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Request for submissions - Strengthening prudential requirements for remuneration

PwC welcomes the opportunity to comment on APRA's proposed new prudential standard on remuneration (CPS 511). We have reviewed the proposed standard, and have detailed our feedback in this paper for your consideration.

We are committed to advocating for positive change to help strengthen the financial services industry, and the broader Australian business community. In particular, we support reform that will strengthen: the governance of reward practices; the balanced design of reward frameworks; and the fairness of reward outcomes. We firmly agree that remuneration practices do need to more effectively reinforce the full range of executive and employee accountabilities and stakeholder interests.

However, we strongly believe reform should not compromise the ability of remuneration and incentives to effectively reinforce desirable behaviours and outcomes, and to penalise undesirable ones. Reform that promotes reward models that are simpler and more transparent, that participants understand and value (such that they do actually have an impact on behaviour and performance), and that supports institutions adopting reward solutions that are most strongly aligned to their unique strategic objectives and target culture is most welcome.

I welcome the opportunity to discuss our views further. Please contact me if you wish to discuss any aspect.

Yours sincerely,

[redacted]

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Content

1. Rationale for and summary of our submission

We support the intent of APRA's draft Prudential Standard CPS 511 Remuneration (CPS 511 or the Standard) in Australia.

The new Standard aims to address the remuneration recommendations made by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ("Royal Commission"or "RC"), as well as the findings from APRA's review into remuneration practices at large financial institutions published in an APRA Information Paper in April 2018 ("2018 Information Paper").

It is our understanding that APRA is required to consider the impacts of the proposed Standard on regulated institutions' financial safety and stability; efficiency; competition; contestability; and competitive neutrality.

As such, we have utilised these objectives to develop our perspectives regarding issues that need to be addressed, and to develop the suggested solutions outlined in this paper. That is, we have only presented issues in this submission if we believe that the current drafting or requirements take away from delivering on these objectives, and we have only presented alternate solutions that enhance delivery against these objectives.

Our submission details a number of areas where we believe the Standard requires amendment, as well as areas that simply require clarification or further guidance, to best meet APRA's objectives of enhancing remuneration policies and practices, particularly the degree to which they promote effective management of both financial and non-financial risks. Namely:

2.1 There are practical challenges with the proposed duties of the board and board remuneration committee (BRC), limiting the effectiveness, and in some cases appropriateness, of their oversight

2.2 The draft standard will create an unlevel playing field in terms of competition for talent and service providers, and possibly discourage or preclude new market entrants

2.3 Compliance prefers a specific type of reward structure - the standard is not reward model agnostic to the variations observed in the market, including variations that would arguably be well aligned with the intent of CPS 511

2.4 A substantial increase on the weighting of non-financial metrics may well result in adverse impacts, or at best, unpredictable impacts on behaviour and reward outcomes

2.5 We expect the prescribed changes to result in pressure on more certain elements of pay (i.e. fixed pay over variable pay, short-term over long-term incentives, and financial over non-financial performance metrics), which is counter to the intent of CPS 511 and the enhanced focus on long-term soundness

2.6 The different sets of criteria for the application of malus and clawback will result in situations where organisations have to apply clawback when it is more practical to apply in-year adjustments or malus

2.7 There are several aspects requiring further guidance or clarification to minimise the likelihood of misunderstandings and inconsistencies in application

We are aware of other aspects of the CPS 511 that either APRA has raised as potentially requiring further discussion, or that other entities we work closely with intend to raise as concerns. As such, our submission does not claim to be a fully comprehensive list of all concerns or potential enhancements, but rather we have focussed on those aspects we feel most strongly about and/or we believe we are most qualified to provide a view on.

Our submission details our perspective on each of the areas above, including why we believe they are issues, and the implications of not addressing each issue. Furthermore, in each case we offer a 'tweaked' requirement and/or alternate wording that we believe still allows APRA to address the RC Recommendations, and the findings from the 2018 Information Paper in relation to the implementation of the earlier standards, CPS and SPS 510.

2. Key issues, challenges and suggested changes

2.1 There are practical challenges with the proposed duties of the board and BRC, limiting the effectiveness, and in some cases appropriateness, of their oversight

In this section we raise concerns in relation to the following:

2.1.1 Breadth and depth of board oversight and approvals

2.1.2 Oversight of remuneration arrangements of employees and contractors of some third party entities

2.1.3 Additional governance burden on foreign branches

Related APRA consultation questions: Are the proposed duties of the board appropriate? Are the proposed duties of the BRC appropriate?

Summary of key concerns
• Significant additional Director duties and oversight with questionable return in some areas • Scope increase in relation to employee arrangements covered and individual approvals will see boards and BRCs stepping into the role of management • Some duplication between the duties of the board and the BRC • Expansion of the scope of board oversight to employees and contractors of some third parties is unenforceable and impractical • Foreign branches do not have boards, and will need to make applications to APRA

2.1.1 Breadth and depth of board oversight and approvals

The number of remuneration arrangements boards will be expected to oversee (paragraph 21), and the number of individual outcome approvals required (paragraph 48, 50) has been expanded substantially. Whilst we support the need for an expanded governance focus relative to what boards were typically providing oversight to under CPS 510 / SPS 510, our view is that the relative expansion is unnecessarily large.

Firstly, CPS 511 regulates remuneration arrangements for all employees and some service providers (paragraph 19), going beyond the persons in specific categories covered by CPS 510 paragraph 57 / SPS 510 paragraph 30. For the largest companies, boards may now need to preside over upwards of 20 different remuneration arrangements, versus an average of 3-5 today. While we agree that all remuneration arrangements should be monitored and governed to achieve the desired remuneration objectives and to avoid inappropriate payments, we question if all arrangements should, or need to be overseen by the board. That is, to elevate all arrangements to the same level of scrutiny is a practical challenge with questionable benefits.

Secondly, the scope of individual approvals required by the board has expanded. This is principally due to the broader definition of material risk-takers (paragraph 16(f)), where the test of variable remuneration “*significance*” has been removed, as well as the definition now going beyond those who can materially impact the financial soundness of the entity, to those that can impact the entity's "risk profile, performance, and "*long-term soundness'*" as well as being "highly paid". A number of our clients have estimated a significant increase in the number of individuals whose remuneration outcomes are required to be approved by the board, from a handful of senior managers, up to almost 100 persons meeting the new definitions of senior manager and highly-paid material risk-taker, including persons three to four levels down from the CEO. In our view, it would be a practical challenge for the board to consider the performance and pay outcomes for populations of this size, and of this reporting level, with questionable value.

In order to 'approve' individual variable remuneration outcomes for example, additional information regarding both pay and performance would be required by the Remuneration Committee for the expanded list of individuals to assess individual performance outcomes and make variable pay recommendations to the board. No longer will a high level overview of performance assessments be satisfactory (usually 1-2 lines), but individual performance data will potentially increase up to a page to several pages per individual. In this scenario, it will be hard for the board to separate its oversight role to that of managing performance for the ~100 persons that they are required to sign-off on.

Furthermore, it is questionable whether the board could, or even should, provide sufficient challenge on the appropriateness of remuneration outcomes for individuals 4+ levels down in the organisation. By moving certain management approvals to board level, there is a risk that independence and quality of challenge offered by the board will diminish.

BRCs in our larger institutions are already meeting between 5-8 times per year for several hours with very full meeting agendas and lengthy papers to review and draft prior. This is a minimum level of activity required with a predominant focus on CEO and executive remuneration. We have already observed BRCs and boards increasing the amount of time dedicated to remuneration matters in 2018 to respond to regulatory related initiatives and scrutiny (no doubt at the expense of other strategic matters), , as evidenced by some instances of BRCs moving to monthly meetings. Current practices will no longer come close to the time required to deliver on the additional board oversight and approval requirements set out in CPS 511, and boards and management teams will need to adjust accordingly. And most importantly, we question if all this additional effort by the board will realise tangible benefits.

Suggested change #1

a) **Rescope requirements related to BRC recommendations and board approvals, such that the BRC recommends, and the board approves the remuneration arrangements and variable remuneration outcomes as follows:**

- **Individually for senior managers;**
- **Collectively for material risk takers; and**
- **Collectively for risk and financial control personnel.**

The BRC shall sight the individual outcomes for each individual in the special role categories.

This impacts paragraphs 48 and 50.

b) **For individual outcome approvals of all material risk takers and risk and financial control personnel, we suggest that there are allowances to delegate individual approvals to management, with the approval process formally involving the Chief Risk Officer or person in a similar role.**

This could be achieved through prudential guidance informed by current governance arrangements utilised both here and in the UK whereby relevant management committees are established. Such committees are often referred to as a 'Management Risk and Remuneration Committee', or 'Remuneration Adjustment/Consequence Committee'), which have been shown to be an effective governance mechanism particularly when such committees:

- have appropriately senior members and cross functional representatives (e.g. Head of HR / Performance & Reward, Senior Risk and Control function leaders, Business Unit leaders etc.)
- have clear and detailed board approved remuneration design parameters/guard rails to work within, and escalate any arrangements to the board that do not comply with such parameters; and/or
- cover outcomes for individuals sitting three to four levels down the organisation that the board have less exposure to/intimate knowledge of.

Suggested change #2

Simplify and clarify the role of the board and the BRC such that:

- **the annual compliance review of the remuneration framework** (per paragraph 33);
- **the triennial effectiveness review** (per paragraphs 34-36)**; and**
- **adjustments to variable remuneration outcomes** (per paragraphs 41-42)

provide the reasonable steps to appropriately oversee the "*remuneration arrangement*" or "*remuneration framework*" for persons outside of the special role categories. That is, it is the expectation that the board in its oversight role will not need to sight/review and/or approve the *"structure and terms of remuneration arrangements"* (paragraph 18c) for every employee and contractor of the entity (paragraph 19a and b), and for all employees and contractors of related/connected entities (paragraph 19c).

This impacts paragraphs 21, 23, 29, based on the definition of "*remuneration framework*" per paragraph 18.

2.1.2 Oversight of remuneration arrangements of employees and contractors of some third party entities

The board's oversight of remuneration arrangements also extends to the employees and/or contractors of some third party service providers (paragraph 19(d)). This could extend to those providing outsourced investment management services; outsourced internal audit; as well as brokers and other sales agents.

This requirement feels like an 'overreach' in terms of the board (and entity's) authority and influence, as unlike the contractual relationship between the regulated entity and the service provider, there is no contractual relationship between the regulated entity and the employees and contractors of the service provider. Furthermore, as noted earlier, it extends to all arrangements which meet the criteria set out in paragraph 19(d), which is not limited to the specific categories of roles as was the case under CPS/SPS 510 (CPS 510 paragraph 57; SPS 510 paragraph 30).

While the documented remuneration policy may only need to set out the structure and terms of these third party employee and contractor remuneration arrangements *"at a high level"*, all other requirements apply as if the persons were employees or contractors of the regulated entity itself. For example, CPS 511 places restrictions on the design (such as the limit on financial performance measures in paragraph 38); the remuneration outcomes (such as the entity having powers to adjust remuneration downwards in paragraph 41(b)); and the governance of remuneration arrangements for employees and contractors of some third parties (including active oversight in paragraph 21).

In principle, we believe that it is fair to expect that the board should at least be aware of the commercial arrangements that exist with any third party provider that could have an adverse impact on customers (e.g. performance fees paid to external fund managers that are based purely on financial performance) and to expect that the board request changes if such arrangements enhance the potential for non-financial/conduct risk. However, requiring boards to then oversight individual employee remuneration arrangements within the third party seems a step too far presenting a number of practical challenges, the two most pertinent being:

- The board doesn't have authority to dictate contractual arrangements of employees at unrelated entities.
- The requirement as it is currently drafted could mean that a single entity is being directed by multiple organisations (e.g. 3-4 RSEs who all utilise the same external investment management house) to comply with their respective remuneration policies resulting in confusing and conflicting demands.

As such, it is not clear how this could be achieved in practice, and we question the appropriateness - and the value - of extending board accountability to oversee arrangements for persons that they have very little oversight or control over.

Suggested change #3

Rescope the inclusion of third party remuneration arrangements such that it is limited to the service contract between the APRA-regulated entity and a body that is not a related body corporate of the APRA-regulated entities if certain criteria are satisfied (i.e. criteria in paragraph 19(d)(i) and (ii)).

This impacts paragraph 19.

2.1.3 Additional governance burden on foreign branches

Notwithstanding paragraph 3, which clearly states that the obligations for foreign branches only apply to the Australian branch operations of the entity, there are other requirements in CPS 511 which contradict this and have significantly wider implications for foreign branches.

Firstly, the CPS 511 paragraph 23 requires the boards of all APRA-regulated entities to establish a BRC. However, not all APRA-regulated entities have a board. Foreign ADIs and Category C Insurers do not have boards, and instead have a Senior Officer Outside of Australia (SOOA) with responsibility for overseeing the branch operations. Additionally, eligible foreign life insurance companies (EFLICs) typically establish a Compliance Committee which oversees the Remuneration Policy. For these entities it would be more practical for oversight of the remuneration policy to sit with the SOOA or Compliance Committee as appropriate. Unlike CPS 510 where the requirement for BRCs is limited to locally incorporated entities (CPS 510 paragraph 65), under CPS 511 these foreign ADIs and category C insurers would need to seek approval from APRA (paragraph 32) to maintain their current governance structures.

Secondly, the obligations to oversee the remuneration framework (paragraph 21 and 23) appear to cover all persons employed by or a contractor of a body corporate which is a related body corporate or connected entity of the APRA-regulated entity (paragraphs 18(c) and 19(c)). While it is common for branches to outsource some activities to related entities, this could potentially require the remuneration policy of the branch to cover not only the persons who have a role in the operations of the branch, but also all persons employed by or contracted by any other related or connected entity. It is not clear why oversight is required of remuneration arrangements for persons who do not have any role in the operations of the branch.

It is our view that this is an unnecessary regulatory burden given such governance processes and structures were previously supported by CPS 510 for Foreign ADIs and Category C Insurers, and we are not aware of any regulatory concerns/issues that have emerged as a result.

Suggested change #4

Recognise the alternative governance structures for foreign branches by:

- **limiting the requirement to establish a BRC to locally incorporated APRA-regulated entities only; and**
- **allowing for the articulated role and responsibilities of the BRC to sit with the SOOA for foreign ADIs and Category C Insurers, and the Compliance Committee for EFLICs.**

This impacts paragraph 23.

2.2 The draft standard will create an unlevel playing field in terms of competition for talent and service providers, and possibly discourage or preclude new market entrants

In this section we raise concerns in relation to the following:

2.2.1 Competition for talent and go-forward employee value proposition

2.2.2 Competition for service providers

2.2.3 Barriers to market entry

Related APRA consultation questions:

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

Summary of key concerns
• The standard imposes the most restrictive remuneration requirements applicable in FS globally • Insurance and superannuation will be most adversely impacted, given the 'gap' to current practice in the Australian market, and the incremental deferral proportions and periods relative to regulation in global insurance and investment markets • Creates an obstacle to attracting more diverse talent from outside, and into the FS industry, that may have the greatest impact on the customer experience (e.g. senior technology, digital, customer, and data science roles) • To complete for talent, it may lead to an upward pressure on remuneration quantum, particularly fixed pay • Service providers may choose to limit or cease their services to APRA-regulated entities • May preclude new market entrants, where the "implied" preferred remuneration structure is not commercially viable for a start-up

2.2.1 Competition for talent and go-forward employee value proposition

From our analysis comparing the prescriptive requirements for performance measures, deferral and clawback requirements across several other jurisdictions we observed:

- No other jurisdiction sets a prescriptive requirement regarding the balance of financial and non-financial measures within variable remuneration arrangements;
- Deferral requirements range from principle based requirements to prescriptive requirements requiring deferral for between three to five years[1] applicable to significant banks;

[1] FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Sixth Progress Report*, 17 June 2019 (link)

- Only one jurisdiction requires deferral periods longer than 5 years, being the UK where Level 1 and 2 banks require deferral periods of 7 years for Material Risk Takers ("MRTs") who perform a PRA Senior Management Function (lesser deferral periods apply for other MRTs)[2];
- Deferral requirements applicable to insurance and asset managers are generally principle based, however there are some examples of prescriptive requirements e.g. in the UK where Category 1 and 2 insurers must defer 40% of variable pay over 3 years (with pro-rata vesting allowed);
- Clawback requirements are only in place in select jurisdictions. 15 jurisdictions reported to the FSB that there were legal difficulties in both implementing clawback provisions and in the application of such provisions and only six jurisdictions reported that there are no legal difficulties[3].
- The only prescriptive requirement incorporating a time period for clawback that we are aware of is for the Level 1 and 2 banks in the UK, who must apply clawback for at least 7 years from the date of award, with scope to extend to 10 years in certain circumstances[4].

Accordingly, the CPS 511 proposals are generally more prescriptive and go beyond: the requirements in other FSB jurisdictions; current practices at our largest institutions; and recently implemented BEAR requirements. We are concerned that the nature of these requirements, will create an unlevel playing field in terms of competition for talent with the adverse impact on entities ability to attract and retain talent playing out at multiple levels:

- *Within regulated entities* - Significant Financial Institutions (SFIs) becoming less attractive as compared to other APRA-regulated entities;
- *Within the FS industry* - APRA-regulated FS entities becoming less attractive as compared to non-regulated FS entities;
- *Within the ASX 100 and broader Australian market* - APRA-regulated entities becoming less attractive as compared to non-FS entities (particularly relevant for industry agnostic talent); and
- *Within the global FS market* - Global FS organisations with APRA-regulated entities becoming less attractive in overseas markets than other global or local FS organisations with no APRA-regulated entities (particularly relevant for Australian-headquartered groups with a global presence).

Firstly, the lengthy deferral and clawback requirements apply to the ARRA-regulated entities considered to be SFIs. Whereas, a principle-based requirement applies for all other APRA-regulated entities, allowing the freedom to set appropriate deferrals in line with their business and strategic time horizons. As such, SFIs will be at a competitive disadvantage when attracting talent from non-SFIs, and talent employed in SFIs may be too expensive to acquire or "buy out" (given the longer deferral periods and the potential value of cumulative deferred pay) as compared to non-SFIs.

Secondly, there are a range of financial services activities where some competitors are regulated by APRA and others are not, such as in advisory, asset management, equity investments, financial markets, real estate / property investment and other funds. The prescriptive remuneration requirements placed on the APRA-regulated entities will place these entities at a competitive disadvantage when competing for talent. Remuneration arrangements within these sectors are bespoke; have higher upside earnings for outperformance; and are usually financially orientated. For example, for asset and funds management, carried interest arrangements are common where participants share in the profit of the funds. There are commonly no other metrics associated with carried interest plans and so it would be considered to be 100% financially based. Should APRA-regulated entities need to shift away from such arrangements (e.g. to comply with paragraph 38), their remuneration arrangements and therefore, their employee value proposition (for say funds and asset management talent) would become less attractive.

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[2] PRA Rulebook for Capital Requirement Regulation firms (link)
[3] FSB, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Sixth Progress Report*, 17 June 2019 (link)
[4] PRA Rulebook for Capital Requirement Regulation firms (link)

Thirdly, the deferral and clawback requirements may deter senior executives in ‘industry-agnostic’ roles (such as customer, technology, digital, data, HR) from joining or remaining within the FS industry. For example, the ASX 100 norm is to offer a package comprising of fixed pay, STI (in a combination of cash and equity deferred for 1-2 years), and performance hurdled LTI usually with a 3 year vesting period (79% of ASX 100 companies[5]) - significantly shorter than the deferral periods proposed by CPS 511. The implication is that we may see the diverse types of executive talent that the industry is trying to attract, who could enhance the skills and experience base that is necessary to effect customer remediation and drive an improved customer experience, viewing the FS industry as less attractive and seeking employment opportunities elsewhere with non FS entities.

And finally, it will also place Australian-headquartered FS groups or other global FS groups with APRA-regulated entities at a competitive disadvantage to global peers, in offshore markets. Many of our larger FS entities have substantial operations overseas (e.g. QBE, AMP, ANZ, Macquarie), and as seen by recent CEO recruitment at companies like AMP Limited and NAB, our largest financial institutions compete for local talent in global labour markets. The impacts are of course more pronounced relative to certain jurisdictions (e.g. Asia, New Zealand, North America) and certain industries (e.g. insurance, superannuation), where requirements are substantially less onerous.

With proposed prescriptive requirements being longer and more complex / risky (i.e. with a different mix of measures and potential clawbacks) than current local practices, we expect this to result in an upward pressure on remuneration quantum and/or changes to the pay mix with a shift towards fixed and away from variable remuneration to compete for talent. These outcomes are less than ideal as it means firstly, that the elements of pay that can be most easily utilised to reinforce accountabilities and incorporate risk related adjustments may reduce. And secondly, that the payroll cost base will increase so would either need to be passed onto customers or weaken shareholder returns - counter to APRA’s primary objective of financial system stability.

While APRA has justified these proposals as being in line with international “best practice”, and we generally support longer and more substantial deferrals as a means to align executives with the long-term interests of the business, we believe that in this case the effectiveness of long deferral may be compromised. This is partially due to the requirements being more onerous than almost all other jurisdictions, the competitive disadvantages APRA-regulated firms will be exposed to as a result, and also due to the impact on motivational value as discussed in Section 2.5 below.

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[5] Based on performance periods of ASX 100 companies, which includes four companies with only service based LTI plans. Source: PwC Australia, *10 minutes on… 2018 Executive remuneration trends: Movement under the spotlight*, July 2019 (link)

Suggested change #5

Modify the prescriptive remuneration deferral and clawback requirements that apply to SFIs to allow for a proportionate application across industries and/or roles, as illustrated in the table below (blue text indicates a change):

Position	*% Deferred*	*Deferral period (pro-rata vesting)*		
		Banking	**Insurance**	**RSE**
CEO	*60%*	*4-7 years*	*1-3 years*	*1-3 years*
Other SMs	*40%*	*4-6 years*	*1-3 years*	*1-3 years*
Highly paid MRTs	*40%*	*3-5 years*	*1-3 years*	*1-3 years*
Risk and financial controllers and other employees	*Principle based*			
Other employees	*Principle based*			

This impacts paragraphs 53, 54 and 55.

2.2.2 Competition for service providers

As noted earlier (see 2.1.2), CPS 511 extends to the employees and/or contractors of some third party service providers (paragraph 19(d)). However, with the contractual relationship being between the regulated entity and the third party provider, the regulated entity has very little to no control over the remuneration arrangements of the third party providers employees or contractors.

Third party providers may currently provide services to multiple regulated entities, as is common in the case of investment management services; risk management, compliance, and internal audit services; as well as brokers and other sales agents. With each regulated entity imposing requirements on how the service providers pays its employees and contractors, it would quickly become difficult to manage the competing interests of the different regulated entities and their boards. This may make it less attractive for these providers to service regulated entities, or at least to service any more than 2 or 3 regulated entities at the same time. The implication being providers may choose to restrict their offerings to unregulated entities only (so that they still have control over their reward strategy and practices), or that they reduce the number of commercial arrangements they have in place with regulated entities (so that the practicalities of brokering a remuneration policy that serves multiple “masters” is less wieldy). Both outcomes would negatively impact the industry, and may involve additional costs being passed onto customers or shareholders.

Refer to Suggested change #3

Rescope the inclusion of third party remuneration arrangements such that it is limited to the service contract between the APRA-regulated entity and a body that is not a related body corporate of the APRA-regulated entities if certain criteria are satisfied.

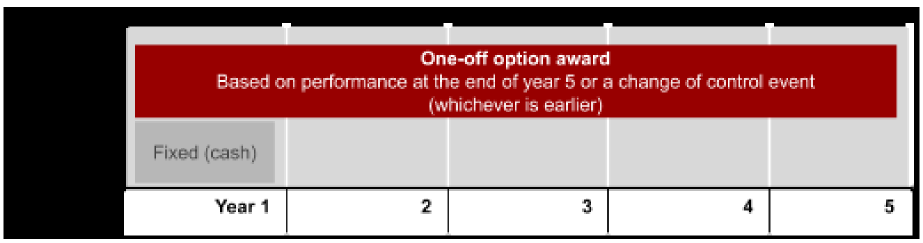
As noted under section 2.1.2 above.

2.2.3 Barriers to market entry

Similar to issues raised in 2.2.1 above, new entrants will face barriers to attract talent. There are three specific barriers to market entry created by CPS 511 which we will discuss further.

Firstly, compliance with CPS 511 prefers a remuneration structure that is not commercially viable in a start-up context. Start-ups are typically cash-light businesses and their remuneration structures typically offer less cash with a much greater focus on equity awards, such as options, which deliver value to participants at an exit event (e.g. initial public offering, trade sale). Equity is typically granted upfront and performance conditions may or may not be applied. The pace of growth and change makes it particularly difficult for some financial performance conditions - let alone non-financial performance conditions - to be defined or accurately forecast and calibrated. An example model is illustrated below:

Illustration 1: Example of remuneration model found in FS start-ups



The typical start-up remuneration model is challenged by CPS 511 given that:

- Variable remuneration structures are predominantly or wholly focused on growth (e.g. no or limited STI and LTI delivered in un-handled options), and so would be non-compliant with paragraph 38, the limit on financial measures.
- Equity awards are usually designed to achieve an exit event, which may occur at an unknown point in time. Therefore, setting deferral periods that are commensurate with the time horizon of possible risk and performance outcomes (paragraph 37(c)) and adhering to the probitation on acceleration of vesting (paragraph 40) would be challenging.
- Equity awards are typically one-off, meaning that the maximum potential variable remuneration is highest in the year of grant, and therefore persons identified to be highly paid MRTs may fluctuate greatly in the start up year, or first year of the plan. This means greater levels of the board oversight in that particular year.

A further barrier to entry relates to the higher standards of remuneration and governance requirements required by CPS 511, as compared to CPS 510 / SPS 510. While it is critical that APRA-regulated entities adhere to higher standards of remuneration and governance requirements, the establishment of sufficiently robust systems and frameworks takes time and investment. In a start-up scenario, time pressures are great as the pace of growth means employee numbers may double or treble in a matter of months - posing a challenge for systems and governance processes to adapt. Particularly in relation to pay and the measurement of performance and risk outcomes, it may take several years to design and implement robust measurement systems that facilitate risk adjustments required under paragraph 37 and 41 for example. We suggest that APRA allow due time for start-up entities to mature and transition to these requirements (see Section 2.7.1 for our discussion on the implementation date).

Suggested change #6

(a) Clarify that the use of un-hurdled options are permissible, where subject to risk adjustments per paragraphs 37 and 41.
(b) Similar to the BEAR, allow for a phased implementation of the standard, allowing smaller institutions have more time to prepare.
(c) Additionally, we suggest that APRA give consideration for future start-ups in the licensing process to allow for a reasonable time to mature their performance management, reporting and other related systems and governance frameworks. That is, some aspects of the standard should allow more time to implement for a new entity.

2.3 Compliance prefers a specific type of reward structure - the standard is not agnostic to the variations observed in the market, including reward model variations that would arguably be well aligned with the intent of CPS 511

In this section we raise concerns in relation to the following:

2.3.1 Practical challenges in determining compliance with the range of remuneration models observed in the industry

2.3.2 Highly paid MRT definition not necessarily capturing those with the most leveraged pay package

Related APRA consultation questions:

- *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?*
- *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?*

Summary of key concerns
• It will be easiest to provide assurance regarding compliance with CPS 511 if the entity adopts a particular remuneration model i.e. based on a maximum/capped earnings opportunity with a scorecard approach to STI and LTI, absent of gateways or modifiers • This may well lead entities and boards to adopt, or at least to move towards this single remuneration model, even though: – there are a broad range of viable remuneration models in the market today – variation in remuneration models appropriately reflects the fact that entities seek to customise and align their remuneration policies to their particular culture, performance objectives, and strategic objectives - a practice that CPS 511 could discourage – a number of incentive design features that would complicate the determination of compliance and therefore may become less common, have previously been supported by local and global regulators (e.g. risk modifiers, discretion) • Issues in demonstrating compliance are greatest for: – the identification of highly paid MRTs – the 50% limit on financial measures – the deferral periods in models where ‘inception’ occurs prior to the grant date • The definition of highly paid MRTs has the effect of requiring the most onerous deferral and clawback requirements for individuals who do not necessarily have the most leveraged or risky pay packages or aren’t necessarily the highest earners.

2.3.1 Practical challenges with the range of remuneration models observed in the industry

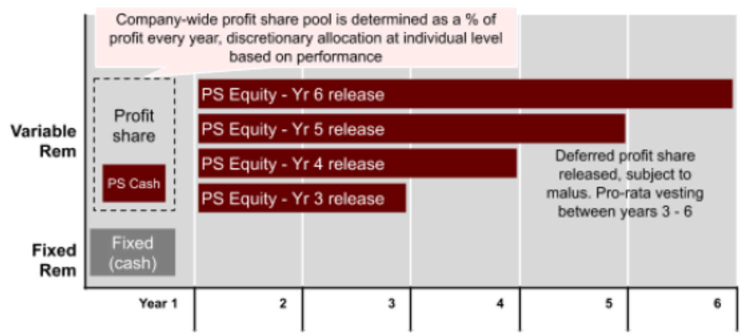
The prescriptive requirements around definition of highly paid MRTs, deferral and financial measures weighting work where the individual incentive opportunity is pre-defined and the outcome is determined using a balanced scorecard, without gateways or modifiers. However, in practice, reward models are complex and vary depending on the nature of the business, its strategic objectives and remuneration strategy, and rightly so.

In the table below, we set out the design elements that are featured in remuneration models used by FS companies and the associated practical challenges in complying with the draft standard:

Table 1: Remuneration design features used by FS companies and the associated practical challenges

Remuneration design features

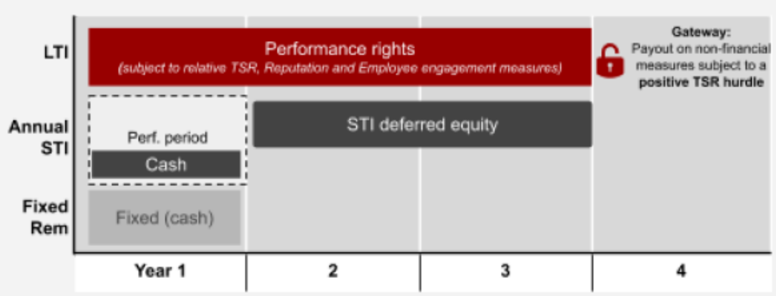
a) Profit-share funding approach, e.g. Macquarie:



Practical challenges:

- **Highly paid MRTs identification**: in the absence of a defined maximum incentive opportunity at individual level, it is not possible to quantify the maximum potential remuneration to identify highly paid MRTs.
- **Weighting of financial performance measures:** given the profit share structure and discretionary allocation at individual level, it is not possible to quantify the weighting of financial measures in determining individual incentive outcome.

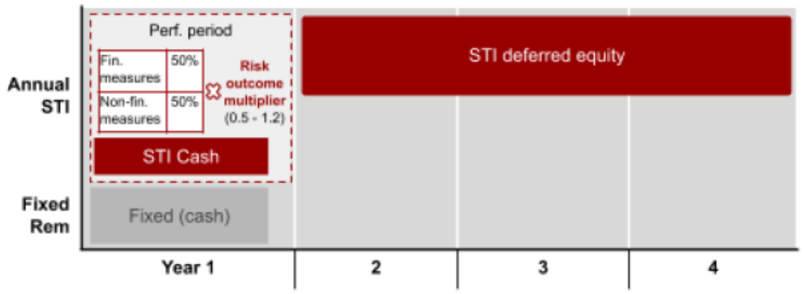
b) Financial gateway, e.g. CBA:



Practical challenges:

- **Weighting of financial performance measures:** if STI payouts are dependent on a threshold level of financial performance (as is not uncommon to support and entities 'capacity to pay') or the LTI funding is subject to a financial performance gateway (as in the example above), it is not clear - or even possible - to assign a discrete weighting to financial metrics, unless one assumes that if a financial gateway exists, the financial weighting is 100% and therefore the cap would always be exceeded.

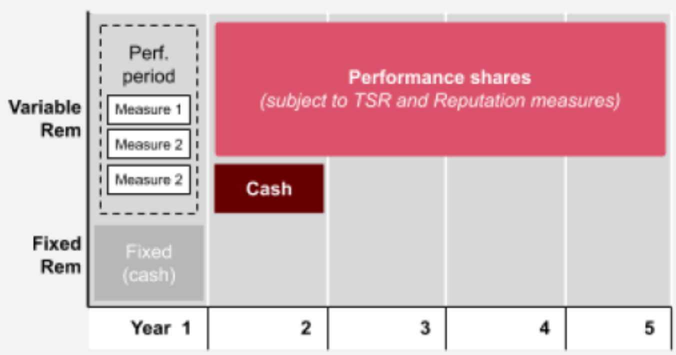
c) Modifier to scorecard outcome e.g. large insurer and bank:



Practical challenges:

- **Weighting of financial performance measures:** the formulaic outcome is subject to a non-financial performance modifier or overlay (in the above example the modifier is based on an individual risk assessment), as a result, it is not possible to quantify the respective weightings on financial measures and non-financial metrics.

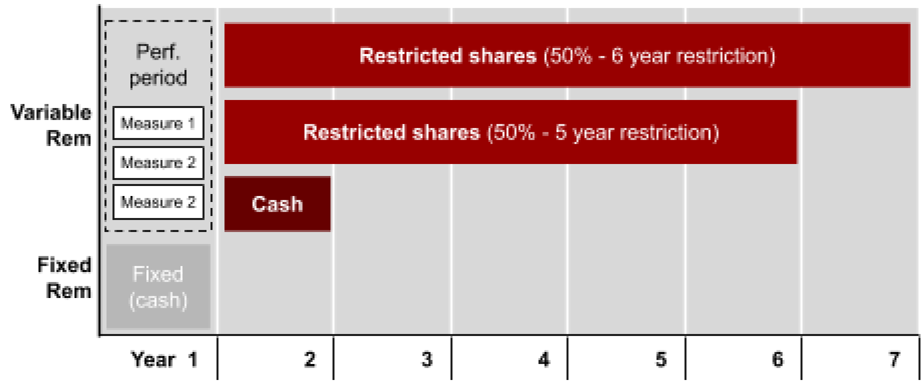
d) Combined incentive plan with performance rights



Practical challenges

- **Weighting of financial performance measures:** challenges in determining the weighting of the performance measures used given there are a multiple performance assessments of
    - (1) an in-year performance measure assessment (which determines the overall value of the variable remuneration grant) and
    - (2) future performance measure assessment at the end of the deferral period (applying to a portion of the variable remuneration, i.e. performance shares)?
- **Deferral period:** the 'inception period' definition is unclear as to whether it refers to
    - (1) the start of the period in which the in-year performance is assessed or
    - (2) the award grant date (i.e. end of period which in-year performance is assessed, which could be 12 - 18 months post).

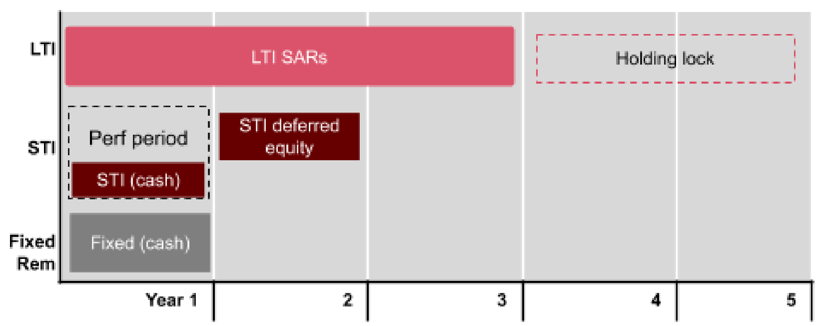
e) Restricted rights or shares



Practical challenges

- **Weighting of financial performance measures:** when the vesting of the restricted shares is time-based only, the vesting outcome is typically subject to a discretionary adjustment (including risk adjustment) during the vesting period. It is therefore unclear whether the condition attached to restricted shares should be considered non-financial or excluded from the weighting calculation.

f) Options / Share Appreciation Rights (SARs) grant



Practical challenges

- **Weighting of financial performance measures:** for Share Appreciation Rights or options grants, given they are not subject to additional performance measures and they only have value if share price increases above current share price (SARs) or above a pre-determined strike price (options), question as to how the award should be considered in meeting the requirements in terms of a cap on non-financial performance measures, or if SARs and options are assumed to be non-compliant given the inherent share price hurdle.

Suggested change #7

Remove prescription on limiting of financial measures and adopt a more discretionary, principle-based approach for all employees, similar to the FSB, such as:

- **Financial and non-financial performance measures should be used to assess individual performance, and**
- **Poor performance in non-financial risk measures should have a significant impact on overall performance and where appropriate, override performance against financial measures.**

This impacts paragraph 38.

2.3.2 Highly paid MRTs definition not necessarily capturing those with the most leveraged pay package

While the definition of highly paid MRTs has some simplicity, it may result in individuals falling into this category notwithstanding their package being largely fixed, or individuals whose actual earnings fall well below the million dollar mark. This has the effect of requiring additional BRC and board oversight of individual pay outcomes that are of little/lesser concern. Additionally, for significant financial institutions, this has the effect of requiring substantial deferrals and clawbacks for individuals who do not necessarily have the highest earnings, or the most leveraged, and therefore 'riskier' pay packages. The definition of total potential remuneration in this case also makes the requirement more onerous than those in the UK and EU where actual remuneration is used.

We understand that the premise for the proposed definition was to capture the most senior individuals in the organisations, and to ensure consistency in the population year-on year, but also across entities. However, we do not believe that this will be the case due to the number of highly paid MRTs may be up to 100 persons in a single institution, being three to four reporting levels from the CEO (as raised in section 2.1.1). This is a sizable cohort and beyond the most senior individuals.

Some reward practices will result in fluctuations in employee numbers/eligibility, such as where one-off equity awards are made e.g. in a start-up (as raised in section 2.2.3) or in relation to a transformation.

Suggested change #8

Revisiting the definition of highly paid MRTs based on:

- **actual total remuneration (i.e. fixed + actual variable remuneration awarded in the last financial year) greater than or equal to A$1m, and**
- **variable remuneration is greater than or equal to 33% of total remuneration.**

This impacts paragraph 16(c).

2.4 A substantial increase on the weighting of non-financial metrics may well result in adverse impacts, or at best, unpredictable impacts on behaviour and reward outcomes

In this section we raise concerns in relation to the following:

2.4.1 Non-financial measures are low in prevalence and therefore maturity, particularly for LTI and so target setting and calibration of pay and performance ranges are relatively untested

2.4.2 Increasing the prevalence and weighting of non-financial measures will likely result in better vesting outcomes, at least in the short term

Related APRA consultation questions:

- *APRA is proposing that financial performance measures make up no more than 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?*

Summary of key concerns
• With current market practice being that LTI metrics are almost exclusively financial, this requirement is likely to result in the most significant change to LTI given STI performance metrics already tend to be more balanced • There is a low level of maturity in setting and calibrating pay and performance against non-financial metrics over an annual period, let alone over the “long term”, as would be required for long-term incentive metrics with payments to vest over a 4-7 year period • Incorporating more non-financial performance measures, without relative benchmarks, may well lead to increased vesting and payout levels as is the case with actual historical vesting patterns across the ASX100 • Remuneration spend may be less impactful given duplication of payments will likely occur for the same/similar performance outcomes. That is, many financial measures are arguably lag indicators of non-financial aspects of performance e.g. Revenue and Total Shareholder Return (TSR) measures (are both influenced by prior performance on non-financial measures (e.g. brand/reputation/customer advocacy)

2.4.1 Non-financial measures are low in prevalence and therefore maturity, particularly for LTI and so target setting and calibration of pay and performance ranges are untested

Non-financial incentive metrics are fairly immature, particularly in the Australian market, but also in other jurisdictions. APRA makes the observation in the Discussion Paper accompanying CPS 511 that *“across the UK banks in the sample, the weighting of non-financial metrics in variable remuneration design (the combination of STI and LTI) ranged from 25 percent to 50 percent”.* In addition, a recent review we conducted of non-financial measures used amongst the largest FS institutions in Australia, UK, US and Canada revealed that broadly, ‘non-financial measure' weightings typically range between 10% and 15%. As such, introducing a 50% cap on financial measures would mean the prevalence and weighting of non-financial metrics in the Australian market would be at the extreme end of UK practice, and would attract up to 5 times the weight relative to current global market practice if we consider Australia, UK, US and Canada.

Recent regulatory reviews, including the ASIC Corporate Governance Taskforce report[6], also found that there is a low degree of maturity in the setting and calibrating of non-financial performance measures (including non-financial risk measures).

With immature performance metrics, it is particularly challenging to calibrate performance and reward ranges. For example,

- what is a reasonable performance expectation against customer or risk measures that should result in a threshold incentive payment?
- what is the incremental performance expectation against such metrics that should result in the maximum incentive payment?

For tried and tested financial measures, the probability of payment for threshold and stretch performance is readily informed by company and market performance history. However, there is a relatively small amount of short-term data for most entities to draw on illustrating the volatility or otherwise of most non-financial metrics that could inform the determination of fair and stretching performance targets. For example, customer advocacy or NPS is a measure increasingly used. Due to a lack of history and experience with such a measure, organisations introducing NPS often struggle to set a performance target that is both fair and stretching and often experience quite volatile reward outcomes (i.e. 'all or nothing') as a result. A broader implication for the market is that if vesting outcomes for non-financial metrics are hard for shareholders to reconcile (because they are incorporated into reward frameworks before they are mature), proxy advisor and investor confidence in the use of non-financial metrics will suffer, an outcome that would detract from the intent of CPS 511.

As such, the introduction of enhanced weightings on non-financial metrics should be done slowly, with caution, and certainly not in proportions that are yet to be trialled in other jurisdictions.

2.4.2 Increasing the prevalence and weighting of non-financial measures will likely result in higher vesting outcomes, at least in the short term

Furthermore, increasing the prevalence and weighting of non-financial metrics may well have adverse impacts for the industry, resulting in an increase in vesting and payment levels, particularly in the absence of appropriate external, relative benchmarking. Our analysis of ASX100 LTI vesting[7] indicated that internal LTI hurdles (which includes non-financial measures) may be slightly easier to achieve (relative to external or relative hurdles), i.e. higher payout is observed on such measures. This also aligns to proxy advisors and investor views that non-financial measures tend to have higher vesting level as they are self-calibrated.

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[6] ASIC, *Information Report: Director and Officer oversight of non-financial risks*, October 2019 (link). Quote: *"In general, we also observed that companies' risk appetite and metrics were less mature for non-financial risks than for financial risks, where metrics were more granular and comprehensive"*

[7] PwC, *10 minutes on...2018 Executive remuneration trends: Movement under the spotlight*, July 2019 (link)

Suggested change #9

Also see suggested change #7.

If APRA still wishes to move ahead with a prescribed cap on financial measures:

- **Modify such that the limit on financial measures is only applicable for SRCs or for a specific group of SRCs (e.g. CEO, SMs and highly paid MRTs)**
- **Reduce the cap to 25-33% where a scorecard is used (or allow the use of an equivalent mechanic (e.g. multiplier) to modify the remuneration outcome such that where appropriate, non-financial performance measures override performance against financial measures**

This impacts paragraph 38.

2.5 We expect the prescribed changes to result in pressure on more certain elements of pay (i.e. fixed pay over variable pay, short-term over long-term incentives, and financial over non-financial performance metrics), which is counter to the intent of CPS 511 and the enhanced focus on long-term soundness

In this section we raise concerns in relation to the following:

2.5.1 The structural requirements will significantly reduce the motivational and perceived value of variable remuneration

2.5.2 Pressure from proxy advisors / shareholders will result in extreme scrutiny on non-financial performance measures, and likely adjustments to associated incentive payouts to reflect the immediate shareholder experience

Related APRA consultation questions:

- *APRA is proposing that financial performance measures make up no more than 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?*
- *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?*
- *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?*

Summary of key concerns
• Behavioural economics, and relevant reward academic research tells us that – More 'trackable' performance measures gain attention, and those less so are ignored – Fixed pay is valued more than variable pay – The longer variable pay is deferred for, or the less certain it is to eventuate, the more its value gets discounted by plan participants • Somewhat ironically, there may well be more pressure and more focus on certain aspects of pay and potentially less focus by participants on the elements of pay that APRA would actually prefer to be emphasised • Entities will will likely show a preference for adopting risk-adjusted financial metrics with the related exclusion, rather than non-financial measures that will create target-setting challenges and obtain less support from proxy advisors. Thus resulting in very little change in the balance of financial and non-financial metrics.

2.5.1 The requirements will significantly reduce the motivational and perceived value of variable remuneration, and lead participants to focus more on certain aspects of pay

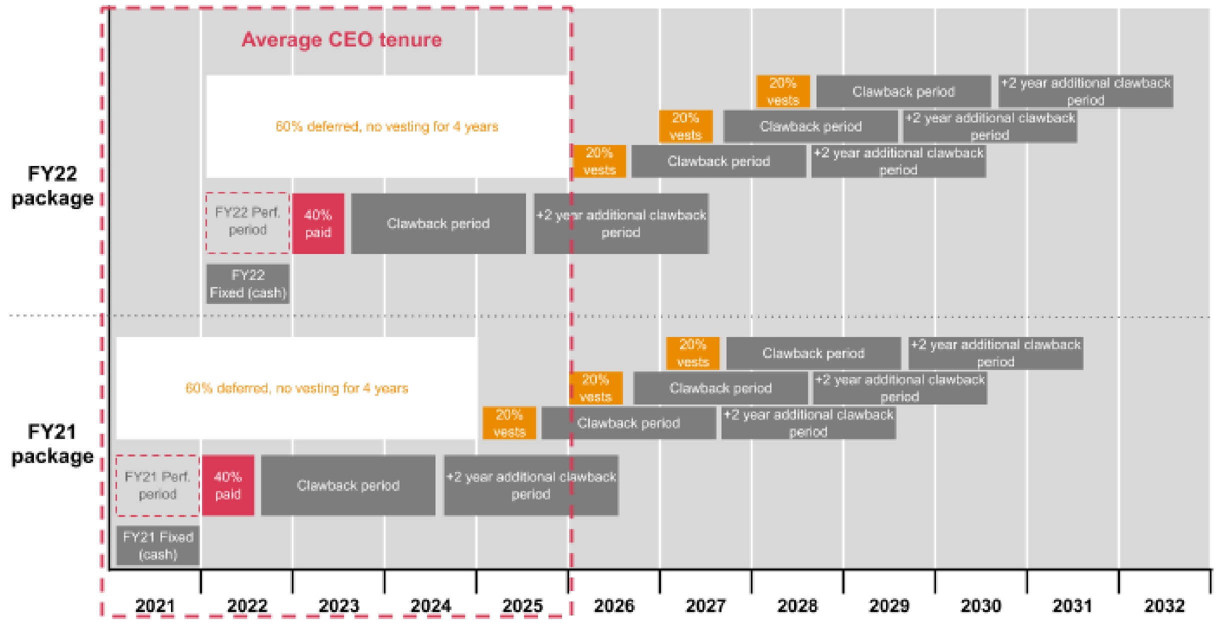
From a behavioural economics perspective, as incentive plan complexity increases (e.g. due to an increased number of performance measures, or increased use of discretion), individuals will likely shift their focus towards measures that are considered “easily quantifiable” and “controllable” and in extreme cases ignoring those that they perceive they are less able to influence, such as those with unclear targets and those subject to significant discretion. In most cases, short-term financial measures will likely be perceived as the former given their quantitative and perceived ‘objective’ nature. Non-financial measures, on the other hand, are often harder to quantify and involve more subjective assessment. As a result, simply imposing an explicit cap on financial measures will not necessarily translate to a shift in focus towards non-financial aspects of performance, the non financial measures have to be robust, rigourous, and “influenceable”.

Longer deferral periods plus the additional clawback period required (9-11 years for CEO and 8-10 years for other senior managers and highly paid MRTs) will have a material impact on the perceived value of long-term incentives given the discount placed on deferred awards. While we generally support longer and more substantial deferrals as a means to align executives with the long-term interests of the business, we believe that in this case the effectiveness of long deferral may be compromised. Our ‘Psychology of incentives’ research[8] suggests that executives typically discount deferred awards up to 30% per annum which means that a 7-year deferral (pro-rata vesting after 4 years) will result in a discount of over 80% (compounded). The implication here being that awards deferred so far into the future may not have much of an impact on behaviour if their value is so heavily discounted.

The cumulative deferral and clawback duration of an incentive award from grant date also well exceeds the average CEO tenure of 5 years[9]. This will further deteriorate the value of long-term incentive awards to the participant - and result in a questionable impact on executive behaviour - given that at the time the executive leaves the APRA-regulated entity, he/she is likely to only realise a small portion of the deferred award that would have vested prior to ceasing employment. This is due to typical practice related to leaver provisions where all unvested deferred awards would lapse on resignation / termination. A possible implication is that entities will seek to modify the leaver provisions such that awards remain ‘on foot’ for more categories of leavers (e.g. termination by mutual agreement or without cause), pro-rated for years of service. However, the competitive nature of FS talent markets means that this solution will not be viable where talent moves to a competitor.

[8] PwC, *Making executive pay work: The psychology of incentives*, May 2012 (link)
[9] PwC’s Strategy&, *CEO Success case study* (link)

Illustration 2: CEO tenure versus CPS 511 proposed time periods for deferral and clawback



As a result, the impact of long-term deferred incentive has on an individual's performance and behaviour is likely to be low, which seems to be contrary to APRA's intent. Subsequently, this may also lead to:

- *Increase in variable pay opportunities and/or fixed pay* - to make up for the loss in value of deferred incentive award;
- *A shift in plan participants focus to the short-term portion of incentive;*
- *More certain / less stretching performance pay* - through re-calibrating the payout levels at target or through the use of performance measures that are self-calibrating and more qualitative, allowing more discretion to be used in determining the pay outcome;
- *Removal of variable pay and increasing fixed pay* - given the gap between perceived value and associated cost to the organisation, many will likely reconsider the value of incentives. The shift to fixed remuneration only will (1) increase the fixed cost base of the company which will likely be passed onto the shareholders and customers, and (2) remove an important adjustment mechanism for risk consequence; and/or
- *Increasing the value of buy-outs and sign-on payments* - to compensate for the lost awards at the previous employer. These awards are not always conditional on performance, and are certainly not risk-adjusted in a manner which aligns with the performance and risk outcomes at the individual's previous employer.

Furthermore, the entity will only be able to clawback a small portion of any award in a given year, due to the pro-rated vesting and the clawback period being expressed as post the payment / vesting date. This is an unnecessary complexity and limits the ability to effect a risk adjustment should one be so significant that it warrants clawback.

2.5.2 Pressure from proxy advisors / shareholders will result in extreme scrutiny on non-financial performance measures, and adjustments to associated incentive payouts to reflect the immediate shareholder experience

In practice, we see investors challenging both the performance measures used and remuneration outcomes where it is perceived that there is no tangible alignment with shareholder return. The scepticism around non-financial performance measures partly explains the lack of non-financial measures used in long-term variable remuneration arrangements to date. Amongst the ASX100 companies, only 11 companies have non-financial measures in their long-term incentive plans, with an average weighting of 23%[10].

We also see investors challenging executive remuneration outcomes where executives receive a payout on delivery of non-financial targets, despite not meeting the financial targets. This likely puts companies under pressure to adjust the remuneration outcome on non-financial measures downwards, leading to a situation where in spite of financial and non-financial measures being equally weighted, there will be pressure for the actual outcome to reflect a greater weight being given to financial outcomes.

Refer to Suggested changes #7 and #9

Remove prescription on limiting of financial measures and adopt a more discretionary, principle-based approach for all employees, similar to the FSB, such as:

- **Financial and non-financial performance measures should be used to assess individual performance, and**
- **Poor performance in non-financial risk measures should have a significant impact on overall performance and where appropriate, override performance against financial measures.**

If APRA still wishes to move ahead with a prescribed cap on financial measures:

- **Modify such that the limit on financial measures is only applicable for SRCs or for a specific group of SRCs (e.g. CEO, SMs and highly paid MRTs)**
- **Reduce the cap to 33% where a scorecard is used (or allow the use of an equivalent mechanic (e.g. multiplier) to modify the remuneration outcome such that where appropriate, non-financial performance measures override performance against financial measures**

As noted in section 2.3 and 2.4 above.

Suggested change #10

- **Align clawback period (currently applies to SFIs) to the length of the required deferral period (i.e. 6/7 years), and**
- **All variable remuneration payments during the period will be subject to clawback (regardless of the date of payment or vesting).**

This impacts paragraph 57.

[10] PwC, *10 minutes on… 2018 Executive remuneration trends: Movement under the spotlight*, July 2019 (link)

2.6 The different sets of criteria for the application of malus and clawback will result in situations where organisations have to apply clawback when it is more practical to apply in-year adjustments or malus

Related APRA consultation questions:

- *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?*

Summary of key concerns
• It is unclear why there needs to be a different set of criteria for malus and clawback application with little / no overlap • This approach differs relative to other FSB jurisdictions • The differential criteria will result in situations where entities are required to utilise clawback to apply remuneration consequence when there are easier and more certain options available to apply penalty (i.e. in-year adjustments and malus)

In our view, the specific criteria for the application of malus and clawback is helpful and will ensure that non-financial risks and conduct matters are considered more routinely and with more consistency within and across entities.

However, it is unclear why there needs to be a different set of criteria for malus and clawback application with little / no overlap. For example, the trigger event "*material misstatement of financial statements or other criteria on which the variable remuneration determination was based*" is listed under clawback, but is not listed as a trigger event for malus.

With the differential criteria for the application of malus versus clawback, entities could find themselves in a situation where they are required to utilise clawback to apply remuneration consequence (e.g. financial misstatement) when there are easier and more certain options available to recoup the money through in-year adjustments or malus (assuming the materiality of the consequence is not greater than an in-year award plus any unvested awards). This can limit the flexibility for organisations to determine the most appropriate adjustment mechanisms through their consequence management policy.

In our experience working with organisations in the UK and EU, as long as the right trigger events are included and the materiality of the risk events and the resulting remuneration consequence is determined appropriately, companies don't differentiate between the types of risks that should apply to in-year versus unvested versus vested incentive - often the starting point for any adjustment is in-year incentive given the practicality, and then deferred STI and unvested LTI is affected in sequential fashion until the pre-determined quantum of adjustment is recouped.

In addition, although it is not impossible to apply clawback in Australia, at a practical level this can be difficult to enforce. A clawback would be in the form of a contractual entitlement to have a payment or other benefit returned in certain circumstances. If the employee did not comply with the obligation the employer would be required to commence legal proceedings claiming damages for breach of contract against the employee in order to effect the clawback. This may involve considerable resources for the employer and ultimately still may not assure the clawback, for example, if the employee is impecunious.

It's also worth noting that the UK regulations (the PRA Rulebook[11]) does include specific circumstances where malus and clawback should apply, however, the two sets of criteria overlap substantially, allowing for malus and/or clawback to be applied where such event occurs.

Table 2: Comparison of malus and clawback trigger criteria in Australia and the UK for banking institutions

	Malus	Clawback
Australia *Draft CPS 511*	● a significant downturn in financial performance; ● evidence of misconduct or negligence resulting in losses; ● a significant failure of financial or non-financial risk management; ● a failure to meet the entity's code of conduct; and ● significant adverse outcomes for customers, beneficiaries or counterparties.	● responsibility for material financial losses; ● material misstatement of financial statements or other criteria on which the variable remuneration determination was based; ● breach of compliance obligations including in relation to misconduct risk; and ● failure of accountability or fitness and propriety.
UK *CRD IV; PRA Rulebook*	● there is reasonable evidence of employee misbehaviour or material error; ● the firm or the relevant business unit suffers a material downturn in its financial performance; or ● the firm or the relevant business unit suffers a material failure of risk management.	● there is reasonable evidence of employee misbehaviour or material error; or ● the firm or the relevant business unit suffers a material failure of risk management

Suggested change #11

- **Modify the malus requirements for SFIs, to include all specific criteria under clawback.**
- **Reduce the clawback trigger criteria to only include the most extreme scenarios, similar to the UK, such as:**
    - **a. material misstatement of financial statements or other criteria on which the variable remuneration determination was based**
    - **b. failure of accountability or fitness and propriety.**

This impacts paragraph 44.

[11] PRA Rulebook for Capital Requirement Regulation firms, Remuneration chapter, paragraphs 15.22 and 15.23 (link)

2.7 There are several aspects requiring further guidance or clarification to minimise the likelihood of misunderstandings and inconsistencies in application.

In this section we raise a number of aspects that require further clarification and/or guidance:

2.7.1 Effective date and implementation expectations

2.7.2 Application of highly paid MRTs definition

2.7.3 Use of holding locks to meet the deferral requirement

2.7.4 "Time of inception" definition

2.7.5 How the deferral proportions will be tested

2.7.6 Exemption to the deferral requirements

2.7.7 Exclusion of risk-adjusted financial measures from the 50% limit on financial performance measures

2.7.8 Acceleration of vesting in a change of control events

Related APRA consultation questions: What areas of the proposed requirements most require further guidance?

2.7.1 Effective date and implementation expectations (Section 1.7, Discussion paper)

APRA noted in its Discussion Paper[12] that it *"expects that the requirements will come into force from 1 July 2021."* There is no further detail on whether this means the requirements will apply to the first full performance period starting on or after 1 July 2021 (and therefore payment in relation to this period) or all awards granted / payment made on or after 1 July 2021 must comply with the requirements (which means companies will need to ensure their remuneration framework is compliant with the requirements before 1 July 2021).

2.7.2 Application of highly paid MRTs definition

There are a number of practical challenges in determining the highly paid MRTs population using the total potential remuneration fixed remuneration plus maximum potential variable remuneration) threshold, namely:

- Some reward practices may complicate the identification of highly paid MRTs, such as in profit share / self funding plans (as raised in section 2.3.1) where there is no maximum potential variable remuneration
- For MRTs based overseas, an added complexity will be accounting for foreign exchange rate fluctuations in determining whether the A$1m threshold is exceeded.
- Differences in benefit offerings, and the valuation of benefits (such as defined benefit pensions) may not provide an accurate and true reflection of the total value in a particular year.

Further guidance on how entities with such arrangements should determine their highly paid MRTs population will be helpful.

[12] APRA, *Discussion paper - Strengthening prudential requirements for remuneration*, 23 July 2019 (link)

2.7.3 Use of holding locks to meet the deferral requirements (Paragraph 53 and 54)

In the implementation of BEAR, where companies operate a long-term incentive plan (with forward-looking performance conditions), such a plan is often used to meet the deferral requirements. Given the longer deferral period proposed under the draft standard relative to that under BEAR, it will be helpful to confirm that companies can use holding locks, i.e. time-based conditions only to satisfy the deferral requirements of pro-rata vesting post the 4th year. There doesn't appear to be anything preventing this solution under the current drafting.

2.7.4 "Time of inception" definition (Paragraph 53 and 54)

The APRA Discussion Paper illustrates the deferral period commencing after the initial performance period used to determine the incentive outcome. However, where a long-term incentive award is used to meet the deferral requirements, these awards typically have a different performance period to that of the short-term incentive element. In addition, the start of the forward-looking performance/vesting period for the long-term incentive award may differ from the award's grant date.

As a result, it will be helpful to understand whether "time of inception" should be interpreted as the start of the performance period or the award's grant date (see Illustration 4 which sets out our interpretation of the requirement).

It's also worth noting that under BEAR, the commencement of the deferral period is defined as *"the day after the day on which the decision was made granting [...] the variable remuneration."*

Illustration 3: CEO time periods of deferral and clawback - Modified illustration from APRA's Discussion Paper

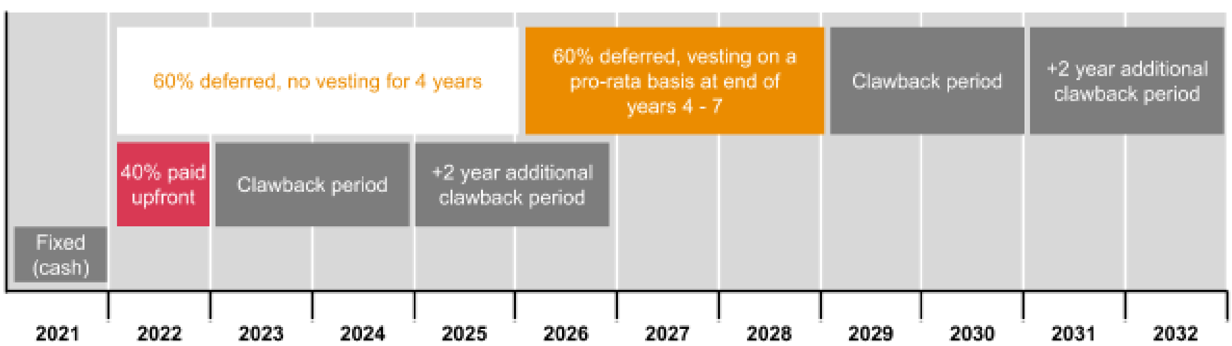
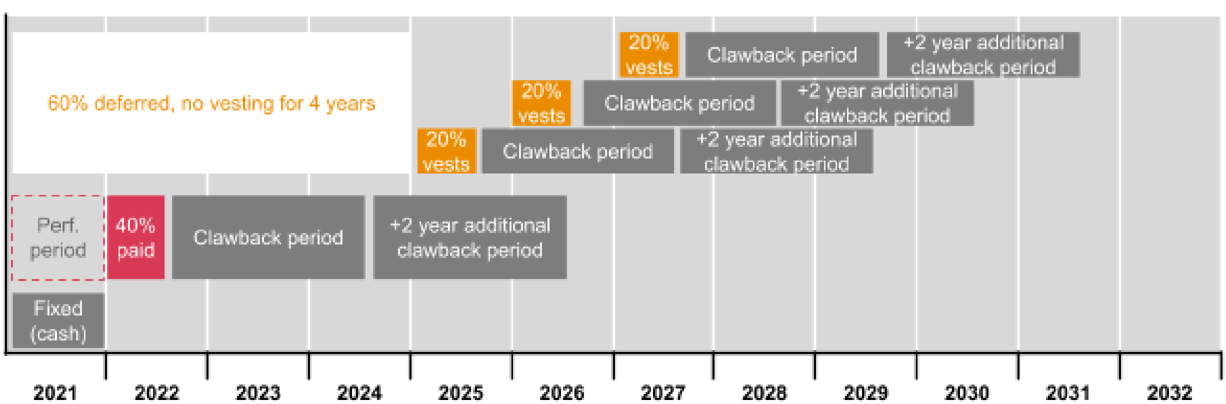


Illustration 4: CEO time periods of deferral and clawback - PwC interpretation



2.7.5 How the deferral proportions will be tested

To date, there is no guidance under BEAR as to how deferral proportions will be tested - based on the definition of deferral period commencement noted above, it can be interpreted that deferral is tested based on total incentive award granted in the financial year, i.e. actual STI payment made, plus LTI grant.

It will be helpful to clarify in the standard and / or prudential practice guide as to how the deferral proportions will be tested in any given year for the purpose of complying with the standard.

2.7.6 Exemption to the deferral requirements (Paragraph 55)

The CPS 511 deferral exemption threshold of $50,000 variable remuneration does not align with similar exemption set out under BEAR (i.e. deferred variable remuneration amount of $50,000). Aligning these thresholds will make it easier for companies to comply with the requirements under both regulations.

2.7.7 Exclusion of risk-adjusted financial measures from the 50% limit on financial performance measures (Paragraph 38)

Under the draft standard, risk-adjusted financial measures are excluded from the 50% weighting limit. Although not explicit, it can be interpreted that such measures will be considered non-financial for the purpose of complying with the standard, meaning that they will be preferable for companies and investors over non-financial measures.

In our view, risk-adjusted financial measures often only reflect financial risks or risk impact that is quantifiable. As a result, an increase in the prevalence of risk-adjusted financial measures will not, in our view, address APRA's objective to *"improve the financial system stability"* through increasing attention to non-financial risks.

If the interpretation above is correct, it will be helpful for APRA to confirm this in the prudential practice guide.

2.7.8 Acceleration of vesting in a change of control events (Paragraph 40)

The draft standard only permits accelerated vesting under specific circumstances, namely death, serious incapacity, serious disability or serious illness. In Australia, it is common for companies to include provision in the remuneration policy that permits board / remuneration committee to exercise discretion in relation to the vesting of outstanding awards in a change of control events, particularly where there is a change to the entity's legal structure.

As such, further clarification is required as to whether a change of control event is considered "specific exceptions" as noted in paragraph 40.

3. Summary of PwC's suggested changes

Aspect	Suggested changes (# as per section 2 above)	Cross-reference to section 2
3.1 Governance	1. Rescope the BRC recommendations and board approvals, such that the BRC recommends, and the board approves the remuneration arrangements and variable remuneration outcomes as follows: • Individually for senior managers; • Collectively for material risk takers; and • Collectively for risk and financial control personnel. The BRC shall sight the individual outcomes for each individual in the special role categories. For individual outcome approvals of all material risk takers and risk and financial control personnel, we suggest that there are allowances to delegate individual approvals to management, with the approval process formally involving the Chief Risk Officer or person in a similar role.	Section 2.1
	2. Simplify and clarify the role of the board and the BRC such that: • the annual compliance review of the remuneration framework (per paragraph 33); • the triennial effectiveness review (per paragraphs 34-36); and • adjustments to variable remuneration outcomes (per paragraphs 41-42) provide the reasonable steps to appropriately oversee the "remuneration arrangement" or "remuneration framework" for persons outside of the special role categories.	Section 2.1
3.2 Scope	3. Rescope the inclusion of third party remuneration arrangements such that it is limited to the service contract between the APRA-regulated entity and a body that is not a related body corporate of the APRA-regulated entities if certain criteria are satisfied (i.e. criteria in paragraph 19(d)(i) and (ii)).	Section 2.2
	4. Recognise the alternative governance structures for foreign branches by:	Section 2.2

	• limiting the requirement to establish a BRC to locally incorporated APRA-regulated entities only; and • allowing for the articulated role of the BRC to sit with the SOOA for foreign ADIs and Category C Insurers, and the Compliance Committee for EFLICs.	
	8. Revisiting the definition of highly paid MRTs based on: • actual total remuneration (i.e. fixed + actual variable remuneration awarded in the last financial year) greater than or equal to A$1m, and • variable remuneration is greater than or equal to 33% of total remuneration.	Section 2.3
3.3 Deferral and clawback for SFIs	5. Modify the prescriptive remuneration deferral and clawback requirements that apply to SFIs to allow for a proportionate application across industries and/or roles	Section 2.2
	10. Align clawback period (currently applies to SFIs) to the length of the required deferral period (i.e. 6/7 years), and All variable remuneration payments during the period will be subject to clawback (regardless of the date of payment or vesting).	Section 2.6
	11. Modify the malus requirements for SFIs, to include all specific criteria under clawback. Reduce the clawback trigger criteria to only include the most extreme scenarios, similar to the UK, such as: • material misstatement of financial statements or other criteria on which the variable remuneration determination was based • failure of accountability or fitness and propriety.	Section 2.6
3.4 Limit on financial measures	7. Remove prescription on limiting of financial measures and adopt a more discretionary, principle-based approach for all employees, similar to the FSB, such as: • Financial and non-financial performance measures should be used to assess individual performance, and • Poor performance in non-financial risk measures should have a significant impact on overall performance and where appropriate, override performance against financial measures.	Section 2.3 and 2.5

	9. If APRA still wishes to move ahead with a prescribed cap on financial measures: • Modify such that the limit on financial measures is only applicable for SRCs or for a specific group of SRCs (e.g. CEO, SMs and highly paid MRTs) • Reduce the cap to 25-33% where a scorecard is used (or allow the use of an equivalent mechanic (e.g. multiplier) to modify the remuneration outcome such that where appropriate, non-financial performance measures override performance against financial measures	Section 2.3 and 2.5
3.5 Other	6. (a) Clarify that the use of un-hurdled options are permissible, where subject to risk adjustments per paragraphs 37 and 41. (b) Similar to the BEAR, allow for a phased implementation of the standard, allowing smaller institutions have more time to prepare. (c) Additionally, we suggest that APRA give consideration for future start-ups in the licensing process to allow for a reasonable time to mature their performance management, reporting and other related systems and governance frameworks. That is, some aspects of the standard should allow more time to implement for a new entity.	Section 2.2