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General Manager - Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
Via email:

Dear

Subject: Consultation on draft Prudential Practice Guide CPG511

Thank you for providing us with an opportunity to make a submission in response to the draft Prudential Practice Guide CPG 511 – Remuneration (Guide), released for consultation on 30 April 2021.

As we stated in our submission to the draft Prudential Standard CPS511 – Remuneration (Standard), we support the intent of the draft Standard and the need to strengthen the governance of remuneration within the Financial Services industry. We agree that financial incentives have, in some incidences, contributed to poor customer outcomes and serious misconduct.

We acknowledge that some of the concerns raised by the industry regarding the level of prescription for the weighting of performance measures have been addressed by APRA in the Guide. We believe the change in the Guide to requiring a "material weight" of non-financial measures is a positive and will assist in organisations operating remuneration plans that are aligned to the unique organisational objectives, culture, and people strategies of each organisation. However, we are concerned that the level of prescription on remuneration design as outlined in the Guide is unnecessary and inconsistent with international standards.

Bendigo and Adelaide Bank's (BEN) purpose is "to feed into the prosperity of our customers and their communities, not off it". We strongly believe a purpose-driven culture and a responsible remuneration model are essential to achieving positive customer and community outcomes.

This has meant that our approach to remuneration has not been the same as our peers, for example, we removed sales-based commission for our financial planners well before the introduction of the Future of Financial Advice (FOFA) requirements. Likewise, our approach to executive remuneration has been different to other listed organisations and large financial institutions. Our approach to executive remuneration, including the recently introduced Loan Funded Share Plan, and our historical use of 'deferred base pay', have been supported by our stakeholders yet the draft Guide makes it unclear if APRA views these programs as acceptable, even when applied judiciously.

We are supportive of the ABA's industry response to the Guide. We would be grateful if APRA could clarify the proposed requirements regarding the governance of service providers, as well as the effective start date of the new Standard. In addition, we would like to highlight the following concerns.

Remuneration Design

CPS 511 requires entities to align remuneration with performance and risk, and incorporate risk management into the design of variable remuneration arrangements. This is a regulatory objective that BEN agrees with, and an objective we currently meet.

However, we have concerns regarding the implications of 'Table 2. Forms of variable Remuneration[1]' and the associated commentary, specifically Paragraph 40[2] and Paragraph 45[3].

Firstly, we note that while the table refers to variable remuneration some of the 'forms' of variable remuneration, such as fringe benefits and guaranteed payments, do not appear to meet APRA's definition of variable remuneration. Further, while the table notes 'hedging instruments' are prohibited (as they are under CPS510) they would not constitute a form of variable remuneration. This inconsistency combined with the term 'tightly controlled' in Paragraph 40 makes ARPA's intent unclear as to whether these forms of variable remuneration are allowable in certain circumstances or are in effect banned.

Secondly, we believe that the judicious use of leveraged reward instruments, such as loan funded share plans and options, is consistent with the actions of a prudent organisation. It is important to consider the quantum of the grant, the use of performance measures, and the broader reward and people context when assessing their impact.

BEN introduced a Loan Funded Share Plan (LFSP) as the primary incentive plan for its executives and a small cohort (circa 30) of our senior leaders. The plan was introduced after careful consideration of our culture, strategy, and risk profile. During the design phase we consulted with key stakeholders, including proxy advisors, shareholders, and APRA in July 2020. While the LFSP's design is different to other executive incentive arrangements in the Australian financial services landscape, BEN received a high level of support from many of the stakeholders we engaged with because the LFSP is closely aligned with our specific organisational and strategic context. Executives will only be rewarded if they achieve our strategic objectives, which includes maintaining customer advocacy above our peers.

The LFSP has similar economic outcomes as option plans. It is our understanding that no other international regulators have limited the use of options. The Financial Stability Board (FSB) has made the following commentary on the use of options:

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[1] CPS 511 defines variable remuneration 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.

[2] Table 2 below sets out common forms of variable remuneration, including more complex arrangements that APRA expects would be avoided or tightly controlled.

[3] 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.

"Some evidence implies that traditionally structured options, which are out-of-the-money when granted, are inferior to ordinary equity because the asymmetric payoff properties of options offer incentives to take too much risk. However, options that are in-the-money when granted might have different properties in that they would be similar to ordinary equity in terms of upside payout but, like a clawback, would reduce compensation in event of poor firm performance. The goal should be a mix of cash, ordinary equity, and appropriately structured options that generates a closer match between executive incentives and the long-term stewardship of the firm than in the past." – page 11, FSB Principles and Standards on Sound Compensation Practices

In addition to the restriction on leveraged instruments, paragraph 45 of the draft Guide also appears to strongly discourage the use of unleveraged instruments– such as 'serviced-based awards' which we interpret to include deferred shares that are only subject to a service condition and risk adjustment.

BEN had operated a deferred base plan for several years before the change to our executive reward framework. Our deferred base plan provided annual grants of deferred shares to executives, that were subject to a service condition and risk adjustment. The plan was designed to increase long-term alignment with shareholder's expectations through increasing equity ownership, and to allow for risk adjustment. Many of our peers used deferred short-term incentives to achieve these outcomes, however BEN was of the view that the deferred base plan did this without increasing the focus on short-term (annual) performance targets. This approach was well received by both executives and external stakeholders.

Again, we do not believe there is a rationale for this level of prescription. We note that while other international regulators (such as the FSB and BoE) make some comments about 'service-based' awards – particularly 'retention awards', no other regulation or guidance restricts their use to this extent. It is our understanding that several UK banks provide 'fixed share awards' to their executive. For example, RBS, Barclays, HSBC and Lloyds all provide some form of share grant, which may have some form of pre-assessment or 'underpin', but none the less are primarily 'service-based' awards. We believe that service-based awards can be a prudent component to remuneration design.

Downward adjustment for breaches

While we hold compliance with the spirit and letter of the law as paramount, it is nevertheless inevitable that breaches and errors will occur from time to time, given the complexity of banking and financial sector regulation.

Paragraph 70 of the draft Guide states that 'a breach of a prudential standard or other regulation would typically be expected to result in a risk adjustment for an individual or group'. This statement, taken literally, would apply to any breach, however we believe that it would be more appropriate for a materiality concept of some sort to apply to this requirement given the very complex regulatory environment that Australian banks operate within.

This paragraph does not consider organisational context, event context and remuneration strategy. Any adjustment should not only consider the context in which the event occurred, but the purpose of any variable remuneration, and/or if there are other consequences that are more appropriate.

Conclusion

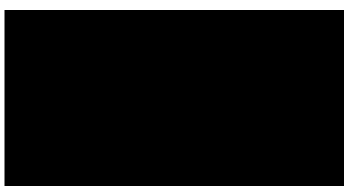
The prescription outlined in the draft Guide is likely to result in organisations being required to operate short-term and long-term incentive plans based on scorecards, using a mixture of cash and deferred shares / performance rights. This homogenisation of remuneration practices across the financial services market has the potential to result in increased overall remuneration levels, as organisations are forced to copy the remuneration designs and therefore compete purely on quantum.

Further, this level of prescription is not consistent with the findings in the final report of the Financial Services Royal Commission, which stated that:

> *It was apparent from the evidence before the Commission as well as international work in this area – and unsurprising – that no-one has identified an 'ideal' or 'optimal' system of executive remuneration for financial services entities.*[1]

We support APRA's objectives for the draft Standard, and believe the increased focus on Governance, Remuneration and Culture is beneficial for the industry. However, to support competition within the industry it is important for organisations to be able to implement remuneration strategies that are tailored to fit their unique circumstances. We therefore ask that APRA further consider the specific guidance regarding remuneration design, and at a minimum clarify their intent of the phrase 'tightly controlled'. The current level of ambiguity makes it difficult for BEN to plan for future grants under our current executive reward framework, a framework that was thoughtfully developed and is consistent with our strategic, cultural and risk objectives.

Yours faithfully,



Chairman, Board Governance and HR Committee
Bendigo and Adelaide Bank Limited

[1] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, February 2019, Volume 1, page 350