# Submission to APRA's Consultation: CPS511 Remuneration Revised Draft

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## Summary/Recommendations

The Australian Prudential Regulation Authority (APRA) proposes revising prudential standards concerning remuneration in financial institutions (CPS511). Consistent with the initial draft, the revised draft emphasizes the importance of remuneration governance with a significant focus on non-financial criteria in performance evaluation and the proposal to implement deferrals to support the use of malus provisions.

Since the previous round of consultation our research has continued to investigate the issue of deferrals. Our recent findings, explained in the body of this submission, provide further evidence of the benefits of deferrals. As predicted, they produce better compliance outcomes due to superior monitoring. Contrary to industry fears about the recruitment/retention of talent, we find that talented individuals are disproportionately *attracted* to environments with deferred remuneration where their behaviour will be more closely monitored. In light of this, its our opinion that APRA's focus on deferrals/malus provisions to support risk management objectives is sound and likely to be effective.

APRA persists in requiring a material weight for non-financial measures when determining variable remuneration, despite the abandonment of defined limits. Although we agree with the need to adjust the variable remuneration downward in light of adverse risk and conduct *outcomes* (paragraph 37b), we cannot support paragraph 37a. We are concerned that the use of non-financial measures for determining variable remuneration eligibility increases the risk of poor outcomes. In particular there is a risk that important management information will become contaminated due to gaming behaviour. It is unnecessary to take this risk in light of the apparently successful impact of the BEAR (Sheedy and Canestrari-Soh, 2020) and the likely benefits of greater use of deferrals.

We recommend that APRA maintain its focus on a) remuneration governance, b) outcomes management, and c) deferrals and malus, but discard the requirement of a material weight on the use of financial measures for performance pay eligibility. The requirements to justify the use of variable remuneration (paragraph 43) should be extended to the entire sector. We also suggest that APRA consider incorporating the issue of promotion into this standard, given the importance of promotion as a form of reward for the vast majority of employees.

## Introduction

Revising Prudential Standard CPS511 on remuneration practices is an important step in responding to the Hayne Royal Commission on Misconduct in Banking, Superannuation, and Financial Services. Reforms to remuneration practices in the financial sector are much needed and can influence financial institutions' culture, the behaviour of all staff, and outcomes for external stakeholders.

We applaud much of what is contained within the revised draft CPS511. The purpose of this submission is to highlight some potential issues with the revised draft CPS511 and new evidence we have obtained on deferrals.

## Overview of the recent revisions

Overall the revised draft has made the definitions of relevant terms clearer, such as clawback, conduct risk, executive-director, financial measures, etc. And it allows different entities to have a phased commencement for the new standard.

The revised draft abandons the defined limits on the use of financial measures for remuneration (e.g., the old draft documented that "financial performance measures must not comprise more than 50 percent of total measures used to allocate variable remuneration. Each individual financial performance measure must not comprise more than 25 percent of total measures."). However, it persists that a material weight must be given to non-financial measures for determining variable remuneration where the remuneration is performance-related.

In the revised draft, APRA sets out less restrictive standards for the non-significant financial institutions, the size of which is below a specific size specified by APRA. Both types of institutions "should align variable remuneration with performance and risk outcomes, and reflect appropriate adjustment tools in the variable remuneration outcomes." At paragraph 43 there are three additional requirements for significant financial institutions. The payment of variable remuneration can only be justified if it: "(1) supports the entity's compliance with paragraph 19 of this Prudential Standard; and (2) is justified on the basis of the effectiveness of risk management of the entity and the relevant business unit; and (3) is justified on the basis of the performance of the person, the relevant business unit and the entity." We think the additional requirements should be extended to the entire sector.

## Why impose a material weight on non-financial measures?

In the proposal, APRA repeatedly emphasizes the importance of non-financial measures. It is well understood in the academic literature, however, that non-financial measures in remuneration systems are problematic due to measurement problems (Prendergast, 1991). As explained in our previous submission, there are particular challenges in measuring risk and compliance outcomes in the short-term. 'Bad' behaviour is hidden while monitoring is imperfect. This means that short-term measures are not just noisy, but systematically biased in the wrong direction. It takes time for poor risk and compliance outcomes to become apparent, so longer-term outcomes are the only appropriate tool.

A proponent of non-financial measures could argue that they provide additional guidance to executives regarding what the organisation values. They enshrine the undoubted importance of risk and conduct criteria. But this should not be necessary if these criteria are baked into the malus and clawback provisions. In other words, if executives understand that they will lose their bonuses for bad risk/conduct outcomes, it should already be abundantly clear that these criteria matter.

The use of *positive* non-financial measures for determining bonus eligibility has no real benefit yet it introduces significant risks. Goodhart, a British economist, was one of the first to point out that linking measures to reward tends to reduce their usefulness (Goodhart, 2014). The harder something is to measure, the more that Goodhart's Law applies. When measures are linked to reward, people often find ways to manipulate or game the measure. Useful management information that is needed for risk management purposes is contaminated. Even worse, if it becomes common knowledge that the risk/compliance measures tend to be gamed, then this could have an adverse impact on risk culture.

## Deferred payment and its experimental evidence

The draft also proposes the implementation of deferrals or remunerations with malus and clawback provisions. The central feature of deferred compensation is that good performance in one period yields the opportunity for benefits in future periods. Deferred payment and shares/options are attractive for creating long-term incentives. Deferrals also make it easier to impose sanctions if the performance is later found to have been overstated. Deferral compensation could be a useful channel to control conduct risks, which often take much longer to evaluate. The revised draft requires a minimum vesting period of six years for CEOs, dropping from seven years in the initial draft, five years for senior managers and executive directors dropping from six years, and four years for highly-paid material risk-takers.[1]

The purpose of this deferral is to allow time for misconduct to come to light since poor behaviour is usually hidden and only exposed due to the efforts of compliance teams and regulators. If apparent profits have been produced through misconduct, then the bonuses can later be withdrawn through 'malus' clauses[2]. The potential benefit of this arrangement is that misconduct will become less common since employees expect that any misconduct is likely to be uncovered over time.

However, this deferred payment remuneration scheme is not a panacea. It could change the composition of the labour force through recruiting or retaining talents. If deferrals are mandated across the industry, then the industry may struggle to recruit talented graduates and retain talented employees who can move to other sectors. This is particularly a risk for employees with roles that transfer easily to other industries such as information technology and data analytics.

To better understand these issues, a team at Macquarie Business School conducted lab experiments in 2019 (with students) and 2020 (with finance professionals). Participants came to the laboratory[3] to participate in a business simulation that was designed to replicate aspects of the real-world environment. The payment they received depended on their performance in the lab, just like in many real-world settings. Professionals received higher payment reflecting the higher opportunity cost of their time.

The experiment was designed to mimic the typical financial services setting, where employees are under pressure to complete transactions for the benefit of the firm. Participants were invited to complete as many transactions as possible on behalf of the employer, provided the transactions complied with policy. Consistent application of the policy would mean rejecting some 60% of transactions, significantly reducing transaction volumes. In other words, participants faced a conflict between the competing requirements to generate higher transaction volumes (thus more profit) and to maintain compliance with policy.

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[1] In the revised draft, the minimum proportion of deferred variable remuneration for CEOs, senior managers and executive directors and highly-paid material risk-takers are 60, 40 and 40 respectively.

[2] Malus clauses in employment contracts give employers the right to withdraw payments that have been awarded but not yet paid, under certain specified conditions. In contrast, clawback clauses relate to payments that have already been made.

**Table 1 Three remuneration structures**

*A. Student Study (recruiting talents)*

| Payment Structure | Variable/Immediate | Variable/Deferred | Fixed |
|---|---|---|---|
| **Timing of Payment** | End of today's session | In one week | End of today's session |
| **Audit rate** | 20% | 90% | 20% |
| Performance | | | |
| Top 10% | $50 | $55 | $20 |
| Next 30% | $24 | $26 | $20 |
| Next 40% | $15 | $17 | $20 |
| Lowest 20% | $10 | $11 | $20 |
| If 2 or more policy breaches are observed. | $10 | $11 | $20 |

*B. Professional Study (retaining talents)*

| Payment Structure | Variable/Immediate | Variable/Deferred | Fixed |
|---|---|---|---|
| **Timing of Payment** | End of today's session | In two months | End of today's session |
| **Audit rate** | 20% | 90% | 20% |
| Performance | | | |
| Top 10% | $100 | $110 | $40 |
| Next 30% | $48 | $52 | $40 |
| Next 40% | $30 | $34 | $40 |
| Lowest 20% | $20 | $22 | $40 |
| If 2 or more policy breaches are observed. | $20 | $22 | $40 |

We compared three different remuneration structures of which two had variable payment and the third had a fixed payment (see Table 1). Under these two reward schemes, participants were ranked according to the number of completed transactions and their reward depended on relative performance. The higher the ranking in terms of completed transactions, the higher the reward to the participant. If the participants were caught with two or more policy breaches, then the payment was reduced, similar to the gateway structures often applied in the industry. The two treatments differed in the timing and monitoring of transactions by the hypothetical audit team. Variable/immediate had immediate payment and only 20% of transactions were checked for compliance. Variable/deferred had delayed payment, with a deferral premium, but 90% of transactions were checked for compliance.

The figures below display our findings, first in relation to compliance, and then in relation to productivity, taking account of self-selection effects.

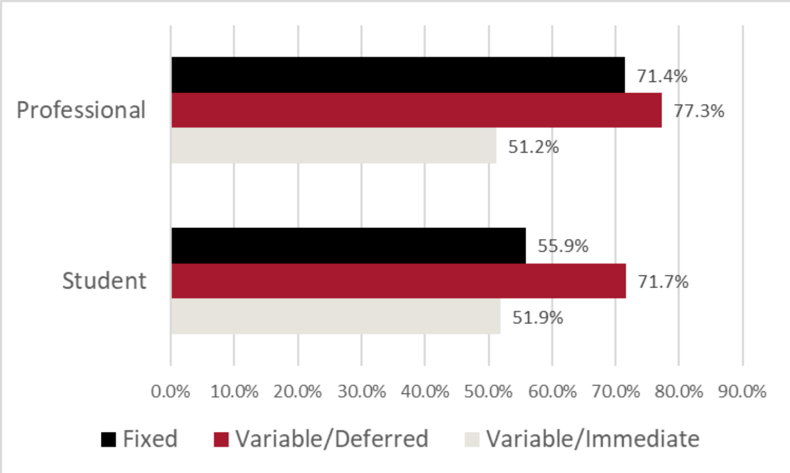


Figure 1: Compliance: proportion of participants with zero compliance breaches

As predicted, Variable/Deferred remuneration had significantly better compliance outcomes than the case of Variable/Immediate. The proportion of professional participants with zero compliance breaches rose from 51.2% to 77.3%. The compliance outcomes under Variable/Deferred even stacked up against outcomes under fixed remuneration (71.4%), where there was no financial benefit for breaching policy. (Note that 71.4% and 77.3% are not significantly different from one another.) The results in the student sample were similar, except for a significantly lower rate of compliance among students who selected the Fixed remuneration structure. We attribute this to the fact that the Fixed structure had no penalty for non-compliance, so participants may not have taken sufficient care to comply with policy. We assume that compliance norms are not as well established in the student population as they are in the professional population.

With regard to productivity, we found that Fixed remuneration was the least effective in both samples, with only 5.2 and 6.3 compliant transactions completed on average by students and professionals respectively. This was expected as previous researchers (Lazear, 2000; Dohmen & Falk, 2011) have shown that talented individuals tend to prefer variable remuneration while less talented individuals gravitate to fixed remuneration. This demonstrates the power of self-selection effects and why it is so important to the industry to be able to attract/retain talent.

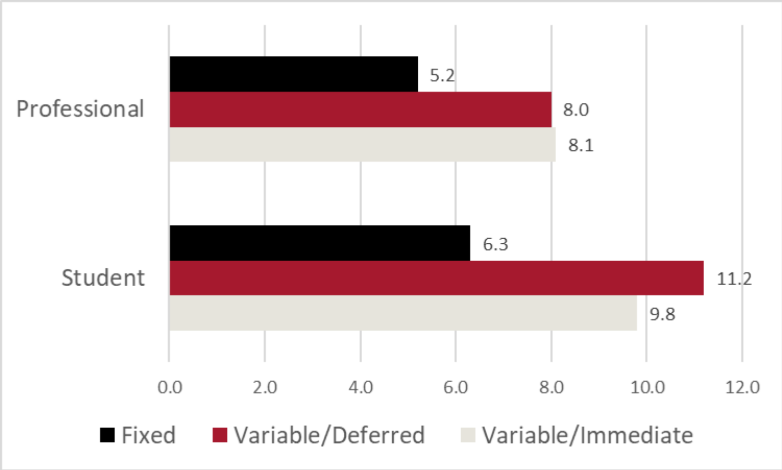


Figure 2: Productivity: average number of compliant transactions

Figure 2 shows that the Variable/Deferred remuneration structure performed very well with regard to productivity, and particularly so in the student sample with a massive 11.2 compliant transactions on average. For the professional sample, Variable/Deferred (8.0) and Variable/Immediate (8.1) are not significantly different from one another, and can therefore be regarded as equivalent in terms of productivity outcomes. After taking account of self-selection effects, Variable/Deferred was either the best, or equal to the best remuneration structure with regard to productivity.

Table 2 presents the findings from our statistical analysis of the factors that influenced remuneration choice. This is crucial for understanding the self-selection effects. The most important finding relates to productivity, since the industry is concerned about its ability to continue attracting talented graduates and then retaining talented staff. It's important to recall that the task in our experiment favoured fast mental processing which is linked to cognitive ability. Cognitive ability is likely to be one of the characteristics that the industry aims to recruit for and retain.

In both our studies, we observed that people who are more productive in the experiment were attracted toward, rather than repelled by, the Variable/Deferred remuneration structure. Notably such individuals were not attracted to the Variable/Immediate structure. In the professional study we found that participants who are eligible for variable remuneration in their current workplace were also significantly more likely to choose Variable/Deferred, even after controlling for productivity in the experiment. It is likely that professionals who are currently eligible for variable remuneration are on average more talented than their peers, so this is further evidence that the Variable/Deferred remuneration structure, but not the Variable/Immediate structure, appeals to talented individuals.

**Table 2: Determinants of Remuneration Choice**

| Characteristic | Students | Professionals |
|---|---|---|
| Productivity, as measured in early work stages. | Productive individuals are less likely to choose fixed remuneration and more likely to choose Variable/Deferred. | As for students |
| Gender | Females are 13% more likely than males to choose fixed; females are 19% less likely than males to choose Variable/Immediate. | Not relevant for choice. |
| Risk tolerance, as measured in survey | Risk tolerant individuals are less likely to choose fixed remuneration. | Not relevant for choice. |
| Eligible for variable remuneration in current workplace | N/A | 28% less likely to choose fixed remuneration and 25% more likely to choose Variable/Deferred. |
| Work for a commercial bank | N/A | 33% less likely to choose Variable/Immediate and 32% more likely to choose Variable/Deferred. |

Our study confirms that talented individuals are disproportionately attracted to the Variable/Deferred structure. This is despite, or perhaps because of the fact that they will be monitored more intensively, and are confident in their ability to succeed under such conditions. Notably such talented people are not drawn to the Variable/Immediate structure, suggesting that industry fears that they will be unable to attract talented graduates or retain talented employees, following a shift to deferrals, are without substance.

## Remuneration is not the only mechanism to incentivise workers

Incentives are provided to workers through institutions' compensation practices, and firms have different mechanisms to align the interests between the employers and the workers. Besides remuneration, other incentives such as promotion also play an important role in incentivising workers (Prendergast, 1999). The policy in its current form says nothing about policies relating to advancement and this is a potential weakness.

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