



General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
Level 12, 1 Martin Place
Sydney NSW 2000

12 February 2021

Submission on revised Draft CPS 511

Dear General Manager

PwC supports many of the key revisions in the revised Draft Prudential Standard CPS 511 on Remuneration ("Standard", "CP5 511"). The revised Standard has removed some of the more prescriptive elements in the first draft, favouring a principle-based approach that is risk-based and proportionate.

While the revised Standard addresses many of the queries raised in response to the first draft, this submission seeks to identify where APRA can further enhance the level of clarity around some of the amendments.

As with our original submission during the first consultation period, we have sought to align our approach with APRA's guiding principles regarding the Standard's impact on regulated institutions' financial safety and stability, efficiency, contestability, and competitive neutrality.

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

Yours sincerely,

[Redacted signature]

[Redacted name]

Partner

[Redacted contact information]

T:

M:

*PricewaterhouseCoopers ABN 52 780 433 757
One International Towers Sydney, Watermans Quay, Barangaroo NSW 2000, GPO BOX 2650 Sydney NSW 2001
T: (+61 2) 8266 000, F: (+61 2) 8266 9999, www.pwc.com.au*

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1. Summary: Key issues and challenges

Our review of the revised CPS 511 has identified areas where additional guidance may enhance APRA's ability to meet their objectives to promote effective management of financial and non-financial risks:

- Practical challenges in interpreting the 'material weighting' of non-financial performance measures.
- The differentiated application of a risk and conduct modifier to both short- and long-term incentive plans, as distinct from existing adjustment mechanisms (e.g. consequence management systems, malus/clawback, conduct gateways, or existing risk modifiers).
- Lack of certainty on the implications of the implementation dates, specifically when an organisation's implementation obligations begin - and to what degree they must be discharged - between the release of the final Standard and the prescribed commencement date.

2. Key issues and challenges

2.1. 'Material weighting' of non-financial performance measures - clarity, consistency and applicability

We support the fundamental change APRA has made towards a principle-based approach to designing variable reward frameworks, that allows organisations to take account of their unique circumstances. However, for practical purposes, further guidance - such as providing examples - may be required for organisations to determine what weight is considered 'material'.

Providing examples of features/elements that will be considered in determining 'material weighting' will support organisations in successfully aligning any changes in remuneration made in anticipation of the final Standard's commencement date. This will support organisations who will need to navigate both the new regulatory landscape and articulate rationale to proxy advisors who have not provided significant support in relation to use of non-financial performance measures - particularly in long-term incentive plans.

That is, while the move to a principle-based approach is supported, clearer guidelines on 'material weighting' will provide greater certainty going forward so that companies are certain they have met regulatory requirements, and additionally have reference material that can be used by companies in discussions with proxy advisors.

Suggested action #1

*PricewaterhouseCoopers ABN 52 780 433 757
One International Towers Sydney, Watermans Quay, Barangaroo NSW 2000, GPO BOX 2650 Sydney NSW 2001
T: (+61 2) 8266 000, F: (+61 2) 8266 9999, www.pwc.com.au*

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APRA to provide organisations additional guidance on the interpretation of ‘material weighting’ in order to:

- Ensure that real change can be affected across the financial services sector and there is compliance with APRA’s expectations, and
- Assist organisations in balancing shareholder needs and proxy adviser expectations while complying with s37(a) of the revised CPS 511.

This guidance could be examples of factors/elements that could be considered sufficient to meet the materiality requirements for non-financial measures or conversely what would be considered insufficient. We anticipate this clarification could be included in the CPG 511 and/or other guidance documents.

2.2. Differentiated application of the risk and conduct modifier as distinct from existing tools for downward adjustments, and their applicability to LTI grants

Based on the CPS 511 Response Paper and our discussions with APRA, it is unclear whether organisations will be expected to create a standalone mechanism - such as a risk and conduct modifier - distinct from other adjustment tools that are currently used (e.g. in-year adjustments, malus and clawback provisions), for downward adjustment of variable remuneration outcomes. In addition, we note that the mechanism is expected to apply to STI, and LTI at the time of grant (see Response Paper, p.22).

Following the self assessment exercises conducted by financial institutions in 2018 and the ASIC guidance released in 2020 (Information Sheet 245 (INFO 245)), many large financial services organisations have implemented deliberate and structured consideration (at least once a year, but sometimes twice) of whether or not discretion should be applied to incentive outcomes. This includes consideration of the specific triggers for discretion, the appropriate adjustment mechanism, the element(s) of pay it should apply to and magnitude of impact. Where a determination is that discretion is not required, a ‘modifier’ of zero is effectively applied, or if discretion is required a negative modifier of normally between 20% and 100% is applied. Or, if positive, may increase outcomes but not usually to the same extent (eg only up to 20%). It is unclear whether these existing adjustment mechanisms, that incorporate risk and conduct considerations, but are also much broader are sufficient to meet APRA’s expectations.

Should APRA determine that existing detailed remuneration consequence / and discretion adjustment mechanisms are insufficient, and the requirement of a standalone modifier be preserved, clarity on the differentiated purpose of an additional mechanism would allow organisations to clearly articulate to participants the individual purpose of each adjustment mechanisms. This would also address concerns that at an extreme the presence of multiple and complex mechanisms to address risk and conduct may over-emphasise risk relative to other critical goals in the organisation such as customer-centricity or strategic goals. We support APRA’s intent, but further information on the practical application of such a mechanism will be necessary to ensure CPS 511 can be followed without adding undue administrative burden or duplicating existing risk and conduct measures.



Suggested action #2a

APRA to consider removing the standalone modifier so as to not duplicate existing mechanisms or provide further clarification on its differentiated purpose relative to existing mechanisms. Benefits include:

- Reduction in complexity around design and implementation, and
- Operational clarity for plan participants

APRA's Response Paper specifically references an ability to adjust variable remuneration for adverse risk and conduct outcomes "prior to the grant being made for an LTI". The purpose of a mechanism for risk-based adjustments at the time of grant of LTI requires clarification. In our view, the purpose of LTI awards is to provide greater alignment between management and shareholders through equity exposure and a focus on longer-term measures of performance. Grant value is typically not determined based on performance (ie is typically determined as a set percentage of fixed pay), with the grant value encouraging a focus on sustainable financial performance and non-financial risks, and where awarded in equity exposure to long-term outcomes of current decisions (e.g. reputational damage suffered due to poor conduct directly impacting a company's share price). The amount to vest is then determined subject to performance hurdles, and also to malus and clawback provisions. Long-term incentives are designed to be forward-looking, to encourage long-term sustainable performance. As such, an upfront reduction in an LTI grant has the potential to reduce the quantum of pay subject to longer-term performance (and equity exposure, when awarded as equity), lessening alignment with shareholders, impacting the balance of short vs long-term focus in remuneration, and reducing the future impacts of current decisions.

Considering this, we believe downward adjustments (eg based on risk / conduct) applied at the end of the performance period (i.e. when the award vests), as opposed to when it is granted, better enhances the management of risk. In addition, as LTI is structured to be forward-looking, it is also unclear as to the appropriate time horizon over which risk should be assessed for a modifier at LTI grant (eg should this be the past year / past LTI performance period / undefined period), thereby increasing complexity and reducing the efficacy of the LTI grant.

Suggested action #2b

If a standalone modifier mechanism is to apply, to apply the risk and conduct modifier at vest / to the performance earned amount which means: (a) for STI at year end, and (b) for LTI at end of performance period - ie not at time of LTI grant.



2.3. Clarifying obligations arising between final commencement and implementation

The revised CPS 511 includes phased implementation based on organisational size and complexity. There is a substantial period between publication of the final Standard and mandated implementation, giving organisations time to make the changes necessary to be compliant. Based on our discussions with APRA, it is our understanding that APRA expects organisations to adopt remuneration frameworks that are in line with the expectations of the standard following release of the final Standard (in mid-2021) and prior to the commencement dates listed in paragraph 9. The primary obligation is for organisations to have created an implementation plan which may be requested for review by APRA at any time after the final Standard's release.

While APRA has indicated that there is no intent to ask organisations to renegotiate 'contracts' that are in place prior to the implementation date, typically practice is for organisations to offer new incentive plans (both short- and long-term) on an annual period and without a requirement to offer new contracts. As such, clearer guidance on whether the commencement date refers to a strict obligation for performance years that commence after the commencement date, or for payments awarded relating to performance years in which the commencement date occurs would help organisations determine an implementation roadmap going forward. This would also be helpful for companies whose financial year does not align with the commencement dates, and deliver a consistent approach to pay for new employees joining post commencement date relative to existing employees pre-commencement date who could otherwise be on legacy arrangements.

Suggested action #3

APRA to provide clarity around the expectations post release of the final standard compared to the commencement date, including timing and guidelines on expected progress.