OWNERSHIP MATTERS

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[redacted]
General Manager, Policy
Australian Prudential Regulation Authority
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RE: Consultation on draft guidance on remuneration under CPS 511

Dear [redacted]

Thank you for the opportunity to comment on APRA's draft guidance on remuneration practices under the new Prudential Standard 511. Ownership Matters (OM), formed in 2011, is an Australian owned governance advisory firm serving institutional investors. This submission represents the views of OM and not those of its clients.

OM generally supports APRA's proposed guidance for entities on complying with CPS 511 and the comments offered below relate to those parts of the draft guidance where OM considers additional clarification could be provided or where OM believes the guidance offered is particularly important.

- **Interaction between financial and non-financial performance:** An overarching area where OM considers additional guidance would be appropriate is in the interaction between incentive outcomes on financial measures and those relating to non-financial performance. The draft guidance makes it clear – for example in paragraphs 64 – 76 - that poor outcomes on non-financial performance could and indeed should lead to lower overall outcomes beyond simple non-achievement of the non-financial component of incentives. It is however unclear from the draft guidance if it is desirable for the reverse to apply: Where poor financial performance should lead to a reduction in incentives overall and not just to non-achievement of financial indicators.
- The draft guidance seems to imply that such overall adjustments are appropriate although limits these to "unusual or exceptional circumstances". Paragraphs 14 – 16 for example which reinforce the need for a board to be able to exercise discretion to reduce remuneration outcomes in such circumstances notes that such a circumstance would include "periods of stress in which the entity may be experiencing negative financial performance and erosion of its regulatory capital base" and "periods of stress in which the entity is provided with exceptional public sector support". It would be beneficial for APRA to incorporate into the draft guidance explicit language noting that incentives based on achievement of non-financial targets are as contingent on financial performance being adequate as the reverse. The most likely way in which the stability of an APRA-regulated entity is likely to be imperiled is through consistent poor financial performance to which poor management of non-financial risks may be a contributor.

- As an aside it is not clear how an entity's remuneration structures could be consistent with the principles underpinning CPS 511 if they require the board to exercise discretion to reduce significant incentive awards for senior executives where exceptional public sector support has been provided or an entity's regulatory capital base has been eroding due to poor performance.
- **Adjustments to quantitative metrics:** The statement in the draft guidance on p.9 that prudent boards would "challenge any adjustments to quantitative metrics" is an excellent addition. The desire of listed entities to focus investor attention on 'cash earnings' or 'cash earnings less large notable items' and the use of such metrics to evaluate outcomes on financial performance has been a contributor to perverse incentive outcomes over a prolonged period at all listed entities and not just those subject to CPS 511. Statutory profit, especially at times when it is substantially lower than management's preferred metrics, is over time a more reliable guide to performance and an entity's financial stability than adjusted management metrics.
- **Need for discretion to be timely:** The clarification in paragraph 16 that discretion be exercised in a "timely manner" and also that boards should not "excuse poor risk outcomes on the basis of good intent" is positive. In OM's experience the lack of consequence for senior executives for poor risk outcomes in remuneration is often due to directors' preferring to focus on the personal integrity or good intentions of senior management rather than the outcomes for which they are ultimately responsible.
- For this reason OM supports the intent of paragraph 72, which notes that where "lower level employees have received downwards adjustments … for adverse risk and conduct outcomes" a board should "consider whether corresponding adjustments" for executives are appropriate. This should however be made more explicit to note it would be *inappropriate* for significant or widespread downwards risk adjustments to be made to lower level employees without similar or more substantial adjustments being made to outcomes for senior executives.
- **Prudential ratios & risk appetite metrics:** The draft guidance in table 3 on p.15 makes explicit that ARA-approved non-financial metrics used to assess management performance include "core prudential ratios and risk appetite metrics". In OM's experience these incentive measures effectively result in senior executives being paid significant sums to achieve 'come to work' outcomes.
- A fundamental responsibility for senior management of an APRA-regulated entity is to ensure that the entity maintains the required prudential ratios and stays within the board's desired risk appetite. To reward management simply for not failing in this responsibility – a feature of executive scorecards at large banks over a prolonged period of time – has been a significant contributor to the culture of entitlement and minimal variation in incentive outcomes that was such a feature of executive pay at major banks prior to 2017. It would be better for the draft guidance to suggest that such measures, especially those related to maintaining prudential ratios, be seen as gateway measures rather than stand-alone goals deserving of reward (outside of cases where a board may wish an entity's management to improve an entity's prudential ratios from their current level).
- **Service providers:** The section of the draft guidance dealing with the need for entities to manage potential risks arising from distribution or sales arrangements with external, non-APRA regulated partners is positive. It is understandable that in the draft

guidance APRA has chosen to specify materiality as one way of identifying service providers whose remuneration arrangements are worthy of review but it would be prudent to make clear what is implied in paragraph 35 that the nature of certain relationships, such as those based on selling or distribution of products, may require scrutiny of partner incentive arrangements at lower levels of materiality.

- A clear potential for reputational and other risks arises as APRA-regulated entities such as banks enter into product or distribution ventures with 'fintechs'. Many of these businesses have grown rapidly in part due to avoiding any form of regulation and their business and remuneration models are designed around rapid growth in revenue or transactions. In some cases the remuneration models of such entities may be incompatible with APRA's intent that incentive structures encourage prudent management of risks.

- **Quantum:** The risk management consequences of high overall pay levels remain unspoken in APRA's approach to executive pay. This remains a material consideration when it comes to prudential supervision. Senior executives of large APRA-regulated entities that have accumulated substantial wealth from their tenures are less exposed to the downside risk of their actions (or inactions) and thus potentially more likely to be inattentive to risk management.

- The now former CEOs of Westpac and ANZ, Gail Kelly and Mike Smith, both realised through cash pay and sales of vested equity incentives more than $85mn during their tenures as CEO. In this context, having equity incentives still at risk valued at $10mn is simply less meaningful than had they not been able to de-risk their personal balance sheets to such a significant extent through the high levels of pay received in prior years. A relatively less successful CEO from a remuneration perspective, Kelly's Westpac successor Brian Hartzer, received over 7.5 years at the bank $44.89mn in cash benefits and sales of equity in addition to shares valued at $3.16mn on departure (adjusted for the value of the shares Hartzer purchased during his tenure, worth $53,000 on departure). The actual harm to these executives' personal balance sheets from any risk management failings during their tenures was minimal.

Please feel free to contact us concerning any aspect of our submission. For the avoidance of doubt we are happy for our submission to be made public.

Yours sincerely,

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Ownership Matters Pty Ltd