



Prudential Practice Guide

PPG 511 – Remuneration

30 November 2009

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About this guide

1. This prudential practice guide aims to assist institutions regulated by the Australian Prudential Regulation Authority (APRA) in considering and prudently managing the risks that may arise from their remuneration arrangements.
2. The information in this guide supports compliance with APRA's *Prudential Standard APS 510 Governance*, *Prudential Standard GPS 510 Governance* and *Prudential Standard LPS 510 Governance* (collectively referred to as the governance standards), which set out APRA's requirements in relation to remuneration. The principles underlying APRA's prudential standards and this prudential practice guide are closely aligned with the Financial Stability Board's *Principles for Sound Compensation Practices*, released on 2 April 2009 and the *FSB Principles for Sound Compensation Practices – Implementation Standards*, released on 25 September 2009. They are also consistent with, but not limited to, the requirements of the *Corporations Act 2001* relating to disclosure, Principle 8 of the *ASX Corporate Governance Principles and Recommendations* (2nd Edition) and the guidelines published by the Australian Institute of Company Directors (AICD) in February 2009.
3. For the purposes of this guide, 'regulated institution' refers to an authorised deposit-taking institution (ADI), general insurer or life company (including a friendly society), or an authorised non-operating holding company (authorised NOHC). Regulated institutions include foreign ADIs, foreign (Category C) insurers and eligible foreign life insurance companies (EFLICs)¹, collectively referred to as 'foreign branches'.
4. Not all of the practices outlined in this prudential practice guide will be relevant for every regulated institution and some aspects may vary depending upon the structure of the institution's business, including its size, complexity and risk profile.

¹ For the full definition of 'foreign ADI' refer to section 5 of the *Banking Act 1959*, for the definition of 'Category C' insurer refer to *Prudential Standard GPS 001 Definitions* and for the definition of EFLIC refer to section 16ZD of the *Life Insurance Act 1995*.

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Introduction

1. In April 2009, the Leaders of the G-20 endorsed the Financial Stability Board's (FSB's) *Principles for Sound Compensation Practices* (FSB's Principles)² (see Attachment 1). In September 2009, the FSB issued *FSB Principles for Sound Compensation Practices – Implementation Standards* (Implementation Standards)² (see Attachment 2). The Implementation Standards provide specific guidance on remuneration governance, structure and disclosure to strengthen adherence to the FSB's Principles. In developing its prudential standards and prudential practice guide, APRA has aligned its requirements with the FSB's Principles and Implementation Standards, adapting them where necessary for the Australian context. Boards may have regard to the FSB's Principles and Implementation Standards for further guidance in addressing APRA's requirements.
2. A regulated institution's business objectives with regard to remuneration are likely to be wider than those discussed within this PPG. For example, remuneration objectives are likely to relate to attracting and retaining staff. APRA's remuneration requirements and guidance relate to managing or limiting risk incentives associated with remuneration. They are not intended to prescribe business decisions regarding pay levels or limit innovative methods of rewarding staff, provided such measures do not compromise the requirements of the prudential standards.
4. The Board has ultimate responsibility for the sound and prudent management of a regulated institution, including its remuneration arrangements. Although the governance standards require the establishment of a Board Remuneration Committee, the Board retains ultimate responsibility for remuneration. In dealing with matters relating to remuneration, the Board would be expected to ensure that executive directors are not placed in a position of actual or perceived conflict of interest. The governance standards require the risks associated with remuneration to be managed in a manner that supports the regulated institution's risk management framework. A regulated institution's Remuneration Policy is one element of this framework. The Board or, in the case of a foreign branch, the senior officer outside Australia (SOOA)³, will need to ensure and be able to demonstrate that there are sufficient procedures, controls and oversight for ensuring compliance with the remuneration requirements. This compliance will need to be attested to in the Risk Management Declaration⁴ submitted annually to APRA.

Governance of remuneration arrangements

3. APRA's governance standards set out the minimum requirements that a regulated institution must satisfy in the interests of promoting effective governance. Remuneration needs to be properly considered in order to mitigate the risks that may arise from poorly designed remuneration arrangements.

Board Remuneration Committee

5. The governance standards require the Board to have a Board Remuneration Committee. APRA may exempt an institution from the requirement to have a Board Remuneration Committee, but will do so only in exceptional circumstances and on the condition that the Board has alternative arrangements in place that achieve an equivalent outcome.

² www.financialstabilityboard.org

³ The Senior Officer Outside Australia is relevant for foreign ADIs and Category C insurers. For EFLICs, all references to the senior officer outside Australia should be read as references to the Compliance Committee.

⁴ Requirements for annual risk management declarations are outlined in APS310, LPS 220 and GPS 220.

6. APRA recognises that a regulated institution may have a Board Committee, other than a Remuneration Committee, that undertakes the functions of a remuneration committee. This is acceptable providing the Committee satisfies the requirements in the governance standards. In such cases, the functions required to be undertaken by the Board Remuneration Committee would need to be formalised in the Committee's charter or terms of reference.
7. The governance standards provide for a regulated institution that is part of a corporate group to be covered by a group Board Remuneration Committee. In such circumstances, the Board of the regulated institution will need to ensure, and be able to demonstrate to APRA, that the recommendations made by the group Board Remuneration Committee are appropriate for the regulated institution. For this purpose, APRA expects the Board to have direct access to the group Board Remuneration Committee and the ability to amend any recommendations of the Committee where the Board considers it appropriate to make such amendments for the regulated institution. Where a group Board Remuneration Committee exists, and is used by a subsidiary Board in the place of its own Board Remuneration Committee, any references to 'Board Remuneration Committee' in this prudential practice guide should be read as 'group Board Remuneration Committee'.
8. The governance standards require the Board Remuneration Committee to periodically review the Remuneration Policy, to ensure that it remains appropriate for its intended purpose. As part of this review, the Committee would be expected to identify material deviations of remuneration outcomes from the intent of its policy. The Committee would also be expected to identify unreasonable or undesirable outcomes that flow from existing arrangements. For a foreign branch, the governance standards require the SOOA to undertake these functions with respect to the branch's operations.
9. It is important that such periodic reviews extend to the three groups referred to in paragraph 27 of this prudential practice guide (PPG). Large numbers of non-executive employees with material financial incentives can take actions that are individually immaterial but collectively can be detrimental to a regulated institution's soundness.
10. The governance standards do not prescribe a minimum review period but APRA would generally expect a review to be undertaken at least every three years.
11. The governance standards also require the Board Remuneration Committee to make recommendations to the Board on the individual remuneration of, at a minimum, the Chief Executive Officer (CEO) and his or her direct reports. This requirement excludes administrative direct reports of executives. The Committee is required also to include other persons who in the Committee's view may be able to affect the financial soundness of the regulated institution. For larger institutions it may be appropriate to include a range of executives from the next level below direct reports to the CEO and to include senior executives of material subsidiaries.
12. The Board Remuneration Committee is also required under the governance standards to make annual decisions on the remuneration of all of the categories of persons required to be covered by the Remuneration Policy (other than those persons for whom individual recommendations are required). This will usually require, *inter alia*, the Board Remuneration Committee and, in the case of foreign branches, the SOOA, to make decisions on the annual distribution of an institution's bonus pool.

13. The Board Remuneration Committee is expected to ensure it has the necessary experience and expertise to perform its duties. APRA notes that a variety of skills will be required to ensure sound governance of remuneration matters. Collectively, the Committee would be expected to have experience in setting remuneration and sufficient industry knowledge to allow for effective alignment of remuneration with prudent risk-taking. The Committee may need to supplement its expertise with appropriate external expert advice.
14. For corporate groups, APRA acknowledges that there will be instances where a person is a 'responsible person' for more than one regulated entity. APRA expects that the remuneration of a responsible person with responsibilities beyond a single institution within a group only needs to be determined once, if there is a group Board Remuneration Committee.
15. The Board Remuneration Committee may rely on administrative support from internal or external parties when conducting reviews. The Committee, in performing its duties, would typically seek information from relevant internal parties including, but not limited to, those responsible for risk management, human resource management and internal audit. APRA expects the Committee to ensure that there are processes in place to ensure advice from such parties is not influenced by conflicts of interest.
16. Effective coordination between the Board Risk Committee and the Board Remuneration Committee will assist in producing a properly integrated approach to remuneration.
18. Under the governance standards, regardless of whether the Board delegates its authority, it cannot abrogate its responsibility for functions delegated to management. Accordingly, it may be appropriate for the SOOA to report back to the Board on matters relating to the Remuneration Policy. This may include, for example, reporting on findings of the review of the Remuneration Policy, any deviations from the Remuneration Policy and any material changes made to the Remuneration Policy as a result of the review. Such communication will assist the Board in maintaining oversight of the remuneration arrangements.

Use of external advisers

19. If a Board Remuneration Committee engages external advisers, the governance standards require that the advisers be commissioned in a manner that ensures that their engagement, including any advice received, is independent. The Board Remuneration Committee will need to exercise its own judgement and not rely solely on the judgement or opinions of others.
20. Where a Board Remuneration Committee chooses to seek advice from a third party, there is a potential for conflicts of interest to arise where the third party provides, or may seek to provide, other remuneration advice or services to the regulated institution or its executives. In engaging an adviser, APRA expects the Committee not to engage an adviser who is acting concurrently or has acted recently on behalf of management or of any executive of the regulated institution in relation to remuneration.

Foreign branches

17. For foreign branches, the SOOA with delegated authority from the Board will be responsible for the duties of both the Board and the Board Remuneration Committee. This can apply where there is a group Remuneration Policy and also where the foreign branch has its own Remuneration Policy. This approach is consistent with APRA's approach across other prudential standards.

Remuneration Policy

21. The governance standards require the Board to have in place a Remuneration Policy. A large, complex and publicly listed regulated institution is likely to need a more comprehensive Remuneration Policy than a smaller, less complex, unlisted regulated institution.

22. APRA recognises that some regulated institutions have little or no performance-based components of remuneration. APRA nevertheless expects such institutions to have a written Remuneration Policy, in accordance with the standard, which explains the objectives and the structure of the remuneration arrangements.
23. A regulated institution that is part of a corporate group can utilise a group Remuneration Policy provided that the group policy as a whole meets the requirements of the governance standards. The group Remuneration Policy may need to be adjusted for the regulated institution if the Remuneration Policy does not address APRA's requirements.
24. A regulated institution that is a subsidiary in a corporate group, with either an Australian-based or overseas-based parent, may rely on a group Remuneration Policy, modified if necessary to satisfy APRA's requirements. The governance standards require the Board of the subsidiary to be able to demonstrate that the Policy complies with APRA's requirements (see also paragraph 7).
25. For a foreign branch, the governance standards require the SOOA with delegated authority from the Board to establish, maintain and approve the Remuneration Policy. If a foreign branch is covered by a group Remuneration Policy, it may rely on that policy, in which case the SOOA, as the Board's representative, will be required to ensure that the policy satisfies APRA's requirements. In doing so, the SOOA may need to make adjustments to the group policy to meet APRA's requirements.
26. For groups with an overseas-based parent, group policies that do not satisfy the FSB's Principles and Implementation Standards (refer Attachments 1 and 2) are unlikely to satisfy APRA's remuneration requirements.
27. The governance standards require that the Remuneration Policy cover all persons or classes of person whose actions could put the institution's financial soundness at risk. In this regard, APRA has specified three groups for the purposes of the Remuneration Policy:
- (a) The first group is 'responsible persons', defined in APRA's 'fit and proper' prudential standards¹ to include directors, executives and senior managers who make or participate in making decisions that affect the whole, or a substantial part, of the business of the regulated institution. The remuneration standards exclude non-executive directors and, for foreign branches, the SOOA and non-executive directors of the corporate agent (where relevant). Appointed Auditors, responsible auditors, external Appointed Actuaries (where relevant) and Reviewing Actuaries (where relevant) of the regulated institution are also defined to be 'responsible persons' but are excluded from this group. For regulated institutions that are part of a corporate group, 'responsible persons' may be designated as such across a number of entities within the group. The governance standards provide that the remuneration of 'responsible persons' may be determined at group level rather than at the individual institutional level.
 - (b) The second group are those whose primary role is risk and financial control (including risk management, compliance, internal audit, financial control and actuarial control roles). The remuneration of such persons requires special attention because of the potential conflict between their own interests and the interests of executives and others whose financial and risk performance they are required to monitor. This group is discussed separately below.

4 Refer APS 520 Fit and Proper, GPS 520 Fit and Proper, LPS 520 Fit and Proper

- (c) The third group are those persons who receive a significant proportion of performance-based remuneration such as through bonuses or commissions. These persons may not individually pose a risk to the institution but may collectively affect the soundness of the institution. Therefore, remuneration arrangements for this class are important. APRA envisages that such persons would typically include, but not be limited to, financial market traders, other transaction-oriented staff, commissioned sales personnel and intermediaries such as agents and broker.
28. The governance standards specify that the remuneration of certain 'responsible persons' be addressed on an individual basis (see paragraph 11). For all other persons covered by the Remuneration Policy, including all other 'responsible persons', APRA's requirement is that the Board accept responsibility for satisfying itself that the remuneration arrangements of these classes or categories of persons are not contrary to the financial soundness of the institution.
29. It is possible that senior risk and financial control personnel will also be 'responsible persons', and will therefore be members of both the first and second groups. The Board will need to ensure that the governance requirements in relation to both hedging equity exposures and independence are applied to such persons.
30. The governance standards refer to 'significant variable remuneration' but do not prescribe what constitutes 'significant'. The determination of whether or not the variable proportion of a person's remuneration is significant will vary according to the context, which will include, *inter alia*, the circumstances of the institution, the role of the individual concerned and the institution's risk management controls and remuneration practices. APRA is not intending to define 'significant' but expects institutions to undertake their own assessments of significance on the basis of the circumstances and the remuneration arrangements of the institution.
31. A regulated institution may extend its Remuneration Policy to a wider range of persons than the minimum coverage required by the governance standards. Additionally, the governance standards enable APRA to designate certain people or classes of people who must be covered by the policy. APRA is likely to use this power only if there is material disagreement between the institution and APRA regarding the coverage specified in its Remuneration Policy.
- Payments to non-employees**
32. The governance standards require the Remuneration Policy to cover persons who are not directly employed by the regulated institution but provide services to the institution and who may, individually or collectively, be able to affect the financial soundness of the institution. Such persons may be contractors or persons employed by a related service company within a group or a third-party body corporate.
33. The nature of the engagement of such persons is expected to be addressed in the Remuneration Policy as follows:
- where the regulated institution contracts with individuals, the payments to these individuals would be expected to conform to the institution's Remuneration Policy;
 - where the regulated institution contracts with a related body corporate, persons employed by the body corporate who provide services to the institution are to be treated as employees of the regulated institution; and
 - where the regulated institution contracts with an unrelated body corporate, it is the contractual terms with the body corporate that are relevant, rather than the remuneration of individuals employed or engaged by the body corporate.

34. Where an unrelated body corporate provides services to a regulated institution, incentive payment structures for such bodies corporate can give rise to inappropriate risk-taking behaviour. Examples of third-party distribution channels such as loan brokers, insurance brokers and financial planners creating losses for a regulated institution highlight the need for careful consideration of incentives associated with financial arrangements made with such entities.
35. Whilst contracts with each individual unrelated third-party may not have a material effect on the financial soundness of a regulated institution, those contracts could when considered collectively. Although it may be the case that the business arrangement with each party is not of a material size, prudent practice would require the Remuneration Policy to consider the collective risks associated with such arrangements.
36. Regulated institutions would be expected to ensure that the contract between the institution and the third party complies with APRA's remuneration requirements. Among other things, contracts regarding third-party sales and distribution activities would be expected to be constrained by the same or similar risk adjustment and deferral arrangements that would apply if this business were undertaken in-house by persons directly employed by the regulated institution.
37. It is not the case, however, that all third-party contract arrangements will be subject to the Remuneration Policy. APRA recognises that regulated institutions may utilise other processes that address the risks associated with incentive-based third-party payment arrangements. In such cases, where the Board Remuneration Committee is satisfied that these arrangements have been deliberated upon and assessed by the Board Risk Committee or another appropriate Board committee, such arrangements will not need to be covered by the Remuneration Policy. Where this is the case, a regulated institution will be expected to be able to demonstrate that the remuneration requirements in the governance standards are being adequately addressed by those processes.

Risk and financial control personnel

38. Risk measures and judgments play a key role in the risk adjustment of remuneration, as do the accuracy and reliability of measures of profit and loss. Persons whose primary role is risk and financial control are usually relied upon to ensure the integrity of these measures.
39. Accordingly, the governance standards require that risk and financial control personnel be remunerated in a manner that does not compromise their independence in carrying out their risk or financial control functions. APRA observes that regulated institutions will normally incorporate qualitative performance metrics based on the quality and integrity of control functions. Generally, the variable remuneration received by such personnel would not be predominantly determined by either the managers or the financial performance of the business areas they monitor.
40. APRA recognises that executives who have risk management and financial control responsibilities for the business as a whole (such as the Chief Financial Officer (CFO) or Chief Risk Officer (CRO)) present some particular issues. The functions undertaken by such persons may be integral to the institution's risk management systems and to measurements of financial performance. Accordingly, paying bonuses based on the performance of the institution as a whole to these persons is an acceptable practice provided there are processes in place that ensure that the performance outcomes are determined independently. Such processes will need to cover the measurement of financial results, the checks and balances applied in decision-making and perhaps other matters.
41. For risk management and financial control personnel generally, an appropriate remuneration arrangement may feature a higher proportion of fixed salary to performance-based remuneration than would be the case for personnel with profit centre responsibility.

Adjusting remuneration for risk

42. Under *Prudential Standard APS 310 Audit and Related Matters*, *Prudential Standard GPS 220 Risk Management* and *Prudential Standard LPS 220 Risk Management*, regulated institutions must have risk management frameworks in place to identify and manage the risks associated with their business activities. Generally speaking, if the risk management framework is effective, the risk-taking incentives provided by remuneration systems are mitigated and would be more likely to remain within the institution's risk tolerance.
 43. The governance standards require that, in rewarding individual performance, the Remuneration Policy be designed to encourage behaviour that supports the risk management framework of the regulated institution. This reflects the reality that controls put in place through the institution's risk management framework are not always perfect and may be undermined by poorly designed remuneration arrangements.
 44. In designing remuneration arrangements, the Board Remuneration Committee will need to consider, among other matters:
 - the balance between fixed (salary) and variable (performance-based) components of remuneration. Performance-based components include all short-term and longer-term incentive remuneration, payable with or without deferral; and
 - whether cash or equity-related payments are used and, in each case, the terms of the entitlements including vesting and deferral arrangements.
 45. These matters are discussed further in the following sections.
47. Financial measures of performance that are based mainly on revenue, volume or market share growth may provide an incentive for employees to pay insufficient regard to the risks associated with business undertaken. Such performance measures can be defined at the product, portfolio or corporate level.
 48. Measuring performance by some version of profits or earnings may be appropriate in some cases but effective remuneration arrangements will include adjustments for risk, including future risks not identified or measured by accounting profits.
 49. A number of techniques are available to adjust accounting profits for risk. The Board would be expected to choose the techniques most appropriate to the circumstances of the regulated institution. Whichever techniques are chosen, the full range of reasonably identifiable material risks will need to be covered.
 50. Measuring performance and adjusting for risk rely on the accuracy and relevance of the measures used to assess financial results. The measurement and allocation of performance-based remuneration based on accounting standards would generally be the starting point for financial measures of performance for remuneration purposes. However, some components of profit and value measures, for example, changes in asset values where a regulated institution's assets are marked-to-market, or changes to the surplus or deficit in an institution's defined benefit superannuation fund, may be outside the control of individuals and so may need to be excluded or modified in making remuneration assessments. Where the institution makes adjustments to the statutory accounts for these purposes and these adjustments affect remuneration arrangements, the adjustments would be expected to be properly documented and substantiated.

Measuring performance

46. Sound remuneration practice will adjust for risk when setting performance targets and measuring actual performance against targets for remuneration purposes.

51. APRA expects the level of performance-based remuneration to reflect the levels of risk to which the regulated institution is exposed by an individual in performing his or her role. For example, it would not be prudent practice to remunerate in the same manner two employees who generate the same accounting profit but assume different amounts of risk on behalf of the institution. A prudent policy will require that performance-based remuneration is low, perhaps zero, where the individual has been found to have exposed the institution to risk beyond its risk appetite or controls.
52. Whilst performance measures are generally related to an institution's own performance, some measures rely on performance relative to other sources, such as relative total shareholder return (TSR). TSR includes in its measurement dividend distributions, which can be based on unadjusted earnings data. If performance-based remuneration is based on TSR, strategies can be devised to boost TSR during the performance period, to the detriment of the longer-term soundness of the regulated institutions. For example, increasing leverage is a technique which can be used to boost TSR. As such, relative performance measures are best used in conjunction with other performance measures. Boards adopting such an approach should do so only after careful consideration of its appropriateness, especially in periods when absolute returns are low or negative.
53. Poor performance on risk control measures or other behaviour contrary to a regulated institution's values or culture can pose significant risks to the institution. It is important for an institution to recognise and adjust remuneration for non-financial measures, such as compliance with risk management and internal audit frameworks, management of staff, adherence to corporate values and displaying acceptable corporate citizenship. Performance against risk-related non-financial measures may be identified through various mechanisms. These include internal or external audit findings,

risk management assessments including any compliance breaches, unexpected taxation or litigation consequences, or administrative, civil or criminal actions taken against the institution. Adverse performance by an individual in these areas would usually be reflected in reductions to, or elimination of, any current or deferred performance-based remuneration.

Measuring performance over time

54. The governance standards require that the design of remuneration arrangements take account of the risks in a regulated institution's business activities and the time needed for outcomes of those business activities to be adequately measured. Prudent practice suggests that a substantial portion and preferably a majority of performance-based remuneration will be deferred and at risk for an extended period. Such remuneration would therefore be exposed to potential reduction or elimination until performance is suitably validated with time.
55. Measuring results with the benefit of hindsight allows the Board and regulated institution to assess the consequences of the risks to which the institution has been exposed. This is particularly relevant where there are uncertainties in the accounting measures applicable to the period in which business is written or generated (e.g. assessing the repayment prospects of loans written during the current year).
56. Portfolio results and corporate results for a given year can usually be measured more reliably some time after the end of that year. Performance measurement in such cases is best deferred. The deferral period may be several years, depending on the portfolio or the business.
57. If there is no deferral, a margin for measurement uncertainty might well be incorporated into performance measurement. More specifically, where deferral does not occur and incentive remuneration is being crystallised before business and financial outcomes can be measured reliably, a downward adjustment or discount is generally needed to allow for measurement uncertainty.

58. For some business activities that have strong controls in place and have well understood risks, it may be the case that performance can be reliably measured immediately.
 59. As already noted, one approach to allow for the time necessary to measure performance reliably is to defer the allocation or vesting of some or all of the performance-based remuneration, with validation of performance and risk outcomes at the end of the deferral period. It is the Board's responsibility to determine the amounts deferred, the length of the deferral periods and any associated vesting arrangements.
 60. Some business lines require many years of exposure before all risks have materialised. Long deferral periods, however, reduce the effectiveness of employee incentive arrangements. Hence, the Remuneration Policy needs to strike a reasonable balance between providing effective incentives and validating the performance measures over a deferral period.
 61. Although the deferral of equity components exposes employees to losses in the event of poor share price performance, it is generally desirable that the deferred equity grant itself be at risk, in part or in full.
 62. A regulated institution may elect to allocate interest on deferred cash payments, or dividends on deferred equity allocations. The vesting of such allocations would be expected to occur no earlier than when the performance-based remuneration is validated.
 63. It is inevitable that the design of remuneration arrangements will be influenced by taxation legislation. Taxation requirements may interact with APRA's principles in a manner that requires, for example, that an institution permit the partial vesting of an amount to cover taxation obligations of the employee arising from the deferred component. Such arrangements need to be adequately documented in an institution's Remuneration Policy.
 64. The decision to permit partial vesting is at an institution's discretion. In doing so, the institution will be expected to consider the administrative issues associated with allowing partial vesting. For example, if vesting does not occur, and an employee leaves the institution, the institution may be left attempting to recoup the released funds from the ex-employee. A perverse outcome could be where an employee ends up receiving a benefit that they are otherwise not entitled to and the company is out of pocket for the amount of the tax liability.
 65. In general, it is desirable to set performance thresholds and targets prior to the start of any performance period. It is also desirable not to reset performance-based remuneration components involving performance hurdles, strike prices and the like due to company, industry, economic or share market adverse performance. Any variation from this approach in exceptional circumstances merits explicit support from the Board Remuneration Committee and the Board.
 66. It would not be prudent practice for deferred payments to vest automatically upon cessation of employment with a regulated institution. It is preferable for deferral and vesting arrangements to remain in place. The fact that cessation of employment is the taxation point for deferred share schemes has the potential to cause conflict between prudent deferral and taxation requirements. Nevertheless, APRA remains of the view that a prudent remuneration policy will include deferral of some benefits to dates that are independent of and beyond cessation of employment. A Board Remuneration Committee will therefore need to consider how to conform to the spirit and principles of APRA's standards as far as possible while also meeting taxation requirements.
- Fixed and variable remuneration components**
67. A prudent overall remuneration structure, including the balance and selection of components of remuneration, would promote a culture and working environment that attract and encourage staff who fit a regulated institution's risk appetite.

68. One aspect to consider in the design of the remuneration structure is the balance between base (or fixed) pay and performance-based (or variable) components. Components of base pay are usually base salary, superannuation and retirement benefits, and perhaps reimbursement of some kinds of expenses.
69. It is desirable that base pay comprise a sufficient proportion of total remuneration to enable the Board to make performance-based components genuinely discretionary. Boards will need to seek a balance in their Remuneration Policy between offering incentives for good performance and avoiding incentives for an individual to take risks that are outside the regulated institution's risk appetite.

Adjusting financial performance measures for risk

70. At the product or portfolio level, prudent decisions generally correspond to sound business practices aimed at generating a continuing profit stream or at enhancing the value of the product or portfolio from year to year. Similarly, at the corporate level, prudent decisions generally correspond to business plans and corporate initiatives that are aimed at generating a continuing profit stream or enhancing the value of the business from year to year.
71. Profits and value enhancements can be risk-adjusted in various ways. One such method, irrespective of other techniques that may also be adopted, is for profit to be measured net of the cost of capital employed in supporting the relevant product, portfolio or business. The basis for this approach is that the level of capital employed should reflect the level of risk associated with the product, portfolio or business. The cost of that capital is as much a business expense as employee expenses, IT costs and other expenses. An astute Board will recognise that:
- profits are most usefully measured relative to a reference return on the amount of capital supporting the product, portfolio or business; and

- the amount of capital should reflect the risks associated with the product, portfolio or business.

72. APRA does not expect that economic capital or similar calculations will be made in all regulated institutions or, even in larger institutions, for every line of business or individual in the regulated institution. The governance standards require risk adjustment, but precision is not intended. At the simplest level, risk adjustment could be achieved by categorising business undertaken as higher or lower risk, or by allocating regulatory capital requirements. For institutions that implement an economic capital model within the organisation, APRA expects that the remuneration policy will be consistent with the current capital allocation to business lines.⁶ Risk adjustment could also include non-financial measures of risk, such as compliance or internal audit scores for the period under consideration.

Dealing with extreme outcomes

73. Performance-based remuneration arrangements are commonly structured to recognise individual performance and contributions to results at both the business unit and whole-of-institution level.
74. There can be a conflict between rewarding individuals and business units that perform well when the regulated institution as a whole, or a relevant large business unit within it, fails to perform well. The Remuneration Policy needs to be structured in a manner that defines in advance how the regulated institution will respond to uneven performance across the institution, including circumstances where the whole institution faces material adversity.

⁶ Economic capital models have been developed by a number of ADIs over recent years, in the context of the 'advanced' approaches available under the Basel II Framework in Australia. APRA also requires general insurers that seek approval to use the internal-model approach to demonstrate that the economic capital model plays an integral role in the insurer's management and decision-making processes, and that this use is embedded in the insurer's operations.

75. Where unexpected or unintended adverse outcomes arise during any deferral period, the governance standards require that the Remuneration Policy provide for and enable the Board to adjust downwards and, where appropriate, eliminate payment of performance-based remuneration for two reasons. One is to protect the financial soundness of the regulated institution in adverse circumstances. Examples include an institution experiencing losses, not meeting prudential capital requirements or relying upon public sector capital injections. The other reason is broader and is for circumstances where material unexpected outcomes arise. These could include material risk management breaches, unexpected financial losses to the institution, reputational damage or regulatory non-compliance. In addition, APRA expects the Board to retain discretion to modify unwarranted remuneration flowing from extreme formula-based bonus calculations. Both of these discretions are intended to cater for extreme circumstances. The exercise of such discretion needs to be contractually permitted.

Other considerations for executive remuneration

76. Executives are often able to make decisions that materially influence the long-term financial soundness of the regulated institution. Accordingly, it is sound practice to structure the components of performance-based remuneration in a way that aligns financial incentives for these executives with long-term, successful stewardship of the institution.

Equity-related components

77. APRA neither requires nor prohibits any particular composition of remuneration between ordinary equity, equity options, cash and other benefits. APRA observes, however, that some remuneration structures are more likely than others to produce outcomes conducive to good risk management. Having a sizeable component of the deferred component of remuneration paid as equity-related benefits for executives, vested over an extended period, can be useful to encourage longer-term risk stewardship by executives. A personal stake in the regulated institution's fortunes can increase the incentives for an executive to preserve and enhance the value of the institution. However, it is also clear that share prices are affected by many factors that are beyond the influence or control of executives.

78. Equity options in performance-based remuneration need to be considered carefully. Options contain the potential to generate more extreme incentives than an equivalent dollar amount of ordinary share grants. Options can generate very high payments to executives when market prices rise, representing a geared return relative to shareholders. On the other hand, when market prices fall and the option value becomes zero, shareholders and ultimately creditors may suffer losses whereas the executive granted options may have no further downside risk. The granting of options may therefore increase the incentives in some market environments for executives to add volatility to a regulated entity's business model or balance sheet. Boards need to be mindful of this problem when designing remuneration arrangements.

79. Particular attention needs to be given to the length of the deferral periods of equity-related remuneration components. Ideally, executives will maintain a long-term view, even when approaching the end of their period of employment. These considerations indicate the need for a thorough risk-oriented assessment by the Board Remuneration Committee of all equity-related, profit-related and value-related remuneration components.

Executive lending and leverage arrangements

80. Past practice in executive remuneration in Australia has included some companies offering leveraged equity ownership arrangements, such as partly paid shares or shares funded by a concessionally priced loan.
81. Such arrangements can raise prudential concerns. A fall in a regulated institution's share price could result in pressure on an executive to attempt to restore the institution's share price, in order to protect his or her own personal financial position. In such circumstances, the pressure upon executives to engage in risky or inappropriate behaviour may be materially increased.

Incoming and terminating payments

82. On incoming and termination payments, APRA considers that the balance between ensuring sound remuneration practices across the institution, compared with the incremental ability to attract or remove individual employees, can only prudently be resolved in favour of sound remuneration practices across the whole institution. APRA recognises that competition in recruiting may encourage a regulated institution to provide cash payments or cash bonuses to incoming staff. Conversely, the desire to part with an under-performing or redundant executive may lead to the desire to 'cash out' such a departure. APRA nevertheless expects institutions to place suitable deferral and performance hurdles on incoming and termination payments.
83. Guaranteed or up-front cash payments beyond normal remuneration for incoming executives or other staff ('golden handshakes') are generally inconsistent with prudent remuneration practice as they generally do not align with the principles of risk adjustment and deferral until performance is validated. Also, such payments restrict the ability of a regulated institution to reduce 'at risk' remuneration upon material adverse outcomes eventuating. APRA expects any remuneration paid to incoming staff as compensation for deferred remuneration forfeited at a previous employer to be subject to performance validation or risk adjustment and deferral.

84. Accelerated or unusually large payments to terminating executives, such as 'golden parachute' cash payout arrangements, are generally inconsistent with prudent practice and may expose a regulated institution to considerable risk. For example, an executive could decide that it is worth taking large risks with the institution's financial position in the knowledge that success would lead to large performance-based payments, and failure will lead to large termination payments. Prudent institutions will carefully review any such existing or proposed arrangements and their potential impact on the institution's financial soundness.

Hedging equity exposure

85. The *Corporations Act 2001* was amended in 2007 to require Boards to disclose their policies on executives limiting their exposure to financial risk regarding equity (and equity options) and on the mechanism used by the company to enforce this policy.
86. To strengthen this requirement for regulated institutions, the governance standards require an institution's Remuneration Policy to prohibit 'responsible persons' from hedging their unvested equity exposure to the institution. The standards also require that the Remuneration Policy set out the actions that would be taken where a person is found to have breached this requirement.
87. An executive may contemplate taking excessive risks near the end of his or her employment with the regulated institution if the option is available to hedge deferred equity exposures upon leaving the institution. A Board will normally consider this risk in establishing the institution's remuneration arrangements. This element of the governance standards only applies to 'responsible persons'. The Board of a regulated institution may also consider, however, whether its anti-hedging approach is appropriate for other staff who receive equity-related benefits as part of their remuneration.

Fringe benefits

88. Some regulated institutions offer perquisites or fringe benefits to their staff, such as discounted products, relocation allowances or reimbursement for business-related entertainment expenses. There is nothing inherently imprudent about this practice. Such arrangements may raise prudential concerns, however, when they comprise a substantial share of an executive's total remuneration or when they are unusually large or generous.
89. Prudent practice would be for material perquisite arrangements involving persons subject to the Remuneration Policy to be documented in the Remuneration Policy.

Other matters

90. APRA supervises a broad range of institutions. Within different industries there is a broad range of size, complexity and business profiles. The governance standards contain a general power to adjust or exclude a specific prudential requirement in relation to a regulated institution. APRA will consider exemption requests in relation to the remuneration requirements in exceptional circumstances. Institutions that are small, have a limited licence to operate within an industry, have simple remuneration practices with minimal performance-based arrangements, have unusual structures or can otherwise demonstrate special circumstances may be candidates for exemptions.

Attachment 1

FSB Principles for Sound Compensation Practices⁷

Effective governance of compensation

- Principle 1. The firm's board of directors must actively oversee the compensation system's design and operation.
- Principle 2. The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.
- Principle 3. Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

Effective alignment of compensation with prudent risk taking

- Principle 4. Compensation must be adjusted for all types of risk.
- Principle 5. Compensation outcomes must be symmetric with risk outcomes.
- Principle 6. Compensation payout schedules must be sensitive to the time horizon of risks.
- Principle 7. The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

Effective supervisory oversight and engagement by stakeholders

- Principle 8. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
- Principle 9. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

⁷ Issued by the Financial Stability Board on 4 April 2009, www.financialstabilityboard.org

Attachment 2

FSB Principles for Sound Compensation Practices – Implementation Standards⁸

Governance

1. Significant financial institutions should have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors. The remuneration committee should:
 - be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital and liquidity. In addition, it should carefully evaluate practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain. In so doing, it should demonstrate that its decisions are consistent with an assessment of the firm's financial condition and future prospects;
 - to that end, work closely with the firm's risk committee in the evaluation of the incentives created by the compensation system;
 - ensure that the firm's compensation policy is in compliance with the FSB Principles and standards as well as complementary guidance by the Basel Committee, IAIS and IOSCO, and the respective rules by national supervisory authorities; and
 - ensure that an annual compensation review, if appropriate externally commissioned, is conducted independently of management and submitted to the relevant national supervisory authorities or disclosed publicly. Such a review should assess compliance with the FSB Principles and standards or applicable standards promulgated by national supervisors.

2. For employees in the risk and compliance function:
 - remuneration should be determined independently of other business areas and be adequate to attract qualified and experienced staff;
 - performance measures should be based principally on the achievement of the objectives of their functions.

Compensation and capital

3. Significant financial institutions should ensure that total variable compensation does not limit their ability to strengthen their capital base. The extent to which capital needs to be built up should be a function of a firm's current capital position. National supervisors should limit variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.

Pay structure and risk alignment

4. For significant financial institutions, the size of the variable compensation pool and its allocation within the firm should take into account the full range of current and potential risks, and in particular:
 - the cost and quantity of capital required to support the risks taken;
 - the cost and quantity of the liquidity risk assumed in the conduct of business; and
 - consistency with the timing and likelihood of potential future revenues incorporated into current earnings.
5. Subdued or negative financial performance of the firm should generally lead to a considerable contraction of the firm's total variable compensation, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.

⁸ Issued by the Financial Stability Board on 25 September 2009, www.financialstabilityboard.org

6. For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm:
 - a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance;
 - a substantial portion of variable compensation, such as 40 to 60 percent, should be payable under deferral arrangements over a period of years; and
 - these proportions should increase significantly along with the level of seniority and/or responsibility. For the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, for instance above 60 percent.
7. The deferral period described above should not be less than three years, provided that the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis.
8. A substantial proportion, such as more than 50 percent, of variable compensation should be awarded in shares or share-linked instruments (or, where appropriate, other non-cash instruments), as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk. Awards in shares or share-linked instruments should be subject to an appropriate share retention policy.
9. The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.
10. In the event of exceptional government intervention to stabilise or rescue the firm:
 - supervisors should have the ability to restructure compensation in a manner aligned with sound risk management and long-term growth; and
 - compensation structures of the most highly compensated employees should be subject to independent review and approval.
11. Guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principle and should not be a part of prospective compensation plans. Exceptional minimum bonuses should only occur in the context of hiring new staff and be limited to the first year.
12. Existing contractual payments related to a termination of employment should be re-examined, and kept in place only if there is a clear basis for concluding that they are aligned with long-term value creation and prudent risk-taking; prospectively, any such payments should be related to performance achieved over time and designed in a way that does not reward failure.
13. Significant financial institutions should take the steps necessary to ensure immediate, prospective compliance with the FSB compensation standards and relevant supervisory measures.
14. Significant financial institutions should demand from their employees that they commit themselves not to use personal hedging strategies or compensation – and liability-related insurance to undermine the risk alignment effects embedded in their compensation arrangements. To this end, firms should, where necessary, establish appropriate compliance arrangements.

Disclosure

15. An annual report on compensation should be disclosed to the public on a timely basis. In addition to any national requirements, it should include the following information:
 - the decision-making process used to determine the firm-wide compensation policy, including the composition and the mandate of the remuneration committee;
 - the most important design characteristics of the compensation system, including criteria used for performance measurement and risk adjustment, the linkage between pay and performance, deferral policy and vesting criteria, and the parameters used for allocating cash versus other forms of compensation;
 - aggregate quantitative information on compensation, broken down by senior executive officers and by employees whose actions have a material impact on the risk exposure of the firm, indicating:
 - amounts of remuneration for the financial year, split into fixed and variable compensation, and number of beneficiaries;
 - amounts and form of variable compensation, split into cash, shares and share-linked instruments and other;
 - amounts of outstanding deferred compensation, split into vested and unvested;
 - the amounts of deferred compensation awarded during the financial year, paid out and reduced through performance adjustments;
 - new sign-on and severance payments made during the financial year, and number of beneficiaries of such payments; and
 - the amounts of severance payments awarded during the financial year, number of beneficiaries, and highest such award to a single person.

Supervisory oversight

16. Supervisors should ensure the effective implementation of the FSB Principles and standards in their respective jurisdiction.
17. In particular, they should require significant financial institutions to demonstrate that the incentives provided by compensation systems take into appropriate consideration risk, capital, liquidity and the likelihood and timeliness of earnings.
18. Failure by the firm to implement sound compensation policies and practices that are in line with these standards should result in prompt remedial action and, if necessary, appropriate corrective measures to offset any additional risk that may result from non-compliance or partial compliance, such as provided for under national supervisory frameworks or Pillar 2 of the Basel II capital framework.
19. Supervisors need to coordinate internationally to ensure that these standards are implemented consistently across jurisdictions.



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