October 22nd, 2019

APRA's CPS511 Remuneration Proposal

Submission[1]

This submission is a comment on APRA's CPS511 Remuneration Proposal published in July 2019.

In sum, this is a strong proposal, rightly focused on schemes of performance-based compensation for senior managers (SM) and highly paid material risk takers (MRTs) at significant financial institutions (SFIs). It:

- increases deferment periods and generally raises standards;
- balances financial and non-financial compensation; and
- retains the flexibility of boards regarding the details of schemes at individual institutions, thereby supporting responsible governance.

However, in each of these dimensions, the proposal could be still stronger. It should:

- raise standards further;
- rebalance financial and non-financial compensation; and
- provide more guidance to boards and their advisors.

Furthermore, disclosure of compensation schemes should be standardized, as this might in fact bring an element of market and stakeholder discipline to bear on compensation schemes.

Really close alignment of SM & MRT incentives with social objectives should internalize within institutions some of what regulators currently do. So it may create a chance to reduce regulatory burden.

Raise standards further

Longer deferment The proposal is toughest for CEOs at SFIs. For them, deferred compensation begins to vest after 3 years, with distributions of 25% in each of subsequent 4 years for a total of 7 years deferment.[2]

Ten years may align private incentives with financial stability better than seven.

Firstly, a ten year deferment period makes it less likely that SMs & MRTs get lucky. Credit cycles have tended to last about seven years. So with 7-year deferment, an SM or MRT with deferred compensation earnt at the top of one credit cycle could look forward to a pay-out at the top of the next one. Ten years of deferment will encourage SMs & MRTs to look *through* the next credit cycle and think about

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[2] Table 6 of discussion paper "Strengthening prudential requirements for remuneration," APRA July 2019.

performance beyond. Secondly, a longer period of deferment makes it less likely that an institution will have to resort to claw-backs. It is always better to withhold payment than to try to recover it after the fact.[3] Finally, one useful point of reference is the deferments for partners in investment banks in the past. These could stretch out well over ten years and beyond, even into retirement.

If CEO deferments are extended, deferments for other SMs & MRTs should be extended proportionately.

Whether or not deferments are extended, banks should have to end-load distributions rather than award pro-rata: say 10%, 15%, 25% and 50% in the last four years rather than 25% in each.

Non short-term performance-related compensation

To be clear: SMs & MRTs should not get any short term performance-based compensation. The consequences of a single year's worth of decisions stretch far into the future. And, if short term compensation is significant, it may work against the sobering effect of deferred performance-based compensation.

A minimum share of deferred compensation in total compensation

The proposal sensibly steers clear of the European cap on performance-based compensation as a percent of total compensation. This is an idea that may make sense when little or no compensation is deferred. But when performance-based compensation is sufficiently deferred, it would be more sensible to impose a floor rather than a ceiling.

A floor of 75 or 80% of compensation being deferred and performance-based might make sense.[4] The point is, SMs & MRTs should be ***heavily*** invested in the long term performance of their institution.

Adjust the balance

Reduce the emphasis on non-financial metrics

If, for example, a bank consistently treats its customers poorly, acquiring and retaining customers will get tougher and more expensive. This may take time, but it will show up in financial results and, if performance-based compensation is deferred enough, it is likely to affect the financial performance metrics used in the scheme. Likewise, other things that could damage its reputation like degraded values and ethical lapses are likely to work through to financial results in due course.

So, with sufficient deferment of performance-based compensation, perhaps a smaller share of compensation needs to be directly dependent on non-financial metrics. For one thing, these metrics are

[3] In one recent and notorious case in the United States, an institution tried to claw-back earnings from a CEO who had left on account of an ethical lapse with a very large bonus in hand. Under his terms of employment, the CEO in question was entitled to use counsel at the expense of the institution with regard to any legal issue arising from his tenure at the institution. As a result, he got free legal advice to contest the clawback and was quite successful at minimizing its value.

[4] In Table 8 of the discussion paper, 60% is suggested for CEOs. This would toughen this standard for all SMs and MRTs.

not yet robust. For another, if non-financial performance is reflected in both the financial results (after many years) and also in the non-financial metrics, then there is a sort of double counting.

Perhaps a going-in position of something like 60% financial and 40% non-financial makes sense more than the proposed 50/50 split.

Provide more guidance

Do away with current-period risk-adjusted compensation

If risk-adjustment calculations affect current compensation, there is an incentive to game them. If they are confined to capital and excluded from compensation schemes and if deferment periods are long enough, the incentive is for SMs & MRTs to foster calculations that are reasonably accurate. After all, that way they run the best chance of maximizing long term performance.

Ensure deferred compensation varies enough with performance

In performance-based deferred compensation schemes, the deferred payments are adjusted by some factor that reflects subsequent performance. To do this deferred payments can be in the form of debt, equity, hybrid instruments, adjusted cash payments, derivatives or some combination.

To be clear, consider the case where today an SM or MRT is granted 1000 shares, valued at A$10 each in today's market, as part of their 2019 compensation. 100 shares are to be granted or vested in 2026, 150 in 2027, 250 in 2028 and 500 in 2029. In 2026, the value of each share may be A$7. In that case, the shares vested or paid out that year would be worth A$70 and the adjustment factor for performance between 2019 and 2026 would have been 70%.

In practice, how can a board think about the relationship between a component of variable compensation and either financial or non-financial metrics? One way to approach this is to ask, what is the lowest and the highest conceivable outcome for any given metric and then, answer the question, how much should variable compensation change between these two extremes? Between this maximum and minimum, the compensation scheme should specify a variation scale such as a pro-rata scale, a non-linear scale or a linear scale with a cutoff above or below some threshold value.

Clarify that gateways should be only for certain discretionary actions

Gateways – qualifications to receive *any* deferred performance-based compensation – should be used sparingly and only applied to critical discretionary actions. For example, on the positive side, some training may sensibly be required to qualify for variable compensation. And on the negative side, an ethical lapse (or termination for cause) may disqualify an SM or MRT from any variable compensation. Gateways are not really appropriate for extreme outcomes over which an SM or MRT has little or no control.

To discourage flitting, it is common for variable compensation such as stock options to vest only after an SM or MRT has been with a firm for a year or two or three. Beyond that however, there is good reason *not* to require continued tenure for vesting. If their variable compensation depends on how well their institution performs after they leave (as opposed to being flat-lined), SMs & MRTs have a strong incentive to get succession planning right.

Standardize calculations and disclosure

Using options methodologies to value compensation components

It can be difficult to calculate the present value of deferred compensation, especially when a scheme depends on many metrics. However, in principle, every element of deferred compensation will depend on the variability of a performance metric, the difference between current and future threshold values, the time value of money and the time until vesting/payout: that is, every element of deferred compensation has an option value.

In practice, numerous choices about methodology and assumptions will have to be made to calculate that value. To simplify things, APRA could propose as a guideline a standard methodology and set of assumptions, and then require SFIs to explain any well-justified occasional deviation from them.

Such a requirement would go a long way towards ensuring comparability when establishing the division between one sort of deferred compensation and another and the division between current and deferred compensation.

It would also provide a common, comparable and fairly straightforward language with which to describe total compensation and its components at the time it was granted. It would, therefore, facilitate standardized disclosure of SM & MRT compensation for publicly traded companies.

While stakeholder and market discipline have been limited on disclosure to date, this may well be because variable compensation schemes have been so hard to understand and compare.

Review regulatory burden

One of the main consequences of higher standards, rebalancing between financial and non-financial measures and better guidance to boards would be to align incentives for SMs & MRTs with social objectives. In particular, the adjustments to the CPS511 proposal suggested here would align incentives with the public policy objective of financial stability. In effect, regulatory values would be substantially internalized within SFIs.

If that is so, how strong is the systemic stability case to regulate things other than SM & MRT compensation? Won't SMs & MRTs be motivated to make good decisions and won't they be in a better position than their regulator to know how to do it?

So for example, consider capital adequacy. While it might be rash to lean too heavily on compensation incentives to ensure that SMs raised and set aside enough capital in their institutions for the long haul, it might be possible to shift at least a bit from the highly detailed prescriptive requirements of today on how to calculate every aspect of risk to a simpler output- or results-oriented approach that would require capital levels to some multiple of the variability in institutional income. To meet that requirement, no doubt some institutions would want to calculate their risk weighted assets and a host of other related quantities, but others might decide it was cheaper and would work better for their business model to use rougher calculations and just to hold a larger capital buffer.

Such a review while complementary, would inevitably be a big exercise and should therefore be undertaken separately.

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Concluding remarks

By international standards, the current CSP511 proposal is quite ambitious. But current international standards are, in fact, not very high. They reflect the limitations of a process of seeking international consensus; they are meant to be minimum standards; and to they have been affected by reform exhaustion as the global financial crisis has receded into the past.

Australia has been a leader in the past with respect to financial regulation. It has consistently been one of the jurisdictions with the highest standards. It was one of the first jurisdictions to adopt the twin peaks approach. Now CPS511 can lead in SM & MRT compensation practices.