

DRAFT PRUDENTIAL PRACTICE GUIDE CPG 511
SUBMISSION TO THE AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

23 July 2021

OVERVIEW

1. ANZ thanks the Australian Prudential Regulation Authority (**APRA**) for the opportunity to comment on the draft Prudential Practice Guide CPG 511 Remuneration (**CPG 511**) which will provide guidance on Prudential Standard CPS 511 (**CPS 511**). All references to paragraphs and defined terms in this submission are to those of CPG 511 unless otherwise indicated.
2. We welcome the draft CPG 511. It provides a valuable insight to APRA's regulated entities on how to comply with CPS 511. Set out below are some points that may help APRA improve the guidance. While the points are laid out on the following pages in order of the CPG 511 paragraph they relate to, the key ones are:

- **Individualised basis of identifying material risk-takers** – Paragraph 28 of CPG 511 suggests that employees could be identified as material risk-takers (**MRTs**) based on their collective impact on the entity. We note that CPS 511 does not ask entities to identify MRTs on this basis and would ask that APRA reconsider the guidance in this light.
- **'Customised' arrangements for risk and financial control personnel** – Paragraph 31 suggests arrangements for risk and financial control personnel should be 'customised'. CPS 511 does not require that these arrangements be unique; the arrangements could apply to non-risk and financial control personnel as well. The arrangements simply need to meet the requirements set out in paragraph 50 of CPS 511. We have suggested some drafting to align CPG 511 with CPS 511.
- **Clarity on 'variable remuneration'** – Table 2 identifies a list of items as 'variable remuneration'. However, a number of these items are simply categories of economic value (e.g. cash) that could be awarded either unconditionally (which would mean they did not form part of variable remuneration as defined by CPS 511) or conditionally (which would mean they did). We would ask that any guidance provided on this topic align with the definition of variable remuneration in CPS 511.

Rather than focusing on items of economic value themselves, APRA could provide guidance on when the provision of economic value will be seen as conditional on the achievement of objectives.

- **Material weight to non-financial measures to 'each component' of variable remuneration** – Paragraph 43 restates the requirement in paragraph 37 of CPS 511 that the determination of each component of a person's variable

remuneration must give material weight to non-financial measures. Paragraph 63 suggests that best practice would be to defer each component of a person's variable remuneration. Applying this requirement and best practice expectation to *each component* could be difficult, particularly for variable remuneration which is service or time contingent. It would be better to constrain the requirement (and best practice) to performance related variable remuneration or the totality of a person's variable remuneration.

- **Buy-outs** – Although this issue arises with CPS 511 itself, we remain concerned that the definition of variable remuneration could capture buy-outs that are paid to new employees in recognition of existing pay entitlements that they have forfeited by moving organisations. These should either be excluded from the definition of 'variable remuneration' or, if included, should be subject to deferral periods which commence when the entitlement first arose at the prior employer.
- **Service providers** – Paragraph 20(c) of CPS 511 concerns remuneration arrangements of 'service providers'. CPG 511 gives the impression that, for banks at least, the primary focus is on service provider arrangements that concern the sale of retail products. However, there is existing regulation in this area. For example, the design and distribution obligations under *Corporations Act 2001* (Cth) (**Corporations Act**) and the mortgage broker conflicted remuneration requirements under the *National Consumer Credit Protection Act 2009* (Cth) (**Credit Act**) already concern how products are distributed and brokers are paid. Consideration of whether further regulation is required and, if so, how it relates to the existing regulation would be useful.

3. Separately from the comments on CPG 511 set out below, we would reiterate the point made in our earlier submission on CPS 511 concerning its commencement date. We believe it is important that there be adequate time to implement the standard with due care. If entities need to be compliant with CPS 511 on 1 January 2023, this would mean that ANZ, for example, would need to start complying with the standard from 1 October 2022. We believe that this is insufficient time to prepare for CPS 511 appropriately. We would contend, instead, that requirements of CPS 511 should apply to entities from the financial or remuneration year that commences on or after 1 January 2023. For ANZ, this would mean we need to start complying with the standard from 1 October 2023.

POINTS ON PARAGRAPHS OF CPG 511

Paragraphs 11, 12, 18 and 31 – Risk and financial control personnel

Paragraphs 11, 12 and 18

4. Paragraphs 11, 12 and 18 provide useful guidance on the types of information that the Board Remuneration Committee might need to perform its duties under CPS 511.
5. On the basis that the paragraphs concern the information that the Committee needs for the purpose of paragraph 47 of CPS 511, it would be useful to clarify that the input called for by paragraphs 12 and 18 is to help assess risk and financial control personnel on a cohort, and not individual, basis.
6. We ask for this clarity as 'specified role' in CPS 511 is defined to include 'risk and financial control personnel'. As such, paragraph 18 of CPG 511 could be read as requiring assessments for *all* individuals who are risk and financial control personnel. As there could be hundreds, if not more, individuals in risk and financial control roles, it would not be feasible or useful for the Board Remuneration Committee to receive assessments for all such individuals. CPG 511 could be redrafted to make it clearer that the assessments are to be of the cohort, and not the individuals within the cohort.

Paragraph 31 – Customised arrangements

7. Paragraph 31 states that (emphasis added):

*APRA expects the remuneration arrangements for risk and financial control personnel would be **customised** to reflect their role in the entity. Risk and financial control personnel would typically receive a higher proportion of fixed remuneration than other staff.*
8. We would note that CPS 511 does not require that the remuneration arrangements for risk and financial control personnel be 'customised' in the sense of being unique relative to the arrangements of other personnel. Paragraph 50 of CPS 511 simply requires that the arrangements 'reflect' the list factors. After reflecting these factors, the arrangements of risk and financial control personnel could be the same as the arrangements of some other employees.
9. In addition, there may be other staff of APRA regulated entities who receive all (or most) of their remuneration as fixed pay. Where this applies, it is perhaps not correct to say that risk and financial control personnel typically receive a higher proportion of fixed pay than other staff.

10. Because of these points, it would be better if the guidance did not focus so much on how risk and financial control personnel compare to other staff (an issue of relativity) but rather on ensuring compliance with paragraph 50 of CPS 511 as written.

11. We would suggest that paragraph 31 be re-written as:

APRA expects that the remuneration arrangements for risk and financial control personnel would ~~be customised to~~ reflect their role in the entity. For example, it may be appropriate for some risk and financial control personnel ~~would typically to receive~~ have a higher proportion of remuneration delivered as fixed remuneration. ~~than other staff.~~

Paragraph 28 – ‘Collective’ material risk takers

12. Paragraph 28 notes that a ‘...prudent entity would consider the identification of groups of material risk-takers as well as individuals, including those that may **collectively** affect financial soundness’ (emphasis added).

13. This suggestion goes beyond the requirements of CPS 511, which in paragraph 18 defines MRTs by reference to whether the activities of ‘a person’ have a material impact on the entity’s risk profile, performance and long-term management. The definition does not require consideration of whether an individual can have this impact on a collective basis.¹

14. The suggestion that best practice requires identifying MRTs on a collective basis raises important policy design questions of:

- How to define ‘collectives’ of employees?

For example, major business units of an entity have a material impact on its ‘risk profile, performance and long-term management’. Because of this impact, should all employees of these units be MRTs? This does not seem to be what APRA intends with CPS 511.

and

- What entities should do in respect of ‘collective’ MRTs?

To the extent that entities did capture individuals collectively, would they be expected to identify highly paid MRTs from within this cohort and apply CPS 511 to those individuals?

¹ We would also refer APRA to Table 5 of its *Discussion Paper – Strengthening Prudential Requirements for Remuneration* (23 July 2019). In this table, APRA appeared to draw a distinction between the then-current regulation in CPS/SPS 510 which defines ‘material risk-takers’ by reference to either individual or collective activities and the proposed CPS 511 which omitted the adverb ‘collectively’.

15. We would ask APRA to remove the suggestion in CPG 511 that best practice is to identify MRTs on a collective basis. If APRA is minded to apply CPS 511 to 'collective MRTs', then we would ask that this be reflected in the standard itself and subject to adequate consultation to allow any policy issues with the concept to be appropriately identified.

Paragraph 29 – Highly paid MRTs

16. We note that paragraph 29 suggests that '...good practice would be for an entity to also monitor *and include* material risk-takers with remuneration close to the \$1 million level' (emphasis added).
17. We agree that it would be fair to monitor the remuneration of individuals who are close to the \$1 million level. This will help entities meet the legal requirements of CPS 511 when they become applicable.
18. However, we do not understand CPG 511 to be altering CPS 511 so that, for example, its deferral requirements apply to MRTs who do not meet the definition of a highly-paid MRT. It may be preferable to remove the words 'and include' from paragraph 29 to make clear that no substantive requirements apply to individuals who are below the \$1 million level.

Paragraph 29 – 'Awarded' variable remuneration

19. Paragraph 29 also elaborates on when an MRT will be 'highly-paid' by reference to variable remuneration that has been 'awarded'. This is different language to that used in paragraph 18 of CPS 511 which refers to 'actual' variable remuneration in a financial year.
20. It is still not clear whether variable remuneration is to be assessed by reference to (a) what is 'awarded' for the financial year (e.g. cash payments (such as fixed remuneration and cash variable remuneration)) and value of deferred variable remuneration awarded for the year but which have not yet vested (i.e. the value was not received during the year) or (b) what the employee receives unconditionally in a financial year (which may include amounts granted conditionally or prospectively in prior financial years). It would be more appropriate if it were (a).

Table 2 – Forms of variable remuneration

21. Table 2 of CPG 511 sets out what are suggested to be forms of 'variable remuneration'. 'Variable remuneration' is defined in paragraph 18 of CPS 511 to capture remuneration which is conditional on objectives, which include performance criteria, service requirements or the passage of time. We are concerned that the table identifies things that do not fall within this definition, at least without further elaboration on the terms on which they may be provided to employees.

22. Specifically, the table includes forms of economic value (such as 'cash', 'lending arrangements', 'fringe benefits' or 'guaranteed cash payments') which are conceptually independent to the terms on which they are provided to employees. These forms of economic value could be awarded to employees unconditionally (indeed, most fixed remuneration is 'cash'). Where there is no conditionality attached to the award of the economic value, it does not fall within the definition of 'variable remuneration' in paragraph 18 of CPS 511. For example, even though the table lists termination payments, these may be made without conditionality (other than the cessation of employment).
23. We would ask APRA to refocus Table 2 on examples of arrangements (not simply examples of economic value) that fall within paragraph 18 of CPS 511.

Table 2 – Incoming awards (aka buy-outs)

24. Separately, we would appreciate APRA considering the issue of buy-outs of equity for employees who move from one employer to another. We raised this issue in our February 2021 submission on CPS 511. It is our view that these should be excluded from the definition 'variable remuneration'. This is to avoid these individuals becoming 'highly-paid material risk takers' due to the buy-out alone.
25. If APRA continues to include buy-outs of equity within the definition of variable remuneration, we would ask that APRA make clear that any deferral or clawback period commence when the employee first become entitled to the remuneration at their prior employer. This will avoid the clock starting again when the employee moves employers. If the clock starts again, then employees will face a disincentive to move employers, which could affect the ability of firms to attract the skills they need.

Paragraphs 33-36 – Service providers

26. We note the guidance provided on service providers in paragraphs 33-36. These paragraphs are important as CPS 511 does not define 'service providers'. From these paragraphs, it appears that, for banks at least, APRA is primarily concerned with how third parties distribute products. To the extent that this is the case, we note that there is already regulation that concerns the distribution of retail products and how mortgage brokers are paid. Specifically:
 - The remuneration of mortgage brokers is regulated by Division 4 of Part 3-5A of the Credit Act.
 - The distribution of financial products, including by third parties, is regulated by the design and distribution obligations in Part 7.8A of the Corporations Act.

27. We would be interested in APRA's consideration of how the obligations of CPS 511 interact with these existing regulations. For example, it would be important to consider whether there is any policy gap that CPS 511 needs to address in light of this regulation. To the extent that APRA intends CPS 511 to concurrently regulate third party remuneration connected with retail product distribution, it may be useful if the guidance made clear that following the existing regulation is sufficient to comply with CPS 511.
28. Separately from these points, it would be helpful if APRA could clarify that entities do not need to consider all of the remuneration arrangements of relevant third-party service providers but only those arrangements that relate to the service being provided to the entity.

Paragraphs 43 and 63 – Each 'component' of variable remuneration

29. Paragraph 43 restates the requirement in paragraph 37 of CPS 511 that the determination of each component of a person's variable remuneration must give material weight to non-financial measures.
30. Paragraph 63 states that:

Good practice is to apply deferral to each material component of an individual's variable remuneration including, for example, any one-off payments such as sign-on awards and buy-outs.
31. In considering the proposed guidance of CPG 511, it is not clear how the requirement in paragraph 43 or the best practice in paragraph 63 will work for each individual component of variable remuneration. This is because some variable remuneration will be based on conditionality unrelated to factors that could cause risk for an entity and, thus, does not need to have eligibility assessed against non-financial measures.
32. For example, it is unclear how entities could give material weight to non-financial measures for remuneration which is conditional on a period of service. Such remuneration is awarded on the basis of years that an employee has been with an employer. It is not clear how this conditionality needs to, or could be, balanced against non-financial measures.
33. It would seem more appropriate if this requirement and best practice applied to variable remuneration that is primarily contingent upon performance, rather than service or the passage of time (i.e. true bonuses). Alternatively, the requirement in paragraph 37 of CPS 511 and the best practice in paragraph 63 of CPG 511 could be expressed as applying to an individual's total variable remuneration (rather than each component of it).

Paragraph 55 – Quantifying impact of non-financial measures

34. Paragraph 55 suggests prudent entities would be able to 'quantify' the impact that non-financial measures can have on remuneration arrangements. Because there may be judgement and discretion involved in deciding on remuneration outcomes, it could be difficult for entities to 'quantify' the impact. It would be preferable if the paragraph required entities to ***be able to demonstrate qualitatively*** the impact that non-financial measures can have on remuneration outcomes.

Paragraph 62 – Deferral amount

35. Paragraph 62 suggests entities use the 'number' of shares rather than their 'dollar value'. We wondered if this is intended to mean that equity based remuneration should be determined on a 'face value' basis rather than on a 'fair value' basis? It may be simpler if CPG 511 were to use these terms.

ENDS