Governance Institute of Australia

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Australian Prudential Regulation Authority

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Discussion Paper: Strengthening prudential requirements for remuneration

Governance Institute of Australia (Governance Institute) is the only independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance professionals and risk managers are unrivalled.

Our members have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies, as well as not-for-profit organisations (NFPs) and the public sector.

Governance Institute welcomes the opportunity to provide a submission to APRA on the Discussion Paper *Strengthening prudential requirements for remuneration* and on the draft *Prudential Standard CPS 511 Remuneration* (Standard).

We also thank APRA for the opportunity to meet APRA representatives to discuss the Standard on 1 October 2019.

General comments

Our members consider that a number of aspects of the Standard will bring improvements to accountability and remuneration governance and assist in addressing issues identified by the Final Report of the Prudential Inquiry into the Commonwealth Bank of Australia (CBA Report) and the Final Report of the Royal Commission into Financial Services (FSRC). The requirement to consider risk when determining remuneration and for boards to actively oversee and vary remuneration outcomes, if necessary, should bring greater rigour to remuneration considerations. Similarly the extension of board oversight to remuneration for all employees should assist in bringing about positive change. Regular board reviews of their entity's remuneration frameworks will also give boards and stakeholders greater confidence that remuneration, particularly incentive-based remuneration, is leading to the desired outcomes.

Our members have identified a number of concerns about the Standard which are detailed in the Attachment to this letter. Their three major concerns relate to the blurring of the distinction between the board and management, the level of prescription and the fact that the Standard further complicates remuneration policy by layering further complexity on top of an already complicated regime.

As governance professionals our members are frequently charged with responsibility for explaining what is required under new requirements to their organisations. They are also actively involved in assisting their organisations, both with external reporting and with board governance reporting. They actively promote increased accountability and a strengthened governance culture. For this reason it is important that any changes not be overly prescriptive or so complex that they are poorly understood and implemented across industry. Our members consider that a 'tick the box' approach to compliance with the Standard is not what is required to achieve the type of change contemplated by the CBA Report and the FSRC.

Our members consider that the Standard takes a 'one-size fits all' approach to remuneration in APRA-regulated entities which may be appropriate for large Australian listed entities with the resources to implement it, but may prove more difficult for smaller APRA-regulated entities. An 'if-not, why not' approach, particularly for smaller entities with less complex governance arrangements, is preferable. As a founding member of the ASX Corporate Governance Council, Governance Institute is a long-standing advocate for a flexible disclosure-based approach to governance matters.

Key recommendations

Governance Institute recommends that**:**

- APRA reconsider the drafting of the Standard to ensure the important demarcation between the board and management is maintained and that the drafting does not inhibit boards' ability to rely on information and advice provided by others
- APRA reconsider the overly prescriptive nature of the Standard, particularly as it will relate to smaller APRA-regulated entities
- APRA consider the importance of balancing the task of implementing the FSRC recommendations, with not adding a further layer of complexity to an already overly complicated remuneration regulatory regime, particularly for listed entities
- a preferable approach to imposing a 'hard cap' on financial metrics for variable remuneration is to include a recommended percentage and to require entities to report on an 'if not, why not' basis against the recommended percentage
- APRA reconsider the length of the deferral period so that variable remuneration operates as a real, rather than an illusory incentive
- the drafting of paragraph 58(b) of the Standard refer to a **'material'** breach of compliance obligations and that APRA consider alternatives such as an appropriate deferral period and malus provisions in place of claw back
- TSR be considered as a useful measure of performance for remuneration in conjunction with other suitable risk-based measures
- APRA consider the potential unintended impact of the Standard on the dynamics of corporate democracy in listed entities and the potential impact on the rights of retail shareholders
- the approach to the alignment of the BEAR with the Standard be settled and agreed, with appropriate industry consultation, before the Standard commences and that APRA consider the implementation date for the Standard given that the impact of BEAR will not be clear until the requirements come into effect for small and medium ADIs until 1 July 2020, with appropriate transitional provisions
- the implementation date for the new requirements align with the entity's financial years, that early adoption of the new requirements be encouraged and that APRA consider permitting

grandfathering of existing incentive plans, subject to appropriate limitations

- APRA consider the unintended impact of the deferral and other requirements in the Standard on the ability of APRA-regulated entities to attract suitably skilled staff and for the Australian financial services sector to remain globally competitive.

Governance Institute would welcome the opportunity to be involved in further deliberations on the Standard and the accompanying guidance.

Yours sincerely,

[redacted]

Attachment

1. Blurring of distinction between the board and management

There is much contemporary commentary about what boards should be doing to restore trust and to right the wrongs uncovered by the FSRC.

For very practical reasons, directors have power under the Corporations Act to delegate (sections 190, 198D and 201K). In most Australian entities, directors have delegated day-to-day management of the business to the CEO and the senior management team. There is a separation between the board and management. The types of matters a board reserves to itself and those it delegates to management will be a function of an entity's size, complexity, ownership structure, history, culture and the skills of the board and the management team. These will not necessarily remain static but will change as an entity changes and evolves. Given that they are not full-time employees of entities, it is not directors' function to involve themselves in the day-to-day management of an entity, hence the need to rely on the CEO and the senior management team. In fact, it is good governance for there to be a clear delineation between the roles and responsibilities of board and management.[1]

It is good governance for listed entity boards to have a majority of independent directors.[2] Independent non-executive directors are a key governance mechanism for avoiding situations where an individual or group of individuals polarise board decision-making and for maximising the likelihood that board decisions will reflect the best interests of the entity as a whole, rather than individual security holders or interest groups. Independent directors also play an important role in challenging management and holding them responsible and to account.

Again for practical reasons directors are able to rely on information or advice provided by others (section 189 Corporations Act). The reliance must be made in good faith; and after making an independent assessment of the information or advice, having regard to the director's knowledge of the entity and the complexity of its operations and structure. The extent of what directors must do in order to undertake an 'independent assessment' does not require directors to redo the task themselves. Directors are entitled to rely on others, but should apply an enquiring and unbiased mind to the information brought to them. The practicalities of what this will require depend on the particular matter and the nature of the information.

The ability to delegate and to rely on information and advice provided by others are two important ways in which the business of an entity is able to be carried out efficiently. For this reason our members are concerned at the blurring of the demarcation between board and management in the Standard. It is important to clearly maintain this distinction so as to ensure that boards maintain sufficient distance from the day-to-day operations of an entity to enable them to bring independent and objective judgement to bear on remuneration matters. If directors are not able to rely on information and advice provided by others, subject to the important caveats referred to above, it is almost impossible for them to carry out their role.

Governance Institute recommends that APRA reconsider the drafting of the Standard to ensure the important demarcation between the board and management is maintained and that the drafting does not inhibit boards' ability to rely on information and advice provided by others.

2. Prescription

Our members are concerned about the prescriptive nature of a number of the proposals, particularly the lack of discretion in relation to entities' governance arrangements, notably the

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[1] *Corporate Governance Principles and Recommendations,* ASX Corporate Governance Council, 4th edition, February 2019, Recommendation 1.1.

[2] *Corporate Governance Principles and Recommendations,* ASX Corporate Governance Council, 4th edition, February 2019, Recommendation 2.4.

operation of board committees and the proposed remuneration design requirements (see 4 below). The following are examples of areas of concern:

- Paragraph 36 of the Standard prescribes the terms of an APRA-regulated entity's triennial review of their remuneration framework. Our members consider that this would be better restated as a set of principles.
- We note that on the current wording of the Standard (paragraph 48) it would seem that the board Remuneration Committee is required to assess and make recommendations on the remuneration arrangements and variable remuneration 'individually' for senior managers and highly-paid material risk-takers. Our members consider that this is overly prescriptive and that it would be more appropriate for Remuneration Committees to look at this group as a cohort with appropriate discussion in relation to outliers.
- The Standard prescribes the interaction between the various board committees. While this may be appropriate for large well-resourced listed entities, this may not be scalable for smaller APRA-regulated entities. Our members consider and 'if not, why not' approach to these arrangements would be preferable.
- Our members note that while the Standard is prescriptive in many areas, the critical link between remuneration and strategy is nowhere referenced. There are references to 'business plans' but these are usually tactical rather than strategic
- Paragraph 19(d)(2) (service contracts) could have the unintended consequence of requiring an entity to be involved in the structure and terms of remuneration arrangements of employees and contractors of unrelated service providers (a potentially large group of people, particularly in the superannuation sector where outsourced arrangements are very common), simply because the services provided may materially affect how the entity manages its risks and fees are based on how well services are performed. We recommend APRA clarifies in its guidance what service contracts it intends to capture by this provision.

Governance Institute recommends that APRA reconsider the overly prescriptive nature of the Standard, particularly as it will relate to smaller APRA-regulated entities.

3. Complexity of the Australian remuneration regime

Remuneration in Australia operates within a confusing patchwork of law, guidance and the accounting standards. Since the requirement to put the remuneration report before shareholders was introduced (section 250R Corporations Act), there have been a substantial number of new requirements added to the Corporations Act in relation to this disclosure requirement. Each new requirement supplements rather than replaces existing remuneration disclosure requirements. With the stated policy objective of simplification, the addition of more layers of regulation rather than adopting the approach of taking a holistic view, has resulted in complexity and confusion for investors, particularly retail investors.

Governance Institute has advocated for some time that there is a pressing need for an approach to legislative reporting requirements that aims to simplify reporting, rather than adding further layers of complexity.[3] The Standard layers further complexity on top of an already complicated regime.

Governance Institute recommends that APRA consider the importance of balancing the task of implementing the FSRC recommendations, with not adding a further layer of complexity to an already overly complicated remuneration regulatory regime, particularly for listed entities.

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[3] See Submission to Treasury *2016-2017 Budget Submission*, 5 February 2016.

4. Remuneration design, deferral and clawback

Our members have identified several areas of concern in related to the requirements proposed by the Standard:

- *The balance between financial and non-financial measures for variable remuneration schemes*

The balance between financial and non-financial measures is a concern, as is the limitation of financial metrics for variable remuneration to no more than 50% of the total measures used for allocation of the remuneration (Standard paragraph 38). Neither the FSRC Report nor the Financial Stability Board (FSB) has dictated a measurement. The FSRC recommendation was to 'set limits on the use of financial metrics in connection with long-term variable remuneration'. This is one area where our members consider the requirements of the Standard are overly prescriptive. The Standard and BEAR both make boards accountable for remuneration outcomes which our members consider is a preferable policy outcome to imposing a hard cap on financial measures.

One aspect of our members' concern relates to the limitation on boards' discretion in relation to remuneration. By prescribing a cap on financial metrics for variable remuneration, the Standard is removing the key link between remuneration and strategy and a board's ability to adjust variable remuneration for failure to implement strategy or a year of poor financial results. An unintended consequence of a minimum 50 per cent allocated to financial measures might be that in a year of poor sectoral financial performance an entity is unable to adjust an incentive downwards. An alternative may be to look at 'gateways' so that variable remuneration awards can only be made provided certain gateways, including meeting financial targets, are met. Meeting financial targets is also critical to ensuring the affordability of incentive schemes. Many investors view conduct gateways, such as expected standards of behaviour, compliance and conduct, favourably as they set a minimum bar. An entity should at a minimum meet its financial targets before any sort of variable remuneration award is considered.

Our members consider that imposing a 'hard' cap on the proportion of financial measures will not necessarily achieve the stated objectives of APRA's review of the Standard. It is still possible to have an incentive plan with a significant proportion (40 per cent to 50 per cent) of non-financial measures applied and still produce pay for performance misalignment. The issue relates more to improving accountability and oversight within entities, rather than prescribing pay and incentive parameters. In our members' experience there remains considerable debate between shareholders and governance advisors as to what types of non-financial measures should attract a reward - as opposed to incurring a negative accrual or trigger malus or clawback. Similarly the most effective form of incentive will vary between entities for sound reasons. At this stage there does not seem to be a consensus and setting an artificial limit pursuant to the Standard may be counter-productive. We also understand from discussions with our equivalent body in the United Kingdom that the introduction of 'caps' has had the effect of increasing fixed remuneration for CEOs and senior executives.

A preferable approach to imposing a hard cap may be to include a recommended percentage for financial metrics and to require entities to report on an 'if not, why not' basis against the recommended percentage. This would allow for the fact that there are variety of remuneration plans in use at the moment and that what is appropriate for a large ADI may not be suitable for an insurer. Superannuation funds, particularly in the not-for-profit sector do not typically pay variable remuneration. It would also allow entities greater flexibility to provide more meaningful discussion about their incentive plans.

Governance Institute recommends that a preferable approach to imposing a hard cap on financial metrics for variable remuneration is to include a recommended percentage and to require entities to report on an 'if not, why not' basis against the recommended percentage.

- *The deferral requirement for CEO and executive variable reward in significant financial institutions*

Our members also consider that the requirement to defer the CEO's and other executives' (including material risk takers) variable remuneration for either six or seven years with a minimum vesting period of four years is overly prescriptive. Practically they question the perceived benefit a CEO will attach to variable remuneration that cannot vest for four years when the average CEO tenure is approximately five and half years.[4] They consider that any return is likely to be heavily discounted in the minds of prospective CEOs and is also likely to make the financial services sector less attractive to prospective employees (see 8 below). Our members also note that setting a minimum deferral period assumes all significant financial institutions share a similar risk profile and ignores questions of strategy.

Governance Institute recommends that APRA reconsider the length of the deferral period so that variable remuneration operates as a real, rather than an illusory incentive.

- *Claw back – length and enforceability*

Under paragraph 56 of the Standard variable remuneration for senior managers and highly-paid material risk-takers must be subject to clawback. Our members consider the length of the proposed claw back period for up to two years beyond full delivery and four years for a person under investigation in significant financial institutions is too lengthy. In our members' experience clawback is extremely difficult to achieve without resorting to litigation against the employee. Given that litigation always involves uncertainly does this mean that variable remuneration cannot be contemplated for these types of employees? Our members question whether it is in the best interests of customers, shareholders and other stakeholders for an entity to have to resort to litigation against a former employee to manage the consequences of poor behaviour, noting that litigation is usually expensive, protracted, stressful and disruptive to a business. It would also be a significant concern if an issue had not crystallised within nine years, being the sum of the proposed seven year deferral period and the two year claw back period. This may also impact the statutory limitation period for contractual claims.

We also note that claw back should be an extreme measure and for this reason **Governance Institute recommends** that the drafting of paragraph 58(b) of the Standard refer to a **'material'** breach of compliance obligations. **Governance Institute also recommends** that APRA consider alternatives such as an appropriate deferral period and malus provisions in place of claw back.

- *TSR*

The other issue of concern to our members in this area is the role of Total Shareholder Return (TSR) in performance metrics (paragraph 38 of the Standard). Our members acknowledge there is some evidence to support APRA and the FSB's contention that relative TSR incentives encourage excessive risk taking. Nonetheless in their experience, TSR is a widely accepted and understood measure of an entity's performance, readily accepted by investors. While APRA considers it to be a financial metric, there are a number of other factors 'baked into' the measure which implicitly include non-financial matters such as reputation and standing in the market and performance relative to peers. Investors would argue it is a total measure.

Recent analysis by Guerdon and Associates carried out over seven years of ASX 300 remuneration report votes found that TSR for the year prior to the AGM had a negative impact on votes against the remuneration report. This means that a lower TSR increased the chance of

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[4] *CEO turnover at the ASX200 rises to 20pc: Robert Half survey finds*, P Durkin, Australian Financial Review, 15 October 2018.

a vote against the remuneration report.[5] The analysis observes that this outcome is sensible as shareholders that are unhappy with their return would be more likely to express dissatisfaction by voting against the remuneration report. Given its importance as a measure of shareholder satisfaction with an entity's performance, our members consider that TSR continues to have a role in setting remuneration objectives.

Governance Institute recommends that TSR be considered as a useful measure of performance for remuneration in conjunction with other suitable risk-based measures.

5. Investors and remuneration

A further complexity in relation to remuneration, particularly in larger listed entities, is the role that proxy advisers and institutional investors play in driving the use of financial metrics in remuneration. While there is some acknowledgement that non-financial objectives have a place if they have clear metrics, there is certainly a strong focus in their guidelines on achieving financial targets. For example, ISS Australia's 2018 Proxy Voting Guidelines provide: 'Where non-financial objectives are used as part of the performance conditions, ISS expects the majority of the payout to be triggered by the financial performance conditions'.[6]

Our members consider that there is potentially a major challenge for boards in that investors may not agree with the remuneration outcomes created by the Standard and may vote against remunerations reports. Directors potentially find themselves in an unenviable position where the Standard prescribes one approach and some shareholders are seeking another. It would be unfortunate if the Standard were to, in effect, create a two-tiered structure of listed entities competing for capital in the same market – those which have remuneration regulated by APRA and those which do not. This mitigates against a well-functioning market and potentially makes APRA-regulated entities less attractive to investors.

We also understand that some investors' advisers have expressed concerns that the Standard runs contrary to the interests of corporate democracy by limiting shareholders ability to fully determine the remuneration outcomes for executives, particularly paragraphs 38, 53, 54. We consider that retail shareholders may also have concerns that the important right of shareholders to approve remuneration reports is neutralised by the Standard in its current form.

Governance Institute recommends that APRA consider the potential unintended impact of the Standard on the dynamics of corporate democracy in listed entities and the potential impact on the rights of retail shareholders.

6. Interaction between the Standard and BEAR

One significant issue with the Standard identified by our members is how its requirements interact with the Banking Executive Accountability Regime (BEAR) which will ultimately extend to all APRA-regulated entities. In some areas the Standard duplicates some of the BEAR requirements and it will be extremely important for the two regimes to be considered side-by-side. Areas of potential duplication include: the roles in scope and the length of remuneration deferral periods – there are some slight differences in the wording of some clauses that do have an impact. For significant financial institutions typically all persons covered by BEAR should fall into the longer deferral periods under the Standard. However, there may be situations where they do not, which means that entities must comply with different provisions for different classes of employees. This is both administratively burdensome for entities and leads to employee

[5] The Variable that Correlates Strongly with Remuneration Report Votes, Guerdon and Associates Newsletter 5 March 2019.

[6] See *Proxy Voting Guidelines, Benchmark Policy Recommendations*, Effective for Meetings on or after October 1, 2018 page 18, ISS Australia at https://www.issgovernance.com/file/policy/active/asiapacific/Australia-Voting-Guidelines.pdf.

uncertainty about their terms of employment. Our members also note that BEAR includes definitions of small, medium and large ADIs so question the need for an additional definition of 'significant financial institution' in the Standard. This is particularly the case, given the policy intent of BEAR according to its Explanatory Memorandum is expressed in similar terms to the policy intent of the Standard.

Similarly we consider APRA should clarify that the intention of paragraph 16(k)(i) is to be consistent with BEAR and not inadvertently capture every director of a subsidiary group but rather BEAR 'Accountable Persons'. Our members consider that the Standard should be as consistent with BEAR as possible, to avoid entities having to comply with inconsistent remuneration regimes.

We understand discussions are underway to align the two sets of requirements. Our members consider it would be preferable for these discussions to be concluded and an approach agreed, with appropriate industry consultation, before the Standard commences. Given the changes to individual remuneration contemplated by the Standard, it would be disruptive for the Standard to commence operation only to be amended shortly thereafter because of inconsistencies with BEAR. Implementing the Standard on the basis of entities' financial years (see 7 below) may allow sufficient time for the harmonisation to be completed.

Governance Institute recommends that the approach to the alignment of BEAR with the Standard be settled and agreed, with appropriate industry consultation, before the Standard commences. **We also recommend** APRA consider the implementation date for the Standard given that the impact of BEAR will not be clear until the requirements come into effect for small and medium ADIs until 1 July 2020. We ask that APRA clarify that the intention of paragraph 16(k)i(i) is to include BEAR 'Accountable Persons'.

7. Implementation date for new requirements

Our members consider that it would be preferable for the implementation date of the new requirements to align with entities' financial years, rather than the 'hard' start date contemplated by the Consultation Paper and the Standard. Alignment with entities' financial year will allow a smoother start to the new requirements, particularly given that many entities may have to amend existing contractual arrangements and transition to the new requirements.

Allowing entities to adopt the new requirements from the commencement of a new financial year will avoid the complexities and potential inequities created by changing existing performance plans mid-stream. There may need to be some grandfathering of existing arrangements.

If a financial year commencement date is adopted it would be possible to allow entities to early adopt the new requirements.[7] We also recommend that APRA consider allowing entities to grandfather existing incentive plans, given the potential disruption created by implementing APRA's requirements during the course of an incentive plan.

Governance Institute recommends that the implementation date for the new requirements align with entities' financial years, that early adoption of the new requirements be encouraged and that APRA consider permitting grandfathering of existing incentive plans, subject to appropriate limitations.

8. Talent drain

Our members consider that the deferral requirements (see 4 above) included in the draft Standard will impact on the ability of APRA-regulated entities to attract suitably skilled staff at a

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[7] The ASX Corporate Governance Council has adopted this approach in relation to the 4th edition of the *Corporate Governance Principles and Recommendations*.

time when many of them are in need of skilled staff. This is likely to impact on banks and superannuation funds in particular, by creating a non-level playing field for talent. It will be challenging for deferral requirements of 6 years to be imposed on Material Risk Takers (even if these requirements are only imposed on significant financial institutions).

The remuneration requirements imposed by the Standard, particularly the lengthy deferral periods for incentives, potentially make the financial services sector less attractive and candidates are likely to favour industries not operating under these constraints. For example, those working in areas such as such as HR, Company Secretariat and Legal may decide not to work in an APRA-regulated entity as their remuneration would not be subject to clawback and malus provisions in non-APRA-regulated sectors. Similarly those working in superannuation may find the funds management industry a more attractive proposition. It would also be undesirable if the consequences of the requirements of the Standard were to make Australia a less attractive option for those working in financial services. At the senior executive level the employment market, particularly in significant financial institutions, is global and the constraints imposed by the Standard potentially make the Australian financial services sector less competitive when compared to other financial centres in the region.

Governance Institute recommends that APRA consider the unintended impact of the deferral and other requirements in the Standard on the ability of APRA-regulated entities to attract suitably skilled staff and for the Australian financial services sector to remain globally competitive.