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

11 February 2021

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

RE: Revisions to proposed new Prudential Standard CPS 511

Dear APRA,

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

The proposed revisions to APRA's original proposed CPS 511 should make it more likely that the intent behind the standard – improving management of non-financial risks through better incentive structures and oversight of those structures. Our comments below are confined to listed entities subject to the proposed new standard (chiefly ADIs and general insurers) as that is our area of experience of incentive pay arrangements for APRA-regulated entities:

- **Proportional approach:** OM supports the proposed 'proportional' approach in the revised CPS 511, with higher expectations and obligations for 'significant financial institutions' (SFI). OM has no view on the definition of what constitutes an SFI but considers it appropriate for regulatory and investor attention and resources to be directed toward the most material entities with the greatest capacity to bear such scrutiny.
- **Remuneration design (revised paragraph 37):** The shift in the revised proposals to a "principles-based approach" to incorporating non-financial measures into determining variable remuneration outcomes is a major improvement on the original prescriptive approach specifying weights for non-financial measures.
- OM would still urge APRA to reconsider its view, reiterated in the revised standard, that non-financial measures exclude measures "entirely dependent on share price performance". As noted in OM's submission on the original proposed CPS 511, relative total shareholder return is, in OM's view, the 'least worst' long term incentive measure due to its objectivity and the difficulty in it being influenced by management over a prolonged period. It will also, if measured over a sufficiently long period, incorporate how well an entity manages non-financial risks relative to its peers as if it is consistently shown to treat customers poorly relative to peers this will over time influence its financial performance and hence its value relative to better-managed peers.

- A similar argument can be made with regard to measures based on earnings so long as they are properly administered to ensure management are held accountable for costs resulting from their actions or inactions. After all, Australia's four major banks and two largest listed wealth management firms have collectively incurred ~$10.2bn billion in costs relating to poor management of conduct risk over the period FY18 – FY20 which has had a direct impact on financial returns and commonly used financial measures of performance.

- In the discussion paper APRA has noted in relation to TSR (and also ROE) that they "do not reinforce individual accountability for effective management of non-financial risk". This is not a fault with the measures themselves but with how they are used and with other oversight mechanisms especially board discretion to adjust outcomes to reflect individual actions or inactions.

- In the paper APRA also notes that TSR (along with ROE) "can also be significantly lagging indicators of the effectiveness of non-financial risk management, which can lead to too much variable remuneration being awarded in the short-term". This is again a reflection of problems with current incentive structures – too high a weighting to measures assessed over one year and too much cash paid upfront - which other aspects of the CPS 511 proposals are designed to address such as much longer deferral periods (although see comments below in relation to the proposals relating to deferral periods and to quantum generally).

- **New disclosure of how remuneration and risk management interact:** The discussion paper also notes that as part of the move to a principles-based approach to incorporating non-financial measures dealing with risk & conduct into incentives, APRA intends to introduce new disclosure requirements. In the discussion paper APRA notes it plans further consultation on this point but calls for initial feedback; OM considers that any type of mandated disclosure around how incentives reflect management of non-financial risks should focus on demonstrating that good conduct has in fact been rewarded while those responsible for poor conduct – either through or act or omission - have been held accountable through remuneration outcomes.

- The initial suggestions provided by APRA of cohort-based disclosures of upward and downward adjustments would be useful in showing that this had in fact occurred and would extend voluntary disclosures already provided by groups such as Macquarie Group of consequence management across the organization during the financial year. To avoid becoming boilerplate however, these disclosures should specify both the number of positive and negative adjustments by employee cohort, the types of conduct for which adjustments were made, the aggregate size of adjustments, how the adjustments were made (ie. through malus, clawback or adjustment of annual outcomes) and the range of adjustments made. OM looks forward to engaging further with APRA on this issue during the flagged future consultation process.

- **Changes to deferral requirements:** The slight relaxing of deferral requirements for variable pay in the revised CPS 511 proposal do not materially alter the stated aim of increased deferral requirements – that is, to ensure that highly paid material risk takers and senior executives are unable to reap immediate, crystallised reward for conduct that may have negative long term consequences for customers and shareholders alike.

- Deferral of incentives for five to six years as a risk mitigation measure is a major improvement over incentives paid immediately or over shorter periods but deferral is an imperfect mechanism when used in conjunction with metrics assessed over a single year. Incentives assessed over three or more years – usually called long term incentives – have a much greater correlation with actual outcomes for shareholders and other stakeholders than incentives based on performance assessed over a year. If boards in response to executive displeasure over longer deferral periods shift to annual metrics and away from long term measures than deferral's effectiveness as a risk mitigation measure will depend on boards' willingness to reduce deferred incentives in response to risk management failures and the willingness of shareholders and potentially APRA to ensure boards are held accountable should such adjustments not occur.

- **Revised board oversight requirements**: The new proposals around requiring the board of an APRA-regulated entity to focus on principles of remuneration design and outcomes by cohort for groups below senior executives rather than approving individual executive outcomes are also welcome.

- **Quantum:** An issue that remains unspoken in APRA's approach to executive pay at the entities it regulates is the absolute level of executive pay. It is understandable that the regulator is reluctant to consider this emotionally charged topic but it is a material consideration when it comes to prudential supervision.

- A senior executive team of an APRA-regulated entity that has accumulated substantial wealth from their tenures is simply less exposed to the downside risk of their actions (or inactions). As an example – the now former CEOs of Westpac and ANZ, Gail Kelly and Mike Smith, both realised through cash pay and sales of vested equity incentives more than $85mn during their tenures as CEO. In this context, having equity incentives still at risk valued at $10mn is simply less meaningful than had they not been able to de-risk their personal balance sheets to such a significant extent through the high levels of pay received in prior years. Even Kelly, whose minimum shareholding requirement at Westpac was more than $15mn at the end of her tenure, the highest by some distance for any bank CEO, had 'taken off the table' more than five times this amount by the end of her tenure.

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

Yours sincerely,

[redacted]

[redacted]

Ownership Matters Pty Ltd