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## Re: Prudential Standard CPS 511: KPMG's submission to consultation process

KPMG Australia is pleased to provide our attached submission in response to the draft Prudential Standard CPS 511 – Remuneration (**Standard**) and discussion paper, released for consultation on 23 July 2019.

As a leading professional services firm with a remuneration consulting practice, we are committed to contributing to the debate in respect of reward at this pivotal time for the financial services industry.

KPMG is supportive of the Standard's objectives to improve oversight of regulated entities' remuneration arrangements and achieve remuneration outcomes aligned with performance and risk outcomes.

APRA has sought to draft the Standard in a manner which is consistent with its "principles based philosophy". There are aspects of the proposal though which are highly prescriptive and may benefit from further consideration.

In preparing our submission, we have sought to address what we consider to be the key issues (particularly for larger financial services companies including Significant Financial Institutions (SFIs), with significant employee populations). The detail of our submission is set out in **Attachment A.** Where appropriate, we have suggested alternative approaches for APRA's consideration. In summary our key areas of focus are:

- **Limit on financial measures:** while we understand that the proposal aims to strengthen the sound management of non-financial risks, the inclusion of a limit on financial measures is overly prescriptive. As an alternative, APRA could consider requiring entities to determine the right balance between financial and non-financial measures to support their objectives.
- **Deferral periods for Significant Financial Institutions (SFIs):** the proposed deferral periods for SFIs should create better alignment with the long-term soundness of the business as well as the investor view. However we think that the $50,000 variable remuneration may create a disproportionate impact on some employees (given varied remuneration arrangements) and that longer deferral periods may result in unintended consequences.
- **Clawback:** mandating clawback will help strengthen consequence management in regulated entities. However the proposed clawback period, in operation with the proposed deferral period for SFIs, is considered excessive.
- **Board oversight of incentive plans:** the Standard establishes clear obligations for the Board and Remuneration Committee to increase their oversight of remuneration. However we see that some aspects of the Standard may create practical challenges in executing this oversight and to some degree may risk blurring the line between Board and management responsibilities.

We have also outlined some additional considerations in respect of specific industries (e.g. superannuation) and taxation consequences of the draft Standard, for completeness.

# Attachment A

## Remuneration design

### Limit on financial measures

We understand APRA's concern that the historical over-emphasis on financial measures in incentives has not supported the sound management of non-financial risk, and has discouraged consideration of the interests of broader stakeholder groups (e.g. customers).

However, we consider the proposed 50% limit on financial measures (and the 25% individual weighting limit per financial measure) as too prescriptive, misaligned with APRA's "principles based" approach and creating practical challenges. It should be removed from the Standard for the reasons set out below.

As an alternative, paragraph 37 of the Standard could be amended to include a new sub-paragraph which states that the design of variable remuneration arrangements must incorporate "an appropriate balance between financial and non-financial performance measures to support the achievement of the entity's remuneration objectives as set out in paragraph 20."

This alternative approach is more aligned with requirements in overseas jurisdictions. We note that the UK's Prudential Regulatory Authority does not currently mandate a split between financial and non-financial measures under variable remuneration arrangements, and instead requires firms to ensure that, where remuneration is performance related, "when assessing individual performance, financial as well as non-financial criteria are taken into account."[1]

- **Companies should have the flexibility to determine an appropriate balance between financial and non-financial measures which is aligned with their business strategy, in year priorities and broader economic conditions.** There is no "right" split and what is appropriate will be dependent on the particular circumstances of the entity. There is also a risk from prescription that the Board's accountability may be diminished because their ability to set the appropriate framework for the entity has been curtailed.
- **This prescriptive limit does not adequately accommodate varying remuneration frameworks and may result in unintended outcomes.** In practice, companies have differing approaches to determining incentive outcomes including pooling mechanisms (i.e. where a company-wide pool is created and then distributed to individuals based on an assessment of their scorecards) and gateways which must be met before employees are eligible to receive an incentive (e.g. risk and compliance gateways).

  It is unclear how the proposed limit would interact with such mechanisms and it could create unintended consequences if strictly applied. For example, how would this limit apply to a Company with a "risk and compliance gateway" on their short-term incentives (STI) but a scorecard that is 75% financial? In that scenario, it is arguable that the limit has been achieved as the non-financial gate determines eligibility for an incentive (however, this is unlikely to be the desired outcome).
- **The proposed limit applies to the entire employee population, which is predicated on the notion that companies have a formulaic scorecard approach to incentives throughout their entire organisation. This is often not the case in practice.** In fact, it is common in contemporary approaches to performance management, for employees below the executive level to have goals agreed with their leader in broad focus areas (which may include goals against specific projects or across different roles) which feed into an overall performance rating / assessment (rather than a set scorecard which applies for the whole year). It may be difficult to assess whether the limit has been met in practice.

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1 *Prudential Regulatory Authority 2015* (UK) Rulebook: CRR Firms: Remuneration Instrument 2015/53, r 15.10.

- **In our experience, it is difficult for a Board to set robust and quantifiable "non-financial" measures over the long-term that are acceptable to shareholders.** While financial outcomes can be reliably measured and most organisations have good data to set those metrics, it is more difficult to measure non-financial outcomes reliably and consistently over the long-term (e.g. 3 to 4 years). The use of non-financial metrics in long-term incentives (LTI) has garnered criticism from investors and proxy advisors in the past for this very reason.

  While appearing straight forward, it can also be a case of trial and error in selecting non-financial measures which drive the right sorts of behaviour. For example, if the Company's strategy is to deepen customer relationships, then the measure selected may be increasing the number of products to each customer. While this is not a direct "revenue" measure, it could have an unintended outcome of encouraging employees to push unsuitable products onto customers.

- **Using other adjustment tools, such as Board discretion or formal modifiers could achieve similar outcomes to what APRA intends.** These tools allow Boards / management to make an overall assessment of factors beyond just financial performance and can be applied at an aggregate and individual level.

## Deferral period for Significant Financial Institutions (SFIs)

Overall, the proposed deferral period for significant financial institutions (i.e. 7 years for the CEO and 6 years for senior managers and highly paid material risk takers) is in line with emerging practice overseas and does create better alignment with the long-term soundness of the business and the long-term investor view.

However we think that the $50,000 variable remuneration may create a disproportionate impact on some employees (given varied remuneration arrangements) and that longer deferral periods may result in unintended consequences.

- **The $50,000 threshold is disproportionate to the length of the deferral period.** For example, an employee earning $55,000 in variable remuneration in a particular financial year, would be subject to the same deferral and clawback requirements as an employee earning $1M in variable remuneration. This does not seem a proportionate response. APRA should consider increasing the minimum threshold.

- **Longer deferral periods may result in unintended consequences such as the reweighting of pay packages to fixed remuneration and reduced market competitiveness of SFIs.** The proposed deferral periods are significantly longer than typical LTI plans in Australia (i.e. with performance periods of 3 to 4 years). This may reduce the market competitiveness of SFIs, as employees have a tendency to discount the value of incentives that vest a long time into the future. As APRA is seeking to encourage the sound management of non-financial risk, it is important that SFIs are able to attract the "best and brightest" who understand these considerations.

  The longer deferral period could also result in changes in the pay mix amongst SFIs i.e. a reduction in variable remuneration in favour of fixed pay. This may undermine APRA's intent to have variable remuneration available as a consequence management tool (e.g. subject to malus and clawback).

## Clawback requirements for SFIs

We agree that mandating clawback does strengthen consequence management. However the proposed clawback period, in operation with the proposed deferral period for SFIs, is considered excessive. As an alternative, consideration should be given to limiting the Standard to malus (i.e. forfeiture of variable remuneration) over the proposed deferral period for SFIs. The circumstances in which clawback may be exercised are also broad.

- **Malus / clawback periods should be aligned with the timeframe for an individual's actions and risk issues to "play out", and remuneration consequences to be applied.**

  As currently drafted, the interaction of the deferral period with the clawback window (i.e. 2 years post release with up to 4 years where there is an ongoing investigation) means that remuneration can be available for clawback for up to 11 years for a CEO. In our view, the proposed deferral period for SFIs (7 years for the CEO and 6 years for senior managers and highly paid material risk takers

(MRTs) is a sufficient time period for any negative events impacting the entity to "come to light", and for remuneration consequences to be applied to the individual.

In light of this, APRA should consider limiting the Standard to malus (i.e. forfeiture) over the deferral period (as against mandating clawback post release for 2 – 4 years), if the deferral period length remains unchanged in the final Standard.

In addition, the proposed clawback period may be perceived by employees as a very long period where they cannot be certain of receiving their remuneration. This too could create unintended outcomes regarding pay mix and movement of talent. We also note that clawback is already very difficult to implement in practice and typically requires legal action to be commenced on the basis of contract. The lengthy clawback periods proposed under the Standard may be difficult to enforce in practice from a legal perspective.

- **The criteria proposed for clawback (paragraph 58a) includes application where the individual is responsible for material financial loss.** It is agreed that these circumstances are undesirable. However, there is a risk that this criterion could discourage appropriate commercial risk taking within the set risk appetite, and investment in innovation. We suggest this specific "trigger event" be removed.

# Board oversight of incentive plans

## Oversight of individual pay outcomes for special role categories (>$1M)

In our experience, Boards understand that greater oversight of remuneration is an expectation in a post Royal Commission world and that it will help to rebuild public trust in Corporate Australia.

With this in mind, the requirements for Boards to review the remuneration framework annually from a compliance perspective (paragraph 33) and triennially from an effectiveness perspective (paragraph 34) are strong underpinnings of governance.

The obligation on the Board Remuneration Committee to oversee individual pay outcomes for senior managers and highly paid MRTs (i.e. those with total remuneration greater than $1M) will be challenging in practice (paragraph 48a). The threshold for "highly paid" MRTs should either be lifted or consideration given to alternatives for how oversight may be achieved for companies with large numbers of MRTs.

- **The requirements as drafted have the potential to place a considerable practical burden on some Boards.** It is common for Board Remuneration Committees to have oversight of individual pay outcomes for the CEO and their direct reports. The more granular review of senior managers and highly paid MRTs will require considerably more oversight by Committees (including not only in respect of remuneration arrangements but also individual performance drivers and outcomes). For some SFIs, this may increase oversight to several hundred employees.
- **The requirements for broader oversight of individual pay outcomes also risks blurring the lines between Board and management responsibilities**. The Standard requires Remuneration Committees to assess and make recommendations on the remuneration arrangements and outcomes for these special role categories. This type of decision making is an unusual role for Boards and more typically the role of management (with Board oversight).

# Additional considerations

## Applicability of CPS511 to Registrable Superannuation Entity (RSE) licensees

APRA has sought feedback as to whether RSE licensees should be captured by CPS511, or whether the requirements specific to RSEs should be articulated in a separate standard. Some feedback from the superannuation industry has been that the Standard (as currently drafted) is overly complex and difficult to follow, and APRA should consider excluding RSE licensees from the remit of CPS 511.

Additional considerations in respect of RSE licensees are set out below.

- **APRA should consider narrowing the scope of what is required to be covered by each entity's documented remuneration policy, having regard to the business models of some RSEs (and others).** Paragraph 19(d) of the Standard requires the documented remuneration policy of entities to set out "at a high level, the structure and terms of remuneration arrangements" of third parties where the "services provided...may affect the entity's long-term soundness or materially affect the management of financial or non-financial risks". In some industries (such as superannuation), it is not uncommon for entities to have a large portion of their business model operating under outsourced arrangements (e.g. outsourced investment arms). This creates an oversight issue for the APRA regulated entity, having to cover employees of another entity (or contractors) they do not control.
- **APRA may wish to clarify how the proposed Standard applies to entities who do not have variable remuneration (e.g. some RSE licensees).** The proposed Standard (and the upcoming extension of a BEAR-like regime beyond authorised deposit taking institutions (ADIs)) has caused some entities to question whether APRA's intent is for them to introduce variable remuneration in order to comply with the proposed requirements (particularly given APRA's view that variable remuneration is an important consequence management tool i.e. it is available for malus / clawback). We do not expect that this is APRA's intention and note that some entities do not have variable remuneration in place for strongly held cultural reasons (e.g. profit-for-member industry funds).

## Accelerated vesting of unvested variable remuneration for former employees

The Standard specifies that entities must not accelerate the vesting of unvested variable remuneration for former employees unless "specific exceptions" apply (which include for "death, serious incapacity, serious disability or serious illness") (paragraph 40). APRA should consider extending these "specific exceptions" to include permitting accelerated vesting of a portion of incentives to allow the former employee to meet their income tax obligations.

Under Australian tax legislation, a tax obligation arises for the individual at the time of cessation of employment (regardless of whether a portion of unvested equity incentives remain on-foot and the value has not yet been realised by the employee). It is not uncommon for companies to release at least a portion of variable remuneration to allow participants to meet these tax obligations (to ensure the individual is not left "out of pocket").

## Transitionary arrangements

APRA should consider providing greater clarity in the Standard as to the intended transitionary arrangements i.e. will the new requirements only apply to remuneration granted post the effective date of the new Standard (as against grants currently on-foot)? The interaction with other regulatory regimes (e.g. BEAR and the intended "BEAR-like" regime which will apply to other APRA regulated entities) would also be benefit from further clarification.