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General Manager
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By email: PolicyDevelopment@apra.gov.au

Dear Sir/Madam

Re: Draft Prudential Standard CPS 511 Remuneration

Thank you for the opportunity to comment on APRA's draft Prudential Standard CPS 511 ("the draft Standard") regarding the remuneration arrangements of APRA-regulated entities.

The Challenger Board considers that the active oversight of executive remuneration is critical to attracting and retaining the most appropriate intellectual capital required to manage a complex business like ours. We support a standard that provides a clear, principles-based framework to guide the Board's approach. If the standard is overly prescriptive, this could have the effect of diminishing the Board's ability to set and implement remuneration practices appropriate to the business and in the best interests of all stakeholders.

In our submission (Appendix A), we have focussed on key areas in which there are opportunities to refine the final standard, to ensure it can be applied effectively to achieve its aims. In particular:

- The standard seeks to ensure a strong focus on prudent risk management. This submission sets out how this can be achieved through the application of a risk gate-opener for variable remuneration. In practice, the proposed extended deferral provides a sufficient opportunity for the Board to lapse executive rewards if risk or conduct issues emerge, which should negate the need for separate non-financial measures in long term incentives.
- The remuneration arrangements and quantum for employees designated as senior managers may vary significantly between individuals. Consequently, application of a single deferral requirement could create inequitable outcomes for employees. A progressive scale that considers proportionality of remuneration components could address this while achieving the intent of the standard.

We would welcome the opportunity to meet with you to discuss key elements of the draft Standard and elaborate on our submission. Please do not hesitate to contact either of us or Michelle Taylor, Chief Executive People, Corporate Affairs and Sustainability (michelletaylor@challenger.com.au), should you wish to discuss this further.

Yours sincerely

[redacted]

Appendix A

Challenger's focus on risk

The Board views the determination and governance of executive remuneration as a core responsibility. Over many years it has set and applied a remuneration framework and supporting management practices underpinned by a strong focus on risk management and shareholder alignment.

The Board assesses the performance of executives by first reviewing risk outcomes as a gate-opener. This review is undertaken with input from the Board Risk Committee and Chief Risk Officer. The Board then considers performance against a balanced scorecard of financial and non-financial key performance indicators (KPIs), equally weighted with an assessment of behaviours (including risk). Having undertaken this thorough review, the Board then uses its discretion to determine the appropriate variable reward outcome for each executive. This discretionary overlay ensures that there are no unintended consequences which may arise where the assessment of performance is formulaic.

Risk behaviour is a key element of all employee performance assessments and is a gate-opener for participation in Challenger's variable remuneration plans. The consideration of risk extends beyond the determination and allocation of remuneration generally. Consequently, deferred and longer-term remuneration is subject to ongoing forfeiture provisions which are tied to the financial soundness of Challenger and our agreed risk appetite.

Proposed limits on financial performance measures

Clause 38

For any variable remuneration arrangement of an APRA-regulated entity, financial performance measures must not comprise more than 50 per cent of total measures used to allocate variable remuneration. Each individual financial performance measure must not comprise more than 25 per cent of total measures. Financial performance measures include but are not limited to:

(a) revenue, profit and volume based measures;

(b) share-based measures that reflect changes in the value of shares and dividends paid or the return on the number of shares issued; and

excludes risk-adjusted measures and an RSE licensee's investment return measures.

Challenger has adopted an approach that provides flexibility to set and manage performance measures for variable remuneration across a range of financial and non-financial factors. This enables the Board and company to respond to changes in the economic environment and strategic priorities.

The two components of variable reward are short term incentives and long term incentives. We will discuss these separately as they serve distinct purposes and operate differently. Short term incentives are designed to reward performance in the twelve (12) month period before they are awarded. Long term incentives are designed to reward future performance.

Short term incentives

Our current approach, at both a company level and in evaluating individual outcomes, is based on a broad range of financial and non-financial considerations and is consistent with the policy intent of the draft Standard. Importantly, as noted earlier the company incorporates risk as a mandatory non-financial gate-opener for participation in any variable remuneration plan.

Challenger recognises that the intent of the Standard is to ensure that performance assessment and reward outcomes are not overly weighted to financial outcomes. Challenger's existing approach achieves this through:

- the use of risk behaviour as a gate-opener, which ensures employees are not rewarded for financial outcomes that are achieved through poor risk behaviours;
- utilisation of a performance framework that explicitly assesses non-financial and financial performance, with the ability to apply overall discretion to achieve the desired balance; and
- assessment of performance that equally weights KPIs[1] and behaviours, to ensure that financial measures do not take precedence in determining reward outcomes.

Challenger is concerned that the draft Standard prescribes both the type and relative weighting of performance measures. This level of prescription would inhibit the Board's ability to select and assess the appropriate measures. Currently our Board makes this assessment having regard to the company's risk appetite, stakeholder expectations, operating environment, financial objectives and accountabilities of each individual role. Reducing Board discretion is inconsistent with the policy intent of the draft Standard and the recommendations of the Royal Commission. In particular it limits the ability for Boards to ensure that company performance and reward systems are appropriately aligned and usurps a key requirement of the draft Standard that: "the Board of an APRA-regulated entity is responsible for the remuneration framework and its effective application".[2]

It is Challenger's view that the equal weighting of behaviours and KPIs in the current framework ensures that no single measure or group of measures (financial or non-financial) exert disproportionate influence on the overall outcome. When combined with the discretionary overlay that the Board exercises within our current performance and remuneration framework, it achieves the intent of the draft Standard.

Illustrative example
The simple example below, demonstrates the impact that the assessment of behaviours has on the overall performance assessment of an individual which in turn informs variable remuneration determination.

Measure	Categorisation	Weight	Individual A performance outcome	Individual B performance outcome
Financial	Financial	50%	Exceeds objectives	Meets objectives
Risk and culture	Non-financial	25%	Meets objectives	Meets objectives
Customer and strategic initiatives	Non-financial	25%	Meets objectives	Exceeds objectives
KPI assessment			Exceeds objectives	Meets objectives
Behaviours			Mostly[3]	Role model[4]
Overall assessment			Meets expectations	Exceeds expectations
Risk gate-opener			Met	Met

In the example:
- Individuals A and B are peers in the same role with the same objectives;
- Individual A has been assessed to have exceeded the set objectives (KPIs), while Individual B has met them; and

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[1] KPIs include a mix of financial and non-financial measures that vary according to role. For some employees the majority of their KPIs are financial measures.
[2] Draft Standard CPS 511 page 1
[3] Mostly displays the Challenger Principles in action (for FY20 Challenger has introduced new values which will be used in performance assessments – see attachment 1).
[4] An excellent example of the Challenger Principles in action and a role model for others.

- Individual B has been assessed as a role model of the Challenger behaviours which when considered along with achievement against the KPIs has elevated the overall assessment to exceeding expectations. In contrast Individual A, has been assessed as not consistently displaying the Challenger behaviours and the overall assessment has been adjusted downwards.

Consequently, although both individuals have met the Risk gate-opener for participation in Challenger's variable remuneration plans, the superior overall assessment for Individual B will result in a materially[5] greater variable reward outcome than Individual A will receive. This demonstrates the inherent balance in Challenger's current framework of financial and non-financial performance measures and behaviours.

If APRA would like to explore this further, we would be happy to provide de-identified examples where poor risk behaviours have resulted in nil or substantially reduced variable reward outcomes.

Long term incentives

Given these awards will only vest in the future if performance conditions are achieved, it is important for employees that the measures used are well defined, to some extent within their control, and are able to be consistently and reliably measured and reported. This is currently achieved using a shareholder return measure, recognising that where companies do not adequately manage risk the share price ultimately reflects this.

Considering the options presented in the draft Standard, risk adjusted financial measures are likely to best meet these requirements. Based on the draft Standard and Challenger's subsequent consultation with APRA, it is not yet clear what will constitute applicable risk-adjusted measures for Challenger. Challenger welcomes greater clarity and principles-based guidance in the final Standard in this regard.

In considering the use of non-financial performance measures (outside of a balanced KPIs framework), the Board of Challenger has been concerned that the use of non-financial performance measures can result in unintended outcomes. Non-financial measures can be subject to gaming through methodology, such as participant selection where surveys are used. In the worst examples, measures such as customer complaints or errors have been seen to lead to suppression, rather than the surfacing of issues.

Given that long term incentives are subject to extended deferral periods during which awards can be forfeited, this provides sufficient time for poor risk behaviours or conduct to surface. APRA could consider allowing a long term incentive framework which utilises appropriate financial performance hurdles and is clear (in both its communication and execution) that awards will be forfeited if poor conduct or risk behaviours become known.

Proposed deferral periods for variable remuneration

Clause 53

A significant financial institution must, for a Chief Executive Officer (CEO), defer 60 per cent of their total variable remuneration for at least seven years from the inception of the variable remuneration component. Vesting of this 60 per cent may only occur after four years from the time of inception and no faster than on a pro-rata basis.

Clause 54

A significant financial institution must, for a senior manager other than its CEO and for a highly-paid material risk-taker, defer 40 per cent of their total variable remuneration for at least six years from the inception of the variable remuneration component. Vesting of this 40 per cent may only occur after four years from the time of inception and no faster than on a pro-rata basis.

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[5] Challenger's variable remuneration quantum is discretionary. Benchmarking to market, previous period outcomes and peer outcomes are used to ensure variable remuneration outcomes appropriately reflect the performance assessment as described.

Clause 55

Paragraphs 53 and 54 do not apply in respect of any person with variable remuneration of less than AUD $50,000 in a financial year.

Challenger in general supports the principle of longer deferral which is aligned with shareholder interests and customer outcomes, providing the ability to adjust remuneration where necessary. The flexibility to pro-rate vesting after four years, as considered in the draft Standard, is also supported in principle as it allows companies to structure remuneration to align with their objectives.

Recent changes to Challenger's remuneration framework to extend the deferral periods for Deferred Performance Share Rights (DPSRs) and Hurdled Performance Share Rights (HPSRs) demonstrates our existing alignment to this objective. However, the draft Standard is more prescriptive, and this may have unintended consequences. Under the current drafting of the Standard, Challenger's preliminary analysis indicates that there are a range of employees across Challenger who would be designated as senior managers and accordingly would be in scope for the deferral requirement. The range of employees designated as a senior manager means that employees with different variable remuneration components and substantially different variable remuneration quantum would be subject to the same standard of deferral, with no consideration to proportionality. This could significantly deter designated employees on lower variable remuneration from working at Challenger or indeed, more broadly in the financial service sector subject to the draft Standard.

Before dealing with the specific proposals in relation to mandatory deferral thresholds, it is worth noting that the mandatory deferral periods, as an unintended consequence, may:

- inadvertently lead to a re-balance of pay mix whereby a greater proportion is delivered as fixed pay (and therefore not subject to performance, deferral or consequence);
- negatively impact the ability to compete for talent with unregulated entities or from other jurisdictions;
- negatively impact the ability to retain and attract talent who have skills and experience that can be readily applied in other industries; and
- create a talent retention and attraction risk for our employees located outside Australia, who are designated as senior managers. The proposed deferral arrangements under the draft Standard may not be aligned with either the regulatory environment or labour market in which these employees operate.

APRA could consider allowing companies to comply with the requirements of each relevant jurisdiction where that jurisdiction has a regulator considered acceptable to APRA. This would ensure continued good governance of remuneration practices while not inhibiting the ability of Australian businesses to compete for talent in other international jurisdictions.

It is Challenger's view that the proposed $50,000 variable remuneration deferral threshold is too low and, based on our analysis of the remuneration structure and quantum of impacted employees, we submit that it should be raised to at least $100,000.

In addition, a progressive deferral scale based on variable remuneration quantum could be considered for employees covered under Clause 54. The progressive scale could be determined based on the level of variable remuneration as a percentage of total remuneration or based on variable reward in absolute terms. Use of the percentage of fixed pay approach would deal with issues of the Standard's application to organisations across a broad spectrum of operations and size. Consistent with the draft Standard, prorated vesting should also be applied on a progressive scale.

To illustrate, the tables[6] below provide an example of the two approaches.

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[6] The data in the tables is provided only for illustrative purposes. It does not constitute a recommendation from Challenger.

Variable remuneration quantum	Minimum deferral period
$100,000 to $150,000	4 years
$150,000 to $250,000	5 years
$250,000 and above	6 years

Variable remuneration quantum as % of fixed pay	Minimum deferral period
30% to 40%	4 years
40% to 50%	5 years
50% and above	6 years

In applying the Standard, Challenger would welcome alignment between the deferral arrangements in the final Standard and the Executive Accountability Regime (still to be drafted). This would avoid differences in mandatory remuneration deferral periods for accountable persons and the likely broader coverage of employees (for SFIs) established by the Standard.

Proposed clawback for variable remuneration

Clause 56

A significant financial institution must subject the variable remuneration of a senior manager or a highly-paid material risk-taker to clawback. Variable remuneration must only be awarded if an amount corresponding to it can be recovered from the person if recovery is justified on the basis of the criteria specified in paragraph 58.

Clause 57

For the purposes of paragraph 56, variable remuneration must be subject to clawback for:

(a) at least two years from the date of payment or vesting; and

(b) in circumstances involving a person under investigation, for at least four years from the date of payment or vesting.

Clause 58

Subject to conditions set in the remuneration policy, a significant financial institution must set specific criteria for the application of clawback, including:

(a) responsibility for material financial losses;

(b) material misstatement of financial statements or other criteria on which the variable remuneration determination was based;

(c) breach of compliance obligations including in relation to misconduct risk; and

(d) failure of accountability or fitness and propriety.

Clause 59

A significant financial institution must take reasonable steps to recover an appropriate amount corresponding to some or all paid or vested variable remuneration subject to clawback, in circumstances where any of the criteria specified in paragraph 58 is satisfied, whether or not the employment or engagement of the individual has ceased.

Challenger supports the principle of ensuring executive reward is subject to satisfactory longer-term outcomes for stakeholders to ensure that they are not rewarded for poor conduct and are aligned with the shareholder experience.

As noted earlier, recent changes to Challenger's remuneration framework (i.e. extended vesting period for DPSRs and HPSRs) demonstrate our commitment to this principle. However, the interaction of the proposed periods for clawback with the mandatory deferral requirements for this population creates what could be viewed as an excessive extended period where the underlying value of the deferred remuneration is 'at risk' from factors outside the control of the executive. These risks would not necessarily pertain to the period in which the variable remuneration was awarded but may arise in the longer term and unduly erode the underlying value of the deferred remuneration:

- Share price risk due to general stock market volatility;
- Share price risk where the individual is no longer with the company and has no stewardship of ongoing company performance; and
- Misalignment of vesting timing with business cycles (e.g. the ‘Insurance Cycle’).

The length of the combined period of deferral and clawback should balance long-term consequence management with practical implementation. We suggest this should be no longer than seven (7) years. Longer deferrals reduce the value employees attribute to their variable reward. This could lead to unintended consequences such as companies moving to cash for deferred incentives to provide employees with certainty of the final value they will receive. While actions such as this would still allow forfeiture and clawback, it would reduce alignment with business outcomes over the medium to longer-term.

Attachment 1 - Project How – Challenger values

Values	Act with integrity	Aim high	Collaborate	Think customer
Description	**We do things the right way**	**We deliver outstanding results**	**We work together to achieve shared goals**	**We make decisions with our customers front of mind**
Supporting behaviours	• We ask not only 'can we?' but 'should we?' • We consider and plan for current and future risks • We're honest in all our interactions • We're authentic • We're brave enough to make the right decision, even when it's hard • We speak up and listen when things aren't right • We respect and abide by our regulatory obligations	• We're accountable for delivering sustainable results for our shareholders • We're commercially minded and strive for excellence • We adapt to changes and are resilient • We're inquisitive and look for opportunities to grow • We innovate and continuously improve • We think about what could go wrong and learn from our mistakes	• We're inclusive and embrace diversity • We care for each other • We build strong relationships • We respectfully challenge each other • We're curious and listen to learn • We achieve more working together than as a group of individuals • We share ideas and help each other to succeed • We recognise and celebrate great work	• We recognise all roles contribute to providing our customers with financial security for retirement • We deliver for our customers by working closely with many different stakeholders • We know who our customers are • We deliver great customer outcomes • We create solutions to meet customer needs • We honour our customer promises • We inspire confidence with our actions
What this doesn't look like	• Winning at all costs • Putting personal gain before others • Taking only a short-term view • Taking unacceptable risks	• Undermining and competing against one another • Being complacent • Not stepping up when needed • Doing things just because we've always done them • Setting unrealistic expectations	• Operating in silos • Excluding others and ignoring diverse points of view • Being unreliable • Not harnessing each other's strengths and capabilities • Blaming others • Not taking accountability	• Poor levels of customer service • Making decisions without considering the impact on our customers • Making unsupported assumptions about what our customers need • Not delivering for other stakeholders