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General Manager, Policy Development

Policy and Advice Division

Australian Prudential Regulation Authority

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Submission on Revised Draft CPS 511

Dear General Manager

We set out EY's response to the Australian Prudential Regulation Authority (APRA) revised draft of Prudential Standard CPS 511 (Revised CPS 511, Redraft or Standard). EY considers that overall, CPS 511 improves the regulatory landscape for remuneration in financial services, and the Redraft addresses a number of issues identified in the initial draft of CPS 511.

In particular, EY supports:

- The adoption of an overarching principles- based approach throughout the Standard;
- The reduction in deferral and clawback timeframes;
- Increased alignment of deferral timelines with the Financial Accountability Regime (FAR); and
- Changes to the scope of remuneration framework effectiveness' reviews.

However, EY does not support that Non-Significant Financial Institutions (SFI) do not require a remuneration committee and are not required to review their remuneration framework.

We are of the view that greater guidance and clarity is needed across the Redraft for effective and consistent implementation of the Standard. Our submission below provides further detail on these areas.

Please let us know if you would like to discuss the submission.

Yours sincerely

[redacted]

[redacted]

Partner, People Advisory Services

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EY submission on Revised CPS 511

EY supports many of the proposed changes in Revised CPS 511. Our submission focuses on areas where additional change and clarity are required to support the effective implementation of the Standard.

Our proposed changes are summarised below in terms of those matters that EY does not support, and those matters where we believe further clarity and/or guidance is required. Further detail on each point is set out in each section below.

Executive Summary

Proposed change	Comment and proposal summary
1. Changes which EY does not support:	
1.1 Non-Significant Financial Institutions (SFI) do not require a remuneration committee	Non-SFIs are not required to maintain a remuneration committee. This change is imposing a lower governance requirement on APRA regulated entities than is expected under Australian corporate governance standards.
1.2 Non-SFIs are not required to review their remuneration framework	The Redraft does not require non-SFIs to review their remuneration framework. EY considers that they should be required to review their framework in order to understand whether the remuneration framework is operating as intended.
2. Areas where the Standard should be amended:	
2.1 Alignment to FAR	EY notes areas where the Standard does not align to the Australian Treasury's FAR regime. APRA should aim to align CPS 511 to FAR.
2.2 Highly Paid Material Risk Taker (HPMRT) definition	A HMPRT should be defined as an MRT who received remuneration exceeding $1m in the prior year.
2.3 Remuneration framework definition	Clarify the definition so that it covers broader remuneration matters, not just remuneration risk.
2.4 Add 'performance related' definition	Remuneration that is 'performance related' must give material weight to non-financial performance. The Standard should define 'performance related'.

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Proposed change	Comment and proposal summary
2.5 Clarify application to corporate groups	Under the Standard, the Remuneration Policy must cover connected entities and related parties of regulated entities that are not head of the group. The Standard does not clarify whether remuneration of entities that are not head of the corporate group should accord with all sections of Standard, or just the Remuneration Policy requirements.
2.6 Application to service providers	The Remuneration Policy must cover service providers. This definition is too broad. The Standard should be clarified and provide specificity.
2.7 Effectiveness review	The Standard should be amended to require the report resulting from an independent effectiveness review to be given directly to the Board remuneration committee.
2.8 Clawback	The Standard should not require Boards to impose clawback where other accountability mechanisms are available.
3. Areas for guidance:	
3.1 Commencement date	APRA should outline implications (e.g. new starters, consistency of terms across executive teams) of the commencement date of CPS 511 on entities that are part-way through their performance year when the Standard commences.
3.2 Risk and financial control personnel	Further guidance required on criteria for identifying risk and financial control personnel.
3.3 Sign-on and buy-out awards	APRA should provide guidance specifically on treatment of buy-out awards for the purposes of variable remuneration and deferral.
3.4 Recognition and reward	APRA should clarify that the Remuneration Policy should cover broader aspects of reward and employee motivation, such as recognition, promotion and progression.
3.5 Non-financial performance measures	APRA should clarify that remuneration gateways and remuneration modifiers are considered 'measures' for the purposes of the Standard.

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Proposed change	Comment and proposal summary
Malus and clawback (See section 2)	APRA to clarify the relevant 'significant' and 'material' thresholds.
3.6 Pre-grant assessment for long-term incentives (LTI)	The Response Paper states entities must conduct a pre-grant assessment for LTI. APRA should clarify when entities are to undertake assessments.
3.7 Remuneration deferral policy	APRA should clarify that entities can set a policy outlining how they will consider, calculate, and determine the remuneration deferral requirements for each variable remuneration arrangement.

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Detailed EY submission

EY sets out the following matters for APRA's consideration.

1. Changes which EY does not support

The redraft of the Standard has increased the gap in requirements for SFIs and Non-SFIs. APRA should be aware that this may have broader industry ramifications, for example differences in talent attraction and retention between SFIs and Non-SFIs, and may act as a disincentive for industry consolidation due to the change in individual executive's remuneration structure upon an entity meeting the SFI threshold. Particularly, we raise the following requirements:

1.1 Removal of the requirement to maintain a remuneration committee

EY does not support the removal of the requirement for non-SFIs to maintain a remuneration committee and we suggest this requirement be reinstated for the following reasons:

- *Divergence from Australian requirements for international groups*: Some large international groups globally centralise their HR and reward function. EY is concerned that removing the requirement for these entities to maintain a remuneration committee will lessen the focus on Australian remuneration arrangements and lead to decisions being made that do not reflect local market experience.

- *Lower governance standards than CPS 510*: The change in requirements imposes a lower governance standard on non-SFIs than are currently required under existing CPS 510. The role of an independent remuneration committee in reviewing and making recommendations to the board on the Remuneration Policy and remuneration of key employees is fundamental to remuneration governance and facilitates the achievement of the policy aims of the standards.

  While a remuneration committee may not be fundamental for non-SFIs that do not have significant amounts of variable remuneration, entities can already request dispensation from this provision by APRA.

- *Misalignment to Australian standard governance practice:* By proposing this change APRA is effectively imposing a lower compliance standard on entities it regulates than would be required by similarly sized Australian Stock Exchange listed organisations under the Corporate Governance Council's Corporate Governance Principles and Recommendations. Recommendation 8.1 outlines that the Board of a listed entity should have a remuneration committee. It is important to note that there are corporate groups that are part of the ASX 200 (typically considered the largest ASX entities) but which are unlikely to be considered SFIs under CPS 511.

- *The change does not align with market practice:* There is emerging market practice amongst all financial services entities to strengthen remuneration governance and support the reduction in misconduct risk.

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1.2 Removal of the requirement to conduct a remuneration compliance and effectiveness review

EY does not support the removal of the requirement for non-SFIs to undertake an annual compliance and tri-annual effectiveness review of their remuneration framework. EY notes the concerns of non-SFIs that conducting an annual compliance and tri-annual effectiveness review will increase costs and regulatory burden. However:

- A number of non-SFIs maintain a-typical and complex remuneration arrangements. Removing the requirement to conduct reviews may mean that the Board does not receive an independent view of those arrangements.

- It is inconsistent with the Financial Services Royal Commission recommendation 5.3 that APRA regulated entities make regular assessments of the effectiveness of their remuneration system.

A number of the referrals to the Australian Securities and Investments Commission resulting from the Financial Services Royal Commission related to entities that are considered non-SFIs based on their assets.

2. Areas where the Standard should be amended

2.1 Alignment to the Financial Accountability Regime

EY supports APRA's intention to align CPS 511 with the FAR, and we note the difficulty of this given that the FAR Bill is not yet released. There are the following points of divergence between FAR and Revised CPS 511:

- *Roles:* FAR requires the deferral of remuneration for Accountable Persons. CPS 511 requires the deferral of remuneration for Senior Managers and Highly Paid Material Risk Takers. There will be some cross-over between these groups, but they do not completely align.

- *Deferral period:* FAR proposes a four year deferral period, whereas CPS 511 proposes a 5 or 6 year period for Senior Managers. EY supports APRA's approach that a forward-looking performance period can be counted when determining the deferral period. As a result, the higher of FAR or CPS 511 will be applied.

- *Applicable remuneration:* the definition of variable remuneration under the Banking Executive Accountability Regime (BEAR) does not align to the definition in CPS 511. If the FAR legislation is consistent with BEAR, it could result in two separate calculations being conducted, one for FAR and one for CPS 511.

- *Consequence application*: it is proposed that under the FAR, an entity must reduce an Accountable Person's variable remuneration by an appropriate amount following a failure to meet relevant accountabilities. Under CPS 511, an entity is only required to apply a malus reduction for a 'material failure of…accountability'. APRA should consider aligning CPS 511 to the FAR.

EY supports greater harmonisation of these regimes.

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2.2 Highly Paid Material Risk Taker actual remuneration should be referenced to prior financial year

Based on industry feedback, the Redraft proposes that a HPMRT be determined by actual remuneration in order to reduce the number of individuals classified as HPMRTs. EY supports the approach but proposes that the HPMRT be based on actual remuneration for the prior financial year.

Under the proposed approach, a HPMRT's 'actual' remuneration cannot typically be determined until the end of the financial year as this is when annual performance is usually assessed, and incentives determined. This timing creates inconsistency with other sections of the Standard (for example section 51(c) which requires remuneration for HPMRTs to be deferred) which require the entity to take certain actions during the year with respect to HPMRTs.

This can be overcome if the 'actual' remuneration for a HPMRT is based on their total remuneration in the prior financial year. Therefore, if a HPMRT received actual remuneration exceeding $1m in the prior year they will be treated as a HPMRT for the following financial year.

2.3 Clarity of the remuneration framework definition

The proposed 'remuneration framework' definition is too narrow. It should be broader than just reflecting remuneration risk. The relevant definition per section 18(p) of the Standard is:

Remuneration framework – means the totality of systems, structures, policies, processes, and people within an entity that identify, measure, evaluate, report and control or mitigate all internal and external sources of risks relating to remuneration.

EY is concerned that the definition is limited to those aspects that 'control or mitigate all internal and external sources of risks relating to remuneration'. We propose that the definition be expanded to cover more aspects of remuneration. For example:

- The totality of systems, structures, policies, processes, and people within an entity that identify, measure, evaluate, report remuneration; and which
- Evaluate, report and control or mitigate all internal and external sources of risks relating to remuneration.

2.4 Define 'performance related'

Each component of performance related remuneration must give 'material weight' to non-financial conditions where the remuneration is 'performance related'. The Standard does not define 'performance related' remuneration. We propose that this definition be added.

'Performance related' is used in section 37(a) of the Standard. It is clear that 'performance related' remuneration is intended to be a sub-set of variable remuneration, because, for example, it would be inappropriate for remuneration subject to service requirements or the passage of time to give 'material weight' to non-financial performance conditions. This is an important change that is required to give clarity to when 'material weight' must be given.

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EY supports the differentiation of variable remuneration and performance related remuneration. EY recommends a definition is included to assist entities in interpreting the Standard.

2.5 Application of the Standard to corporate groups

The Standard needs greater clarity as to the requirements imposed on corporate groups.

This clarity is needed because:

- Under section 5, an APRA regulated entity that is not head of the group is not required to apply the Standard throughout the group;
- Section 20(b)(iii) requires the Remuneration Policy of an APRA regulated entity to set out the structure and terms of remuneration arrangements that apply to persons who are employed by a related body corporate or a connected entity; and
- Section 36 requires the APRA regulated entity to design all variable remuneration arrangements to align with its remuneration framework.

The Standard should clarify the obligation on an APRA regulated entity that is not head of the group to ensure that compliant remuneration arrangements are in place for connected entities and related body corporates. It is unclear whether section 36 applies to remuneration arrangements for only the employees of the APRA regulated entity, or the remuneration arrangements for all employees/contractors covered by the Remuneration Policy.

It is not uncommon for an APRA regulated entity to have no employees in its own right. For example, a group employing entity may be used as the employer for all group entities. Additionally, the Specified Roles for the APRA regulated entity may be performed by broader group employees.

If section 36 is applied only to the employees/contractors of the entity, it may result in a small number of employees being identified. However, applying it to the broader group may cover employees that are unconnected to the APRA regulated entity. This could be overcome by having a service nexus between the APRA regulated entity and the relevant employees/contractors. In any event, greater clarity is required.

2.6 Application of the Remuneration Policy to service providers

The requirement to review whether any conflicts of interest exist between an entity's and third-party service providers' remuneration framework is too broad and will be administratively burdensome on industry. Currently the Standard captures all service providers.

We suggest that APRA limit this definition to certain types of service providers by reference to the criticality of the role of the service provider to the entity. For example, those that are distributing product on behalf of the entity or are critical outsource providers (particularly in relation to superannuation and mortgage brokers).

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2.7 Require the compliance and effectiveness review reports to be given to the Board remuneration committee

The operationally independent party conducting the tri-annual effectiveness review should report directly to the Board or the Board remuneration committee.

Section 33 states that an APRA regulated entity must document and report the results of the compliance review and the effectiveness review to the Board remuneration committee. This suggests that the party conducting the compliance or effectiveness review may report to management, who then document and report the results to the Board remuneration committee.

Comparatively, Prudential Standard 220 requires the independent risk framework assessment to be reported directly to the Board risk committee.

EY proposes that this section be reframed to require the party conducting the review to report directly to the Board remuneration committee, to ensure that the report received is unfiltered and represents the findings of the party conducting the review.

2.8 Malus / clawback

EY supports the harmonised approach to the triggers for malus and clawback. We have the following comments on these sections:

a. *Guidance required on 'significant' and 'material'*

Under section 38 an APRA regulated entity must apply malus where a 'significant' criterion is met, and under section 55 it must apply clawback where a 'material' criterion is met.

The terms 'significant' and 'material' are not defined in the Standard. EY suggests that APRA provide guidance on when a matter may be considered 'material' and 'significant' to assist entities to draft their specific clawback and malus criteria.

b. *Application of clawback*

Under section 56 an entity must apply clawback where a 'significant' criterion is met. APRA should clarify that an entity can impose malus (or such other remuneration adjustment tool), either solely or in addition to clawback, when a 'significant' criterion has occurred.

Currently the Standard is worded such that clawback must be imposed where a significant criterion is met. However, situations can arise where clawback is inappropriate, either because another remuneration adjustment provision could appropriately be applied, or because the relevant individual has no vested remuneration available to clawback.

We suggest that section 55 be reworded to require the Board to take reasonable steps when a specified criterion has occurred, but that this could include applying other remuneration adjustment tools.

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3. Areas for guidance

3.1 Guidance on 'effective' commencement date

APRA should provide guidance on the commencement date for entities that will be part-way through their performance year when the Standard commences.

Our discussions with entities have shown that there is uncertainty regarding the practical commencement date for CPS 511. If entities want alignment across remuneration terms, they will need to have their remuneration framework in compliance with CPS 511 at the start of the financial year immediately preceding the implementation date.

The commencement dates are clearly stated in the Standard. However, these do not always align to an entity's financial year. As a result, there will be a misalignment between the Standard's commencement and the performance period for remuneration. EY notes that our original submission proposed that CPS 511 commence on the entity's first financial year after the relevant commencement date to overcome this challenge.

For example, a SFI authorised deposit-taking institution with a financial year ending 30 June 2022 would be in the following situation:

- 1 July 2022: performance period start date for remuneration for Senior Managers – this remuneration does not need to be compliant with CPS 511 as the Standard has not yet commenced.
- 1 January 2023: remuneration provided to any 'new starters' after 1 January 2023 is required to be compliant with CPS 511.

Therefore, if an entity wanted all employees to be on the same remuneration terms, the remuneration arrangements must be consistent with CPS 511 from 1 July 2022, making this the entity's 'effective' commencement date.

3.2 Guidance required on who is considered risk and financial control personnel

EY notes some variation across the industry as to whom entities are considering to be 'risk and financial control personnel' (RAFCP). Guidance outlining how entities should identify relevant individuals would be helpful. For example, should individuals in the following situations be considered RAFCP:

- Individuals in a division or team which performs a risk, compliance, internal audit, financial control or actuarial control function.
- Individuals in dedicated line 1 risk/control roles within a business function.

Additionally, guidance on what is considered a 'control' role will assist entities. For example, it will help to between finance roles from financial control roles.

3.3 Variable remuneration definition – sign-on and buy-out awards

EY supports the broader and clearer definition of variable remuneration under the Redraft.

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In discussions with industry, concerns have been raised as to how 'sign-on' and 'buy-out' should be treated under the definition of variable remuneration. EY notes APRA's intention to provide guidance in Prudential Practice Guide CPG 511. We suggest that this guidance include the circumstances in which buy-out awards will be considered variable remuneration, and whether buy-out awards can match the prior-employer vesting period or must be deferred for the deferral period relevant for the specified role.

3.4 Recognition and reward – inclusion in Remuneration Policy

APRA should provide guidance on how entities should prepare their Remuneration Policy. Matters that relate to reward and recognition of employees should be included.

Entities that do not have variable remuneration typically rely on other aspects to reward and recognise their employees, to a greater extent than entities with variable remuneration. These could include performance reviews, non-monetary benefits, education, promotion and progression. Each of these aspects can give rise to misconduct risk to the same extent as remuneration, where an employee may act in a certain way to achieve a favourable outcome or avoid an unfair outcome. EY suggests that APRA provide guidance specifying that these broader matters be referenced in the Remuneration Policy where entities rely on these to reward employees.

For entities that do not have variable remuneration, APRA may wish to consider that the 'material weight' to non-financial measures threshold is also applied to other aspects of recognition and reward used by these entities.

3.5 'Material weight' to non-financial measures

EY supports change to a principle-based approach for the application of non-financial measures. We have the following comments on this section:

a. *Further guidance required on the meaning of 'material weight'*

The Standard requires that each variable remuneration arrangement that is performance related must give 'material weight' to non-financial performance conditions. APRA should provide guidance on how entities should determine 'material weight' for the purposes of the Standard. Such guidance should consider whether consequence management tools can be considered when determining material weight, whether material weight can differ depending on seniority or role type, and how material may be considered under different operating scenarios.

b. *Risk gateways and risk modifiers should be considered 'measures'*

We suggest that APRA issue guidance stating that risk 'gateways' and risk 'modifiers' are 'measures' for the purposes of section 37.

The Standard requires that each component of a person's variable remuneration must give material weight to non-financial performance measures where the remuneration is performance related.

In June 2020, EY surveyed 7 ADIs regarding how they incorporate risk measures into their remuneration frameworks. The results showed that all entities included a risk modifier or risk gateway that allowed the entire remuneration amount to be reduced to zero for non-financial performance. This assessment is based on either pre-determined measures or board discretion. Only two organisations included a specific risk metric as part of their short-term incentive balanced scorecard.

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Currently the Standard is unclear whether risk gateways and risk modifiers will be considered 'measures' for the purposes of section 37. Given the prevalence of these tools in the market clarity as to whether they can be considered 'measures' would be useful.

c. *Definition of 'performance related' remuneration*

Refer to paragraph 2.4 of this submission.

3.6 Pre-grant assessment for LTI

The Response Paper states that entities must conduct a pre-grant assessment for LTI. EY submits that the timing of this assessment should be determined by the entity. The Standard (as proposed) will still allow entities to conduct the review pre-grant, however an assessment at this point should not be mandated. We are aware of entities who undertake both a pre and post grant assessment.

The Response Paper stated that:

> An entity would be expected to scale variable remuneration, including potentially to zero, for known risk and conduct incidents. APRA expects this would occur following assessment of performance for an STI and prior to the grant being made for an LTI.

EY proposes that entities choose to undertake an assessment pre-grant, during the vesting period or at vesting based on the circumstances, such as the timing a material issue arises.

3.7 Remuneration deferral policy

Section 51 of the Standard requires entities to defer a certain percentage of remuneration for specified roles for a period of time. To assist entities with this obligation, EY proposes that APRA require entities to set a policy setting out:

- How the entity will value 'total variable remuneration';
- The point at which the determination of the deferral requirement will be conducted; and
- How it will determine the relevant vesting period for each variable remuneration arrangement.

Maintaining this information in a policy allows entities to deal with the complexity of different arrangements, while ensuring there is a process agreed up front for how these will be determined.

As APRA would understand, there are a variety of remuneration arrangements offered by regulated entities. These arrangements may differ by entity domicile, sector, or company life stage. This creates challenges for setting blanket rules around how the remuneration will be valued and considered for remuneration deferral purposes.

EY has encountered similar issues under the BEAR regime which does not have such guidance, which is why clarity would be helpful. For example, such issues include:

- How would the relevant deferral period be calculated for an incentive that vests upon a corporate event (such as IPO)? This event could occur before or after four years.

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- How should Options or loan shares be valued when calculating the relevant amount of remuneration to defer? For tax purposes, it is possible for these arrangements to have a nil value.
- Should the determination of remuneration deferral occur at the start of the performance period or at the end?

Requiring entities to maintain a policy on these matters will ensure they are able to interpret these provisions in the most administratively efficient way, while providing a definitive position for future consideration.