PRUDENTIAL PRACTICE GUIDE

CPG 511 Remuneration

18 October 2021

Contents

About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss statutory requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

This PPG sets out guidance for all APRA-regulated entities on remuneration practices, to support *Prudential Standard CPS 511 Remuneration* (CPS 511). CPS 511 sets out requirements to ensure entities maintain remuneration arrangements which appropriately incentivise individuals to prudently manage the risks they are responsible for, and apply consequences for poor risk outcomes.[1]

Subject to meeting prudential requirements, and other legislative and regulatory requirements relating to remuneration, including those that would apply under the Financial Accountability Regime (FAR) when they take effect, entities have the flexibility to manage their remuneration practices in a manner that is best suited to achieving their objectives. Not all of the guidance in this PPG will be relevant for every entity, and some practices may vary depending upon an entity's size, complexity and risk profile.

[1] Authorised deposit-taking institutions (ADIs) must also comply with the requirements of the Banking Executive Accountability Regime (BEAR) under the *Banking Act 1959*. *Prudential Practice Guide APG 223 Residential mortgage lending* (APG 223) provides additional guidance for ADIs on prudent remuneration practices in relation to residential mortgage lending.

Introduction

1. A prudent remuneration policy is an important component of sound governance. An entity's long-term soundness requires prudent remuneration arrangements and clear accountabilities for outcomes. In particular, senior executives should not be financially rewarded where there are failings in risk management.

2. As set out in CPS 511, an APRA-regulated entity must maintain a remuneration framework that:

   a) aligns with the entity's business plan, strategic objectives and risk management framework;

   b) promotes effective management of both financial and non-financial risks, sustainable performance and the entity's long-term soundness;

   c) for a registrable superannuation entity (RSE) licensee, promotes performing its duties and exercising its powers in the best financial interests of beneficiaries; and

   d) supports the prevention and mitigation of conduct risk.

3. This PPG sets out guidance on good practice to support entities in improving and maintaining prudent remuneration practices, in line with CPS 511. The PPG is principles-based rather than prescriptive, and is intended to guide entities to enhance Board oversight, improve the use of non-financial measures in remuneration design and ensure there are appropriate consequences for poor risk management.

Proportionality

4. Certain requirements in CPS 511 only apply to significant financial institutions (SFIs). This proportionate approach sets simpler requirements for smaller and less complex entities.

5. CPS 511 defines SFIs based on asset size. The minimum asset size thresholds for SFIs are set out in CPS 511 and summarised in Table 1 below. In addition, APRA may also determine an entity to be an SFI based on the complexity of its operations or remuneration practices, or its membership of a group.

6. SFI specific requirements include establishing a Board Remuneration Committee, applying a material weight to non-financial measures in variable remuneration arrangements, applying minimum deferral periods and clawback arrangements, and periodically reviewing the remuneration framework.

7. Under CPS 511, foreign branches with assets above the SFI threshold are required to defer the variable remuneration of highly paid material risk-takers, in line with the requirements of SFIs. Foreign branches would not need to meet other SFI requirements, unless otherwise determined by APRA.

Table 1. SFI definition: minimum asset size thresholds

Industry	Total asset thresholds for SFIs[2]
Authorised deposit-taking institutions	>$20 billion
General and Life insurers	>$10 billion
Private health insurers	>$3 billion
Registrable superannuation entities	>$30 billion[3]

[2] Total assets is as derived in *Reporting Standards ARS 322.0 Statement of Financial Position* (or *ARS 720.0 ABS/RBA Statement of Financial Position* for ADIs that do not report under this standard), *GRS 300.0 Statement of Financial Position*, *LRS 300.0 Statement of Financial Position*, *HRS 602.0 Financial and Capital Data and SRS 320.0 Statement of Financial Position*.

[3] This threshold applies to a single RSE operated by an RSE licensee, or if the RSE licensee operates more than one RSE where the combined total assets of all RSEs exceeds this amount.

Role of the Board

8. Under CPS 511, the Board, or relevant oversight function, is ultimately responsible for the entity's remuneration framework and its effective application.[4]

9. APRA expects Boards to ensure that remuneration practices are well supported by broader frameworks and policies that influence behaviour, beyond financial rewards. This includes clear accountabilities and expectations for risk management, effective consequence management and a strong tone from the top on risk culture.

10. In providing oversight of remuneration, other prudential standards and guidance are also applicable, in particular requirements on governance and risk management. Broader regulatory requirements and expectations, including guidance provided by the Australian Securities and Investments Commission (ASIC), are also relevant for the Board.[5]

Board Remuneration Committee

11. Under CPS 511, the Board of a SFI is required to establish a Board Remuneration Committee (RemCo) to oversee the design and implementation of the remuneration framework. The RemCo is responsible for making recommendations to the Board annually on the remuneration arrangements and variable remuneration outcomes for persons in specified roles.

12. A prudent Board would ensure that the RemCo is composed of members with the appropriate skills, experience and expertise to exercise competent and independent judgment. This includes a clear understanding of what constitutes good risk management.

13. While the Board of a non-SFI is not required to establish a RemCo, it must put in place arrangements to meet the requirements of CPS 511 and ensure there is appropriate oversight of the remuneration framework and key remuneration decisions.

Aligning remuneration and risk

14. In determining the variable remuneration outcomes for individuals and cohorts in specified roles, the assessment of performance and risk is a critical input. It is important for the RemCo to ensure it understands the performance and risk outcomes for persons in specified roles, as well as for the entity overall.

15. APRA expects that the assessment of performance and risk would include direct input from senior risk management personnel, and not be based on self-assessments alone.

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[4] Relevant oversight function is defined in CPS 511. It is only applicable to foreign ADIs, Category C insurers and EFLICs. Consistent with CPS 511 requirements, references to the Board and Board Remuneration Committee in this guidance refer to the relevant oversight function, where appropriate.

[5] This would include ASIC guidance in Information Sheet 245 *Board oversight of executive variable pay decisions*, the Australian Securities Exchange's (ASX) Corporate Governance Council's *Corporate Governance Principles and Recommendations*, and the Financial Stability Board's (FSB) *Principles of Sound Compensation Practices*.

Good practice would be for risk and internal audit executives to present a comprehensive assessment of key risk and audit metrics on at least an annual basis, to inform remuneration decision making and outcomes.

16. Under CPS 511, the RemCo must consult the Board Risk Committee and Chief Risk Officer to enable risk outcomes to be appropriately reflected in remuneration outcomes for persons in specified roles. The use of joint meetings with the Board Risk Committee can be an effective mechanism for providing insights into risk considerations for the RemCo. It would not be prudent to rely on cross-membership between the RemCo and the Board Risk Committee as the sole means of providing a view on risk.

Board oversight and discretion

17. There may be occasions where the Board would need to exercise its discretion to challenge and override remuneration recommendations, and make downward adjustments for individuals, cohorts or all personnel.

18. A prudent Board would be actively engaged in the oversight of key remuneration decisions, providing robust challenge and independent scrutiny. Board oversight and discretion to adjust variable remuneration would be particularly relevant in unusual or exceptional circumstances. These circumstances may include:

    a) material cases of adverse risk or conduct outcomes, especially where these have impacted the entity's prudential standing or prudential reputation;

    b) periods of stress in which the entity may be experiencing negative financial performance and erosion of its regulatory capital base; and

    c) periods of stress in which the entity is provided with exceptional public sector support.

19. It is important that the Board uses its discretion in a timely and informed manner, rather than acting only on the basis of realised outcomes. For example, it could be appropriate for a Board to reduce pre-emptively variable remuneration during a period of stress, rather than waiting for losses to be realised.[6] It would not be prudent to act only once risk issues are made public, to adopt management recommendations without challenge, or to excuse poor risk outcomes on the basis of good intent.

Board reporting

20. It is the responsibility of the Board and RemCo to guide management on the reporting it needs to fulfil its role. A prudent Board and RemCo would regularly review the information they are provided with to ensure that reporting is sufficient and insightful. Poor quality, inadequate, incomplete or voluminous reporting can significantly hamper oversight and challenge.

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[6] For an ADI, good practice would be to take a forward-looking approach to reductions in discretionary bonus payments to staff, before being formally required to by the constraints imposed by the capital conservation buffer regime as set out in *Prudential Standard APS 110 Capital Adequacy*.

21. Good practice would be for the RemCo to be provided with formal documented performance and risk assessments for individuals in specified roles, and summaries for relevant cohorts such as risk and financial control personnel. This would include clear qualitative and quantitative assessments for measures that have formed the basis of decisions, including key metrics, and an outline of how assessments have flowed through to remuneration outcomes.[7] It would not be prudent to rely on verbal discussion and generalised attestations as evidence of performance or risk assessments, or high-level summaries of major incidents.

22. Good practice for cohorts would be to assess, on an aggregated basis by business unit or role type, similar information to that which is reviewed for individual remuneration decisions. Additional information may also be useful, such as trends and outliers, summary indicators that show distributions, averages or medians, and other data-driven insights.

[7] A prudent Board would challenge any adjustments to quantitative metrics. This would include in particular any adjustments to profit measures that could affect whether hurdles for variable remuneration are met.

Remuneration framework

23. CPS 511 requires an entity to maintain a remuneration framework that sets out the key policies and processes needed to meet CPS 511 requirements. This includes the structure and terms of remuneration arrangements, the process for mitigating material conflicts from compensation arrangements with any third-party service providers, and operational systems and processes. Key components of a typical remuneration framework are illustrated in Figure 1.

Figure 1.Key components of the remuneration framework

24. Under CPS 511, the remuneration policy is required to cover all employees of the regulated entity, including those retained under contract or employed by a related party. APRA expects that an entity would take reasonable steps to ensure all employees understand how their performance will influence their variable remuneration, including the role of downward adjustments for adverse risk and conduct outcomes. This could be through the use of induction and periodic training, guidance on performance assessments, and easily accessible and understandable policies.

25. An entity that is part of a wider corporate group may adopt and apply the group remuneration policy, provided that it meets the requirements of CPS 511 and has been approved by the Board. Good practice would be for the entity to assess how the policy complies with each requirement of CPS 511, is appropriate for its specific business activities and risk profile, and meets the spirit and intent of the standard.

Specified roles

26. Under CPS 511, the variable remuneration outcomes for persons in specified roles must be approved by the Board, on either an individual or cohort basis. APRA expects the remuneration policy would define the particular specified roles for the entity, and summarise the remuneration arrangements for these roles.

27. Specified roles are defined in CPS 511 and are intended to capture those individuals and cohorts who can have a material influence on the performance and risk profile of the entity, in both the short and long-term. Specified roles comprise senior managers,

executive directors, material risk-takers (including highly-paid material risk-takers) and all risk and financial control personnel.

28. Senior manager is defined in CPS 511 and takes into account the impact that an individual can have on the business of the entity or an entity's financial standing.[8] Senior managers would typically include the direct reports of the Chief Executive Officer (CEO). For larger entities, it may be appropriate to include a range of executives from the next level below direct reports to the CEO.

Material risk-takers

29. As set out in CPS 511, the variable remuneration outcomes of all material risk-takers must be approved by the Board on a cohort basis.[9] Good practice is to develop, disclose and keep under review a threshold definition for material risk-takers, including quantitative indicators and qualitative criteria for the identification of such roles.

30. An entity is expected to consider a range of factors in identifying material risk-takers, including analysis of their potential impact on the entity's risk profile. This could be through the use of quantitative indicators, such as the impact on regulatory capital, or qualitative criteria, such as the impact on the entity's reputation, customers and prudential standing.

31. Good practice would be to consider the identification of groups of material risk-takers as well as individuals, including those that may collectively affect financial soundness. This would typically include financial market traders and material insurance underwriters.

32. Highly-paid material risk-takers are subject to specific minimum deferral requirements under CPS 511. This cohort is defined as material risk-takers whose total fixed remuneration plus actual variable remuneration is equal to or greater than $1 million in a financial year of the entity.

33. There may be material risk-takers with remuneration close to the $1 million level. A prudent entity would consider whether deferral should also be applied to those persons.

Risk and financial control personnel

34. A prudent Board would closely monitor the remuneration of risk and financial control personnel as a cohort, to ensure arrangements are adequate to attract and retain suitably qualified, skilled and experienced staff.[10]

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[8] For an ADI, APRA expects all Accountable Persons as defined under the BEAR to be in specified roles, with the exception of non-executive directors.

[9] A material risk-taker is defined in CPS 511 as a person whose activities have a material potential impact on the entity's risk profile, performance and long-term soundness, and in addition for an RSE licensee, a person whose activities have a material potential impact on performing its duties and exercising its powers in the best financial interests of beneficiaries.

[10] Risk and financial control personnel are defined in CPS 511 as persons whose primary role is in risk management, compliance, internal audit, financial control or actuarial control.

35. APRA expects that the remuneration arrangements for risk and financial control personnel would be tailored to reflect their role in the entity. Risk and financial control personnel may receive a higher proportion of fixed remuneration than other staff.

36. To safeguard the independence and authority of the function, APRA expects individual performance measures for risk and financial control personnel to be based principally on non-financial measures. To avoid potential conflicts of interest, variable remuneration for risk and financial control personnel would not be determined by managers of the business areas that they are responsible for overseeing and challenging.

Service providers

37. CPS 511 requires entities to identify and mitigate material conflicts to the objectives of the remuneration framework that may result from their compensation arrangements with third-party service providers.[11] Third parties may include, for example, external investment managers, mortgage brokers and insurance brokers. APRA would not expect changes to a third-party service contract or termination of an arrangement where a regulated entity has put effective mitigants in place.

38. A prudent entity would take reasonable steps to identify which service providers may give rise to material conflicts or risks. This may include a materiality threshold or definition, approved by the Board, which would be used to identify the scale and nature of service providers that are likely to present a material conflict or risk.

39. There are a range of possible mitigants available to entities, depending on the conflict. For example, an entity might heighten its focus on non-financial risks and conduct risks in its own commission or payment structures with the third-party. Business written by the third-party could also be subject to heightened oversight or additional controls, to more actively incentivise the management of non-financial risks and the prevention and mitigation of conduct risk. This could include tighter approval criteria, increased reviews, or more frequent and detailed monitoring. An entity might consider changes to the design of variable remuneration for an accountable person that oversees the third-party business. Entities might also seek assurances from third party service providers.

40. It is important that entities have appropriate mechanisms in place to address instances of adverse risk and conduct outcomes, even where these arise from the activities of third-party service providers. Good practice would be to maintain a record of the assessment of the potential conflicts of third-party service providers, and monitor the effectiveness of measures that have been put in place to mitigate material conflicts.

[11] In meeting this requirement, a prudent entity would have regard to other regulation related to third-party service providers, including *Prudential Standard CPS 231 Outsourcing*.

Remuneration design

41. CPS 511 requires entities to align remuneration with performance and risk, and incorporate risk management into the design of variable remuneration arrangements. This includes the effective management of both financial and non-financial risks, sustainable performance and long-term soundness, the prevention and mitigation of conduct risk, and for an RSE licensee, the best financial interests of beneficiaries.

42. In the design of remuneration arrangements, a prudent entity would carefully consider the balance between fixed and variable remuneration, to ensure there are appropriate incentives for performance and risk management. Entities may decide not to offer variable remuneration, if this does not support their objectives or business model.

43. The form of variable remuneration is also important. A prudent entity would consider the appropriate mix between cash, benefits and equity, in line with its overall remuneration objectives. For example, the use of equity-based variable remuneration can reinforce incentives for prudent long-term decision making.

44. Under CPS 511, variable remuneration is defined as the amount of a person's total remuneration that is conditional on objectives, which include performance criteria, service requirements or the passage of time. Table 2 below sets out common forms of remuneration, which may meet the definition of variable remuneration under CPS 511. APRA expects that more complex remuneration arrangements would be subject to more rigorous oversight and risk controls.

Table 2. Forms of remuneration

Remuneration	
Common forms	• Cash, non-cash and equity-based remuneration; • Service, time-based or project completion awards; • One-off awards, including retention, sign-ons, buyouts and termination payments; • Short-term incentives, which reward performance over a period of 1 year or less, and longer-term incentives for periods beyond this; and • Deferred awards, including amounts that remain on foot following termination.
More complex arrangements	• Lending and leveraged arrangements, such as shares funded by a concessionally priced loan, which can be highly sensitive to movements in share prices; • Equity options, which can generate highly geared incentives on the upside and limited downside;

Remuneration	
	• Guaranteed cash or equity payments, which are not performance related, or up-front payments, which are not deferred; • Fringe benefits, where these comprise a significant proportion of remuneration; • Proportion of performance fees and carried interest; and • Hedging arrangements for equity-based remuneration, which are prohibited under CPS 511 as they undermine the purpose of deferral.

45. Entities have the flexibility to use various models and approaches to determine variable remuneration. To determine the overall size of the variable remuneration pool to allocate in a given year, a prudent entity would consider a range of factors, including the impact on regulatory capital. For individuals, common industry practice is to assess performance using balanced scorecards and modifiers, based on a range of measures.

46. In the design of variable remuneration arrangements, it is important to distinguish clearly between financial and non-financial measures of performance:

    a) financial measures, as per CPS 511, are measures based on revenue, sales, profit, the entity's share price, total shareholder return, return on equity, and other measures that directly affect these;[12] and

    b) non-financial measures would be other measures that support the broader objectives of the remuneration framework, including risk management. Examples of non-financial measures are outlined in Table 3 below.

47. CPS 511 requires SFIs to give material weight to non-financial measures in the determination of each component of a person's performance-related variable remuneration. APRA expects that non-SFIs would also carefully consider whether and how to incorporate non-financial measures into variable remuneration arrangements.

48. In incorporating non-financial measures into the design of variable remuneration arrangements, good practice would be to ensure that:

    a) the impact of non-financial measures on individual variable remuneration can be easily understood, particularly in complex methodologies;

    b) remuneration outcomes are sensitive to the assessment of non-financial measures, as they would otherwise have limited scope to impact behaviours;

[12] Risk-adjusted financial measures, such as economic profit, are more prudent metrics for the assessment of profitability, but would not be classified as non-financial measures. They may be used to supplement non-financial measures, but would not replace them.

c) non-financial measures can impact each and all components of variable remuneration, including any long-term and short-term incentive plans; and

d) the impact of non-financial measures is not merely considered in cases of significant events, such as misconduct or adverse risk outcomes.

49. Certain types of remuneration models may make it more challenging to meet the expectations outlined above. This includes, for example, discretionary profit share plans and service-based awards. The use of gateways, modifiers and other remuneration adjustment tools can be effective, but would be unlikely to meet the expectations above if used only in cases of significant adverse risk and conduct outcomes.

Defining non-financial measures

50. The purpose of applying a material weight to non-financial measures is to promote a balanced approach to incentives, encourage the prudent management of risk, and limit financial performance measures so that they are not the only or predominate driver of remuneration outcomes.

51. APRA expects an entity to define non-financial measures that best suit their particular strategy and risk objectives, and reflect their specific risk profile. The selection of non-financial measures is critical in articulating, shaping and promoting the goals and incentives for employees. A prudent entity would be able to demonstrate how non-financial measures support their desired risk culture, and promotes the prudent management of key risks.

52. Examples of non-financial measures used domestically and internationally are outlined in Table 3 below. This is an illustrative list of examples, rather than an exhaustive set or checklist.

Table 3. Illustrative examples of non-financial measures

Non-financial measures – illustrative examples	
Financial risk	Core prudential ratios and risk appetite metrics
Non-financial risk	Risk management objectives and initiatives, remediation activities, control effectiveness, regulatory and audit findings, and risk culture surveys
Best financial interests of beneficiaries (RSE licensee)	Fund performance and member returns
Conduct risk	Breaches, incidents, event reports and customer complaints

Non-financial measures – illustrative examples	
Broader indicators	Strategic goals, employee engagement, customer satisfaction, and inclusion and diversity indicators

53. Non-financial measures may include specific and measurable metrics as well as qualitative assessments based on defined criteria. Too many measures or metrics can dilute and dull the impact of incentives. A prudent entity would also not apply a wholly discretionary approach without defined measures, as this may leave expectations unclear and result in poorly designed incentives.

54. A prudent entity would be able to demonstrate how non-financial measures incentivise risk management, and would not rely only on metrics such as strategic goals. It is important that the use of broader indicators do not lead to the exclusion of risk management indicators.

55. In determining appropriate non-financial measures, a prudent entity would consider:

    a) for an individual person, how to suitably tailor the measures to reflect their particular role and responsibilities; and

    b) for the entity as a whole, how to ensure the measures for individuals provide in combination full coverage of the entity's material risks.

56. Non-financial measures for an individual are expected to be targeted on the key risks they are responsible for and can influence, reflecting their span of control either individually or as a contributor to a particular team. Group-wide or division-wide measures can help drive collective accountability, but only where the individual has a reasonable degree of control and influence on the outcome. For example, customer satisfaction measures could be appropriate for individuals involved in selling and distributing products, but would not typically be relevant for risk personnel.

57. When viewed in aggregate across the entity, it is important that non-financial measures comprehensively reflect the entity's risk profile without gaps in key areas. All material risk categories, as defined in *Prudential Standard CPS 220 Risk* Management (CPS 220) and, for RSE licensees, in *Prudential Standard SPS 220 Risk Management* (SPS 220), would be considered, to ensure there is full coverage of the risks for the entity as a whole.[13]

Determining a material weight

58. The level of the weighting applied to non-financial measures reflects the level of importance the entity places on managing its risk profile and supporting broader objectives beyond financial performance.

[13] Material risks include credit, market and investment, liquidity, insurance, operational, strategic and other risks. For an RSE licensee, material risks cover governance, investment governance, liquidity, operational, insurance, strategic and other risks.

59. APRA expects entities to clearly define how material weighting is applied in the design of variable remuneration arrangements, and quantify the impact that non-financial measures can have on remuneration outcomes. It would not be prudent to rely on a completely discretionary or opaque process.

60. In assessing whether material weight is being applied effectively in the design and determination of variable remuneration outcomes, a prudent Board would consider whether the weighting:

    a) is a sufficient incentive to influence an individual's behaviour, priorities and decisions;

    b) is robust and cannot be overshadowed or diminished by performance or out-performance on financial measures;

    c) is applied to measures over which the individual has a reasonable degree of control and influence;

    d) is applied to measures that effectively support the objectives of the remuneration framework, including risk management; and

    e) has been demonstrated to work in practice to incentivise prudent outcomes over time, where this is possible to determine.

61. Material weightings may vary across roles. For some roles, such as the Chief Risk Officer, the weighting applied to non-financial measures would typically be the predominate driver of variable remuneration outcomes. This could also be the case for a broader range of roles during some periods, such as where an entity is rebuilding financial resilience or implementing a remediation programme.

62. A prudent Board would establish clear guidelines to ensure appropriate weight is applied to non-financial measures in the determination of variable remuneration. This could include a minimum level or range. Good practice would be for the Board to review these guidelines on an annual basis to ensure it is operating as intended in driving expected behaviours.

63. To assess whether the weighting for non-financial measures is driving intended behaviours and outcomes in practice, a prudent Board would consider how effectively risk and conduct is managed. Reporting on non-financial measures for the entity as a whole, as well as aggregate information on risk adjustments, would support this assessment. Entities with a high reliance on downward adjustments for adverse risk and conduct outcomes would investigate root causes and, where appropriate, consider if the weighting to non-financial measures needs to be increased or the design improved.

Deferral

64. The length of deferral periods for variable remuneration reflect the length of time that risk and conduct issues can take to appear and crystallise; they are intended to prevent short-term rewards where long-term risks may persist.

65. CPS 511 sets out minimum deferral periods for variable remuneration for specified roles at SFIs.[14] SFIs may consider longer deferral periods and deferral for other roles. Non-SFIs would also consider and apply deferral arrangements, to align variable remuneration outcomes with risk time horizons.

66. Under CPS 511, the deferral period must include the period over which performance is assessed. APRA expects the deferral period to start from the beginning of the performance period for which the variable remuneration is being assessed.[15]

67. To determine the amount to defer and the vesting schedule, APRA expects SFIs to use the total value of variable remuneration awarded in the financial year. This calculation would generally be straightforward where individuals participate in one incentive plan. Figure 2 below provides an illustrative example of how an entity might meet minimum deferral requirements for a CEO.

Figure 2.Illustrative example of a CEO, awarded $1m in variable remuneration

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Amount received	$0.4m	--	--	$0.2m	$0.2m	$0.2m
Proportion of total variable remuneration	40%	--	--	20%	20%	20%

68. Where individuals participate in multiple plans, vesting schedules can be more complex. A prudent entity would ensure that, even for more complex arrangements, vesting schedules comply with prudential requirements.

69. In determining the proportion of variable remuneration to defer, APRA expects an entity to base the calculation on all variable remuneration awarded, including amounts that are subject to further performance hurdles in subsequent years before vesting. These amounts are commonly referred to as long-term incentive plans (LTIs) and would be based on the value of the incentive awarded. Figure 3 below provides an illustrative example of how an entity might meet minimum deferral requirements for a CEO participating in multiple plans.

[14] Deferral requirements do not apply to deferred variable remuneration of less than AUD $50,000 in an entity's financial year.

[15] Where performance measures are backward looking, such as a 3-year rolling average that accounts for the current and prior two years, a prudent entity would only count the current performance year (and not prior years) as part of the deferral period.

Figure 3.Illustrative example of a CEO, awarded $1m in short-term incentives (STI) and $1m in long-term incentives (LTI)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Amount received - STI	$0.8m	--	--	$0.2m	--	--
Amount received – LTI*	--	--	--	$0.2m	$0.4m	$0.4m
Proportion of total variable remuneration	40%	--	--	20%	20%	20%

* Assumes that any performance hurdles are fully met before vesting.

Risk and conduct adjustments

70. While it is important that material weight is placed on non-financial performance, CPS 511 also requires entities to go beyond this in cases of significant adverse risk and conduct outcomes.

71. Under CPS 511, all entities are required to have in place appropriate in-period adjustments, malus and clawback arrangements, to ensure that there are consequences for serious risk issues or misconduct, including those that may emerge several years after the event. To provide the legal basis for action, these design features would be built into relevant contracts and policy.

72. Where a downward adjustment to variable remuneration has been applied, it would be inconsistent with prudent practice to make offsetting increases in remuneration, such as higher fixed pay or non-salary benefits.

Downward adjustments

73. Under CPS 511, the process for downward adjustments is required to be clearly defined, with predetermined triggers to ensure potential cases of adverse risk and conduct outcomes are duly considered. Scenarios or example incidents can be useful in determining these triggers.

74. CPS 511 requires entities to establish clearly defined risk criteria for the application of variable remuneration adjustment tools.

75. Under CPS 511, an entity must take reasonable steps to adjust variable remuneration downwards when, as a minimum, any of the following criteria are met:

    a) misconduct leading to significant adverse outcomes;

    b) a significant failure of financial or non-financial risk management;

    c) a significant failure or breach of accountability, fitness and propriety, or compliance obligations;

    d) a significant error or a significant misstatement of criteria on which the variable remuneration determination was based; and

    e) significant adverse outcomes for customers, beneficiaries or counterparties.

76. A prudent entity would also consider the need for adjustments in less severe instances. These adjustments can have important deterrent effects.

77. A prudent Board would consider a wide range of evidence and ensure appropriate mechanisms are in place to escalate issues. Good practice would be to consider, for example, known incidents, findings from audits and regulatory reviews, product failures, trends in conduct or risk incidents. APRA expects that a risk adjustment would be

considered, for an individual or cohort, in the event of a breach of a prudential standard or other regulation.

78. APRA expects considerations of downward adjustments to be made on a timely basis, including but not limited to the regular performance assessment. Prudent entities would consider downward adjustments outside of the regular performance assessment cycle in response to information about misconduct or adverse risk outcomes.

79. Where employees at lower levels have received downward adjustments to variable remuneration for adverse risk and conduct outcomes, a prudent entity would consider whether corresponding adjustments at an executive level are appropriate to recognise overall line or functional accountability.

Assessing severity

80. Under CPS 511, the total downward adjustment to variable remuneration must be proportionate to the severity of the risk and conduct outcome. In considering proportionality, a prudent entity would include all variable remuneration which can be subject to downward adjustments, including current year, deferred amounts and any amounts that are subject to clawback.

81. APRA expects the use of in-period risk adjustments, malus or clawback to be guided by an assessment of the severity of the adverse risk or conduct outcome. In some adverse risk and conduct events, the use of an in-period adjustment alone may provide for proportionate consequence. However, where in-period adjustments do not provide a sufficient consequence, malus and clawback would be considered.

82. In gauging the severity of a case, a prudent entity would consider a range of factors. This would include the expected or actual impact on the entity's reputation, customers or beneficiaries and prudential standing, as well as any financial loss. An individual's contribution to circumstances which led to the adverse outcome would also be considered, potentially including inaction. Good practice would be to develop a severity scale, with example cases and any precedents, to guide decision-making on the level of severity and indicative remuneration impacts that would be expected to result. This scale would support a Board in applying proportionate downward-adjustments to variable remuneration, and in applying consistency across different cases.

83. It can take time for the full extent of some issues to emerge. In these cases, a prudent entity would make an initial adjustment to reflect timely action, and revise this through a final adjustment when the full impact of the incident is known. Where an individual is under internal or external investigation, vesting or other payment of variable remuneration would typically be suspended until the conclusion of the investigation.

84. Good practice is to record all adjustment decisions, including where an adjustment was considered but ultimately decided against. The development of a comprehensive library of past risk adjustments can also be useful, both to readily recall prior decisions and for consistency. This is particularly relevant for borderline decisions.

Review of the remuneration framework

85. The review of the remuneration framework is important in testing whether policies are operating as intended and to enhance the design of remuneration arrangements, in line with evolving better practice. SFIs are required in CPS 511 to conduct an annual compliance review and a triennial effectiveness review. Prudent non-SFIs would also consider the need to review their remuneration framework, as appropriate.

86. SFI's annual compliance review would typically include a self-assessment against CPS 511 requirements, examining both the design and outcomes of the remuneration framework. The annual compliance review would be conducted by staff with appropriate skills and experience, and be subject to appropriate independent challenge. To avoid conflicts of interest, the review would be conducted by staff that were not involved in, or reporting to those involved in, the design of the entity's remuneration framework.

87. An SFI's triennial effectiveness review would typically provide a deeper and broader assessment of the remuneration framework, including comparison to better practice. The review would provide recommendations to improve the effectiveness of the framework where relevant. Improvements could arise from considering:

    a) any changes in the entity's strategy, risk profile or risk management objectives;

    b) benchmarking against market trends and the evolution of better practice in remuneration design at relevant peers domestically and internationally;

    c) specific findings from any internal, external or regulatory reviews of the remuneration framework, or any updated relevant regulatory guidance;

    d) general findings from regulatory reviews of risk management and any breaches of regulatory requirements more broadly, which may cumulatively indicate that the framework is not delivering prudent incentives to manage material risks;

    e) domestic and international examples of poor risk and conduct outcomes; and

    f) the degree to which remuneration outcomes have been consistent with the objectives of the remuneration framework.

88. The scope of the triennial review would encompass the role of the Board, the design of remuneration arrangements, and the effectiveness of risk and conduct adjustments. This would include any key design features, such as the definition of material risk-takers and the application of non-financial measures. The review would also assess the appropriateness of any remuneration adjustments made, to ensure that triggers and criteria for downward adjustments are prudently calibrated.

89. CPS 511 requires the triennial review to be conducted by operationally independent, appropriately experienced and competent persons. A prudent entity may consider the use of external expertise to meet this requirement. Where internal staff conduct the review, a

prudent Board would gain assurance that they are operationally independent and are able to provide an objective review, with the requisite skills, experience and expertise.

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