OWNERSHIP MATTERS

Suite 4, Level 5, 167 Queen St, Melbourne VIC 3000 **T** +61 3 9602 4548 **www.ownershipmatters.com.au**

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General Manager
Policy Development
Policy & Advice Division
Australian Prudential Regulation Authority
Email: PolicyDevelopment@apra.gov.au

RE: Proposed new Prudential Standard CPS 511

Dear APRA,

Thank you for the opportunity to comment on APRA's proposed new prudential standard on remuneration, CPS 511. Ownership Matters (OM), formed in 2011, is an Australian owned governance advisory firm serving institutional investors. This submission represents the views of OM and not those of its clients.

Our comments are confined to listed entities subject to the proposed new standard (chiefly ADIs and general insurers) as that is our area of experience of incentive pay arrangements for APRA-regulated entities. Our comments also incorporate our views, where relevant, in relation to areas where APRA has specifically sought feedback:

- **Remuneration design (proposed paragraph 38):** In OM's view it is fundamentally misconceived for the prudential regulator to be specifying the precise weighting of performance metrics used to assess staff performance. It puts the regulator in the position of having to adjudicate whether or not a particular performance measure meets its criteria for being deemed a 'financial' or 'non-financial' measure. It is also likely to lead to the boards of regulated entities simply closely following APRA guidance on constructing performance scorecards and metrics rather than exercising informed, independent judgement likely to promote an entity's long term financial stability. The poor outcomes revealed by the Financial Services Royal Commission from oversight of for-profit superannuation groups relying on a 'tick-a-box' review of compliance documents rather than demonstrably poor outcomes for fund members indicate the shortcomings of a doctrinaire approach.[1]
- A better approach would be to simply delete the proposed paragraph 38. Paragraph 37 already directs APRA-regulated entities to ensure their "variable remuneration arrangements must incorporate … financial and non-financial risks that could materially impact the entity's risk profile, performance, long-term soundness". Together with proposed paragraphs 41, 42 and 43 the proposed CPS 511 already requires remuneration frameworks that incorporate management of non-financial risks and require remuneration outcomes to reflect management of these risks. The prescription proposed under paragraph 38 runs the risk of offering an

[1] See, for example, Financial Services Royal Commission, Final Report, Vol. 1 p.233.

APRA-regulated entity an easy option in demonstrating actual effective incorporation of risk management and outcomes into variable pay.

- For example, an episodic net promoter score for a wealth manager may record high levels of customer satisfaction based on personal interactions between an entity's staff and its customers but may not reveal systematic problems with advice provided. Many of the case studies of the Royal Commission (and the media reporting that helped bring the Commission into existence) revealed purportedly happy customers whose losses as a result of their interaction with financial entities and their employees only become apparent after many years.
- The approach behind paragraph 38 also appears to be informed by a view, unfortunately echoed by the Financial Services Royal Commission's recommendations, that the long term interests of shareholders and customers of APRA-regulated entities are in conflict. As the substantial and growing costs borne by shareholders of major listed financial institutions from poor conduct over the past two years indicate, poor non-financial performance will manifest itself in poor financial performance especially in an environment of effective external regulation.
- Should APRA elect to proceed with paragraph 38 in its present form in the final CPS 511, OM would urge APRA to reconsider its publicly expressed view, reiterated in the definition of a "financial measure" as including "share-based measures that reflect changes in the value of shares". Relative total shareholder return is, in OM's view, the 'least worst' long term incentive measure devised due to its objectivity and the difficulty in it being influenced by management over a prolonged period. It will also, if measured over a sufficiently long period, incorporate how well an entity manages non-financial risks relative to its peers as if it is consistently shown to treat customers poorly relative to peers this will over time influence its financial performance and hence its value relative to better-managed peers.
- Similarly, OM would also urge APRA should it decide to retain paragraph 38 to allow entities the flexibility to determine which element of variable pay non-financial measures are best applied to: For example, allow an entity to have annual incentives based predominantly on non-financial measures (as is already the case at some large listed banks) and long term incentives assessed using predominantly financial measures.
- It is also unclear from the proposed standard and the discussion paper whether an entity that created an incentive pool for staff based on financial performance which then distributed that pool among staff on the basis of financial and non-financial performance would meet the requirements of CPS 511.
- **Remuneration outcomes (proposed paragraph 41 & 42):** OM welcomes APRA's focus in the discussion paper and proposed CPS 511 on ensuring remuneration outcomes are "commensurate with performance and risk outcomes". As APRA itself has noted in its remuneration review, "downward adjustments to individual executives' remuneration were rare" despite "multiple examples where employees at lower levels received downwards adjustments".
- This is consistent with OM's own data – for example, over the seven years to the end of FY18, across NAB, ANZ and WBC there were 211 disclosed executive bonus outcomes and only 89 were paid below target (with 45 of these occurring at NAB). At CBA, over the five years to the end of FY16 out of 60 disclosed executive bonuses just four were below target and none were below 93% of target (no executive

received a bonus at CBA in FY17 and no executive received above target in FY18). Between FY13 and FY15 neither WBC nor CBA paid below target bonuses to any disclosed executive (a total of 69 disclosed bonuses) while at ANZ none of the 33 disclosed bonuses paid from FY12 – FY15 were below target).

- These outcomes also illustrate the importance of board oversight in ensuring appropriate incentive outcomes rather than weightings to financial and non-financial metrics. The FY15 balanced scorecards disclosed for annual incentives by each of the major banks for FY15 indicate a heavy weighting to non-financial measures: The Westpac scorecard had only a 40% weighting to financial measures (with 'economic profit' treated as a financial measure – it is unclear if such a 'risk adjusted profit measure' would be considered a financial measure under CPS 511 as proposed),[2] the ANZ balanced scorecard as described was weighted heavily to non-financial measures,[3] the CBA scorecard had at most a 45% weighting to financial measures,[4] with NAB the only bank to have a majority weighting to financial measures in its annual incentive scorecard.[5] This was a period during which the banks were incurring what the market now knows are significant liabilities relating to poor treatment of customers.
- The focus in CPS 511 on outcomes being appropriately adjusted for poor performance is welcome but puts the regulator in the difficult position of having to adjudicate what constitutes acceptable performance and an acceptable adjustment (although the BEAR requirements for detailed disclosure of areas of accountability for executives should make it easier for APRA to determine which executives should properly be held accountable). It is also unclear what penalty APRA would impose in a situation where variable pay outcomes were consistently too high relative to performance even following APRA intervention. Determining what constitutes acceptable performance is likely to require APRA to engage in a systematic way with, where possible, institutional investors in APRA-regulated entities which has its own challenges for APRA.
- **Deferral (paragraphs 53 & 54):** The proposed deferral requirements for periods of four to seven years for senior executives are welcome and the part of the changes in CPS 511 as proposed most likely to ensure a lasting link between executive and entity outcomes. Clarifying through additional guidance to entities exactly how the deferral requirements will operate would be beneficial: For example, if an entity abandoned any annual incentive and only allocated long term incentives assessed over four years, it would presumably be able to release 55% of the CEO's vested incentive at the end of four years.
- **Clawback (paragraphs 55-59):** OM supports the intent of the proposed clawback arrangements in CPS 511 but is uncertain whether the complications such arrangements would present in structuring remuneration arrangements (and in APRA overseeing such arrangements) is worth the potential benefits. This is however partially addressed by the fact the specified range of circumstances in which clawback is likely to be pursued (in paragraph 58) is relatively narrow and confined to circumstances of extremely poor conduct at best and criminal conduct at worst.

[2] WBC, 2015 Annual Report, pp.53-54.
[3] ANZ, 2015 Annual Report, pp. 43-44.
[4] CBA, 2015 Annual Report, p.49.
[5] NAB, 2015 Annual Financial Report, p.35.

- **Quantum:** Unspoken in APRA's past and proposed approach to executive pay at the entities it regulates is the issue of the absolute level of this pay. It is understandable that APRA is reluctant to consider such a fraught and emotionally charged topic but it is however a material consideration when it comes to prudential supervision.
- A senior executive team of an APRA-regulated entity that has accumulated substantial wealth from their tenures is simply less exposed to the downside risk of their actions (or inactions). As an example – the now former CEOs of Westpac and ANZ, Gail Kelly and Mike Smith, both realised through cash pay and sales of vested equity incentives more than $85mn during their tenures as CEO. In this context, having equity incentives still at risk valued at $10mn is simply less meaningful than had they not been able to de-risk their personal balance sheets to such a significant extent through the high levels of pay received in prior years. Even Kelly, whose minimum shareholding requirement at Westpac was more than $15mn at the end of her tenure, the highest by some distance for any bank CEO, had 'taken off the table' more than five times this amount by the end of her tenure.

The discussion paper has specifically sought views on a variety of issues. Where OM has a view that is not otherwise addressed above it is given below:

- **Frequency of reviews:** A requirement to review the remuneration framework every three years appears reasonable. OM notes the requirement for this review to be 'independent' poses some challenges and would hope APRA would not regard an entity simply seeking a review from a professional services firm as constituting an appropriate "operationally independent" review. Any fair-minded person, considering the track record of major consulting and accounting groups as advisors to financial services entities, would struggle to categorise them as independent, objective actors.
- **Areas requiring more guidance:** If APRA intends to persist with the prescribed weightings to financial and non-financial targets outlined above then a significant level of additional detailed guidance as to, for example, what constitutes a financial target will be required.
- **Board oversight:** OM has some concerns that the expanded role for board oversight of remuneration, especially remuneration outcomes (rather than the policy & framework) for an expanded group may prove unworkable at large financial institutions where the board may be required to assess outcomes for potentially 100 senior staff. Requiring the board to have carriage of the remuneration policy & framework, oversight of its effectiveness and detailed review of outcomes for the most senior executives (the group executive committee), material risk takers and persons in critical risk and control functions would be more likely to allow the board to exercise its oversight duties appropriately.
- **Impact on ability to recruit and retain staff:** In OM's view any impact on the ability of large financial institutions to retain and attract staff as a result of implementation of CPS 511 is likely to be marginal. Staff with specialist financial services skills from other comparable markets have been dealing with similar requirements for some time or are simply, in the case of North American financial institutions, already too expensive for the Australian market (there is also little to no evidence to suggest that North American financial institutions are likely to poach senior Australian financial executives at commercial banks, general insurers or wealth managers).

The impact on the ability to recruit non-specialist staff for large financial institutions is also likely to be small given the high levels of pay relative to other entities offered by Australia's large listed financial institutions.

- **Transparency:** OM supports the suggestion in the discussion paper that entities be required to disclose – retrospectively – the "specific performance metrics used to set variable remuneration" and their weightings, as well as the outcomes against these metrics. This will assist in effective market discipline as it will allow investors to assess whether targets were set at a sufficiently demanding level (for example, for the handful of listed entities in Australia that provide comparable disclosure it is notable that often incentives start to be paid for performance that is objectively poor in that it is well below what the market's expectations were at the beginning of the performance period). Many large listed entities have substantially improved disclosure of such information but many still provide only a general description of performance relative to outcomes.

Please feel free to contact us concerning any aspect of our submission. For the avoidance of doubt we are happy for our submission to be made public.

Yours sincerely,

[redacted]

Ownership Matters Pty Ltd