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A Legg Mason Company

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General Manager
Policy Development, Policy and Advice Division
Australian Prudential Regulation Authority (APRA)
By email: PolicyDevelopment@apra.gov.au

Consultation on renumeration requirements for all APRA-regulated entities

Dear Sir/Madam

Martin Currie is a global fund manager with A$24 billion in listed equity strategies assets under management. Of these assets, A$12 billion is in Australian equities and is managed by the Martin Currie Australia team. As such, we are large shareholders in several Australian financial and non-bank financial companies which are regulated by APRA.

We refer to the request for submissions to the APRA Discussion Paper, *Strengthening prudential requirements for remuneration*, dated 23 July 2019.

Having considered the discussion paper and the impact of the reforms as a whole, we would like to voice our concerns regarding the proposed core element on page 5 of the paper to limit the use of financial performance metrics.

We formally request that APRA makes no change to the prudential framework for variable remuneration design to limit the use of financial performance metrics to 50%, and for this to apply to all employees, as is currently drafted under CPS 511 on page 18, for the following reasons:

1. Financial metrics are tangible and objective

Our central premise is that in relation to remuneration ("REM"), we believe the majority of measures for both short term incentives ("STI") and long-term incentives ("LTI") should be easily identifiable, measurable and relate directly to the company's performance. To measure success, financial metrics which include relative total shareholder returns ("TSR"), are very tangible and objective.

We believe that if a company is law abiding, treats its staff well, has excellent customer experience and delivers a product or service which has purpose and relevance to the population at large, that company will over the long term deliver good financial returns to shareholders.

It follows that the Board will also have sound company polices to ensure the company is not just compliant, but focused on their key stakeholders (shareholders, customers, suppliers, community) and will reward the CEO and executive team to derive consistent positive outcomes by implementing the strategy set by the Board.

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2. Qualitative measures can create confusion, conflict and lack of accountability

Our concern with a prescriptive quantity of qualitative measures is that it can create confused incentives.

By way of example on, we would like to share the recent comments made by prominent professor of Finance at NYU's Stern School of Business, Aswath Damodaran, as it succinctly summarises our views on the matter[1]:

"In some sectors and in some markets and during some time periods, markets will not do the job, leaving us as the mercy of bad behavior by some or many corporate players. It is therefore not surprising that stakeholder wealth maximization is seen as an alternative corporate model.

It is quite clear that the corporate mission in this version of corporatism has been enlarged to cover all stakeholders, often with very different interests at heart. On the surface, it may look like constrained capitalism, but unlike it, in this version, you have multiple objectives, with no clear sense of which one dominates. Your job as a top manager or CEO is to pay not just a fair, but a living wage, even if you cannot afford it as a company, but also deliver maximum value to your customer, preserve society's best interests and ensure that your business stays competitive, while also making sure that you deliver the returns your stockholders and lenders desire. In my view, it is destined to fail for three reasons:

- ***Conflicting interests**: By treating the interests of all stakeholders as equivalent, it ignores the reality that decisions in companies, almost by definition, will make stakeholders better off and others worse off. Since some of these costs and benefits will be not easily translated into numbers, it is not clear how managers will be able to decide what investments to take, what businesses to enter and exit, how to finance these businesses and when and how much cash to return to shareholders.*
- ***No accountability**: The fact that there are multiple stakeholders with conflicting interests also leaves CEOs and top managers accountable to none of them, with the excuse with any group that was ill-served during a period being that other group's interests had to be met.*
- ***Decision paralysis**: If one of the problems at large companies has been the time it takes to make decisions, I will predict that expanding decision making to take into account the interests of all stakeholders will create decision paralysis, as the "on the one hand, and on the other" arguments will multiply, often with no way to resolve them, since some stakeholder interests will remain fuzzy and non-measurable."*

3. Adverse outcomes from qualitative measures

We are also concerned that qualitative measures can often lead to perverse outcomes.

Bringing this to an Australian context, we note the recent history of changes to incentives at Commonwealth Bank of Australia (CBA); in particular at its 2016 Annual General Meeting on 9 November 2016 where a proposal was passed to shorten performance periods for the relative TSR and customer satisfaction hurdles, and reduce the importance of the relative TSR and customer hurdles to accommodate the introduction of a '*people & community*' metric. This qualitative metric related to diversity, sustainability and culture 'including risk culture'.

What is noteworthy about this change was that it invoked a high degree of reliance for shareholders to place on the CBA Board in assessing outcomes under the 'people and community' targets. We believe that should have been a particular leap of faith for shareholders, given that up to this point the Board's oversight of annual bonuses had resulted in only one bonus payment below target out of 48 disclosed bonus outcomes for senior executives over the previous four years. We note that as shareholders, we voted against the proposal to change remuneration measures at the time.

[1] Source: Damodaran, A 2019, *From Shareholder wealth to Stakeholder interests: CEO Capitulation or Empty Doublespeak?,* Musings on Markets, accessed October 2019, http://pages.stern.nyu.edu/~adamodar/

It was subsequently reported by corporate governance watchdog Ownership Matters in its voting advisory for the 2017 AGM that absent the board's subsequent intervention for the Austrac issues, the initial outcome for the CEO's bonus scorecard was calculated as 103% of target in FY17[2]:

Ownership Matters note that:

"CBA was in dialogue with Austrac prior to the legal action being launched in August 2017, and by its own admission the Board had been aware of the issues raised by Austrac during FY16 (at the latest).

It is therefore unclear how the CEO could have received 67% of target bonus (approx. A$530,000) on "people and community" measures including relating to reputation".

Absent of formal intervention, we believe that in this case the application of the non-financial '*people & community*' metric would have resulted in an outcome that was outside of the realm of reasonability.

4. Difficulty in devising correct non-financial metrics

The other concern we have is in respect to the difficulty in ultimately devising the correct non-financial metrics.

For example, in APRA's final report of the Prudential Inquiry into the CBA, the author noted[3]:

"*Reporting to the Board on aggregate customer satisfaction continues to emphasise CBA's ranking relative to its peers. However, reporting does not emphasise the serious customer complaints that may be a small portion of overall complaints but may nonetheless represent a large number of customers with an extremely negative experience. These complaints may pose reputational or other risks to CBA*".

In this case, the CBA thought it was accurately measuring non-financial feedback from stakeholders, but it was arguably misleading.

Incentive structures must be readily identifiable and if a number of intangible measures are used, we expect management will find ways to ensure they are met. Financial returns such as TSR are as a result of the efforts by management to implement a strategy set by the Board which delivers benefits to shareholders and stakeholders.

5. Some merit for front line staff

As regards to the proposal for the changes to have minimum design requirements for all employees, we do see merit in using non-financial measures for key performance indicators (KPIs), especially for front line staff that interact with customers and suppliers.

We note that a number of Australian bank branch staff have only a minority of revenue based KPIs and a majority of non-financial measures including fully informing customers about product/risks, customer satisfaction and willingness for training and development.

We see significant differences in accountability between staff and their duty to customers compared to the CEO and Board accountability to their shareholders.

[2] Source: Ownership Matters 2017, *Commonwealth Bank of Australia (CBA) Voting Advisory*, accessed October 2017, https://www.ownershipmatters.com.au
[3] Source: APRA 2018, *Prudential Inquiry Into The Commonwealth Bank Of Australia*, accessed October 2019, https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry_Final-Report_30042018.pdf

Conclusion

For the above reasons, we do not support the proposal to change variable remuneration design to limit the use of financial metrics to 50%, and for this to apply to all employees, as currently drafted under CPS 511.

Should law makers decide that components of STI and LTI become increasingly non-financial by nature, we as shareholders will continue to vote against such measures when nominated at AGMs.

We believe that active ownership, with strong interaction with both Boards and management, will ultimately see better outcomes for all stakeholders. Furthermore, incentive structures are already very focused on these outcomes.

Watering down financial objectives will only diminish the focus and expectations of Boards and management of listed companies and not be in the interests of the stakeholders that the proposed changes are aiming to align to.

[redacted]

Yours sincerely

[redacted]