

23 July 2021

To General Manager  
Policy Development  
Policy & Advice Division  
Australian Prudential Regulation Authority

By email: [REDACTED]

Dear General Manager

## Submission on proposed draft CPG 511 Remuneration

This submission is made in response to the draft *Prudential Practice Guide CPG 511 Remuneration (CPG 511)* released by the Australian Prudential Regulation Authority (APRA) on 30 April 2021.

The draft prudential practice guide provides valuable guidance to regulated entities on the implementation of the requirements of proposed CPS 511 and will be an important element of the enhanced framework for the regulation of remuneration of APRA regulated entities. This submission identifies several areas where we consider the proposed CPG 511 could provide further guidance or requires clarification to ease the regulatory burden on entities and avoid potential confusion.

### 1 Alignment with the proposed *Financial Accountability Regime*

As an overriding objective, we believe it is critical that both CPS 511 and the guidance provided by CPG 511 aligns with the remuneration requirements proposed under the Financial Accountability Regime (see the exposure draft of the Financial Accountability Regime Bill 2021 (FAR) released by Treasury on 16 July 2021 which is presently subject to public consultation). The FAR and CPS 511 must work hand in hand to ensure there is an effective regime for the regulation of remuneration in APRA regulated entities. Accordingly, the publication of the final form of the prudential standard and practice guide should await completion of the passage of the FAR through the parliamentary process even if this requires a delay in the proposed implementation dates for CPS 511. Adopting an alternative approach presents a risk of inconsistency and unnecessary costs for industry and has the potential to undermine the objectives of the new regulatory framework.

It is helpful that the provisions of both the proposed CPS 511/CPG 511 and the FAR relating to the deferral of variable remuneration adopt a simpler approach than the current BEAR regime and address some of the uncertainties previously raised regarding the BEAR regime - see section 7 of our submission dated October 2019 (CPS 511 Submission). However, there are some aspects of further alignment or clarification we consider could be addressed by CPG 511 as follows:

- both the draft FAR and CPS511/CPG511 provide that the deferral period for variable remuneration will run from the beginning of the performance period for which the variable remuneration is being assessed but the instruments use different language to describe the same principle. While this is understandable given the different nature of each instrument (ie legislation versus a prudential standard) it would be helpful for the language to be aligned so far as is possible or at least for instruments published by APRA to confirm that the approach to determining the commencement and duration of the deferral period under CPS 511 is to be determined consistently with FAR requirements (noting of course FAR may require a longer deferral period in some instances – see below);
- the deferral periods proposed by CPS 511 will be longer than FAR for certain executives of Significant Financial Institutions (**SFIs**) – while recognising this issue arises from the requirements of CPS 511 rather than CPG 511 we do consider there to be significant utility in aligning the duration of the deferral periods to the mandatory FAR requirements for the reasons outlined in section 4.2 of our CPS 511 Submission;
- the FAR deferral requirements do not apply to individuals holding the role of an “Accountable Person” for less than 90 days – a similar exemption should apply a short term occupant of a “specified role” at an SFI under CPS 511;
- the FAR also provides APRA with the ability to provide relief from deferral requirements or provide determinations on the calculation of variable remuneration to regulated entities but this is not expressly provided for in CPS 511/CPG 511.

There may be other alignment issues that arise once the FAR is finalised and it will be important for these to be addressed in a consistent manner so far as is possible.

## 2 Meaning of ‘variable remuneration’ and deferral requirements

CPS 511 defines ‘variable remuneration’ to include remuneration that is conditional upon service requirements or the passage of time. This is helpful to clarify some uncertainty associated with the definition in BEAR and also aligns with the definition of variable remuneration under FAR (see 1.81 of the Exposure Draft Explanatory Materials released by Treasury).

However, there are aspects of the proposed application of CPS511 and CPG 511 which will present practical challenges for service awards and could be clarified:

- it would be helpful for CPG 511 to confirm that the use of gateways, modifiers and remuneration adjustment tools reflecting the malus and clawback requirements of CPS 511 will be sufficient to meet the requirements of CPS 511 for service based awards provided these tools are applied appropriately (the reference to “can be effective” in paragraph 45 causes some potential uncertainty);
- industry participants have previously raised concerns about the application of the deferral requirements to buy-out awards where industry practice is to replicate the previous employer’s awards on a like for like basis in terms of deferral period. The Consultation Response Paper for CPS released on 12 November 2020 indicated that CPG 511 would outline better practices relating to sign-on awards<sup>1</sup> but the only reference to this in CPG 511 is at paragraph 63 which indicates deferral should apply to each material component of variable remuneration. Buy-out or sign-on

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<sup>1</sup> See page 27 of the Response Paper

awards should be exempted from the CPS 511 deferral requirements provided the buy-out or sign-on award is deferred for a period which replicates the period under the previous employer's award.

The application of the deferral requirements under BEAR have proved challenging for employers to understand and apply in practice. While the provisions of CPS 511 are simpler in approach the prudential guidance could possibly be enhanced by providing some worked examples of the deferral requirements being applied to common remuneration arrangements.

The second sentence of paragraph 62 of draft CPG 511 is also potentially confusing and could be improved by clarifying that it is referring to good practice when determining the amount of equity to be deferred.

### 3 Other issues

#### 3.1 Specified roles

It would be helpful to clarify the way in which APRA expects the remuneration policy of an entity to record the specified roles for the entity (see paragraph 23 of draft CPG 511). We presume this will be through a descriptive approach rather than listing role titles (as this would impose a significant burden on entities) but it would be helpful for CPG 511 to confirm this.

There are also two further points which may warrant further consideration:

- large entities have experienced some difficulty in defining their full cohort of specified roles (particularly given the degree of judgment involved in the definition of "senior manager") and may be assisted by further practical guidance on roles captured by the senior manager definition. The inclusion of roles "from the next level below direct reports to the CEO" potentially includes a significant number of employees for large entities;
- the inclusion of "all risk and financial control personnel" as specified roles will capture a significant number of roles particularly if it is read to include first line business risk roles as opposed to risk and control personnel performing a second line function under the traditional three lines of defence structure – the scope of risk and control personnel to be covered should be clarified.

#### 3.2 Board oversight and discretion

CPG 511 states (at paragraph 16) that "*It is important that the Board uses its discretion in a timely manner, rather than acting only on the basis of realised outcomes... It would not be prudent to act only once risk issues are made public*". While the board should act in a timely manner it is also appropriate for the board to act in an informed manner (as much seems to be recognised later at paragraph 75 of draft CPG 511) particularly given the potentially severe consequences for individuals. There is a need for a balanced and considered approach and considerations of procedural fairness for individuals for boards to consider when exercising their discretion.

#### 3.3 Aligning remuneration and risk

CPG 511 states (at paragraph 13) that "*The use of joint meetings with the Board Risk Committee can also be an effective mechanism for providing insights into risk considerations for the RemCo.*" Given the volume of work and time constraints currently experienced by boards, the opportunity for joint meetings of the Board Risk Committee and Board Remuneration Committee will be limited. It may be more appropriate to suggest the Remuneration Committee can obtain insights from the Risk Committee through reporting or through a delegate of the Remuneration Committee attending certain Risk Committee meetings in that capacity and reporting back to the Remuneration Committee.

### 3.4 Risk and conduct adjustment

Paragraph 65 of CPG 511 proposes that malus, clawback and other similar mechanics required by CPS 511 would be built in employment contracts to provide a legal basis for action. This may be appropriate for new employees but an employer is unlikely to be able to unilaterally introduce these features into an existing employment contract without employee consent which may be difficult to obtain. The more feasible approach (which should be recognised in CPG 511) is for these features to be included in the relevant incentive plans which are typically ancillary to the employment contract and typically able to be changed at the discretion of the employer.

### 3.5 Assessing severity

CPG 511 (paragraph 74) states that when determining the severity of an adverse risk outcome, a number of factors should be considered including expected or actual impact on the entity's reputation, customers or beneficiaries and prudential standing, as well as any financial loss. These factors all focus on the severity of the event and CPG 511 does not also suggest the entity should assess the contribution an individual employee made towards the event (either by reference to their responsibility or accountability) for the matters which gave rise to the event. This is an important element to ensure individuals are properly held to account for their actions. The section of CPG 511 addressing risk and conduct adjustments (particularly paragraph 74) could be amended to also recognise the importance of individual responsibility or accountability for the event in determining the appropriate remuneration adjustment and consider making reference the factors itemised in section 2.2.3 of the *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices – The use of compensation tools to address misconduct risk (9 March 2018)* to assess individual accountability for an adverse risk event.

## 4 Conclusion

We respectfully suggest that APRA consider the various points made in our submission with a view to ensuring that:

- there is sufficient certainty regarding the regulatory requirements for APRA regulated entities;
- the changes imposed by CPS 511 do not unnecessarily add complexity to the current legal and regulatory framework;
- the guidance provided by APRA is useful to industry and aligned to market remuneration practices;
- there is a more robust reform package that does not result in multiple regimes, with potentially inconsistent features, as this will increase costs for industry participants and potentially undermine the legitimate policy objectives seeking to be achieved through the reform package.

We would be happy to discuss our submissions further with APRA.

Yours faithfully

King & Wood Mallesons

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