Commonwealth Bank

Commonwealth Bank of Australia

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Dear Sir/Madam

CBA response to APRA's discussion paper 'Strengthening prudential requirements for remuneration' (23 July 2019)

Thank you for the opportunity to respond to APRA's consultation paper *'Strengthening prudential requirements for remuneration'*, and the draft new prudential standard CPS 511.

CBA supports the objectives of APRA's draft CPS 511, aimed at uplifting governance, culture and remuneration practices in the financial services industry, and addressing the remuneration-related recommendations 5.1 - 5.3 of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ('**Royal Commission**').

CBA is of the view that the Royal Commission recommendations are best addressed through a principles-based regulatory approach, rather than with a prescriptive 'one-size-fits all' approach set at a single point in time. An overly prescriptive approach will not enable Boards to have the required flexibility to determine how best to achieve the requirements and spirit of any regulatory standard within the context of their current and rapidly evolving organisational models and contexts. This flexibility is particularly important where such design changes would bring with them an uneven talent playing field, creating attraction and retention risks, including in relation to 'Fintech' organisations which are not APRA-regulated and not subject to APRA's remuneration design and governance requirements.

CBA believes that the overall culture of an organisation, including risk culture, and a strong risk management system, are fundamental to supporting high collective and individual operating standards and conduct, and ultimately delivering better customer and risk outcomes. At CBA, remuneration forms part of 'total employee reward', i.e. monetary and non-monetary benefits, and operates within the context of the broader employee value proposition, ecosystem and culture.

We acknowledge that extrinsic motivators, including variable remuneration, can be strong reinforcers of positive or negative culture. However, they are only one lever organisations can utilise to enable their desired culture. Cultural levers beyond remuneration (e.g. leadership, capability, performance management systems, recognition programs, career progression, and tone from the top) are critical enablers of positive or negative culture and practices. As such, changes to remuneration systems alone will not provide a 'silver bullet' solution for cultural change.

Similarly, a strong financial and non-financial risk identification system is a critical component of the risk and consequence management framework. As with any organisational framework, the

responsiveness and effectiveness of remuneration is dependent on the broader ecosystem in which it operates, including governance, capability, decision making and risk monitoring systems. In recent years, CBA's clear focus has been on implementing a far stronger ecosystem, including the management of non-financial risk, which in turn has enhanced the effectiveness of our remuneration frameworks and practices. The continued development of this enabling ecosystem is of paramount importance in continuing to uplift governance, culture and remuneration practices across the bank.

Notwithstanding the above, we acknowledge that performance and remuneration frameworks, when appropriately designed and governed, play an important role in supporting sound risk management and promoting a strong risk culture. In particular, variable remuneration as one component of remuneration, and within the broader culture and ecosystem, can, and should, act as an effective way to:

- attract and retain critical talent and capability (including capability supporting sound risk management practices) in a manner that is competitive across industries and markets, now and over time;
- align, motivate and engage employees to achieve balanced & sustainable performance and reinforce individual and collective accountabilities;
- fairly, simply and transparently recognise the contribution of individuals and teams both in terms of the outcomes achieved and the manner in which they are achieved; and
- help mitigate risks by reinforcing clear risk accountabilities and expectations, and supporting consequence management through both rewarding or penalising risk conduct and outcomes as appropriate.

APRA's 2018 Prudential Inquiry into CBA highlighted shortcomings in governance, culture and accountability in the Group. Work is well progressed to address the Prudential Inquiry's 35 recommendations under our Remedial Action Plan (**RAP**) and the approach under the RAP is aligned with APRA's proposed enhancements under CPS 511. We believe these changes provide a foundation from which we can meaningfully and positively shift the dial on the bank's culture and risk practices.

The RAP initiatives implemented to date have already had a materially positive impact on reinforcing greater accountability and a stronger risk culture, by setting clear expectations, providing robust decision making frameworks, and delivering consistent and appropriate remuneration consequences.

Experience gained through the RAP implementation reinforces CBA's view that CPS 511 objectives can be achieved through a principles-based approach to remuneration design, supported by appropriate guidance, ongoing monitoring and supervision, and sharing of learnings and better practice examples across industry and the community. A principles-based approach, as opposed to '*one size fits all*' prescription at a point in time, will provide flexibility for organisations to develop sound remuneration frameworks and practices, reflecting their individual context, business model and cycle, and risk profile.

Under a principles-based approach, organisations should be required to provide a strong rationale, and demonstrate effectiveness, in delivering on APRA's regulatory principles. This would be supported by APRA's proposed effectiveness reviews, which, under CBA's remuneration policy, we are committed to conducting at least every two years.

Our detailed response to the draft CPS 511 is set out in Attachment A, and summarised below.

Board oversight

A key foundation of good governance is the clear delineation between the roles of Boards and management. A Board's role is to set the remuneration framework and policy, and determine remuneration outcomes for the CEO and senior direct reports.

For other employees, the Board's role is to oversee the application of the remuneration framework, ensuring management operates within policy and guidelines. This is consistent with APRA's supervisory philosophy founded on the premise that the ultimate responsibility for the prudent management of a financial institution rests with its Board and management. Board oversight should be supported by strong analytics and reporting to provide meaningful insights.

We recommend:

- Remuneration Committees and Boards should be required to assess remuneration on a *collective* rather than an *individual* basis for all employees other than:
    - the CEO and senior direct reports; and
    - any other cohort determined by the RemCo or Board, and
- Boards should approve the methodology for identifying Material Risk Takers (**MRTs**) relevant to their respective businesses which APRA should review in its supervisory capacity.

Variable remuneration design

Subject to meeting the risk gate opener and affordability thresholds, CBA believes in rewarding performance considering both "what" has been achieved and "how" it was achieved, measured through values and risk assessments. Additionally, variable remuneration outcomes must support the financial soundness of the Group, and reflect consideration of all stakeholders, including shareholders, customers, employees and the community.

In assessing what has been achieved, an effective remuneration framework must consider an appropriate balance of financial and non-financial measures. CBA's experience in the application of non-financial measures dates back to 2008 when Customer Satisfaction was first introduced into the long-term variable remuneration plan.

When non-financial measures are understood, robustly designed and can be quantified, they are important lead indicators of sustainable organisational performance and long-term value creation. However, if not designed and implemented effectively, they risk becoming 'soft' and strategically misaligned measures that may create risk, while also reducing performance variability and transparency.

Under a principles-based approach, organisations should demonstrate to APRA how their approach supports their business strategy and cultural priorities, as well as meeting APRA's stated objectives.

We recommend:

- a principles-based approach for Boards to determine appropriate variable remuneration design, including the mix of financial and non-financial performance measures, gateways and modifiers relevant to their organisation. Prescription in this regard will not deliver 'best fit' outcomes for individual organisations. APRA could provide guidance on maximum target weightings of financial metrics across all variable remuneration (for example 75%), with Boards to comply or explain variations;
- APRA allows sufficient time for organisations to develop appropriate and robust non-financial metrics and transition to the new arrangements; and
- providing clear criteria to guide the development of financial and non-financial measures, in relation to individual measures as well as in the context of financial gateways, risk modifiers, remuneration funding, and other similar arrangements.

Deferral, malus and clawback

CBA believes that regulatory guidelines should provide Boards with flexibility to determine deferral periods appropriate and reflective of the organisation's risk profile and maturity, with the Banking Executive Accountability Regime (**BEAR**) providing a foundation. We view the remuneration consequence mechanisms of in-year and malus adjustments to be a more effective risk management tool than clawback.

Significantly longer deferral periods and the threat of clawback will negatively impact our ability to attract and retain the best talent, in particular where skills can easily transfer to unregulated areas within financial services, and other industries or jurisdictions not impacted by equivalent remuneration requirements.

Based on overseas experience, longer deferral periods (e.g. more than four years) will likely serve to diminish the value executives place on variable remuneration and influence a rebalancing towards fixed remuneration. This unintended outcome would undermine the objectives of APRA's proposed regulatory reforms.

By contrast, appropriately designed deferral frameworks, with in-year and malus adjustment mechanisms (e.g. restricted periods) as appropriate, provide effective tools for Boards to lift risk culture and apply appropriate consequences while managing the talent challenges.

We recommend:

- Boards retain discretion to determine appropriate variable remuneration deferral periods and the application of in-year and malus adjustments, with clawback only as a last resort;
- deferral requirements should align with BEAR, with a minimum four-year deferral period and the exemption for small amounts of variable remuneration (*de minimis*) for special category roles;
- for Accountable Person (**AP**) roles only, Boards could determine post vesting restriction periods if appropriate, and APRA could provide guidance on this. For example, up to two year post-vesting restriction periods could apply for AP roles (up to three years for the CEO), with prorata release over that period; and
- transition arrangements, which are essential to responsibly managing the change impacts of longer deferral for both employees and organisations. New deferral requirements should be phased in over a period of at least two years after commencement of CPS 511 on 1 July 2021, to appropriately manage any compensation gap that could provide a window for the departure of senior executives to non-SFI financial services organisations, non-APRA-regulated Fintechs, outside the industry or overseas. Awards granted in relation to performance years prior to the start of CPS 511 should remain unchanged: retrospectively applying the requirements would be unfair to employees and challenging to implement in practice.

Introducing a minimum four year deferral period to special category roles in addition to AP roles will demonstrably strengthen the prudential framework. For CBA, the expansion of BEAR deferrals beyond AP roles would result in a greater portion of variable remuneration requiring deferral and subject to malus for a longer period.

The Group welcomes APRA's proposed reforms to strengthen remuneration governance standards across the Australian financial services industry.

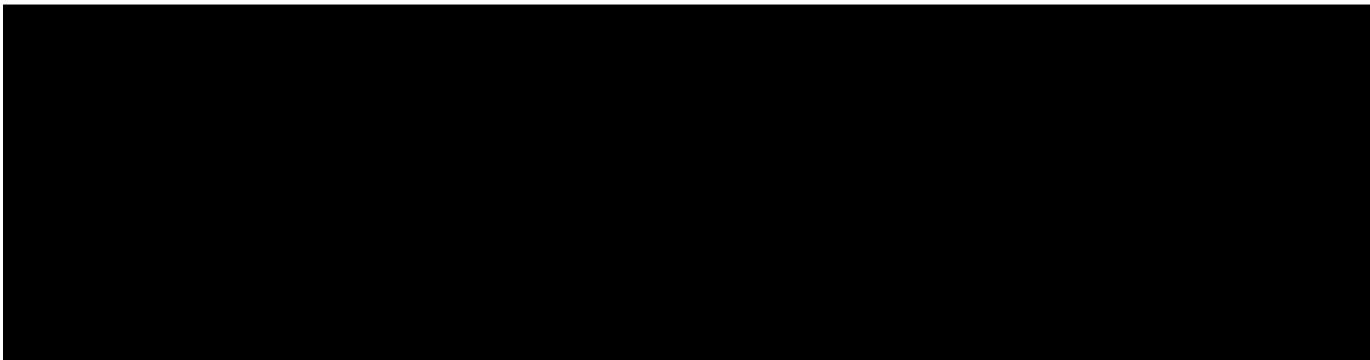
We also recognise and appreciate the challenge of strengthening the prudential framework while appropriately balancing principles that allow sufficient Board flexibility. However, we are of the strong view that Board flexibility in applying APRA's principles is critical to effectively delivering better remuneration governance and outcomes in the context of the ever changing organisational environment, business models and risk profiles across the industry.

APRA should not impose rules that would remove the Board's fundamental ability to attract, retain and motivate senior executives. An approach which is not based on principles and is too prescriptive, with a one-size-fits all approach fixed in time, could well do this.

Further context and rationale for our recommendations are set out in Attachment A. CBA has also contributed to the financial industry response to APRA's CPS 511 by the Australian Bankers' Association (**ABA**).

CBA will be pleased to meet with APRA to discuss any of the points discussed in this submission in more detail.

Yours faithfully



Attachment A

1. Recent developments in CBA's remuneration governance framework

CBA acknowledges that the Group's approach and responsiveness in applying collective and individual consequences for risk issues was not adequate in the past. We understand the need for change in this area, and since 2017 have begun implementing significant changes to our governance and accountability frameworks, and fostering changes to our culture.

These changes were further informed by the RAP and other considerations, including addressing the Sedgwick recommendations, and through feedback loops and insights provided to the Board.

We believe well-designed remuneration can reinforce positive risk behaviours and promote the right balance between commercial outcomes, strong risk-alignment, customer outcomes, and individual and collective accountability.

Consistent with this belief, in recent years CBA has implemented significant enhancements to our remuneration framework, policies and governance, including:

- robust guidance to support setting better individual key performance indicators (**KPIs**), risk milestones and expectations;
- new values expectations and a code of conduct for the bank;
- strong principles and criteria for variable remuneration design, as set out in Table 1 below;
- a new approach to discretionary variable remuneration pool funding which formally assesses collective accountability for risk matters at the Group and Business Unit level;
- a new framework and policy for considering individual accountability for risk and conduct matters and applying in-year and malus adjustments where appropriate;
- implementing Sedgwick recommendations including reducing the maximum weighting of financial metrics to 30% of performance scorecards for all employees and their leaders, with tellers' rewards based solely on customer feedback and leader observations;
- improved Board governance of the Group's remuneration framework by developing more effective coordination between the People and Remuneration Committee (**PRC**), Board Audit Committee (**BAC**) and the Board Risk Committee (**BRC**), as well as integrating Board guidance on risk assessment and short term variable remuneration (**STVR**) reductions in the performance and reward cycle;
- enhanced support for the Board's effective oversight of the remuneration framework through the development of comprehensive analytics and enhanced reporting from management, including demonstrating the link between risk outcomes and remuneration consequence. This in turn supports effective decision making regarding potential changes to performance and reward frameworks, and drives a more thorough evaluation of remuneration policy effectiveness;
- improved rigour and governance of the assessment of risk management for senior leaders through the introduction of executive risk scorecards for three executive levels below the CEO, the development of a consistent set of metrics to support the risk assessment, and the introduction of processes to support greater oversight and challenge by the Risk Management function of risk assessment outcomes across the Group; and
- identification, recognition and reward of positive risk behaviours and outcomes through the implementation of a new risk assessment rating of 'Exceptionally Managed' into the FY19 annual performance review to identify and recognise employees who role model the management of risk. In addition, the introduction of specific communications across the Group of the impact of both good and poor risk outcomes on remuneration reinforces the link between accountability and consequence, and supports a strong risk culture.

Solutions implemented are well aligned with both the intent and form of the draft CPS 511 and have strengthened the link between remuneration, risk and governance processes and outcomes.

Table 1: Key variable remuneration design principles

Variable remuneration plans must:

- comply with legal and regulatory requirements in jurisdictions in which the Group operates, including internal and external governance requirements;
- balance the needs of all stakeholders including our customers, communities, shareholders, employees and the Group;
- balance the achievement of performance outcomes with the way in which those outcomes are achieved (ie. values and risk management), with a maximum weighting of 30% for financial outcomes;
- provide discretion for managers to reduce outcomes, including to zero;
- be governed by appropriate and effective internal controls commensurate with the level of risk;
- exclude design features that could increase inappropriate risk-taking;
- ensure retail customer-facing employees are rewarded on a balance of customer measures and not solely on the sale of product (including referrals);
- have a total aggregate cap and, where applicable, a cap on individual payments; and
- ensure an appropriate ratio of annual variable remuneration to fixed remuneration in line with the Group's job family framework.

These solutions have the overall critical goal of strengthening governance and oversight within the Group, encouraging a proactive approach to risk management and building a more accountable, customer-focused and transparent culture. They also serve to enhance identification and application of consequence of risk matters, better supporting and enabling the responsiveness of current remuneration frameworks, including deferral periods and malus adjustments. Importantly, the changes have also sought to ensure that our remuneration approach recognises and rewards individuals who demonstrate exceptional management of risk and role model our aspirational risk culture and values expectations.

Recent enhancements have resulted in more robust risk assessments across the Group. Figure 1 demonstrates the impact of stronger risk assessments on Executive General Manager (**EGM**) risk ratings over the three years to FY19. For FY19, individual risk ratings of 'Partially Met' resulted in 10%-60% negative STVR adjustments for 46% of the EGM population.

Figure 1 EGM Risk Ratings (FY17 to FY19)

Similarly across the Group, the proportion of employees receiving ratings below 'Fully Met' over this period, was FY17 4.5%, FY18 9% and FY19 12%.

The principles-based approach to recommendations resulting from APRA's Prudential Inquiry, have supported the Group in developing enhancements to our frameworks and processes in a manner appropriate to CBA's business strategy, risk profile and aspirational culture. We discuss the benefits of a principles-based approach in more detail in our responses to APRA's key consultation questions below.

2. Responses to APRA Consultation questions

(a) Board oversight

APRA consultation question:

Are the proposed duties of the Board / RemCo appropriate?

APRA proposes for RemCos to be involved in the oversight and approval of remuneration arrangements for persons in special role categories, including Material Risk Takers (MRTs). In particular, that RemCo individually reviews and makes recommendations to the Board for approval, remuneration arrangements of individual highly-paid MRTs and senior managers.

CBA Response:

CBA believes that the role of the Board is to review and approve the remuneration framework and policy, remuneration outcomes of the CEO and senior direct reports, and oversee and hold management to account for decisions within the context of Board approved frameworks for all other employees. Through effective oversight and feedback loops, the Board's function is to set future policy, frameworks and guidance for the organisation.

The Group's Board and PRC currently undertakes a line-by-line review of remuneration arrangements of direct reports to the CEO, APs and Bank Responsible Persons. Remuneration arrangements include not just base salary and variable remuneration opportunity, but also performance scorecards, variable remuneration outcomes, sign-on or retention awards (if applicable), and the application of malus to deferred equity awards.

The first of the ASX Corporate Governance Council's eight central principles[1] calls for listed entities to *'clearly delineate the respective roles and responsibilities of its Board and management and regularly review their performance.'*

In line with this, Boards should set an organisation's remuneration strategy, frameworks and policy, and then oversee management decisions within those parameters. Line-by-line Board review is appropriate in setting remuneration for the CEO and their direct reports and any other populations determined by the RemCo or Board (e.g. critical roles and talent, significant and/or remuneration outliers).

The mandatory reviewing of other employee groups on a line-by-line basis serves to blur the important delineation of Board and management roles and presents practical challenges given the scheduling limitations of RemCo and Board meetings throughout any given year. Moreover, Boards are not best placed to make judgements deep in the organisation, and it is appropriate for management to do this within Board-approved frameworks, being held to account by the Board (who can request periodic sampling to satisfy itself that the application was working as intended).

In relation to the proposed individual RemCo and Board review of remuneration arrangements of Highly-Paid MRTs, separating MRT roles into two categories by means of a quantitative threshold[2], is unlikely to achieve APRA's intention of an uplift in remuneration governance.

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[1] 'Corporate Governance Principles and Recommendations', ASX Corporate Governance Council, 4th Edition, February 2019.

[2] Definition highly-paid MRT: *'A MRT whose total fixed remuneration plus max, potential variable remuneration is equal or greater than 1 million AUD in a financial year',* draft CPS 511, page 6, definition (f)

A set quantitative threshold will become out-of-date over time, resulting in more roles falling within this category which would be subject to greater Board scrutiny, and longer deferral requirements. However, the quantitative threshold test will not necessarily identify MRTs with a 'more' significant impact on the risk profile of the business. This will also result in an uneven application of Board oversight and differing mandatory deferral requirements among senior managers with similar accountability levels.

Additionally, setting a quantitative threshold based on potential remuneration, rather than actual outcomes, will capture a larger group of individuals whether or not they actually achieve total remuneration of $1 million or more. Of our MRTs with the potential to receive $1 million or more in FY19, only 6% actually received remuneration of that level.

This issue is compounded by the lack of a consistent methodology for identifying MRTs across the financial industry in Australia. This was identified by APRA in the information paper '*Remuneration practices at large financial institutions.*'[3] APRA should provide a clearer definition of MRTs to support a more consistent application across the industry, and Boards should approve the methodology to apply within their organisation, considering the entity's strategy, risk profile and business. The approach to MRT identification should be reviewed by the Board periodically (as selection criteria may change over time), and considered by APRA as part of its enhanced prudential supervisory activities.

CBA acknowledges the importance of identifying all roles that, due to their nature, have the potential to materially impact the organisation's risk profile. We believe that, having regard to the principles of good governance, Boards should approve the methodology for identifying these roles, considering the entity's strategy, risk profile and business model. The Board approved approach to MRT identification should be reviewed by APRA as part of its enhanced prudential supervisory activities.

Following identification of MRTs and determination of their remuneration frameworks by the Board, we proposed that RemCo and Board's oversight comprise an annual collective review of management compliance with approved frameworks, with the review of individual remuneration arrangements and outcomes only as determined by RemCo and Board. A mandatory wider individual 'line-by-line' review blurs the role of Boards/RemCos with that of management and risks being 'form over substance'.

Recommendation 5.3 of the Royal Commission final report[4] is that APRA-regulated entities improve the quality of information being provided to Boards and their Committees. This, in our view, will support RemCos and Boards having access to appropriate information to enable them to set the framework and management guardrails to support effective delivery and oversight of remuneration arrangements across the organisation on a *collective* basis.

RemCo and Board reviews of remuneration on a *collective* basis, should be informed by comprehensive analysis and insights to ensure Directors have sufficient context to understand the application of the remuneration framework and decision-making by management across the organisation, with visibility of any individual exceptions to policy and approved parameters. Collective review should include understanding remuneration in the context of the risk profile for the collective population, performance and cultural indicators, and related insights (e.g.

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[3] APRA's finding was that *"… a variety of approaches to identifying MRTs was observed even amongst entities with similar profiles (size and characteristics). For example, different definitions have been applied to 'significant portion of total remuneration based on performance' including metrics related to the dollar value of variable remuneration and percentages of variable remuneration or of fixed pay. In some cases individuals with very significant remuneration packages were not considered MRTs and there was no analysis provided as to whether their roles could affect the financial soundness of the institution. Given the differences in definitions, the review also found a significant difference in the number of MRTs being identified across the entities (between 6 and 70). This suggests that the MRT identification practice needs to be reviewed for all entities. APRA considered that most institutions in the sample underestimated the extent of MRTs within their organisations that needed to be covered by the remuneration policy.*' Remuneration practices at large financial Institutions, page 24, April 2018.

[4] '*APRA should: … encourage APRA-regulated entities to improve the quality of information being provided to Boards and their committees about risk management performance and remuneration decisions.*'

customer, gender, talent), with key trends and/or segments within the collective population being highlighted (e.g. longitudinal individual risk outcomes, outlier remuneration outcomes).

At any time RemCos and Boards can determine any cohorts for closer review, or to direct future changes to the remuneration framework and policies to address any issues or opportunities systemically over time. From time to time cohorts for closer review may include potential successors for key senior roles, high talent, or outliers and exceptions.

Undertaking regular reviews of the effectiveness of the Group's remuneration policy provides a further opportunity for RemCos and Boards to assess how remuneration arrangements for all employees, including special category roles, encourage sound management of non-financial risks. As an example, Table 2 below provides a high-level summary of the CBA Group Remuneration Policy's effectiveness review criteria as approved by the Board.

*Table 2 – Group Remuneration Policy (**GRP**) effectiveness review criteria*

Focus area	Criteria
Alignment of remuneration policy and frameworks	1. The GRP is compliant with regulatory requirements and guidelines across applicable jurisdictions
	2. The GRP and the remuneration and performance frameworks support the Group and Business Unit strategies and requirements
	3. Remuneration and performance frameworks are aligned with the GRP principles
	4. The GRP provides a clear and complete link to associated standards, guidance, and/or policies
Use and application in the business	1. Remuneration levels are in line with the GRP, are equitable, and appropriate to attract, retain and motivate across the Group
	2. The Group's strategic categories (KPIs) are, as appropriate, cascaded throughout the organisation and applied
	3. STVR outcomes are in line with business objectives and performance
	4. The remuneration and performance frameworks encourage sound risk management, including management of non-financial risk and misconduct
	5. Remuneration arrangements and performance frameworks are clearly communicated to and accessible by employees to guide and support understanding, and messages are aligned with GRP intent
Culture and behaviour	1. Employee perceptions are aligned with the intentions of remuneration arrangements and performance frameworks
	2. The remuneration and performance frameworks support appropriate risk and values expectations and a positive impact on culture

(b) Variable remuneration design

APRA consultation question:

Are the proposed limits on financial performance measures appropriate?

APRA proposes to set both overarching as well as individual weighting limits on the use of non-risk adjusted financial metrics in the variable remuneration components of all employees within an APRA-regulated entity.

CBA Response:

CBA believes in rewarding performance considering both "what" has been achieved (including using financial measures in a balanced scorecard) as well as "how" the outcome has been achieved through values and risk assessments. An effective remuneration framework must balance financial and non-financial measures that adequately reflect and foster sustainable performance, both in the short-term as well over an extended time horizon. It must also support the financial strength of the organisation and align shareholder experience, through performance orientation and being fiscally responsible.

A prescriptive approach to determining the mix of financial and non-financial performance measures may force a simple scorecard approach and hinder companies tailoring remuneration design to reflect their unique circumstances, while diminishing other important determinants of

variable remuneration outcomes (e.g. funding models, gateways). A formulaic approach may also risk undermining the mature risk culture we are working towards, through reducing leader discretion and judgment in assessing performance, behavior and risk.

While CBA supports APRA's intent of defining an 'optimal split' of performance metrics, we believe there is no optimal, one-size-fits-all approach, and that a less prescriptive and more principles-based approach would be more effective. This also recognises Boards are best placed to determine the appropriate mix of measures that support the culture, performance orientation, and remuneration model of the organisation. Given the wide range of variable remuneration frameworks across the financial services industry, and even within individual organisations, a prescriptive approach will be challenging to apply in practice.

Commissioner Hayne points out in the Royal Commission's final Report the challenges associated with prescription, and that an '*ideal*' or '*optimal*' remuneration system doesn't exist in practice, and, as such, '…*there are limits to what can or should be regulated or prescribed.*'[5]

A principles-based approach to the use of financial and non-financial performance metrics will provide Boards with the flexibility to consider the interests of different stakeholder groups in setting measures, and flexibility to ensure differentiation of variable remuneration outcomes in line with those measures. Proxy advisers and shareholder groups have a stated preference for a higher weighting of financial measures and may not trust non-financial measures, whereas other stakeholders may prefer a greater weighting on non-financial measures (e.g. Recommendation 13b of Sedgwick's report). In particular, shareholders' expectations appear to have not been given sufficient consideration in APRA's proposed approach.

CBA's current approach for measuring performance reflects a balance between both the 'what' results are achieved (*KPIs across a range of categories*) and 'how' these results are achieved (*values and individual risk assessment*).

Through the combination of CBA's performance framework and our approach to determining STVR pool funding, an individual employee's STVR outcome ultimately reflects a combination of Group, business unit, team and individual performance. Individual performance and values outcomes equally determine the applicable individual STVR outcome within the funding range.

STVR outcomes are therefore a result of an equally weighted assessment of demonstrated values and KPI performance (financial and non-financial, weighted 30% maximum and minimum 70% respectively at target), adjusted based on the individual risk assessment over the relevant performance period (adjustment range 0%-100% depending on the risk assessment outcome). For Senior Executives, the values assessment, in addition to risk, serves as a gateway to achieving variable remuneration outcomes.

In this context, the financial measures in the performance KPIs reflect just one performance dimension within the overall framework, with risk (and values for Senior Executives) as a gateway for all employees having an effective weighting of 100%. We believe that this approach sends a strong and clear message to individuals regarding the paramount important of non-financial measures (risk and values) in the overall performance and remuneration framework.

To support Boards in determining the appropriate mix of measures, APRA could provide guidance on maximum weightings of financial metrics across all target variable remuneration (for example 75%). This approach aligns with APRA's broad intent and goes further than the Royal Commission recommendation to limit financial metrics in connection with just LTVR. In comparison with APRA's proposal, this approach would also provide greater flexibility for organisations to determine the appropriate application across their short-term and long-term variable remuneration arrangements across the industry and within organisations. We note that

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[5] The full quote reads as follows: '*But there being no agreed 'ideal' or 'optimal' remuneration system, there are limits to what can or should be regulated or prescribed. And it must be recognised and accepted that it may never be possible to identify a single 'ideal' or 'optimal' system. As the FSB said in its Principles, 'financial firms differ in goals, activities and culture, as do jobs within a firm'. One size does not fit all.*' Final Report Royal Commission into misconduct in the Banking, Superannuation and Financial Services Industry, page 350, Experimentation in the design of remuneration systems

governing effective rather than target weightings is challenging due to the mechanics of remuneration, including the application of discretion.

A principles-based approach would better support the application of financial and non-financial measures over time horizons appropriate for individual organisations, and with consideration of the availability of robust target setting and measurement methodologies (particularly in the case of non-financial measures where this is more challenging).

With regard to financial and non-financial performance measures, more guidance is sought from APRA with regard to how metrics and plan mechanics will be categorised and treated within the overall remuneration framework, and the specific criteria to define these measures. Some examples of the practical interplay between performance measures and remuneration framework mechanics, and clarity of definition include:

- Gateways and modifiers
  Example: CBA's LTVR for the CEO and Group Executives has two non-financial measures (*'Trust and Reputation' and 'Employee Engagement'*) weighted at 25% in total, and underpinned by a financial gateway (*positive relative Total Shareholder Return (TSR)*). Given the interaction between the non-financial and financial measures in this scenario, clarity is required as to whether such combined performance measures are to be regarded as financial or non-financial overall. Would CBA's LTVR be categorised as 100% *financial* given the gateway, or would the gateway be effectively ignored or discounted? If the former, this would diminish the positive intent of the LTVR of balancing the importance of non-financial objectives while supporting shareholder alignment.

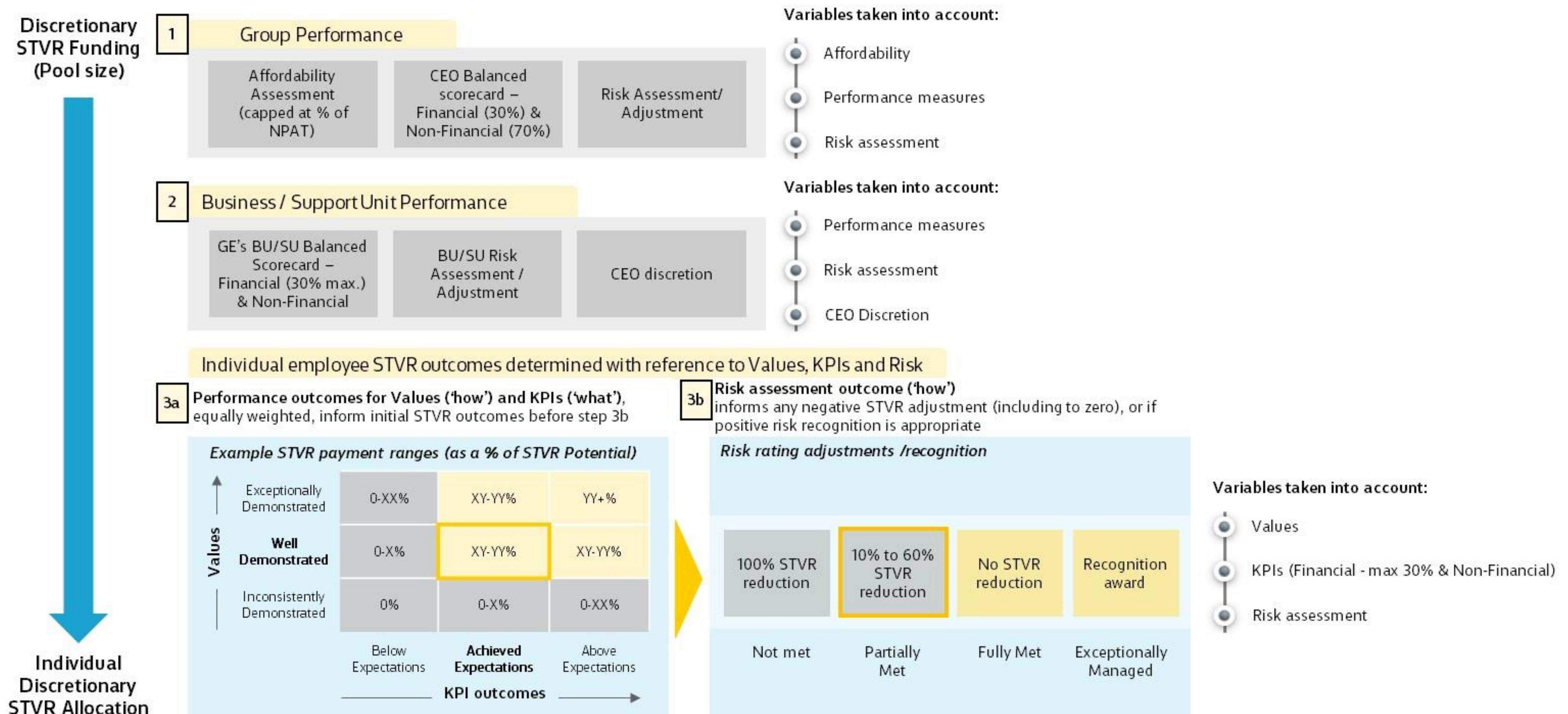
- Pool funding models
  Example: Determination of variable remuneration pools often considers financial performance and/or an affordability overlay. CBA's discretionary STVR pool is determined with reference to both financial and non-financial performance, an assessment of risk, and a financial affordability cap. Further clarity is sought regarding how such financial affordability caps or modifiers impact the balance of financial and non-financial measures used to determine variable remuneration funding.

- Total Shareholder Return (TSR)

  Example: Assigning some measures as financial, risk adjusted, or non-financial without further criteria from APRA may be problematic. Research by PwC and others questions whether TSR is simply a measure of financial performance. While some view TSR as a financial measure given it calculates the value generated for investors, TSR also reflects the market's perception of performance and risk which is also subject to extraneous impacts such as environmental, social & governance issues. Issues driving these impacts can arise anywhere in an organisation, and be impacted by external factors, and therefore cannot be solely attributed to executive performance. PwC concludes that "whilst short-term financial performance will clearly impact the TSR performance, other broader factors … can also significantly impact the share price even if there is no immediate impact on financial results. In this sense, TSR should not be seen as a pure measure of short-term financial performance in the same way as Earnings Per Share (**EPS**) or profit, but also as a metric that considers the market's confidence in the company's longer-term performance and its ability to avoid behaviours that ultimately jeopardise the company's long time viability." In this context it is understandable that executives do not value highly, remuneration which is subject to TSR performance.

We believe that our current approach (detailed in Figure 2 below) is aligned with APRA's stated principle that performance and remuneration models must achieve a balance of outcomes relating to effective risk management, sustainable performance and long-term soundness. The manner in which this alignment is achieved through CBA's approach to remuneration funding and allocation (including gateways) may be deemed to not fully align with the proposed prescriptive standards, despite the underlying intention.

Figure 2 - CBA Discretionary STVR Funding and Determining Individual Outcomes



A transition period will be important to provide organisations sufficient time to develop relevant and robust non-financial measures and targets that can be reliably assessed over an extended time horizon. As APRA notes, non-financial performance measures can be difficult to measure reliably and objectively, particularly in long term variable remuneration arrangements where the measurement period can be up to four years. The transition period will also allow time to ensure a multi-year gap in pay is not created, that could provide a window for employees to leave or be actively poached.

We note that, an overly prescriptive approach can create a higher risk of unintentional outcomes and potentially higher payments where there is low maturity in identifying and setting non-financial measures across the industry.

Our proposal takes this into account by reducing the level of prescription while requiring organisations to explain how they have determined the most appropriate approach to rewarding and measuring non-financial outcomes. APRA's intent to enhance disclosure and provide greater transparency of approaches and outliers within the industry may also act to drive greater use of non-financial measures.

(c) Variable remuneration design & remuneration outcomes

APRA consultation questions:

What would be the impact of the proposed deferral and vesting requirements for SFIs? What practical hurdles are there to the effective use of clawback provisions and how could these be overcome?

Draft CPS 511 prescribes variable remuneration deferral periods as well as malus and clawback mechanisms in SFIs for Chief Executive Officers, senior managers and Highly Paid MRTs.

CBA Response:

CBA believes that regulation should provide Boards flexibility to determine deferral periods using the BEAR as a foundation and taking into account their respective strategies and time horizon for measuring risks. Further, the Group believes that Boards should retain discretion to determine the appropriate remuneration consequence mechanisms, such as in-year adjustments to current-year STVR, and/or malus adjustments to (four-year) deferred awards. The Board's approach would consider the particular circumstances, supported by a comprehensive remuneration adjustment framework and associated process. We view the remuneration consequence mechanisms of in-year and malus to be a more effective risk management tool than clawback for the reasons set out below.

CBA agrees that many types of risk materialise over an extended time horizon, and that a sound remuneration framework should provide adequate tools and flexibility to adjust remuneration outcomes proportionally as appropriate where these risk and performance outcomes later come to light.

FSB's supplementary guidance to the Principles and Standards for Sound Compensation Practices (supplementary guidance) states that there are three commonly used tools to adjust variable compensation that has been awarded or paid, namely: (ex-ante) in-year adjustments as well as ex-post -malus or clawback adjustments. However, the supplementary guidance also notes that '*it is for firms to determine which tool is most appropriate for the specific circumstance. Consistent with the Principles, at a minimum, compensation outcomes should be symmetric with risk outcomes.*'[6]

[6] FSB supplementary guidance to the Principles and Standards for Sound Compensation Practices, recommendation 6, page 7, March 2018.

While CBA acknowledges APRA's preference for longer deferral periods for CEOs and special role categories, there is a concern that longer deferral and clawback periods will significantly disadvantage SFIs in their ability to attract and retain talent. The industry operates in a global market, with new disruptive competitors, where the critical skills and experience of senior executives are at a premium and easily transferable across industries and geographies without prescribed long deferral and clawback periods.

In-year STVR adjustments and malus adjustments to deferred awards are the most effective mechanisms for applying remuneration consequences for risk management outcomes. The development of the Group's policies and procedures provides a framework where remuneration consequences are applied consistently, fairly and appropriately where a serious risk, misconduct or other prescribed malus event has occurred, irrespective of whether or not the awards relate to the period in which the risk or misconduct event occurred.

The policy also provides flexibility to apply an appropriate adjustment at any time through malus as well as in-year variable remuneration adjustment where required (for instance in circumstances where insufficient deferred remuneration is available). The events that may result in a malus adjustment include:

- issues with material customer and/or shareholder impact (e.g. share price);
- a significant and/or systemic incident, issue or event with financial/reputational impact;
- regulatory intervention (e.g. legal action, license conditions);
- material restatement of the Group's financial statements;
- serious risk issues;
- misconduct or serious misconduct issues; and
- any other circumstance where the Board determines that all or part of the variable reward was not justified.

When determining a remuneration consequence under our framework, consideration is given to the nature and severity of the risk or misconduct event and the total value of the variable remuneration (cash and equity) relating to the period of the serious risk or misconduct event. Through the deferral framework, executives build a cache of deferred awards over time which, along with the ability to adjust in-year variable remuneration for risk or misconduct events, should usually be sufficient to apply a proportionate and meaningful consequence where required.

Figure 3 demonstrates how deferred variable remuneration tranches build over time giving senior employees '*skin in the game'* over the longer term, including the vesting period and subsequent holding lock periods. This shows how a malus framework allows for adjustments even if relevant issues arise over multiple performance periods.

In the example in Figure 3, if a remuneration consequence were determined for an executive in FY22, the Board could determine to apply an in-year adjustment to current year STVR (up to $200,000) and/or a malus adjustment to deferred equity awards held at that point in time (up to $240,000, noting the value of this award would vary with the share price). Even in the event that a risk matters originating in FY20 was not identified until FY26, at this point the Board would be still be able to apply an in-year STVR adjustment of up to $200,000 and would have deferred awards of up to $440,000 (or 240% of variable remuneration value) on which malus could be applied.

Approach to deferral periods and the application of malus and clawback

With consideration of the significant talent attraction and retention barriers, the adoption of the four-year BEAR deferral period to a broader population of special roles can achieve APRA's objectives, if supported by improvements in the identification of risk matters requiring adjustment of variable and deferred remuneration. In addition, the Board of each entity would then be able to determine any additional deferral or holding period to be applied as appropriate.

This approach will also give Boards the flexibility to determine more complex arrangements, including longer pro-rata vesting for special category roles or other roles, depending on their respective strategies, time horizon for measuring risks and consideration of talent risks. An

additional benefit may be the prevention of future rebalancing of variable to fixed remuneration, which is not in line with the intent of the reforms.

If it is determined that the CEO and other AP roles are required to be subject to malus beyond the four year vesting period, post-vesting restriction periods (holding locks) could be used with pro-rata release, for example, over up to three years post-vesting for the CEO, and up to two years post-vesting for other AP roles. Under this approach, awards would vest but remain subject to malus until released, but they would not be subject to service conditions.

In the case of good leavers, although the level of deferred awards on foot decreases over time after their exit, so too the likelihood reduces that a material risk issue emerges that has not been identified through enhanced risk management governance and processes. With the development of robust risk identification and management, as evidenced previously in Figure 1, issues are identified earlier, allowing for in-year and malus adjustments. Additionally, awards can be, and at CBA are, put on hold pending the outcome of investigations and determination of accountability. We have made significant investments in improving risk monitoring, reporting and the identification of individual and collective accountability for material risk matters.

These improvements mean clawback should only ever be considered as a last resort, particularly in the context of the lack of supporting legislation. We note the different sets of criteria for application of malus and clawback set out in the draft standard suggests that for particular events, clawback must be used as the risk adjustment mechanism instead of malus or in-period adjustments. This limits the flexibility for the Board and RemCo to determine the most appropriate adjustment mechanisms when such events occur. In our experience, in-year and/or malus adjustments can be implemented more effectively than clawback.

Our position is that clawback should be limited to instances such as gross personal misconduct or fraud. We note that even if positioned as a last resort, and operating within a limited scope, the adoption of clawback will significantly reduce the perceived value of remuneration offers and increase executive talent attraction and retention risks for the vast majority of executives to which clawback would likely never be applied.

Following the rationale under the BEAR, CBA believes the exemption for small amounts of variable remuneration or *de minimis* provision included in paragraph 55 of CPS 511 should align with the current BEAR threshold (i.e. four year BEAR-aligned deferral only where amount of the variable remuneration that would be required to be deferred is $50,000 or more). In circumstances where the *de minimis* exception applies, the Group's standard deferral arrangements would apply.

CBA is supportive of the proportion of variable remuneration proposed to be deferred under CPS 511. The group's current approach for CEO and Group Executives (excluding the Group CRO) provides approximately three-quarters of target remuneration as variable and at-risk, from which 61% is deferred (over one and two years for STVR and four years for the LTVR component). For most other executives (that are not APs), one-third of the STVR award is deferred and delivered in equity that vest in equal tranches over three years. All deferred STVR awards are subject to a risk review prior to vesting.

Regardless of the approach to be implemented, CBA requests that APRA allow businesses sufficient time to transition to the new mandatory deferral requirements to provide employees with adequate time to manage the personal implications of the extended deferral period. We understand from the discussion paper that the deferral periods applicable to variable remuneration on foot at the commencement of CPS 511 are not intended to be impacted, and we support that approach.

Figure 3 – Example deferral and restriction period

Total Annual Variable Remuneration (VR): $200,000 (for illustrative purposes, assumes same VR each year)