Fidelity International
11/167 Macquarie St.
Sydney NSW 2000

To,

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

We are pleased to contribute to the Australian Prudential Regulation Authority's consultation on remuneration at APRA-regulated entities (Prudential Standard CPS 511). Fidelity International has A$598 bn in assets under management, with approximately A$17 bn invested in Australian listed equities.

As active fund managers, we are deeply committed to our responsibility to act as good stewards of our clients' assets - clients which include numerous Australian institutions and pension funds - and we are responding to this consultation in the hope that it will contribute to an effective and practical implementation of the Royal Commission's recommendations.

As a general comment, we are broadly supportive of APRA's proposals concerning board and remuneration committee responsibilities, deferral periods and malus/clawback. On remuneration design, we recognise that there is a critical need to ensure that financially-driven performance metrics are limited so as to avoid creating incentives that encourage unethical behaviour or which are fundamentally misaligned with the interests of the company's stakeholders. However, having considered the potential consequences that could result from a hard limit on financial measures, we encourage APRA to adopt a more flexible, principles-based approach. A more detailed explanation is provided in the body of this letter.

We have not endeavoured to answer all of the questions in the consultation but only those on which we hold a definitive view.

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?

The draft of CPS 511 states that the remuneration objectives of regulated entities must align with the entity's business plan, values, and compliance obligations and must promote effective management of both financial and non-financial risks, sustainable performance, and the entity's long-term soundness. We fully support this requirement. However, we would not deny that when it comes to designing variable remuneration schemes, boards face a difficult task in effectively needing to distil a complex multi-year strategy into a set of performance metrics that measures managers' and key employees' contributions to the company's success while appropriately excluding external factors that may impact on results (either positively or negatively), meeting shareholders' expectation of alignment and focus on long-term profitability, and having appropriate regard for the interests of other key stakeholders, including employees, customers, suppliers, regulators, and taxpayers. There are various ways that this challenge can be addressed in the context of remuneration policy design, but in our view, a strict percentage limitation on financial metrics in the context of a balanced scorecard approach is the approach which is most likely to create skewed incentives and vulnerability to gaming. Rather than imposing a strict percentage limit, we would advise that APRA adopt rules allowing companies the flexibility to use non-financial considerations as a modifier, gateway, underpin, or rationale for applying discretion (or a combination thereof) to directly link financial with non-financial considerations so as to ensure that financial objectives are earned 'the right way'.

Though this should be clear, it warrants mentioning that well-designed financial incentives which focus management's attention on sustainable profitability should align to the interests of all stakeholders, not just shareholders. To put it plainly: a company which conducts business unethically or treats its employees, customers, and suppliers poorly will inevitably fail in the long run, but a company which fails to generate sustainable profits and innovate will eventually cease to exist regardless of how well it treats its various stakeholders. For private enterprise, long-run economic success is the factor that underpins everything, and it is therefore to all stakeholders' benefit that this should be the primary driver of management incentives.

Moreover, financial performance targets remain the most objective, robust, and transparent way of measuring long-term economic progress. Their advantages include the fact that they are audited, comparable, and provide clear line of sight and alignment to long-term success. In contrast, most of the non-financial performance measures that are used in the financial services sector in other parts of the world measure factors that either improve fundamental business characteristics (e.g. employee wellbeing, customer satisfaction, culture, brand/reputation) or which make them worse (e.g. misconduct, risk), but may not directly link to strategy or positive economic performance. These types of non-financial measures are important for ensuring that management is incentivised to do business the right way, and should play an important role in proper remuneration design, but giving them an equal or greater weighting than financial measures risks diverting attention from what should be management's primary objective.

Diluting the incentive to create sustainable positive economic performance could have serious consequences for the Australian financial services sector. We are concerned that if APRA-regulated entities are required to adopt this policy, they will be unable to demonstrate a clear link between their non-financial targets and the company's long-run economic success, which will heighten the risk of skewed incentives and unintended outcomes. In turn, shareholders may be less willing to invest assets in APRA-regulated entities where they believe that management are insufficiently focused on long-term economic performance. We are also concerned that applying a strict limit on financial measures would effectively lock boards into a 'balanced scorecard' approach on all long-term incentives, which would stifle innovation in remuneration design.

We would not disagree that financial targets have at times led to poor remuneration outcomes, but in our view this has tended to be the result of poor design and/or a lack of willingness on boards' part to apply appropriate discretion where it has been warranted. It has been argued that this is because boards have been responding to what shareholders want i.e. a focus on financial returns to the exclusion of all other considerations. For avoidance of doubt: as a long-term shareholder of APRA-regulated entities, we wish to see our investee companies succeed by behaving ethically and doing right by their customers, employees, and the communities where they operate. In our view this is the only sustainable way to do business, and we therefore would not wish for management incentives to be viewed as pitting shareholder and other stakeholders' interests against each other. Moreover, it is equally possible for poorly-designed non-financial targets to create false incentives. For example: a return on equity metric could in theory incentivise management to delay much-needed investments in IT infrastructure and new products until after the end of a performance measurement period, which could harm innovation and put the firm at risk of systems failures and cyberattacks; on the other hand, a customer satisfaction metric could in theory incentivise management to adopt aggressive pricing tactics to increase their NPS, which could erode returns and necessitate additional capital injection. In both scenarios, what is needed is an incentive structure that aligns to the objective of conducting business sustainably by linking financial and non-financial considerations closely together, and a board that is willing to step in and make adjustments where needed, for instance in response to a changing market environment or a shift in strategic priorities, in order to avoid false incentives.

There are a number of approaches which we believe would fulfil the Royal Commission's objective of setting limits on financial measures without the substantial drawbacks of a percentage limitation. These include:

The use of risk-adjusted financial metrics. As APRA has mentioned in the discussion paper, most regulated entities currently use non-risk adjusted financial metrics. APRA has stated that it does not intend to restrict the use of measures that are risk-adjusted and relate to financial soundness, such as risk-adjusted capital adequacy, risk-adjusted cost of funding, and RSE licensee investment return measures. We believe that adjusted profitability or financial return measures such as e.g. risk-adjusted return on capital could also serve as an appropriate incentive in some cases and should be explicitly supported in APRA's guidance.

The use of non-financial incentives as a gateway/underpin. This in essence means that binary non-financial targets linked to customer/stakeholder satisfaction, conduct, reputation, culture metrics, and others could serve as a prerequisite before any incentive pay based on financial targets could be paid out. Conceptually, this approach has appeal because it directly links financial and non-financial considerations and treats factors like ethical conduct and fair treatment of customers as a basic requirement of doing business (which they should be) rather than aspirational goals that need to be incentivised.

The use of non-financial incentives as an incentive plan modifier. This is similar to the gateway/underpin approach but allows for vesting on a sliding scale rather than an all-or-nothing test. So for instance, under this approach underperformance on a customer satisfaction metric could result in downward adjustment to award vesting rather than full cancellation.

Board discretion. The remuneration policy could require the board to take specified non-financial factors or a broad view of impact on stakeholders into account when determining variable pay outcomes, and to explain its decision on whether or not it applied discretion, as well as the quantum of any such adjustment, in a public statement that could then be scrutinised by shareholders and other stakeholders.

A board could choose to utilise one or several of these options together - including in combination with a set of appropriate non-financial measures making up a minority weighting in a balanced scorecard -- and this would, in our view, meet the Royal Commission's objective of restraining the impact of financial metrics on remuneration award outcomes and giving appropriate weight to non-financial considerations.

We would therefore suggest that the percentage limits in Sec. 38 of the draft of CPS 511 be deleted, and that the following principle-based approach be adopted in the guidance for regulated entities:

Long term variable remuneration structures should be chosen to align executive behaviour to the delivery of strategy and to the long-term performance of the company. These structures cannot be based solely on financial metrics but must also incorporate non-financial metrics. Non-financial metrics may be included in the form of balanced scorecards, gateway measures, underpins, or other structures (or a combination thereof) which are appropriate to the current circumstances, stakeholder relationships and strategy of the entity.

The relevant board committee minutes must articulate the remuneration structure's link to strategy, as well as an assessment of the behavioural risks that could arise from of the structure and its incorporated metrics, and the oversight role the board will play in monitoring, managing and if necessary mitigating these behavioural risks.

What would be the impacts of the proposed deferral and vesting requirements for SFIs? Would the proposals impact the industry's capacity to attract skilled executives and staff?

We share the view that an over-emphasis on short-term performance can contribute to poor customer and beneficiary outcomes and jeopardise financial soundness, and have made long-term incentives issue a key point of emphasis in our engagement with corporate issuers and in our proxy voting. As stated in our Responsible Investment Policy, we currently encourage companies in many markets to adopt a guaranteed share retention period of at least five years for senior executives (this includes both the vesting period and any post-vesting sales restriction period). As APRA has noted, longer share retention periods are now required for companies engaged in financial services in EU jurisdictions. Moreover, five-year share exposure periods for long-term equity plans are now recommended best practice for listed companies in the UK regardless of industry sector, and over time it is our hope is that practice will move in this direction globally.

We are therefore supportive of the proposed deferral requirements for APRA-regulated entities for the reasons covered in the discussion paper i.e. that there is often a discovery time lag for significant incidents such as mis-selling or inappropriate credit risk. We would also add that a normal LTI vesting period of three years often aligns poorly with the length of time required to implement a long-term strategic programme and see the fruits of this effort fully manifest in economic performance. In our view, requiring executives and key employees to maintain their equity exposure following the end of the vesting period leads to better alignment with long-term business planning and helps to further embed a long-term ownership mentality in the workforce.

We support APRA's intention to refrain from being overly prescriptive on remuneration design, for example its decision not to propose a pay cap or fixed to variable pay ratio. That said, given competitive pressures in the market for key personnel we would expect that boards of APRA-regulated entities to respond to the deferral requirements by making adjustments to their executive pay structures. Possible responses to the deferral requirements could include:

- A shift toward higher levels of fixed pay, which is a risk that is acknowledged in APRA's discussion paper.

- An increase in variable pay opportunities, as studies have shown that recipients tend to psychologically discount deferred awards and demand a premium for riskier forms of compensation, such as those with longer deferral periods.
- A move toward shorter LTI performance measurement periods (e.g. deferred bonuses/hybrid plans) as this would partly address the discounting issue by "locking in" awards prior to the end of the vesting period.
- A reduction in the stretch of long-term performance targets -- again as a means of addressing the discounting issue -- which could mean that a portion of incentive pay would be in effect guaranteed or at the very least unlikely to lapse in full.

Shareholders of publicly listed APRA-regulated entities are likely to balk at an erosion in the quality of performance conditions or a significant shift toward fixed pay, and hybrid plans have not won universal shareholder support to say the least. Therefore, if APRA goes ahead with this proposal, it would be advisable for the boards of affected companies to consult with their shareholders on any changes they intend to make in response, and it would also be advisable for the boards and shareholders of affected companies to be particularly mindful of increases in pay quantum that may result from this change, as this would be likely to cause reputational harm for the sector.

APRA has asked whether executive mobility could be harmed by the new deferral requirements. We think it is possible if continued employment is made a requirement during the post-vesting sales restriction period, though in other markets where similar rules have been implemented, the practical impact has been an increase in sign-on bonuses to compensate for forfeited awards.

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.

We have no specific comment on the practical hurdles of using clawback provisions, though based on our observations from other markets we would agree that malus provisions are likely to be easier to apply in practice. Nevertheless, our preference would be for malus and clawback to be used in combination (i.e. malus would apply during the vesting and post-vesting holding periods and clawback would apply for a defined period thereafter).

The draft version of CPS 511, Para. 44 requires regulated entities to set minimum criteria for adjusting any deferred variable remuneration through application of malus. We agree with the circumstances requiring application of malus in sub-paragraphs (a) – (e), though we suggest the following amendments (in red):

44. An APRA-regulated entity must set specific criteria for the application of malus for variable remuneration, including

(a) a significant downturn in financial performance;

(b) restatement, correction, or amendment to any financial statements;

(c) where an individual commits, or is culpable or responsible for, acts of misconduct or negligence resulting in losses;

(d) a significant failure of financial or non-financial risk management;

(e) a failure to meet the entity's code of conduct; and

(f) significant adverse outcomes for customers, beneficiaries, or counterparties resulting from negligence or mismanagement.

The proposed addition of new sub-paragraph (b) is meant to ensure that APRA-regulated entities would be required to apply malus in cases where variable remuneration has been earned on the basis of financial results which are subsequently restated or corrected.

The proposed amendment to sub-paragraph (c) – which is sub-paragraph (b) in the draft version of CPS 511 – is meant to ensure that malus for acts of misconduct or negligence would be applied to individuals who commit such acts as well as those who could be reasonably held responsible for them, which could include, for example, supervisors.

The proposed amendment to sub-paragraph (f) -- sub-paragraph (e) in the current draft version - recognises that adverse outcomes for beneficiaries may be driven by factors that lie outside of management's control, for example an economic downturn. We are concerned that a malus policy requirement which does not explicitly acknowledge this fact could harm the incentive to take appropriate action to preserve the company's long-term health in response to an external crisis. We therefore think the policy should set a clear expectation that malus should be applied in cases of significant adverse stakeholder outcomes when this is the result of poor execution or management.

We hope that this submission will make a positive contribution to your deliberations, but please feel free to contact us if you have any questions.

Yours Sincerely,

[redacted]