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Board and Corporate Governance Advisors

12 September 2019

Mr Wayne Byres
Chair
Australian Prudential Regulatory Authority
GPO Box 9836
SYDNEY NSW 2001

By email via: info@apra.gov.au

Dear Mr Byres,

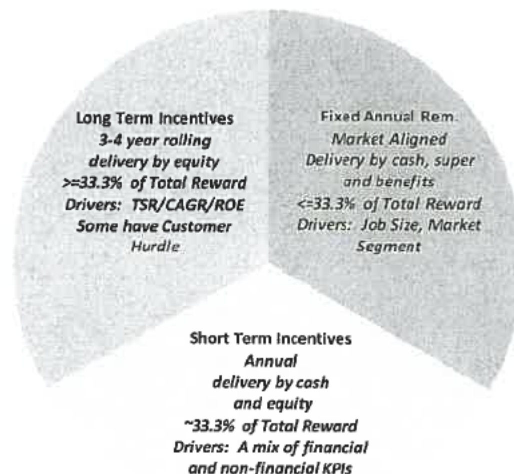
Draft APRA Standard CPS 511
Submission by Geoff Nunn & Associates

My view has always been "back to basics" with executive remuneration in Australia. Companies do not need overly complex models to attract and retain the best talent. In my Submission to the Hayne Royal Commission in April, 2018 I argued that the structure of executive remuneration in major financial institutions was implicated in the misconduct that was uncovered. The proposed new APRA Draft Standard CPS 511 is a step in the right direction. The intention of the comments contained in this Submission is ensure that executive remuneration in the Sector is governed in accordance with stakeholder expectations.

Background

The following comments relate primarily to CEO and executive remuneration. Whilst acknowledging the importance of remuneration structures for all employee categories our focus is Key Management Personnel (KMP) and other highly paid material risk takers.

Executive remuneration in Australia's larger listed corporates has evolved to a high level of complexity over the last 25 years. Corporations have followed a model that was largely developed in the US during the 1980s and promoted by advisory firms worldwide. Its primary objective is to align the financial interests of executives with those of shareholders. The fundamentals of this model are set out on Page 13 of the APRA Discussion Paper, 23 July, 2019 and reproduced here:



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The principles underlying this model have gone largely unchallenged in major reviews in recent years. This includes the Productivity Commission Review of Executive Review Remuneration in Australia, 2009, the Royal Commission into Misconduct in the Banking, Finance and Superannuation Industries, 2018-2019 and various other inquiries. There was some discussion about the basic concepts underpinning the model at the Hayne Royal Commission but it was not pursued in depth. These principles are embedded in the BEAR and supported by Draft Standard CPS 511.

My view is that, even with re-balancing of KPIs and lengthening of vesting periods, this model favours the interests of shareholders over other stakeholders. It does not appropriately support the alignment of interests as stated in the APRA Discussion Paper:

"A resilient financial system is based on alignment between the interests of financial institutions and those of stakeholders including shareholders, customers and beneficiaries, regulators and the broader community. The design and implementation of remuneration arrangements play an important role in better aligning these interests."

Discussion Paper, Strengthening Prudential Requirements for Remuneration, 23.7.2019, Page 5

Rebalancing KPIs is a good first step. But delivery of reward (STIs and LTIs) in equity, or equity related vehicles, sends a strong message to executives that it's profit and Total Shareholder Return (TSR) that really matter. And, of course, they do matter. Financial viability is critical and shareholder returns are important. But the interests of other stakeholders are important too; particularly customers who place their trust in our financial institutions. Set out in this Submission are a number of proposals that are genuinely aimed at restoring that balance.

The current model assumes that all meaningful aspects of corporate performance can be subject to measurement. This is a highly contestable proposition, particularly when it comes to the more subjective dimensions of organisational performance such as maintaining an engaged and innovative corporate culture, providing sustained positive customer experience, active and genuine stakeholder engagement and focus on ethical conduct, to name just a few. Whilst it is certainly possible to construct surveys and other questionnaires which purport to measure these aspects of corporate life what gets measured is at best a surface approximation. A deeper qualitative analysis might well reveal a different story. The numbers don't always paint an accurate picture. Companies rely on surface metrics because digging deeper is more complex and time consuming.

The nexus between reward systems, performance measurement, governance and corporate culture cannot be overstated. The challenge for boards is to take a fresh perspective and look more deeply at the connection between remuneration, culture and governance as Commissioner Hayne recommended. The current model of executive remuneration in the major corporates, as set out above, has fundamental shortcomings. Boards, CEOs, executive teams and regulators seem to be struggling to look beyond it and consider other options.

Commentary on the Specifics of CPS 511

Set out below is my commentary on the proposed in CPS 511 and additional thoughts for APRA's consideration. They cover:

1. Governance Oversight.
2. The Capping of Financial Measures.
3. Deferment and Clawback.
4. Delivery in Equity.
5. Minimum Shareholding Requirements.

The intention of this commentary is to strengthen what is shaping up to be a sound Prudential Standard.

1. Governance Oversight

Boards and Remuneration Committees play a critical role in the oversight of all aspects of the entity's remuneration framework. The oversight of remuneration policy is vital for effective governance. This is well covered by the new Draft Standard Paragraphs 21 to 32.

In terms of executive remuneration (and those other key roles with a high risk profile) I offer the following comments. The role of Board and Remuneration Committee is to:

a) Ensure that the Total Reward opportunity for each executive is in line with market practice. It should be sufficient to attract and retain capable executives without fuelling the market. In setting reward levels the Board and Remuneration Committee should take into account community, regulator and investor sentiment. In the longer term the Board and Remuneration Committee might adopt a strategy aimed at reducing the overall remuneration gap between executives and other staff. There is a perception in the community, and amongst some investors, that executive remuneration levels in the major corporates are excessive and should be reined-in (notwithstanding the market pressure argument).

b) Ensure that the structure of executive remuneration does not encourage excessive risk taking or behaviour that might not be in the best interests of all stakeholders, particularly customers. This is a difficult balancing act. Investors expect strong returns and customers expect that their interests will be safeguarded by financial institutions.

c) Ensure that the performance criteria linked to reward outcomes are balanced and reflect a broad-based view of what constitutes organisational performance. Boards and Remuneration Committees need to look beyond simplistic metrics, such as employee engagement ratings, customer satisfaction survey results and net promoter scores. They should require management to look deeply at issues of culture, customer experience, stakeholder engagement, ethical conduct and provide a thorough qualitative analysis in the areas identified as priorities for each organisation. Boards need to consider their own role in influencing corporate culture and shaping organisational behaviour.

d) Ensure that performance results and related reward outcomes are closely scrutinised. As necessary, independent verification should be sought.

The degree to which these remuneration imperatives can be incorporated into Sections 21 to 32 of the Draft Standard needs to be discussed more broadly. In essence they are guiding principles for Boards and Remuneration Committees. I appreciate that APRA, in setting the Standard, should not overly intrude on board independence in setting executive remuneration policy.

However, there is a community expectation that the Boards and Remuneration Committees of financial institutions will act with restraint and discretion when governing executive remuneration. The Hayne Royal Commission revealed very clearly that restraint and discretion was always in evidence. Shareholder response to the NAB's 2018 Remuneration Report was a stark reminder of this.

2. Financial Measures Capped at 50% of Total Measures (an Individual Measure not to be more that 25%).

Paragraph 38 of the Draft Standard states that financial measures should make up a maximum of 50% of the total measures used to assess corporate performance (Paragraph 38, Page 9). This is different to the Discussion Draft which states that up to 50% of the weighting of financial measures should apply (Page 31). The number of measures and their relative weighting are not the same thing. The follow table, extracted from the Commonwealth Bank 2018 Remuneration Report (STI Scorecard), illustrates:[1]

Measure	%	Threshold 50%	Target 100%	Above expectations 150%	% of STVR target (100% of FR)	% of STVR maximum (150% of FR)	Commentary
Performance scorecard							
Financial/shareholder							
Group cash NPAT	25%	●					
Group underlying PACC	25%	●			10%	7%	Below threshold in Group cash NPAT (including discontinued operations) (Actual: $9,412M, Target: $10,102M) Below threshold in Group underlying PACC (Actual: $5,803M, Target: $6,523M) Progress on productivity targets
Group productivity	10%		●				
Customer							
Blended average of NPS outcomes for retail and business customers (six-month rolling)	15%	●			0%	0%	Actual result was -7.7 (decline of 2 points) Blended average NPS target was set at a level of NPS increase of +5 percentage points relative to June 2017 score (-5.7) (Target: -0.7)
People							
Culture, talent, diversity, safety and wellbeing	15%		●		15%	10%	Board discretion, having regard to: "Your Voice" outcomes for the Group Quality of talent development within the Group Improvement in gender and cultural diversity metrics for Executive Manager and above population within the Group Quality of safety outcomes and processes
Strategy							
Delivery of key strategic initiatives	10%	●			7.5%	5%	Better Risk Outcomes Program established to drive Group response to APRA recommendations and enforceable undertaking Good progress on M&A and divestment strategies
Overall STVR CEO outcome					33%	22%	

[1] Commonwealth Bank 2018 Annual Report Pages 106-109.

In this scorecard three financial measures make up 50% of the total number of six measures. Yet they account for 60% of the total weighting.

For the same Bank there are three LTI measures of which only one is a financial measure (33.3% of the total number of measures) yet TSR accounts for 75% of the weighting:

- Total Shareholder Return (weight 75%);
- Trust and Reputation (weight 12.5%);
- Employee Engagement (weight 12.5%).

Capping the number of measures alone is insufficient to ensure the right balance is achieved. The relative weighting must also be capped. This needs to be clarified in the Draft Standard (Paragraph 38).

3. Deferment and Clawback

The Draft Standard (Paragraphs 53 and 54) proposes 7 year deferral of 60% of the CEO's variable reward with pro-rata vesting after 4 years. For other senior executives (and highly paid risk-takers) 40% of variable reward must be deferred for 6 years with pro-rata vesting after 4 years. This deferral is to occur whether or not the executive remains in the employ of the awarding organisation.

The aim of this strategy is to minimise the risk of vesting remuneration when there might be a subsequent decline in corporate performance. I offer the following comments:

a) The average tenure of a CEO in Australia is around 5 years. A senior executive somewhat less. This being the case CEOs, and other executives, would be relying on the performance of their successors to receive their full reward after the 6-7 year vesting period. From a shareholder, customer and other stakeholder perspective this might seem reasonable. They are primarily interested in sustained corporate performance, not reward outcomes for individual executives.

   However, from the executive's point of view it might be a leap of faith, to place part of their reward in the hands of successor executives.

b) How corporate performance is to be measured over the longer term is not clearly defined. Paragraph 58 of the Draft Standard suggests financial and compliance might be the key measures for vesting to occur. If this is the case it is inconsistent with the re-balancing of KPIs set out in Paragraph 38. It might be better to state that vesting is contingent on the organisation sustaining balanced performance over the period against the criteria it has set for itself (which should include the non-financial aspects of performance as well as the financial).

   To do otherwise and make vesting contingent primarily on sustained financial performance undermines the intent of Paragraph 38.

c) Paragraphs 53 to 59 make no provision for a "Force Majeure". The term is used in the broadest sense. That is, a major event that disrupts corporate performance to the degree that the organisation is no longer able to meet its implicit contract with its shareholders, customers and/or other stakeholders. A

force majeure could also include a favourable event, outside of the control of the executive team, which causes an unexpected upward spike in some aspect of corporate performance. In either case, the board and remuneration committee would need to exercise discretion in determining remuneration outcomes. Paragraphs 21-32 allow for such discretion which would clearly also form part of the Remuneration Committee charter.

All of the above have implications for vesting and clawback.

4. Delivery in Equity

CPS 511 does not specify the form in which variable reward should be delivered. Although various paragraphs do acknowledge that equity, or equity related vehicles, are favoured by the banks and other listed financial entities. The term "skin in the game" appears in the Discussion Paper, meaning holding equity in the employing organisation.

"set minimum deferral periods (up to seven years) for senior executives to provide more 'skin-in-the-game' through better alignment to the time horizon of risk and performance outcomes."

Discussion Paper, Strengthening Prudential Requirements for Remuneration, 23.7.2019, Page 5

There is an inherent tension between holding significant equity in the employing organisation and independent decision making. See Point 5. Moreover, rebalancing KPIs as set out in Paragraph 38, and maintaining delivery in equity at best sends a mix message to executives and other stakeholders. At worst it undermines the re-balancing of KPIs. It sends the message that profitability and TSR remain the top priority.

My suggestion is to insert a clause under Remuneration Design in the Draft Standard that states that the amount of variable reward delivered in equity should match or be less than the percentage allocated to financial metrics, that is, up to 50%. The balance is to be delivered in cash.

5. Minimum Shareholding Requirements

The Big 4 banks and major financial institutions require their executives to hold a minimum level of equity in their employing organisation. This is the "skin in the game" mentioned above. This equity is usually acquired through STI and LTI plans and is accumulated progressively. The following table sets out the requirements of the Big 4 plus the AMP as outlined in their 2018 Annual Remuneration Reports:[2]

Bank/Institution	CEO	Other Executives
	Value	Value
AMP	300,000 shares	60,000 shares
ANZ Bank	200% of FAR	200% of FAR
Commonwealth Bank	300% of FAR	200% of FAR
National Australia Bank	200% of FAR	100% of FAR
Westpac Group	500% of FAR	$1.2m worth of shares

[2] FAR = Fixed Annual Remuneration.

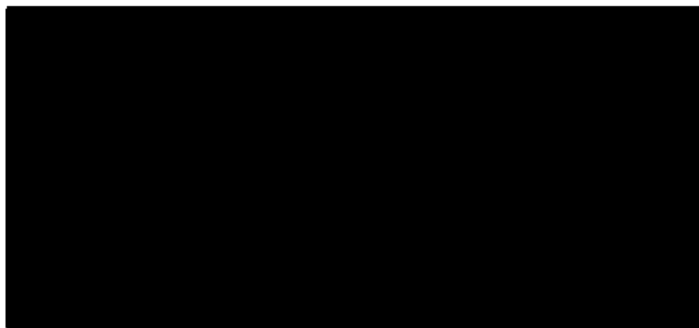
The Draft Prudential Standard CPS 511 is silent on the matter of minimum executive shareholding requirements. Such requirements are a policy decision for each Board and Remuneration Committee. However, I ask whether the intent of Paragraph 38, rebalancing KPIs, is not also undermined while current MSR policies remain in place.

Concluding Comments

Under APRA's regulatory framework and prudential supervision Australia has developed and maintained one of the most robust financial services sectors in the world. Australia has not experienced a major recession in over 25 years. There has not been a collapse of a financial institution since 2011.[3] The strength of the banks, in particular, has provided a bulwark against negative global financial events such as the GFC. Yet the findings of the Hayne Royal Commission shocked the community. Some of that financial strength was achieved, at least in part, by questionable conduct. This is a wake-up call to boards and executive teams not just in the Financial Services Sector but industry more broadly.

The Draft Prudential Standard CPS 511 is a step in the right direction for the governance of executive remuneration. The comments made above are intended to assist in tightening up some Paragraphs in the Draft Standard. Others suggest the need for Supplementary Guidelines to assist boards grapple with this very real and difficult policy issue.

Our perspective has always been a "back to basics" approach with executive remuneration. Companies do not need overly complex models to attract and retain the best talent. Sustained financial, operational, customer, stakeholder and people performance are base-line accountabilities for the CEO and executive team. Fixed Annual Remuneration, at the appropriate level, covers this. If performance dips, the board needs to hold the executive team to account. It doesn't need the "big stick" approach that the current model reinforces. If performance exceeds expectations, across a range of financial and non-financial performance indicators, then modest variable reward mechanisms might activate.



[3] APRA Annual Report 2017-2018 Page 52.

About Geoff Nunn & Associates

Geoff Nunn & Associates was established in 1993 as an independent provider of remuneration and organisation advisory services to the government and corporate sectors. Projects in the area of executive remuneration have been completed in over 1000 organisations Australia, New Zealand and Singapore. The Company now specialises in working with boards, CEOs and executives in the areas of corporate governance, board strategic advice, board renewal, board structuring and design and high level executive remuneration strategy formulation.

Our services include:

- Board Governance Advice
- Board and Committee Charter Drafting
- Board Dynamics and Renewal
- Board and Committee Structuring
- Executive Remuneration Strategy
- Remuneration Governance Advice

See: https://www.gna.net.au/

Geoff Nunn – Board Advisor & Corporate Governance Specialist

Geoff has been involved in remuneration, human resource management and governance for over forty years. He is a specialist in corporate governance, executive remuneration, corporate performance measurement and board and organisation structuring.

He has consulted extensively to the private sector. Organisations include those from manufacturing, utilities, engineering, finance, insurance, superannuation automotive, mining and petroleum industries. Geoff has consulted widely to the government sector and worked with a number of industry associations.

Before entering consulting in 1993, Geoff spent twenty years in a range of senior remuneration and human resource with the National Australia Bank, Public Transport Corporation of Victoria and RioTinto (previously CRA).

Geoff holds undergraduate qualifications in Accounting, a Graduate Diploma and a Master's Degree in Organisational Behaviour from Swinburne University. He is a Fellow of the Australian Human Resources Institute, a Graduate Member of the Australian Institute of Company Directors and is published in the areas of performance and remuneration management.