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Submission – APRA's Discussion paper on strengthening prudential requirements for remuneration

CGI Glass Lewis Pty. Limited ("CGI Glass Lewis") appreciates the opportunity to comment on the Discussion Paper: Strengthening prudential requirements for remuneration ("Discussion Paper") by the Australian Prudential Regulation Authority ("APRA").

CGI Glass Lewis has been providing in-depth proxy research and analysis on ASX-listed companies from its Sydney headquarters since 1994, and is a subsidiary of Glass, Lewis & Co. ("Glass Lewis"), a leading independent governance services firm that provides proxy voting research and recommendations to a global client base of over 1,300 institutional investors that collectively manage more than US$25 trillion in assets.

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Our comments herein only related to listed ADIs and general and life insurers; we refrain from making any comments on RSE licensees or unlisted entities.

Thank you in advance for your consideration and please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail.

Respectfully submitted,

[redacted]

Board oversight

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

In principle, we appreciate APRA's intentions by proposing to increase board and board remuneration committee responsibility, involvement and oversight of remuneration frameworks and arrangements.

In practice, we have two key concerns with these proposals. The first relates to time. The additional time commitment required for directors to sufficiently discharge their duties in this regard may crowd out their ability to provide proper oversight over other areas. By contrast, if directors would be required to devote more time overall to their duties at ADIs and general and life insurers so as to sustain existing attention on other areas, they would need to re-evaluate their external commitments to ensure their professional workload remains manageable. Additionally, we would expect directors to be sufficiently remunerated for the additional time commitments, which would result in higher directors' fees.

The second concern relates to the line between non-executive director and executive roles. We believe that the role of the board and the role of the executive team should be distinct and complementary, with the board focused on governance, oversight and executive accountability, and the executive team focused on design and execution. We believe the proposed duties of the Board and Board Remuneration Committee run the risk of materially blurring the line between the board and the executive team. We are not convinced that this would result in effective segregation of duties.

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?

NB: We interpret the first sentence to be consistent with the key proposed change as stated in page 7 of the Discussion paper, which reads "Financial measures limited to 50 per cent and individually capped at 25 per cent".

We recognise that some of the misconduct highlighted in the Royal Commission was attributable in part to an excessive focus on financial performance. Additionally, we appreciate Commissioner Hayne's recommendation that "APRA should set limits on the use of financial metrics in connection with long-term variable remuneration"[1] was made in that context. In principle, we agree that a singular focus on financial performance in remuneration may increase the risk of misconduct or conduct that is otherwise disadvantageous to stakeholders other than the recipient of that remuneration.

That said, we note that much of the poor pay practices identified in the Royal Commission related to sales commissions and other short-term incentives. APRA's proposed changes does not appear to

[1] https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf, page 357.

make a distinction between short-term and long-term incentives as they relate to the risks of using financial metrics. We believe there is value is measuring financial performance over longer time horizons, as conduct risk is likely to manifest over a longer time horizon.

Additionally, we believe that the devil is in the details when it comes to remuneration scheme design. We have seen instances within and without the financial services industry of boards and executives setting inappropriate performance measures, or setting appropriate measures but soft targets, or switching performance measures from one year to the next that would likely result in more favourable outcomes for recipients. We have also seen instances where management have gamed performance outcomes for the purposes of increasing vesting outcomes, and where boards have not exercised enough discipline in pushing back against management. None of these risks is unique to the use of non-financial metrics—some of the worst behaviour we have seen is in relation to the gaming of financial metrics. Indeed, the risk of gaming is why many shareholders prefer measures such as relative total shareholder return ("RTSR"), as it is considered the "least-worst" option and least susceptible to manipulation.

We would like to examine is the different types of non-financial metrics that could be used in variable remuneration schemes. For example, we would generally be supportive of SFIs integrating risk management directly into remuneration schemes, given that risk management is a fundamental requirement (and ought to be a fundamental competence) of SFIs. A starting point as a performance framework could be the institution's risk register. Presumably most risks on the would be well defined and well documented, with monitoring, review and prioritisation capabilities embedded into the risk management process. Material breaches or consistently elevated risk levels could result in boards or executives withholding remuneration outcomes for employees in whose remit those infringements occur.

Additionally, we would be largely supportive of conduct-related measures being more forcefully integrated into remuneration schemes. Conduct and consequences management is a key human resources function, and it would appear that ADIs and general and life insurers would be able to incorporate this function into determining remuneration outcomes, to the extent that they don't do so already. That said, we believe that conduct-related performance would be best suited as a downward modifier or as a gate before which any variable remuneration could be paid. In other words, we do not think it is appropriate to pay employees extra for merely being in compliance with the organisation's code of conduct.

We also believe there is a role for service quality/customer complaint-related performance metrics. Metrics related to complaints can be relatively objective, including number of complaints, timing of response, timing of resolution, percentage of complaints that are escalated to the Australian Financial Complaints Authority, etc. Measuring relative performance against such metrics on a longitudinal basis could be a prudent approach to incorporate this measure into remuneration schemes. However, we question whether employees should receive extra rewards for reducing or remediating complaints and posit instead that this measure be used as a downward modifier.

By contrast, employee engagement, customer/stakeholder satisfaction, customer loyalty, brand and reputation, net trust score, innovation, cross-bank collaboration, culture, and leadership/effective management/teamwork-related performance indicators are frequently highly subjective. With respect to surveys, these can generate substantively different outcomes depending on timing, questions that are asked, and incentives provided to respondents. For example, with Net Promoter Scores, we have seen boards approve changes to methodologies from year to year that have had the explicit impact of substantially increasing vesting outcomes for executives, without any material change in underlying performance. For other measures, we find it challenging to conceptualise how rigorous, meaningful targets could be set at the beginning of the year.

In additional the concerns regarding the selection of and measurement of performance against non-financial metrics, our other material concern with the use of many non-financial metrics is the lack of meaningful disclosure of performance targets, even on a retrospective basis, as well as the company and/or executive's performance against those targets. In other words, for outsiders including shareholders, in many instances vesting outcomes for non-financial metrics is a black box, and a black box that results in near or at-target vesting more frequently than not. Shareholders simply cannot tell how rigorous the targets are. More comprehensive disclosure of the targets, as well as meaningful disclosure on how the board determined vesting outcomes, could help to build acceptance of a greater reliance on such metrics.

More broadly, whilst we believe that there is a role for non-financial metrics in remuneration schemes at ADIs and general and life insurers, we consider it imprudent for plan participants to be incentivised to focus on one set of incentives or metrics at the expense of another. In other words, whilst we've clearly seen the negative impacts of a singular focus on financial performance, we are wary of the potential negative impacts of a singular focus on non-financial performance. With this in mind, we would be highly supportive of using non-financial performance as a gateway or otherwise downward modifier of vesting outcomes relating to financial or RTSR performance. Conversely, we would offer qualified support for the use of financial or RTSR underpins for determining outcomes relating to non-financial performance.

What would be the impacts of the proposed deferral and vesting requirements for SFIs?

We are largely supportive of the proposed deferral and vesting requirements for SFIs.
The proposed deferral and vesting requirements for SFIs will decrease the present value of most remuneration packages for affected employees at SFIs, if no changes are otherwise made to the parameters of these packages. This could result in affected individuals to lobby for increases in the nominal or "face" value of at-target remuneration levels or, alternatively, a watering down of performance hurdles to reduce the risk of forfeiture. However, there is little appetite in the investment community, let alone broader society, for either alternatives as it relates to highly paid executives. As a result, the practical impact of the proposed deferral and vesting requirements will be a cram-down of pay levels.

Given that the financial services industry in Australia tends to have higher pay levels than other industries, we suspect that this cram-down may have spill-over effects in other industries where there are the equivalent of highly paid material risk takers. More likely, the proposed deferral and vesting requirements will cascade through large-cap ASX-listed companies.

Another impact for APRA to consider is that these changes may result in a material portion of a highly paid material risk taker's personal financial wealth being tied to the performance of their current or former employer. Such a portfolio would not be considered well diversified or efficient and may impact the highly paid material risk taker's behaviour and risk appetite as it relates to their work activities.

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

It is possible that the proposals could provide a drag on the financial services industry's capacity to attract skilled executives and staff, by making the industry less competitive from a comparative remuneration perspective. However, we believe this risk is overstated for several reasons. First, we do not believe the real haircut in expected pay levels will be sufficiently material as to deter would-be highly paid material risk takers from seeking or retaining employment in the industry. Many such individuals have highly specialised skills that likely would not be as marketable or remunerative outside the financial services industry. Second, remuneration levels in the financial services industry in Australia are already lower than in some other high-paying markets (e.g. the United States), and anecdotal evidence suggests that many financial services professionals opt to move to Australia (or stay in-market) for lifestyle reasons, rather than to maximise pay. Third, whilst the financial services industry is increasing competing for talent with other industry, primarily IT, we believe the prestige and stability of the industry will help the industry retain talent, especially when the economic cycle eventually turns and the attraction of tech start-ups loses its lustre.

On a final note, we respectfully assert that the industry might produce better outcomes for stakeholders overall if those highly paid material risk takers who are primarily extrinsically motivated (that is, motivated primarily by their personal financial bottom line) subsequently leave the industry as a result of the proposed changes.

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?

As the evidence presented at the Royal Commission indicates, misconduct can be ignored or hidden for months and years – such as the fees for no service scandals at a number of institutions, which started around a decade ago.

Acknowledging that misconduct may only be revealed over longer time periods, remuneration structures need to have effective malus and clawback mechanisms as well as deferral arrangements that appropriately disincentivise executives and other staff from failing to behave appropriately. The Banking Executive Accountability Regime ("BEAR") has set vesting periods for long-term incentives at four years. Given the length of time some of the misconduct remained "under the rug", we believe that for malus and clawback arrangements to be effective at dealing with misconduct, deferral/vesting arrangements must be pushed back significantly further than four years.

The Investment Association in the UK has also taken note of malus and clawback provisions.[2] We agree with their views that malus and clawback provisions need to be broadened to include additional triggers beyond 'gross misconduct' or 'misstatement of financial results' to enhance their effectiveness for discouraging the behaviour discussed by the Royal Commission.

As mentioned above, we are largely supportive of the proposed deferral and vesting requirements for SFIs. Deferral mechanisms give boards much more flexibility to dial down or take away variable remuneration because the ownership of the remuneration vehicle, with it be cash or securities, has not yet been transferred to the recipient. By contrast, clawback mechanisms are often difficult to

[2] https://www.theia.org/media/press-releases/high-pay-under-fire-toughened-investor-rules

enforce because the transfer of ownership, high legal costs, and possibility that the assets are not recoverable (i.e. the recipient has already spent the money).

It may be worth exploring whether there are remuneration instrument that, once vested, provide the economic benefits of owning securities to the recipient (i.e. access to distributions and exposure to capital growth) without the actual transfer of ownership of securities to the recipient. Such an instrument could then be subject to malus post-vesting for a defined period before then converting to the SFI’s securities or cash equivalent.

In lieu of such an option, we would consider supporting longer vesting requirements to address the structural shortcomings of clawbacks. At the same time, longer vesting requirements would further reduce the real present value of remuneration opportunities for highly paid material risk takers. Boards would need to hold firm if they want to avoid creeping remuneration levels as a result.