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23 October 2019

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To whom it may concern,

SUBMISSION ON THE PROPOSED CPS 511 REMUNERATION

National Australia Bank Limited (NAB) welcomes the opportunity to comment on APRA's consultation paper on 'Strengthening prudential requirements for remuneration'.

CPS 511 has been developed against the background of the revelations and findings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission), with the aim 'to ensure that an entity's remuneration arrangements produce appropriate incentives and outcomes'[1].

NAB agrees there is a need for greater transparency and consistent standards of accountability for remuneration governance across regulated entities. NAB believes that regulation is an important component in rebuilding trust and reputation with financial services stakeholders for a healthier banking industry and sound prudential management.

NAB recognises that while we and our peers have embarked on a process of review and change, a strengthening of the regulatory environment is required for consistent standards and competitive neutrality. Most of the CPS 511 draft and the accompanying Discussion Paper strives to that end, and receives NAB's support.

NAB's efforts to focus and reward performance that represents the interests of all NAB stakeholders is consistent with the draft of CPS 511. Our reward systems have been restructured to drive a customer focus and apply accountability (and remuneration adjustments) when outcomes are poor, or conduct is inappropriate. The practical considerations of our work to achieve this has informed our submission.

Key considerations

Like APRA, NAB wants a healthy, safe and well managed banking industry servicing the capital needs of individuals, businesses and governments. We want CPS 511 to work within that context. To make CPS 511 practical and workable, we offer some observations regarding its implementation, and conclude with our three main recommendations.

1 Discussion Paper: Strengthening prudential requirements for remuneration 23 July 2019 – page 5

Observation 1: How increased deferrals and clawback can affect the Banking industry's ability to attract and retain talent

For a healthy and thriving banking industry we need to attract and retain talent. We are not alone. Other industries also compete for much of the same talent pool from domestic and international markets. Yet these industries are not constrained in how they configure their pay packages to attract and retain this talent. CPS 511, however, requires a significant deferral of employee pay. Deferral reduces its perceived value. Additional malus conditions devalue it further by the uncertainty that it will eventually be received. Other industries have little, or no deferral, and subsequently no malus.

In a relatively small market such as Australia, the application of a prescribed bank remuneration model for one sector of the economy is likely to restrict the free flow of talent domestically, reduce the appeal of the region to offshore talent, and has the potential to weaken the banking system. Special Role category personnel with specialist skills that are not sector bound include information technology, risk management, wealth management, finance and accounting, legal, human resources, and operations. They will not be drawn to an ADI unless the remuneration package offered is competitive.

For example, banking strategies rely heavily on technology to deliver better customer outcomes, better risk management, and ultimately lower long-term costs and better financial strength. These skills are paramount as the industry is challenged by digital disruption, including disruption from competitors not subject to the same regulation. Over time, our ability to attract those individuals from domestic and international markets without providing higher fixed remuneration to offset the relative disadvantages of longer deferral will be significantly challenged. Retention of talent without similar intervention will also emerge rapidly as an issue.

To contain overall costs, the net result would be a reduction in the total variable reward opportunity, limiting the levers available to adjust remuneration commensurate with risk outcomes. This would negate an intent of CPS 511, though may be necessary to serve the talent needs of the entity.

Further, some in the banking industry will be able to respond in this way more effectively than others. As a public company, institutional investors and proxy advisers may limit our ability to respond by increasing fixed remuneration and limiting variable remuneration for our most senior employees, whereas this limitation would not apply to unlisted competitors.

The net unintended impact may well distort the market for talent and erode our competitive position as we vie for talent with private companies, start-ups, offshore entities, and other sectors.

Observation 2: The impact on Board priorities of the definition of Material Risk Taker (MRT)

Bank boards need to dedicate and prioritise their time to the oversight of business strategy and its execution, risk management and the bank's prudential framework.

While NAB agrees it is responsible and appropriate for Boards to oversight more rather than fewer MRTs, it would be impractical for boards to review, individually, the pay of 100s of special role category individuals. Yet this could be the unintended consequence of the regulation's wording for the remuneration approval for MRTs and Highly Paid Material Risk Takers (HPMRTs).

Instead, a common definition of MRT across all regulated entitles that drives a sensible balance between individual oversight of remuneration and collective oversight will ensure boards are able to prioritise appropriately across business strategy and execution, risk management and the bank's prudential framework.

NAB believes the current interplay of the definition of Senior Manager in CPS/SPS 520 and BEAR's requirements of Accountable Persons creates a robust accountability framework where the true responsibility to manage material risk already exists.

The inclusion of a Highly Paid Material Risk Taker definition complicates the landscape where potential remuneration levels rather than potential impact of risk taking drive the need for a higher level of Board oversight. While NAB can accommodate the CPS 511 definition of MRTs, it will maintain the Board's deepest oversight for those individuals captured under the CPS/SPS 520 Senior Manager category where the ultimate accountability for risk taking resides.

Observation 3: How non-financial measures can improve stakeholder outcomes

CPS 511 requires variable remuneration to be contingent on a 50:50 balance between financial and non-financial performance measures.

NAB fully supports the principle that non-financial risk management has a critical role and place in sound prudential management. However, the practicalities are that in a bank, some roles will be focused on compliance, some on financial and risk adjusted returns and some entirely focused on conduct and some a mix of all.

We need to retain the flexibility to design a remuneration framework that focuses the performance of these diverse sets of special role category employees on their deliverables and accountabilities. While there would be some variant of financial and non-financial elements in these roles it will not always be 50:50. But, taken together across the bank, there will be a balance of attention on financial and non-financial performance and risk.

The UK and other international regulations provide useful reference points where a balance between financial and non-financial performance measures is advocated but not prescribed. In these locations, regulators often take a pragmatic approach, encouraging Boards and management to assess the particular drivers of performance and satisfy themselves that they are appropriate. Often, where financial measures are a key driver of performance, Boards will ensure reward outcomes are appropriate by scrutinising non-financial performance measures which are then used to temper outcomes when appropriate.

NAB's recommendations

1. The BEAR deferral regime be used as the CPS 511 default. Because risk-taking and risk outcomes often become clearer over time, it is important to align deferral periods with the duration of the business cycle and risk profile. BEAR is tailored to the financial services industry and so is designed to meet these criteria. The need for longer deferral periods is reduced further where entities can detect and consequence poor conduct or misconduct during the performance year:
    a. Following release of the findings of the Royal Commission and the APRA Information Paper, Self-assessments of governance, accountability and culture (22 May 2019) and in consideration of NAB's self-assessment, we have implemented a consequence management framework which more closely integrates risk and conduct outcomes with performance management and reward.
    b. NAB is confident that with an increase in the sophistication of its risk management frameworks (including data analytics and platform enhancement), the prospects of timely identification of operational and conduct risk are greatly increased, allowing for consequences to be applied during the performance year or malus adjustments made within the BEAR deferral timeframe.
    c. The addition of regular independent remuneration policy effectiveness reviews will provide an appropriately measured level of oversight to protect stakeholders over the long-term.
2. Flexibility in the weighting of performance measures:
    a. Mandating the balance of financial and non-financial measures could undermine a Board's responsibility to exercise 'oversight of the sound and prudent management of that institution'[2] and does not account for differing strategies and risk profiles across different entities.
    b. NAB recommends each entity should retain the flexibility to manage risks as needed and ensure performance is holistic and weighted appropriately taking into account business imperatives and the accountabilities of an individual role. They should also retain the flexibility to further develop non-financial metrics not previously favoured by institutional investors (e.g. customer measures such as Net Promotor Score).
    c. As an alternative to prescribed measures, NAB recommends Boards be required to confirm to APRA how they have balanced financial and non-financial measures in their assessments of performance.

[2] APRA CPS 510 clause 16.

3. If APRA favours a prescriptive balance, NAB recommends a minimum weighting of 25% non-financial measures, or a model which balances the financial and non-financial measures across Special Role Category jobs aligned to the nature of individual roles. The resulting balance would then be subject to board oversight. NAB supports the CPS 511 definition of MRT[3] and Senior Manager[4] but not the creation of an additional HPMRT category as it constitutes an administrative burden that will not necessarily result in an uplift in risk assurance:

    a. The setting and management of the enterprise risk profile remains the responsibility of roles already captured in BEAR and CPS/SPS 520. The execution of business strategy as underpinned by the agreed risk profile is performed through organisational design, role design, accountability statements and delegation framework. An individual's remuneration potential does not necessarily denote their accountability as an MRT or Senior Manager.

    b. The populations captured by the MRT and Senior Manager categories will, by definition, capture the key roles within each entity. The inclusion of an HPMRT cohort on the basis of remuneration potential adds complexity and a board distraction without adding equal uplift in risk assurance.

    c. The reporting line roles into both Senior Managers and MRTs will themselves be subject to rigorous performance assessment, ongoing review and consequence management reflecting NAB's performance and remuneration frameworks. Should any material financial or non-financial issues emerge for what is currently defined as an HPMRT, it will be assessed and addressed as part of these remuneration governance practices, which in turn is subject to Board oversight.

    d. NAB expects that the number of roles captured under BEAR and CPS/SPS 520 (and subject to individual Board oversight) would be no less than 25 and no more than 50 and recommends the Group Chief Risk Officer and Chief People Officer determine this cohort having regard to NAB's risk profile, accountability statements and delegation framework. The designated cohort would then be subject to APRA's approval from time to time.

Appendix A sets out NAB's response to the questions raised in the Discussion Paper accompanying CPS 511, to the extent they are not already addressed in this letter.

Once again, thank you for the opportunity to give early feedback on the proposed CPS 511 Remuneration. We look forward to engaging further with you on this important change.

Yours faithfully

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[3] MRT under CPS 511 means a person whose activities have a material potential impact on the entity's risk profile, performance and long-term soundness, and in addition for an RSE licensee, means a person whose activities have a material potential impact on promoting the financial interest, and reasonable expectations, of beneficiaries.

[4] Senior Manager under CPS 511 means (i) a person who has or exercises any of the senior management responsibilities, within the meaning of Prudential Standard CPS 520 Fit and Proper and for an RSE licensee, Prudential Standard SPS 520 Fit and Proper, for the entity in their capacity other than as a director; and (ii) who is a director within the meaning of the Corporations Act.

APPENDIX A: NAB RESPONSE TO QUESTIONS IN THE DISCUSSION PAPER

NAB's response to questions raised in the Discussion Paper accompanying CPS 511 Remuneration

Remuneration framework	Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework?	• Triennial review is appropriate at a minimum. • The impact of remuneration frameworks need time to allow for any meaningful assessment of the impact on culture and employee behaviour.
	What areas of the proposed requirements most require further guidance?	NAB believes that the following require additional clarification and guidance: • The interplay of CPS 511 deferral and clawback requirements with BEAR. • Confirm that risk adjusted financial measures continue to be categorised by APRA as non-financial when calculating the total weighting of measures across variable remuneration arrangements. • Whether the cap on financial performance measures should be calibrated at an overall entity level, apply to each incentive scheme within an entity, or to the performance of each individual employee (see Paragraph 38 of the Discussion Paper). • How the application of Board discretion (and its consideration of financial and non-financial matters) should be taken in to account when determining a prescriptive balance between financial and non-financial measures. • In relation to malus, what constitutes a 'significant downturn in financial performance' and is this still a trigger for malus when caused by factors outside an individual's control (e.g. unexpected economic shock)?
Board oversight	Are the proposed duties of the Board appropriate?	• CPS 511 sets out the duties of a Board, namely "The Board, or relevant oversight function, of an APRA-regulated entity is ultimately responsible for the entity's remuneration framework and its effective application. The Board must actively oversee the framework." • NAB believes these duties are appropriate. • NAB would also benefit from APRA's practical guidance on what constitutes "active oversight" by the Board of the remuneration framework, which will enable us to assess the adequacy of our current practices and the current delineation of responsibilities between the NAB Board and NAB Remuneration Committee.
	Are the proposed duties of the Board Remuneration Committee appropriate?	• CPS 511 sets out the duties of a remuneration committee, namely "The Board must establish a Remuneration Committee that (a) oversees the design, operation and monitoring of the remuneration framework; (b) is appropriately composed to enable it to exercise competent and independent judgment when fulfilling requirements [of CPS 511]; and (c) has the powers necessary to perform its functions." • NAB believes these duties are appropriate. • NAB would also benefit from APRA's practical guidance on what constitutes these enhanced responsibilities when compared with those required under CPS 510.

Remuneration design	APRA is proposing that financial performance measures make up no more than 50 per cent of variable remuneration measurement and individual financial performance measures no more than 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?	• CPS 511 prescribes a cap of 50% on financial performance measures. NAB queries whether APRA intends to apply the cap generally to the entity, or specifically to each incentive scheme and/or individual. • Institutional investors favour financial performance measures. Some also reason that non-financial influences are already captured in financial metrics (e.g. that trust, reputation, confidence in management are already key drivers of TSR outcomes). • As set out in the covering letter, NAB recommends flexibility be retained to allow entities to tailor the balance depending on the specific role of an individual. • NAB further recommends a staged introduction of any prescriptive limits, such as a smaller initial weighting to non-financial measures, e.g. a minimum weighting of 25%. • These actions will allow entities the flexibility to balance the requirements of all stakeholders and address the maturity of certain non-financial measures.
	What would be the impacts of the proposed deferral and vesting requirements for SFIs? For ADIs, what would be the impact of implementing these requirements in addition to the BEAR requirements?	• CPS 511 proposes a 7-year deferral for CEOs - a 75% increase in deferral over the current BEAR minimum. This will impact both the ADI as well and the individual in receipt of variable reward. • NAB believes the BEAR deferral minimums are sufficient for now, but would prefer an extended deferral period over the impracticalities and enforceability issues surrounding clawback. • As a sequence of interventions, NAB's preference is to: – consequence poor conduct and/or misconduct during the performance year; – malus deferred equity for risk outcomes that become known over the deferral period; – resort to clawback only where other avenues are exhausted or a deferral period proves insufficient to apply malus.
	Would the proposals impact the industry's capacity to attract skilled executives and staff?	• In a relatively small market such as Australia, the application of a prescribed bank remuneration model for one sector of the economy will restrict the free flow of talent and has the potential to weaken the banking system. • Examples of specialist skills that are not sector bound include finance and accounting, legal, human resources, risk management, information technology, wealth management and operations. • The ability to attract and retain employees with these skills is paramount as the industry is challenged by digital disruption, including disruption from competitors not subject to the same regulation. • NAB does not believe these skills would be attracted to the financial services industry without providing higher fixed remuneration to offset the relative disadvantages of longer deferral and more rigorous consequence management.
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?	• There remain practical limitations from a legal perspective on clawing back variable reward paid and these limitations mirror those that already exist under BEAR (i.e. legal enforcement is challenging absent appropriate legislative power). • Without legal precedent, clawback remains problematic, and so NAB believes malus applied to deferred variable reward is a more practical and effective option. • The increased deferral periods under CPS 511 will resolve the impracticality of clawback simply by having more variable reward to malus, but come at the cost of those issues associated with increased deferral mentioned above. • NAB would also benefit from APRA's practical guidance on the application of Paragraph 56 which in its current form requires a Board to be sure it can recover (via malus and clawback) variable reward before it is awarded. This would need to include guidance on the extra territorial powers that might be required to recover (via clawback) from staff who leave and transfer overseas.

	What transitional provisions may be necessary for particular components of the new standard or for particular types of regulated entities?	• NAB recommends CPS 511 prescribe a 'grandfathering' of variable reward arrangements (Long Term Variable Reward and other deferred variable reward) awarded prior to the introduction of CPS 511.
Transparency	What disclosures would encourage a market discipline in relation to remuneration practices?	• NAB believes the existing disclosure requirements for annual remuneration reports are sufficient to satisfy shareholder and external stakeholder requirements. • Further, the triennial independent review of remuneration frameworks will allow APRA sufficient oversight of the impact of incentive programs on an entity's culture, behaviours and achievement of long term strategic outcomes.