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██████████  
General Manager, Policy  
Australian Prudential Regulation Authority

**Submission on Draft Prudential Practice Guide CPG 511 remuneration**

Dear ██████████,

We set out EY's response to Australian Prudential Regulation Authority's (APRA) draft Prudential Practice Guide CPG 511 Remuneration (CPG 511), released for consultation on 30 April 2021. EY considers that overall, CPG 511 provides greater guidance and support to entities in applying the requirements of draft CPS 511.

In particular, EY supports:

- ▶ increased governance expectations on Non-Significant Financial Institutions (SFI) to meet the requirements of draft CPS 511;
- ▶ increased clarity on the key components of a remuneration framework; and
- ▶ the provisions detailing the review of the remuneration framework.

Based consultation with industry and assisting clients prepare for CPS 511, we are of the view that greater guidance and clarity is needed across CPG 511 for effective and consistent implementation of the Standard. Our submission below provides further detail on these areas.

Please let us know if you would like to discuss the submission.

Yours sincerely

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██████████  
Partner, People Advisory Services

## EY submission on CPG 511

EY supports many of the draft guidance provisions set out in CPG 511. Our submission focuses on areas where additional change and clarity are required to support the effective implementation of draft CPS 511.

Our comments are summarised below in terms of those matters where we believe further clarity and/or guidance is required. Further detail on each point is set out in each section below.

### Executive Summary

Provisions	Comments and proposal summary
<b>1. Role of the Board</b>	
Board reporting	<ul style="list-style-type: none"> <li>▶ Limit the reporting requirements to the Board or Remuneration Committee (RemCo), having appropriate oversight of the processes in place to produce the information that it requires.</li> </ul>
<b>2. Remuneration framework</b>	
General	<ul style="list-style-type: none"> <li>▶ APRA should address the inconsistency between the requirements of draft CPS 511 and CPG 511, with respect to the remuneration framework and third-party providers. EY suggests that CPG 511 be amended to align with draft CPS 511 requirements.</li> <li>▶ APRA should clarify:               <ul style="list-style-type: none"> <li>▶ the remuneration framework definition under draft CPS 511 so that it covers broader remuneration matters, not only remuneration risk; and</li> <li>▶ that an entity is required to assess the inconsistency between the remuneration framework of the entity and the payment it makes to a third party.</li> </ul> </li> </ul>
Material risk-takers (MRTs)	<ul style="list-style-type: none"> <li>▶ Further clarity required on criteria for identifying MRTs. EY suggests providing entities with guidance on what is considered a 'material risk' role.</li> </ul>

Provisions	Comments and proposal summary
Highly-paid material risk-takers (HPMRTs)	<ul style="list-style-type: none"> <li>▶ The definition of HPMRT requires further clarification with respect to the \$1 million threshold. EY suggests that:               <ul style="list-style-type: none"> <li>▶ the \$1 million threshold is calculated by reference to an individual's maximum "opportunity" rather than "remuneration", or where not available, their actual remuneration;</li> <li>▶ entities be required to set their own criteria for determining the \$1 million threshold; or</li> <li>▶ the "actual" remuneration of a HPRMT be based on their total remuneration in the prior financial year.</li> </ul> </li> <li>▶ APRA should address the inconsistency between draft CPS 511 and CPG 511, with respect to the remuneration that comprises the \$1 million threshold. EY suggests that CPG 511 be amended to align with the approaches listed above.</li> </ul>
Risk and financial control personnel (RAFCP)	<ul style="list-style-type: none"> <li>▶ Further clarity is required on criteria for identifying RAFCP. EY suggests providing entities with guidance on what is considered a 'control' role.</li> </ul>
<b>3. Remuneration design</b>	
Forms of variable remuneration	<ul style="list-style-type: none"> <li>▶ EY suggests that APRA reconsider the classification of some of the variable remunerations listed under table 2 of CPG 511 to:               <ul style="list-style-type: none"> <li>▶ distinguish cash-based salary from cash as a form of variable remuneration; and</li> <li>▶ remove "lending and leveraged arrangements", "equity options" and "guaranteed cash payments" as forms of more complex remuneration arrangements.</li> </ul> </li> <li>▶ APRA should reframe the provisions under remuneration design to ensure that prudent long-term decision making is a key focus in the design of remuneration arrangements.</li> </ul>
Defining non-financial measures	<ul style="list-style-type: none"> <li>▶ APRA should clarify whether non-financial measures differ based on each individual role, particularly with respect to Long-Term Incentives</li> </ul>

Provisions	Comments and proposal summary
	<p>(LTIs). EY suggests that entities retain the flexibility to determine non-financial measures at the individual, team or entity level.</p> <ul style="list-style-type: none"> <li>▶ EY notes that most of the examples of non-financial measures in table 3 of CPG 511 are risk related, other than those grouped last under “Broader indicators”. This may lead to entities prioritising risk measures ahead of the other measures. As such, APRA should clarify that measures grouped under “Broader indicators” are equally as important as risk-related measures.</li> </ul>
Determining a material weight	<ul style="list-style-type: none"> <li>▶ APRA should clarify that the inclusion of gateways and modifiers in the design and determination of variable remuneration outcomes, forms part of the assessment of determining material weight.</li> <li>▶ Non-financial measures should not be the ‘predominate’ driver of variable remuneration outcomes for roles such as Chief Risk Officers, consideration should also be given to specific business requirements.</li> <li>▶ EY suggests that APRA removes the requirement for the Board to assess and review, on an annual basis, whether non-financial measures are driving expected behaviours.</li> </ul>
Deferral	<ul style="list-style-type: none"> <li>▶ Further guidance is required on the preferred approach to determining variable remuneration and total remuneration. EY suggests that APRA provide entities with the flexibility to determine which approach is the most suitable. For example, APRA should allow entities to use the Opportunity (where that is known) or the Actual (e.g. for uncapped plans).</li> <li>▶ EY suggests that APRA clarifies paragraph 63, to confirm whether the beginning of the performance period for a deferred bonus award (i.e. short-term incentive), would start at the beginning of the performance year to which the deferred bonus relates.</li> </ul>
<b>4. Risk and conduct adjustments</b>	
Downward adjustments	<ul style="list-style-type: none"> <li>▶ APRA should clarify whether the requirement to include downward adjustments in employment contracts is also applicable to lower level employees.</li> </ul>
Assessing severity	<ul style="list-style-type: none"> <li>▶ APRA should address the inconsistency between the requirements of draft CPS 511 and CPG 511, with respect to appropriate adjustment</li> </ul>



Provisions	Comments and proposal summary
	tools. EY suggests the approach expressed in CPG 511 is adopted to allow entities to apply the most appropriate adjustment tool.
<b>5. Financial Accountability Regime</b>	
Alignment to the Financial Accountability Regime (FAR)	<ul style="list-style-type: none"> <li>▶ EY suggests that where an individual meets the definition of multiple role categories, the most onerous requirement should be imposed.</li> </ul>



## Detailed EY submission

EY sets out the following matters for APRA's consideration.

### 1. Role of the Board

#### *Board reporting*

The requirement for the Board and Remuneration Committee to regularly review the information it receives, and to “ensure” that reporting is “sufficient and insightful”, places a new, and significant responsibility on the Board and RemCo. In practice, this will require the Board and RemCo to have oversight of those who are providing such information, and to question the validity of the information it receives.

We suggest that APRA limit this requirement to the Board or RemCo having appropriate oversight of the processes in place to produce the information required.

### 2. Remuneration Framework

#### *General*

We note there is inconsistency between the requirements of draft CPS 511 and CPG 511, with respect to third-party service providers. Under paragraph 20(c) of draft CPS 511, an entity is required to document a remuneration policy which sets out (amongst other things) the process for identifying and addressing inconsistencies that may result from the remuneration arrangements of a service provider. However, paragraph 20 of CPG 511 requires an entity to maintain a remuneration framework that includes the process for managing risks from the remuneration practices of any third-party service providers. EY suggests that CPG 511 be amended to align with draft CPS 511 requirements.

Additionally, based on industry feedback, the interpretation of paragraph 20 of CPG 511 is unclear. EY suggests that APRA clarify the provision to require an entity to assess the inconsistency between its remuneration framework and the payment it makes to a third party.

#### *Material risk-takers*

The current definition of MRTs under draft CPS 511 is broad and has the potential to capture any individual who is employed in a risk and/or financial function. Further, the broad nature of the definition may result in MRTs being inconsistently defined across the industry. Clarity under CPG 511, outlining how APRA expects entities to identify MRTs would be helpful. EY suggests providing entities with guidance on what is considered a ‘material risk’ role.

#### *Highly-paid material risk-takers*

The definition of HPMRTs under paragraph 29 of the proposed CPG 511, refers to a \$1 million threshold. Remuneration outcomes are generally not finalised until an entity's year-end, and it can be difficult for an entity to know in advance, whether certain employees will be HPMRTs and whether the applicable deferral requirements should therefore be operated.



EY suggests that:

- the \$1 million threshold is calculated by reference to an individual's maximum "opportunity" rather than "remuneration";
- entities be required to set their own criteria for determining the \$1 million threshold; or
- the "actual" remuneration of a HPMRT be based on their total remuneration in the prior financial year if the individual is in a similar position (as noted in our CPS 511 Submission).

Further, APRA should address the inconsistency between draft CPS 511 and CPG 511, with respect to the remuneration that comprises the \$1 million threshold. Draft CPS 511 defines the \$1 million threshold as comprising total fixed remuneration plus actual variable remuneration, whereas CPG 511 states that it comprises of total remuneration greater than \$1 million, including variable remuneration that has been awarded. EY suggests that APRA adopts the approaches listed above.

#### *Risk and financial control personnel*

The proposed CPG 511 does not provide clarity on which individuals are covered under the definition of RAFCP. As noted in our CPS 511 Submission, there is disparity across the industry on the interpretation of RAFCP. Guidance outlining how entities should identify relevant individuals would be beneficial and would help to create consistency on the use of the definition amongst entities. Based on industry feedback, potential categories of concern include Chief Financial Officers (CFOs), certain actuarial roles and first line risk employees.

#### *Service providers*

Clarification is required on whether the assessment of the remuneration arrangements of a third-party service provider is limited to the scope of the service contract between the entity and the service provider, or whether the assessment is expected to be based on the service provider's broader remuneration arrangements. Due to the practical difficulties in attaining information on a service provider's broader remuneration arrangements (especially where the provider is a private entity), EY suggests that APRA limits the assessment to the scope of service contract between the entity and service provider.

Additionally, the requirement to understand the intent of a service providers' remuneration framework is problematic, as an entity may not necessarily be privy to this information, especially where the service provider is a private entity.

### **3. Remuneration design**

#### *Forms of variable remuneration*

Paragraph 39 of CPG 511 states that entities should consider a higher proportion of equity-based variable remuneration, compared to cash, for more prudent long-term decision making. Whilst EY notes a significant portion of equity-based variable remuneration is important for risk management, the suggestion that the proportion be "higher" than cash, may create an emphasis towards the achievement

of financial performance over long-term decision making. EY proposes that the paragraph be reframed to ensure that prudent long-term decision making is a key focus in the design of remuneration arrangements. We also note that this requirement is not relevant for many APRA-regulated entities who are unlisted.

Table 2 of CPG 511 lists out the forms of variable remuneration, in particular, those which are considered to be “more complex arrangements”. EY suggests that APRA reconsider the classification of some of these forms of variable remuneration for the following reasons:

- in practice, lending arrangements are not necessarily complex forms of remuneration arrangements. A lending arrangement (such as a loan share plan) requires a financial contribution from an employee, whereas a rights plan (where shares are acquired free of charge) does not require the employee to make a financial commitment. An employee is normally required to repay the loan out of the proceeds they receive in respect of their equity award. Such an arrangement allows an employee to become a shareholder upfront, which aligns the employee’s interests with those of shareholders;
- we do not agree that “equity options” are necessarily complex remuneration arrangements, nor “highly geared on the upside and limited downside”. Equity options are only valuable where the exercise price is less than the value of the shares at exercise, and this would generally require share price growth during the vesting period. Whilst an employee can choose not to exercise an Option that is underwater (and potentially avoid a loss), such an Option has no value. We would suggest that equity options that vest (and become exercisable) upon the achievement of performance conditions (including non-financial measures) be excluded from this list;
- although cash is a form of variable remuneration, the term should be distinguished from cash-based salary; and
- “guaranteed cash payments that are not performance related” should not be classified as a form of complex variable remuneration arrangement, as such payments are not conditional upon the performance of objectives.

#### *Defining non-financial measures*

We note that most of the examples of non-financial measures in table 3 of CPG 511 (“Illustrative examples of non-financial compensation”) are risk related, other than those grouped last under “Broader indicators”. This may lead to entities placing greater weight on risk-related measures. As such, APRA should clarify that measures grouped under “Broader indicators” are equally as important as risk-based measures, to avoid entities from prioritising risk measures ahead of other measures..

Clarity is needed under paragraph 52 of CPG 511 on whether APRA expects (i) non-financial measures to differ depending on the role of each individual; and (ii) whether risk-based measures are required for all roles. The current wording is very broad, and it would not be appropriate to impose individualised non-financial measures on lower level employees (as the risks that they may be responsible for and can influence may be minor), and not all roles necessarily have oversight of risk in a significant way. We therefore suggest that a threshold for these requirements, for employees in senior and oversight roles, is





applied. EY also suggests paragraph 52 to be further clarified to avoid situations where individual measures are used to determine STI pools or regularly included in LTI plans.

#### *Determining a material weight*

EY suggests that APRA clarify under paragraph 56 that the inclusion of gateways and modifiers in the design and determination of variable remunerations, forms part of the assessment of determining material weight.

EY does not support the statement under paragraph 57, that non-financial measures should be the “predominate driver of variable remuneration outcomes” for roles such as the Chief Risk Officer. Variable remuneration outcomes should also align with the role’s specific business requirements. In addition, clarity should be provided on whether “predominate” is a lower threshold than “material”.

EY suggests that APRA removes the requirement for the Board to assess and review, on an annual basis, whether non-financial measures are driving expected behaviours (under paragraph 58), due to the practical difficulties in assessing such behaviours..

#### *Deferral*

There are multiple approaches to determining the value of variable remuneration, and it can be difficult for entities to identify which approach is accepted under CPG 511 (for the purposes of the deferral requirements). Additionally, draft CPS 511 states that the deferred amount applies from the “inception point” of the remuneration arrangement, which is different terminology to CPS 511 (and to the proposed Financial Accountability Regime). Guidance outlining how entities should determine the total value of remuneration would help to create consistency amongst entities. EY suggests that APRA provide entities with the flexibility to determine which approach is the most suitable. For example, APRA should allow entities to use the Opportunity (where that is known) or the Actual (e.g. for uncapped plans).

We also suggest that APRA clarifies paragraph 63, to confirm whether the beginning of the performance period for a deferred bonus award (such as a short-term incentive), would start at the beginning of the performance year to which the deferred bonus relates.

## **4. Risk and conduct adjustments**

#### *Downward adjustments*

Clarification is required on whether the requirement to include downward adjustments in employment contracts is enforceable on lower level employees. We suggest that this requirement is applicable to lower level employees, but that entities have discretion on how they will meet this requirement. Clarification is also required on whether APRA intends for all existing employment contracts to be amended, or whether this would apply to new employment contracts going forwards.

#### *Assessing severity*

We note there is inconsistency between the requirements of draft CPS 511 and CPG 511, with respect to appropriate adjustment tools. Under paragraph 73 of CPG 511, an entity is provided with the



discretion to apply the most appropriate adjustment tool in adverse risk and conduct events. However, this approach is inconsistent with the requirements of draft CPS 511, where a more prescriptive approach is adopted. In particular, paragraphs 38 and 55 of draft CPS 511 set out specific criteria for the application of malus and clawback. We suggest the approach expressed in CPG 511 is adopted to allow entities to apply the most appropriate adjustment tool.

## **5. Financial Accountability Regime**

### *Alignment to the Financial Accountability Regime*

The draft Financial Accountability Regime imposes a requirement on entities to reduce variable remuneration by a proportionate amount following a breach of accountabilities. However, this requirement only applies to the extent that the entity has variable remuneration – where this is not the case, the entity is not required to impose any accountability on the Accountable Person. We suggest that APRA consider incorporating consequence management measures within CPS 511 that require entities to consider matters broader than remuneration, where their framework does not contain variable remuneration. For example, this could include no fixed remuneration increase, additional training or oversight, written warnings, or lack of promotion, or reduction in other benefits. Without such measures the FAR regime creates an accountability regime with limited accountability.