTS%3D1567554417

[ii] For a discussion of this issue, see Productivity Commission *Executive Remuneration in Australia* 49 (19 December 2009), 110.

[iii] A study on variable remuneration has indicated that executives discount future pay at a rate in excess of economic discount rates (PWC *Making Executive Pay Work – The Psychology of Incentives* 18 (available at: https://www.pwc.com.au/publications/psychology-of-incentives.html). For the research underlying this paper, see Alexander Pepper *Applying economic psychology to the problem of executive compensation* Psychologist-Manager Journal (2017); available at: http://eprints.lse.ac.uk/79675/ ). In the Asia-Pacific region, the study estimated that the discount rate which executives place on deferred remuneration is 42% per annum. This study also found, at 16, that most executives are adverse to uncertainty and complexity in their remuneration. Indeed, one of the drivers for our recent changes to remuneration across the bank was that employees dislike the uncertainty that comes with variable remuneration.

[iv] The *Fair Work Act 2009 (Cth)* s 544 states that a person may apply for an order in relation to a contravention of a civil remedy provision under the Act within 6 years after the day on which the contravention occurred. *The Corporations Act 2001 (Cth)* s1325(4) imposes a 6 year limit on an applicant from the time a cause of action arises as a result of specific corporate misconduct.

[v] Ipp, the Hon D.A, Cane, P., Sheldon, D. and Macintosh, I., *Review of the Law of Negligence Final Report*, September 2002, pp. 85-86; retrieved from https://treasury.gov.au/sites/default/files/2019-03/R2002-001_Law_Neg_Final.pdf.

[vi] The Financial Stability Board (**FSB**) has stated that 'The impact on compensation should be commensurate with the severity of the issue or the events that have occurred'; Financial Stability Board *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices – The Use of Compensation Tools to Address Misconduct Risk* (9 March 2018), 11. The FSB has also set out the factors that may be appropriate to trigger performance adjustment. These go to the degree of culpability that the individual has for the relevant event; Financial Stability Board, ibid, 12.

[vii] The FSB has stated that 'It is for firms to determine which tool [referring to in-year adjustment, malus or clawback] is most appropriate for the specific circumstances'; Financial Stability Board, ibid, footnote 13.

[viii] Performance rights are the entitlement to obtain at nil cost one ordinary ANZ share at the end of the three year performance period. The performance hurdles we currently use are ANZ's total shareholder return assessed relatively to our peers and on an absolute basis. 75% of the performance rights are contingent on our total shareholder return relative to our peers and the remaining 25% is assessed on an absolute, stand-alone basis.

[ix] See the FCA's Remuneration Principles at SYSC 19D.3.24 which notes, in relation to economic profit:

> *We consider good practice in this area to be represented by those firms who provide a quantitative reference or starting point that explicitly includes risk-adjusted metrics, before the application of more discretionary factors. Common measures include those based on* ***economic profit*** *or economic capital.* (Bold added)

[x] At SYSC 19D.3.27 and SYSC 19D.3.28, the FCA's Remuneration Principles state:

> *A firm must base assessments of financial performance used to calculate variable remuneration components or pools of variable remuneration components principally on profits.*
>
> *Performance measures based primarily on revenues or turnover are unlikely to pay sufficient regard to the quality of business undertaken or services provided. Profits are a better measure provided they are adjusted for risk, including future risks not adequately captured by accounting profits.*

[xi] ANZ *ANZ 2019 ESG Investor Briefing – Presentation and Investor Discussion Pack* (21 June 2019), 24; available at: https://shareholder.anz.com/sites/default/files/ESG%20Presentation%2021Aug19.pdf