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STRENGTHENING PRUDENTIAL REQUIREMENTS FOR REMUNERATION

On behalf of the Australian Council of Superannuation Investors (ACSI), thank you for the opportunity to make a submission in relation to APRA's revised Prudential Standard CPS511 Remuneration (CPS511).

Established in 2001, ACSI exists to provide a strong, collective voice on environmental, social and governance (ESG) investment issues on behalf of our members, who include 37 Australian and international asset owners and institutional investors. Collectively, our members own, on average, 10 per cent of every ASX200 company, on behalf of millions of beneficiaries. Our members recognise that ESG risks and opportunities have a material impact on investment outcomes.

Our interest is in promoting the sustainable performance and financial success of companies over the long term in the best financial interest of our members' beneficiaries.

As active owners, our members engage with their investee companies using objective standards to identify issues that may have a material impact on investment outcomes. We do this through research and importantly though engagement with management and the board of investee companies.

Our submission draws on this research, analysis and engagement as it applies to listed entities. While the issues raised may have broad application, our expertise regarding remuneration practice does not extend to the internal operation of superannuation funds, asset managers, trusts and other entities beyond listed markets.

We strongly support APRA's focus on non-financial risk. We refer to 'non-financial' measures as it is a generally understood term, even though we support the APRA Capability Review Panel's view, which stated '*This Review is careful not to make the distinction between financial and non-financial risks common in discussion of governance, culture and accountability (GCA). Weaknesses in GCA frameworks feed directly into financial safety and stability.*'

APRA's observations on the historic reluctance to exercise downwards discretion in remuneration outcomes are consistent with our research which shows that there has been little variability in variable reward payments in listed financial institutions over the past decade.

As a representative of long-term investors, ACSI supports APRA's greater focus on the use of 'non-financial' measures in remuneration structures. Like financial measures, hurdles must be objective, transparent, measurable and outcomes truly at risk. Our view is that these elements will be central to the success of CPS 511 in lifting remuneration practice, in line with APRA's aims. Many aspects of the Draft CPS511 standard, such as the provision of guidance on appropriate financial measures and the proposed disclosure provisions will require the development of further guidance and we recommend APRA seek further input for stakeholders on these matters as soon as possible.

Our more detailed comments are set out over the page. I trust our comments are of assistance. Please contact me or Kate Griffiths, ACSI's Executive Manager – Public Policy and Advocacy, should you require any further information on ACSI's position.

Yours faithfully

[redacted]

[redacted]
Chief Executive Officer
Australian Council of Superannuation Investors

Support for improvements to CPS511

We remain supportive of APRA's goals to lift remuneration practice, through enhancing board oversight, improving transparency, increasing the use of non-financial measures in remuneration design and ensuring there are appropriate financial consequences for poor risk management.

We support a number of changes included in the Revised Draft Prudential Standard including:

- Removal of the prescriptive requirement for 50% of performance hurdles to be non-financial measures in favour of a more principles-based approach.

- Requiring that remuneration frameworks address how the framework aligns to the entity's strategy and risk management framework.

- Extending the deferral/performance period for executive remuneration. While shorter than initial proposals, the requirement to defer remuneration for senior executives over 5 to 6 years is an improvement on current market practice. Increased performance periods should act to improve alignment between executives and investors over the long-term and move away from a culture heavily focused on annual incentives. Increasing the deferral of incentives also allows boards to apply discretion and/or malus provisions.

- Clarifying that the 'material weight' requirement applies to each component of an individual's variable remuneration, to reduce the risk of inconsistent application across an organisation.

- Clarifying the expectation for adjustment in outcomes for adverse risk and conduct outcomes.

Further improvements should be considered

Some aspects of the updated CPS511 could be further improved. We are concerned that in practice, some provisions may operate to stifle innovation in remuneration practice that would otherwise be consistent with APRA's policy intent. For example, non-financial measures can be used as a true gateway that operates to prevent any pay out under a financial measure where the non-financial measures are not appropriately met (for example, a fatal accident in an operation would prevent a pay-out under a financial measure). Where relevant non-financial measures are used in this way, they can encourage significant focus on non-financial risk, and therefore meet the policy intent of CPS511. Therefore, we recommend that APRA allow for innovation to form part of the 'material weighting' where it is in accordance with policy intent.

Further guidance on appropriate financial measures is crucial to success

Non-financial measures used in remuneration should be objective, transparent and measurable, with outcomes truly at risk. Our view is that the market would benefit from further guidance in this respect and we note APRA's intention to develop a framework to help entities to determine appropriate measures in the proposed CPG511.

Further guidance on appropriate 'non-financial' measures should focus on ensuring that non-financial measures are appropriate, objective, transparent, measurable and truly at risk. While one set of metrics will not suit all entities, there are common principles that should be incorporated. Entities should be guided to identify the material 'non-financial' risks and the greatest opportunities that are relevant to the particular entity. 'Non-financial' targets should also be appropriately weighted to reflect the range of matters that are important to long-term success, and reflect the entity's strategy, risks and priorities.

Entities could look to their risk appetite and risk monitoring processes (in respect of non-financial risk) to form a basis for integration between risk and remuneration. Clearly, there should be alignment between the non-financial indicators selected by an entity and its risk processes (including for example, the materiality of risks identified and the success of control measures). In addition to the examples included in the initial discussion paper (effectiveness and operation of control and compliance, customer outcomes, market integrity objectives, reputation and alignment with strategies or values), others may include safety metrics, stakeholder satisfaction, employee engagement and corporate culture measures.

Given that the implementation of appropriate non-financial targets by regulated entities will be key to the success of the proposed measures, we recommend that CPG511 be the subject of consultation as soon as possible.

Further clarity on disclosure proposals is required without delay

We agree that the updated CPS511 allows for stronger remuneration outcomes and allows increased flexibility. However along with this increased flexibility comes scope for compromised outcomes.

In a number of places, the response paper outlines that the measures will be reinforced with stronger market discipline which will be supported by disclosure requirements. We recognise that improved disclosure requirements allow the market to assess whether non-financial measures are sufficiently objective, transparent, measurable and truly at-risk. We therefore support the disclosure of useful information that supports investor decision-making.

We note APRA's comments in its Response Paper that there can be inconsistent disclosure of remuneration governance, insufficient detail on remuneration design and outcomes, (particularly for Highly Paid Material Risk Takers) and a lack of clarity on the inputs and outputs of the consequence management process and that these gaps are impediments to effective market discipline of remuneration outcomes. We agree with this assessment in respect of listed companies.

While APRA's Response Paper provides broad guidance as to its future disclosure proposals, additional detail on the proposed disclosure requirements is necessary to form a view on the potential efficacy of the CPS511 proposals overall. We agree that the disclosure proposals should be consistent with existing requirements. Remuneration disclosures that include a clear explanation, in plain language, of the link between the entity's remuneration framework and outcomes and its strategy, culture and risks (and risk control outcomes) are the most helpful. We recommend that entities approach disclosure as an opportunity to facilitate understanding, rather than a compliance exercise. We note APRA's considerations in respect of the following elements of disclosure outlined in the consultation, and add our comments below:

- Remuneration governance and oversight. Qualitative information about the remuneration policy, design, adjustment tools and the process to determine remuneration outcomes. *ACSI comment*: We support the disclosure of information on remuneration governance and oversight. APRA should clearly outline that these disclosures are expected to include how the entity's approach is connected to its identified material risks, risk control outcomes and its strategic goals. Disclosures should include both financial and non-financial measures. Information should be provided about how the entity assesses the effectiveness of its remuneration framework and how the entity's approach is consistent with CPS511 (both the requirements and the intent).

- Remuneration design and outcomes. Quantitative information, aggregated for groups of employees and specified roles, which would cover non-financial measures, performance outcomes and variable remuneration split by plans (STIs, LTIs and others). *ACSI comment*: We support the disclosure of quantitative information as described. In addition, qualitative information that clearly explains the entity's approach and how quantitative outcomes align with material risks and opportunities, risk control outcomes and strategic goals should accompany the quantitative information suggested by APRA. This will encourage entities to provide important context on how the outcomes were reached.

- Consequence management. Quantitative information, aggregated for groups of employees and specified roles, which would cover the value of upward and downward adjustments by adjustment tools. *ACSI comment*: We support the development of these disclosures. Several listed financial institutions are now providing consequence management disclosures, including Macquarie and the Commonwealth Bank. The benefit of these disclosures is that they demonstrate how malus provisions (and related measures) are applied across an organisation such as detailing the number of conduct issues and policy breaches that resulted in formal consequences for staff. We recommend further consultation to develop disclosure standards to ensure entities are providing investors with meaningful information on these matters and avoiding boilerplate disclosure. Again, our view is that qualitative information that clearly explains the link between adjustments and non-financial risk management outcomes should be provided to enhance the quantitative information.

In addition, APRA has specifically asked a number of questions in relation to remuneration disclosure, and our views are outlined below.

What principles should inform the types of information required to be disclosed for prudential purposes?

Remuneration disclosures should facilitate understanding of an entity's remuneration policies, practices and outcomes. Disclosures provide an opportunity to explain the company's approach to remuneration and the link between remuneration, risk, strategy and culture. Disclosures should explain how remuneration drives and rewards the entity's performance and manages risk, with reference to strategic goals and returns. Disclosure should also include information on how the board assesses the effectiveness of remuneration structures.

Therefore, APRA should include transparency, accountability, in its principles and seek to encourage entities to provide a plain language explanation of how remuneration policy, practice and outcomes drive appropriate responses to non-financial risk management in line with the entity's strategy.

How could prudential disclosures complement disclosures required under the Corporations Act?

We support consistency with existing Corporations Act requirements. Disclosures could however complement the existing disclosures by providing additional quantitative information, as outlined in our comments above.

Would a proportional approach to disclosures, similar to that proposed for revised CPS 511, promote market discipline for the appropriate cohort of entities?

As set out above, our expertise is in relation to listed entities. Our view is that the better approach would be that APRA adopt standard and comparable reporting of qualitative and quantitative remuneration information across its listed entity cohort.