HSBC

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General Manager – Policy Development
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Dear Sir / Madam

APRA Discussion Paper - *Strengthening prudential requirements for remuneration*

HSBC Bank Australia Limited
The Hongkong and Shanghai Banking Corporation Limited Sydney Branch (collectively HSBC)

HSBC welcomes the opportunity to make a submission on the *Discussion Paper - Strengthening prudential requirements for remuneration.*

In Australia, the HSBC Group offers an extensive range of financial services through a network of 44 branches and offices. These services include retail and commercial banking, trade finance, treasury and financial markets, payments and cash management and securities custody. HSBC Holdings plc, the parent company of the HSBC Group, is headquartered in London. The Group serves customers worldwide from around 4,000 offices in 70 countries and territories in Europe, Asia, North and Latin America, and the Middle East and North Africa. With assets of US$2,751bn at 30 June 2019, HSBC is one of the world's largest banking and financial services organisations.

We have undertaken a review of the Discussion Paper and write to provide our feedback. HSBC has participated in the industry working groups through the Australian Banking Association (ABA) and Australian Financial Markets Association (AFMA) and are supportive of their submissions. HSBC's preference is to adopt a principles based approach that is suitable to a range of different organisations and structures, rather than a formal prescriptive approach with limited flexibility.

Please note that we have not directly addressed each consultation question and submit our feedback in regard to the areas relevant to HSBC.

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Remuneration design

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?

We seek further clarity from APRA in regard to the 50/50 requirement related to financial and non-financial objectives linked to variable reward, i.e. does this requirement refer to the target objectives against which an individual's performance is assessed and remuneration outcomes determined or to any weightings or combination of objectives at other levels (for example the creation of variable pay pools at a Global, Region or Country level)? When drafting the final Standard, HSBC recommends consideration of a flexible model, which recognises the various levels and ways in which financial and non-financial objectives may be employed, and allows the Board discretion to determine the combination of objectives which is most appropriate to the organisation.

We note that the draft CPS 511 implies a scorecard approach to remuneration design is employed by all organisations and that objectives within the scorecard are assigned specific percentage weightings. The majority of HSBC staff do not have specific weighted scorecards in place and instead our employees have unweighted objectives across both financial and non-financial spheres according to the nature of the role. There is not a formulaic relationship between actual performance and remuneration outcomes that could be directly influenced by the imposition of defined metric weightings.

In addition to performance metrics, HSBC also assesses employees on their values and behaviours. This non-financial consideration acts as both a gate and modifier with regard to remuneration outcomes and focusses employees not just on what they achieve but the way in which they achieve it. We are concerned that a specified 50/50 split within a scorecard structure ignores the other levers within performance and remuneration frameworks that identify and reward (or otherwise) employees for the "how" and not just the "what".

We note the clarification provided by APRA during the consultation process that, in the absence of a scorecard, the onus will be on the Board to demonstrate that due diligence has been undertaken in the awarding of variable remuneration to ensure that non-financial considerations have been taken into account. In light of our structure, we would appreciate APRA's consideration of clarifying the wording in the final drafting of CPS 511 to accommodate different approaches.

What would be the impacts of proposed deferral and vesting requirements for SFIs? For ADIs, what would be the impact of implementing these requirements in addition to the BEAR requirements?

We have grouped our feedback according to the following underlying themes:

<u>Impact of BEAR</u>

HSBC is concerned that the draft requirements under CPS 511 are a further extension to the current standards under the BEAR, which in turn are a level above the prevailing market practice prior to the effective date of the legislation. The medium and small ADIs, including HSBC, have been subject to the BEAR for four months and the major banks for less than 18 months and we believe APRA should provide sufficient time for the impact of the BEAR requirements, especially with regard to conduct and risk outcomes, to be evidenced across the industry.

Definition of a SFI

We note that the size, scale and complexity, as well as composition and quantum of remuneration of the organisations categorised as a SFI under the assets threshold test varies significantly and we recommend APRA consider the impacts of applying one model across such diverse organisations.

The correlation between the size of the organisation and remuneration, both target and earned, is publically evidenced by annual remuneration disclosures for the listed banks, however this quantum and composition does not necessarily apply for other, smaller organisations grouped under the same SFI definition. The complexity of remuneration, specifically with regard to components of variable pay varies between the largest banks and smaller banks and we believe APRA should consider these variables when drafting the Standard.

By way of example, HSBC utilises a Short Term Incentive (STI) variable remuneration design and does not award Long Term Incentive (LTI) to its executives. Organisations not awarding LTI are required to meet deferral requirements through the STI component of remuneration, meaning that an award that, by design, is meant to reward shorter term performance outcomes, has a greater proportion required to be deferred and the executive is required to wait longer to realise the value of the full award. By contrast, those organisations awarding LTI are able to address deferral requirements through their LTI component without significant difference in employee experience.

The Discussion Paper outlines APRA's expectation that CPS 511 will not disadvantage smaller entities relative to their larger competitors, however HSBC's view is that the proposed SFI thresholds and the remuneration deferral implications risk impacting smaller entities disproportionately. HSBC would support further stratification in tiering along the lines of BEAR (small, medium and large) as a more appropriate categorisation of organisations reflecting the size and complexity of operations and remuneration.

Material Risk Takers (MRT)

We believe that the definition of MRT in the draft Standard is broad and open to interpretation, however HSBC does not recommend using a strict qualitative criteria for organisations to identify a MRT. HSBC's preference would be for the Board to be granted discretion to determine which roles are considered to be MRT with consideration for the size and scale of operations of the organisation.

With specific regard to Highly Paid MRTs (HPMRT) the draft Standard sets a threshold of AUD 1,000,000 potential total remuneration for the identification of HPMRT who are required to be subject to the deferral and vesting rules. HSBC does not operate a target based framework and all variable pay is discretionary, therefore the amount of total remuneration for executives will fluctuate annually according to HSBC's global, regional, country, business unit and individual performance.

The current drafting of CPS 511 assumes that all organisations are able to calculate an executive's on-target remuneration in a given year, however under HSBC's discretionary framework, we are unable to identify this group of executives.

HSBC recommends that HPMRT are not categorised as a separate group and are instead included under our proposed Board discretionary powers to determine, on a relative and qualitative basis, the roles and individuals considered to fall under the scope of a MRT.

Proportionality

The Discussion Paper references examples of deferral time periods of six and seven years mandated by some international regulators. HSBC notes that these deferral periods are applicable to the most senior executives at some of the largest global institutions. HSBC's parent bank in the UK, HSBC Bank Plc is in scope for the UK Senior Manager Regime (SMR) and HSBC's Group CEO is subject to a seven year deferral period. This deferral period is proportionately appropriate for the Group CEO of one of the largest global banks in the world with USD 54bn in revenue (2018). If APRA are considering applying a similar requirement to the Australian market however, we would suggest that consideration is given to recognise the relative size of Australian organisations in the global financial services industry, and the vast differences between size and complexity of the Australian major, medium and small banks

We note that under the SMR criteria, the majority of MRT identified are subject to three and five year deferral periods, with vesting occurring on a pro-rata basis from year one. We suggest that APRA consider including a similar position in the drafting of CPS 511.

HSBC would suggest that APRA allow the Board discretion to determine an appropriate timeline for deferrals that aligns risk and reward, considering the proportionate scale and complexity of operations domestically and internationally.

De Minimis

HSBC notes that the de minimis of AUD 50,000 total variable award prescribed within the draft Standard differs to the current de minimis under the BEAR which states that if the deferral calculation results in an amount of less than AUD 50,000 to be deferred then deferral is not required.

HSBC's view is that an absolute de minimis of AUD 50,000 is too low, with an executive required to defer AUD 20,000 for a period of seven years. HSBC recommends that the de minimis criteria be aligned with the BEAR.

Perceived value of variable pay

HSBC believes that the increased deferrals placed on variable pay will have the impact of decreasing the incentive aspect of variable pay and therefore decreasing the incentive for discretionary effort. We suggest APRA consider the risk of reduced motivation for innovation and considered risk taking which poses a risk for organisational performance in the short and longer term. At the same time, HSBC's view is that there will be upward pressure on fixed pay levels as the market seeks to compensate executives for the significant change to their annual cash flow.

Would the proposals impact the industry's capacity to attract skilled executives and staff?

HSBC believes that the more stringent deferral and clawback requirements and the population to which they would be applicable would lead to attraction and mobility issues for HSBC and for the financial services industry as a whole. We note that skills are increasingly transferrable across industries and a flight of talent is a real risk if Australia as a location and Financial Services as an industry become less desirable.

As a global organisation, HSBC promotes international mobility of staff and we foresee that executives will not be willing to come to Australia in favour of jurisdictions with less stringent regimes. There is also the risk that Executive and other senior roles within HSBC Australia become less desirable, with employees not be willing to step up into these roles given the increased deferrals and vesting periods.

Conversely, the lengthy total at-risk period for variable pay, considering both deferral and clawback, may have the impact of inducing executives to stay in their roles longer than is strategically desirable in order that they do not forfeit their significant deferred variable pay.

From a risk perspective, the decreased attraction of Financial Services as an industry and of Australia as a destination for executive talent will lead to a lack of new ideas, perspectives, strategies and energy being brought to ADIs. In addition, it is often new leadership that identifies and takes action to remediate past wrongs. A lack of turnover "at the top" may mean that timeframes for these actions will lengthen.

Remuneration outcomes

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?

In conjunction with the proposed six and seven year deferral requirements, the addition of the clawback extends the total at risk period for remuneration to ten and eleven years respectively from the time that the award was originally determined, and HSBC's view is that this is a disproportionately long period of time. HSBC notes that from the case studies presented to the Banking Royal Commission, none took ten years for the misconduct or negligence to come to light.

HSBC believes that there are practical drawbacks to the use of clawback. Clawback is not legislated and would require executives to contractually agree to the potential clawback of their remuneration. In the event clawback needed to be invoked, legal action may also be required. The potential cost involved with pursuing clawback through the courts may exceed the amount that needs to be clawed back.

HSBC has a global footprint and executives often work across multiple locations during their career. Given the combined deferral and clawback period, the likelihood is that HSBC will be chasing repayment across countries and the question exists as to whether our clawback requirements can be enforced in other jurisdictions where executives are subject to local regimes?

HSBC suggests further clarification is outlined in the drafting of CPS 511 on whether the ADI clawbacks the gross or net paid awards. We suggest that net amount is appropriate as the individual has already paid tax on awards at time of vesting.

Additionally we note that the value of share-based deferred awards fluctuates in line with share price and the Standard should specify whether the clawback is on the value at grant, value at vest or value at date of clawback enforcement.

HSBC's view is that clawback should be employed as a last resort for the most severe misconduct or negligence and that the Board should have the discretion to determine whether clawback is appropriate or whether another penalty may be imposed.

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