FRANKLIN TEMPLETON
INVESTMENTS

Balanced Equity Management
Level 19, 101 Collins Street
Melbourne VIC 3000 Australia
tel +61 3 9652 9400
www.bem.com.au
A Franklin Templeton Investments company

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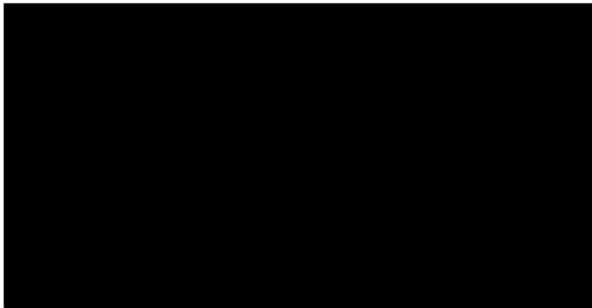
General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Dear Sir/Madam

We are pleased to respond to your request for submissions in response to your Discussion Paper on "Strengthening prudential requirements for remuneration".

Our submission follows; we would be pleased to discuss any aspect.

Yours sincerely



Response to APRA's Discussion Paper of July 2019 on "Strengthening prudential requirements for remuneration"

Balanced Equity Management (BEM) is a wholesale manager of portfolios of Australian shares with funds under management of $9.3 billion. We are part of Franklin Templeton Investments, an international investment management company with its headquarters in the USA. The portfolios we manage on behalf of our clients are invested in large companies including ANZ, CBA, NAB, Westpac, Bank of Queensland, Macquarie Group, AMP, IAG, QBE, Medibank Private and Suncorp. Our policy is to vote on all shareholder meeting resolutions when delegations from the client allow us to do so. We subscribe to proxy advisory services but form our own decisions on how we should vote.

BEM has been engaged in discussions around executive remuneration in investee companies for over twenty years. Over that period we have seen numerous remuneration structures, with some proving to be effective and others less so. We believe our experience places us well to contribute to the discussion.

For each company in which we are invested we seek to have the remuneration structure aligned with enhancing the company's long-term value. This requires policies and a management culture which promote future growth without taking undue risk. BEM sees its interest as a long-term investor in financial institutions as being closely aligned with APRA's objectives of financial safety and efficiency, competition, contestability and competitive neutrality while promoting financial system stability.

BEM is keen to see alignment between executive incentives and long-term shareholder interests. We believe shareholders are best served by the financial institution serving customers and the broader community in a transparent, ethical business relationship. While not doing so may benefit short-term profits, it is detrimental to long-term shareholder value. We agree therefore that remuneration design that has an over-emphasis on short-term financial performance is likely to result in less than optimal long-term outcomes.

Our responses follow the structure of the consultation questions in Table 10 of the discussion paper. However there are some questions where our role as an investor of client assets does not equip us to give helpful responses, and other matters in the paper which we would like to put forward our views despite there being no specific pertinent question.

Remuneration framework

- Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework?
- What areas of the proposed requirements most require further guidance?

We have not been directly involved in preparing or receiving independent reviews, but we like to see consistency over time in companies' remuneration structures. We would not be in favour of independent reviews occurring more frequently than triennially.

Board oversight

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

This is not an area where we can usefully comment.

Remuneration design

- APRA is proposing that *non*-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?
- 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?
- Would the proposals impact the industry's capacity to attract skilled executives and staff?

BEM believes that performance-based variable pay should form a material part of total remuneration. We do not think that shareholder or community interests would be served if poor strategic decisions or implementation outcomes had few or no financial consequences for executives. We agree that a move to a greater proportion of fixed remuneration could blunt overall performance incentives. We are concerned that an unintended consequence of regulatory constraints on variable remuneration could be that packages are structured to give a heavier reliance on fixed remuneration at the expense of variable. The more uncertain and problematic variable remuneration becomes, the greater the risk of this happening.

We support deferral of vesting through deferred equity as it extends the potential period for malus adjustments and because it ensures the eventual benefit is related to shareholder outcomes. However a pro rata link with the share price without performance-related hurdles can result in the impact of poor performance being too muted; significantly poor

shareholder outcomes should have a more severe outcome than just a pro rata reduction in value. We are therefore in favour of a proportion of variable rewards requiring achievement of longer-term performance outcomes before vesting rather than just relying on the effluxion of the vesting period. The remuneration changes that NAB introduced in 2018 had no such performance tests and had a 75% weighting to one-year profitability so we voted our clients' shares against that year's Remuneration Report.

Given our belief in the value of executive exposure to the economic gains and losses of shareholders, we would advocate that the prohibition from hedging economic exposure in unvested shares as set out in Clause 52 of the proposed CPS 511 should be extended from persons in a special role category to all those who receive equity or equity-linked deferred variable remuneration.

Risk

The APRA discussion paper places great emphasis on risk management and ensuring that taking excessive risk is not rewarded. On this we are totally in agreement. It is not in shareholders' interest for risk to be taken which lead to short-term gains but ultimately to long-term losses. The difficulty is that undue risk generally becomes evident only when losses start to accrue, which is often well after bonuses have been paid and banked. Even the deferred component of bonuses has often vested by the time the problems are evident. Clawback post vesting is difficult to enforce except when there is clear evidence of misleading or dishonest behaviour – not just of excessive risk taking. For those reasons we are generally in favour of extended vesting periods, although there is clearly a trade-off as the value of such payments diminishes with time and we do not want to see the proportion of fixed pay increased to compensate.

The problems with identifying undue risk are even greater for shareholders than for management and the board. Whereas internal analysis allows different scenarios to be applied to the trading books to see whether undue risk is being taken, such tools are not available to shareholders. We would like to see remuneration criteria include the outcomes of the institution's internal risk analysis with input from the Board Risk Committee and Chief Risk Officer. Provided reliable measures can be developed remuneration should be adjusted for non-financial risk as well as financial.

APRA carries out highly sophisticated risk analysis on the financial institutions and this work could be used to inform the company's assessment of risk which ultimately feeds into remuneration outcomes. It would not be a bad thing if this caused companies taking greater risks to be exposed as such.

We are supportive of the approach that risk assessment is best used to apply a modifier against the other measures, rather than just being one item in a balanced scorecard (as set out in Section 3 of the April 2018 Information Paper). We also support the principle that poor risk outcomes should be applied to executives in the particular business line rather than 'averaged out' across the business as a whole.

Non-financial measures

In principle we are supportive of the inclusion of clearly defined and measured non-financial measures. However there are certain considerations which need to be addressed when specifying the measures:

- If a narrow-based metric is chosen, management can focus on that particular area to ensure that specific performance targets are achieved at the expense of broader outcomes;
- Shareholder interests can be sacrificed to buy positive customer responses which last only as long as the expenditure is maintained;
- Some measures are surprisingly resilient in the face of adverse developments; board discretion is then required to override vesting.

Considerable thought therefore needs to be given to the non-financial criteria chosen. We are broadly supportive of the use of measures such as:

- compliance with internal and external rules and regulations;
- maintenance of a constructive relationship with regulatory agencies;
- control environment effectiveness;
- supportiveness of market integrity and financial system stability;
- customer advocacy (net promoter score) and trust;
- complaints to ombudsman;
- workplace safety;
- employee diversity;
- employee engagement and assessment of leadership;

with no single measure being dominant.

Outcomes rather than inputs should be measured. For example, it is compliance adherence that matters; compliance training is needed to get there, but training is not an end in itself which justifies performance-based remuneration.

Financial measures

We share APRA's concerns about an undue proportion of variable remuneration being dependent on profit and other financial accounting outcomes. It encourages a focus on short-term profitability at the expense of the long-term sustainability of the institution and its value to shareholders and the community.

However we disagree with the characterisation for this purpose of relative total shareholder return (RTSR) as a financial metric. The share price is in fact a reflection of a wide range of factors, both financial and non-financial.

Earnings are of course an important component of the market's valuation of a company. However the expected future rate of growth of those earnings and the risks to that expectation are critical. Companies with stable and reliable earnings sell at a premium to companies where there is greater uncertainty. Company share prices are highly sensitive to perceived longer-term sustainability and the risk thereto. We therefore regard RTSR as a "risk-adjusted metric" – if risk is perceived to increase, the share price will react negatively and RTSR will be lowered.

There are many examples of a company's share price moving materially as its long-term prospects are reassessed while short-term profitability is unaffected. Reputation is central to the market's view of a company's longer-term outlook and this in turn depends on its relationship with its customers and the broader community. Poor customer outcomes or a weak culture of compliance with the law result in reputational damage which is detrimental to shareholder value. If companies fail to look beyond bottom-line profit to broader accountability to its employees, the community and the environment, this will be reflected in the share price, and shareholder interests will be damaged.

The sensitivity of share prices to a wide range of influences makes RTSR in our view the best single metric in assessing management performance over periods longer than three years. We find that selecting an appropriate comparator group in the narrow Australian market is the main challenge in making RTSR work, but this is less of a problem in the financial sector than elsewhere.

Apart from its utility as a balanced measure of a wide range of financial and non-financial metrics, we believe RTSR has the added advantage of reacting in a more timely way than any of the alternatives. While the share price can only reflect information that is generally available, it reacts to such information almost instantaneously. In contrast there can be a long lag before adverse developments have an impact on reported financial accounting metrics including profitability, market share statistics and customer satisfaction measures.

Preferred approach

As discussed above we are not in favour of combining short-term and long-term incentives into awards based on one-year assessments, even with an extended vesting period. We believe that RTSR is a good measure of long-term stewardship, but only if it is measured over periods of at least three, and ideally four or five, years. We agree with the Benjamin Graham aphorism that "In the short run, the market is a voting machine but in the long run, it is a weighing machine." RTSR also has the advantage of being highly objective and rigorous; the chance of vesting is only 50% and even if it does vest it may vest at less than 100%.

When we consider incentives based on one-year outcomes we share APRA's concern about an undue concentration on short-term profitability. This is particularly the case if the profitability criteria have a binary component whereby a small change in earnings can have a material impact on executive rewards (so-called "cliff vesting"). While the selection of non-financial performance measures needs to be carried out with care, we support their inclusion in short-term incentives so as to reduce the impact of financial accounting outcomes. The minimum required level can be debated, but for financial institutions' short-term incentives we do not think 50% is unreasonable.

With respect to incentives based on longer periods we view financial accounting metrics as having limited utility. At the time of grant of a long-term award, predicting the economic environment at the end of the performance calculation period can be quite problematic. If the economy is strong the targets may be too soft, but in a weak economy they may be unrealistically demanding. The business mix may have changed, or impairment provisions may have been made so that target return metrics need to be adjusted. We support measures which flex with the broader environment and do not require accounting adjustments to allow for changed circumstances. We see RTSR as providing this given its focus on performance relative to other corporate entities and on future value.

Against this background we feel comfortable in letting RTSR represent 100% of the long-term incentive – it is a composite of financial and non-financial influences and it is risk-adjusted. If this is seen as giving it undue weight, the long-term incentive's share of the total package can be reduced, or a non-financial component included in the long-term incentive. If the latter is done in our view it should be based on a relative measure and have rigorous criteria; we have seen too many cases where targets are set and measured with a large element of management input and high vesting outcomes become routine.

In summary, for incentives based on one-year outcomes we support restrictions on the use of financial accounting metrics. For long-term incentives we would favour financial accounting metrics being excluded altogether, but Relative Total Shareholder Return should be regarded as an appropriate composite metric.

At a technical level we believe APRA's proposed restrictions on financial metrics need to be clarified to be effective. In particular it needs to made clear whether the measure is face value or fair value; we think fair value is more appropriate as face value can inflate the significance of components that have a relatively low chance of vesting. Further guidance will also be needed on how to treat a financial metric which is subject to a non-financial gateway or modifier.

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

Period prior to grant

Board discretion is essential but should not be the first line of defence. The objective should be to construct a remuneration structure that is robust to changed circumstances and rarely needs discretion to correct remuneration outcomes that are misaligned with performance.

Period prior to vesting

Our observation is that companies are generally most reluctant to apply malus to reduce deferred awards that have already been granted, but not yet vested. More often when a problem emerges the awards for the year it comes to light are penalised rather than the awards relating to the years when the problematic actions occurred. While that approach has the advantage of simplicity, equity requires that malus penalty be applied to the deferred awards relating to the period of the infractions. If APRA required this approach, executive expectations would be changed and any legal objections silenced.

Period after vesting

It is not surprising that clawbacks post vesting are most uncommon. A very high burden of proof is required to remove variable remuneration once the person is the legal owner. We would not expect that it ever becomes "routine". Extended vesting periods combined with rigorously enforced malus would seem to be the most effective way of ensuring that executive remuneration aligns with shareholder and community outcomes.

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

Remuneration reports are voluminous, but even so do not always supply the information that we seek. We look to understand the underlying value of each executive's remuneration calculated at time of grant, weighted by the likely level of vesting. We also want to understand the factors that are driving vesting outcomes so we can assess whether they are aligned with long-term shareholder interests.

Once vesting decisions are made, we want clarity on each component that led to the outcome so we can tell whether it is consistent with our expectations at the time of grant. In particular, we would like to understand how risk assessments were brought to account and their longer-term implications for the value of the company. We also want to understand whether board discretion has been applied, and if so its extent and rationale.