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General Manager, Policy Development  
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Australian Prudential Regulation Authority

By email: PolicyDevelopment@apra.gov.au

Dear General Manager,

## APRA Consultation on CPS 511 Remuneration

The Australian Banking Association (ABA) welcomes the opportunity to make this submission to the APRA consultation on draft prudential standard *CPS 511: Remuneration*. The ABA supports the recommendations of the Royal Commission and notes that CPS 511 is intended to be the outworking of the Royal Commission's recommendations 5.1, 5.2 and 5.3. It is the intention of the ABA through this submission to offer insights and recommendations to enhance the effectiveness of the prudential standard on remuneration.

The issue being addressed under CPS 511 is that remuneration structures of key staff need to be better aligned with the risk-generating potential of activities of those staff to the organisation. In seeking to bring about a better alignment, draft CPS 511 adopts a prescriptive approach. The ABA believes that a prescriptive approach is problematic on a number of grounds:

- (a) it entrenches a specific way of structuring remuneration: However, the Royal Commission found that remuneration structures tend to be fluid, responsive to business needs and therefore evolving.
- (b) it assumes 'one size fits all': However, remuneration structures across ABA members are diverse because they are structured to meet the strategic objectives of each specific bank.
- (c) it assumes that the Australian banking sector is on parity with international banking sectors: However, it potentially places the Australian banking industry at a disadvantage for attracting talent to the industry on multiple fronts – on a global basis, on a national basis, on a cross-sectoral basis, and it will potentially inhibit movement of talent within the organisation itself;
- (d) it is static and therefore has the disadvantage of becoming out of date the moment it comes into effect, further compounding competitive disadvantage.

It is the ABA's view that in its current form, draft CPS 511 will not achieve its intended outcomes and will cause additional cost and complexity through its prescriptive form. The ABA recommends a principles based approach to the governance of remuneration which enables banks to manage remuneration frameworks that account for risk in a manner relevant to their context.

This submission provides further detail and opportunities for achieving a principle driven prudential standard. Key areas of focus in this submission are:

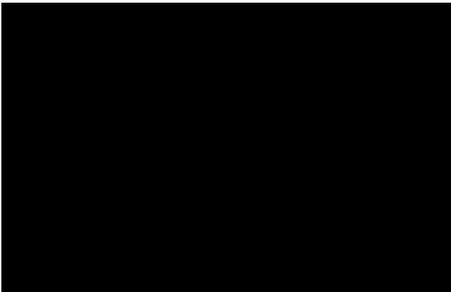
- **Remuneration design:** The ABA strongly recommends avoiding the entrenchment of the scorecard as the key lever for remuneration design. Instead, a principle of requiring a Board to ensure that:
  - remuneration design takes into account the risk duration inherent in a role, and
  - there is an appropriate balance of financial and non-financial considerations when deciding to make the award of the variable remuneration.



- **Special role categories:** The ABA believes that there is both a need and opportunity through CPS 511 to review the number of types of APRA regulated roles. These definitions include Accountable Persons, Responsible Persons, Senior Managers, and Material Risk Takers (under draft CPS 511 to be separated into two sub-categories). To help find a simpler definition for all those roles, the ABA recommends CPS 511 could be anchored by BEAR. As such, any provisions targeted at the CEO or Senior Managers could be simplified by referring to 'Accountable Persons'. The identification of Material Risk Takers should be subject to a Board approved methodology which considers both quantitative and qualitative criteria that is relevant to that organisation. The Material Risk Taker definition should not be prescribed.
- **Deferral and clawback:** The ABA supports the establishment of the principle where the Board is responsible for aligning risk duration with variable remuneration. Further, deferral requirements in draft CPS 511 should be aligned to BEAR for simplicity.

The ABA would welcome the opportunity to workshop this submission with APRA prior to the finalisation of **CPS 511 Remuneration** and we would be pleased to facilitate that session.

Kind regards





## Overview of a principles based approach

The ABA advocates for a principles based, as opposed to a prescriptive, approach to compensation arrangements which is grounded in the understanding that compensation arrangements cannot be taken in isolation from the broader system of human resource management and corporate strategy. It is the entirety of the human resource management structures which supports an organisation's endeavours to ensure that risks of all types are appropriately managed whilst pursuing its strategy.

### **Principles:**

The ABA notes that a principles based approach is implicit in the commentary of Commissioner Hayne in part 6 chapter 1 of the first volume of the Final Report. Commissioner Hayne acknowledged that *'no-one has identified an 'ideal' or 'optimal' system of executive remuneration for financial services entities.'*<sup>1</sup> He further noted that a process of *'trial and error' results in 'better outcomes – and valuable information.... financial services entities must be able (within limits) to try different forms of remuneration and incentive systems.'*<sup>2</sup>

Commissioner Hayne made three recommendations in respect to APRA's supervision of remuneration arrangements within banking. First, he recommended APRA to require remuneration system designs which *'encourage[d] sound management of non-financial risks, and to reduce the risk of misconduct.'*<sup>3</sup> Second, Commissioner Hayne recommended that the prudential standard require Boards to undertake regular reviews of the *'effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing the risk of misconduct.'*<sup>4</sup> Finally, Commissioner Hayne recommended that *'APRA (and, where appropriate, ASIC) should do more to gather information about the way that remuneration systems are being applied in practice, and about whether those systems are actually encouraging sound management of non-financial risks, and reducing the risk of misconduct.'*<sup>5</sup>

Notably, Commissioner Hayne referred to the Financial Stability Board (FSB) when he wrote *'and it must be recognised and accepted that it may never be possible to identify a single 'ideal' or 'optimal' system. As the FSB said in its Principles, 'financial firms differ in goals, activities and culture, as do jobs within a firm'. One size does not fit all.'*<sup>6</sup>

The ABA also notes that the FSB's *'Principles for Sound Compensation Practices'* is a principles based approach to compensation. The FSB does not prescribe practices, instead it describes the objectives and outcomes of remuneration practices. The ABA submits that any standardisation across countries, for example deferral duration of remuneration, is not a *'like for like'* prescription. Such a tendency to standardise detailed prescriptive remuneration requirements across jurisdictions does not take into account the specifics of the Australian banking sector and employment sector. This point is addressed in the next subsection.

### **Context of remuneration structures:**

The ABA acknowledges the FSB's position that *'compensation is an incentive system, not simply a market wage'*<sup>7</sup> and makes two elaborating points which are important to a discussion of draft CPS 511.

First, compensation as an *'incentive system'* is not the only mechanism by which staff actions are aligned to organisational strategies and risk mitigation. Compensation is one of many levers that motivate employees to act in the interests of the company.<sup>8</sup> Compensation systems are operated integrally and in alignment with other strategies, such as people learning and training, implementation and reinforcement of organisational values programs, and appropriate talent acquisition strategies. The

<sup>1</sup> Hayne (2019) Final Report, Vol 1, p350

<sup>2</sup> Hayne (2019) Final Report, Vol 1, p350

<sup>3</sup> Hayne (2019) Final Report, Vol 1, p352

<sup>4</sup> Hayne (2019) Final Report, Vol 1, p352

<sup>5</sup> Hayne (2019) Final Report, Vol 1, p352

<sup>6</sup> Hayne (2019) Final Report, Vol 1, p350

<sup>7</sup> FSF (2009), p4 Available at: [https://www.fsb.org/wp-content/uploads/r\\_0904b.pdf](https://www.fsb.org/wp-content/uploads/r_0904b.pdf)

<sup>8</sup> Motivational theory published by Dr Douglas McGregor researched elements that is tasked with discovering what drives individuals to work towards a goal or outcome. McGregor found that motivation is driven by financial and non-financial elements as well as management style, organisational purpose and culture



entirety of the human resources system is structured to attract the right people, who are professionally and culturally aligned to the strategy (including the risk appetite) of the organisation and are compensated appropriately for their efforts and contributions. It is important to view compensation structures as a subsystem which plays its role in the effective management of all types of risk through integration with an organisation's consequence management framework. It represents only one lever and should therefore be used proportionately within the overall human resources system. Whilst remuneration arrangements, including quantum, deferral and claw back, allow the Board some leverage on consequence for risk, remuneration should not be seen as the lead lever to safeguard the organisation.

Second, it is not possible to ignore the fact that compensation is also a market wage. People work for money, they want to be appropriately compensated for the time, skill and risk they apply to their work. If there is an anomaly in the marketplace for a given sector, that will place that sector at a competitive disadvantage. As an example, a highly skilled fixed income trader who may be employed at an Australian bank will potentially receive job prospects beyond the banking sector, into diverse sectors such as funds management, aviation, and construction. Similarly, a technology executive can find significant work opportunities in an even more diverse grouping of industries.

Added to the in-country talent-flight risk across sectors is the increasing global mobility of skilled labour. For example, the Australian banking industry has been able to leverage work undertaken in the UK on the development of their Open Banking system by bringing highly skilled resources into Australian banks. Australian banks will need to be able to offer commensurate and potentially better remuneration to attract the brightest from overseas and to retain talent in Australia.

Prescribed remuneration structures in the banking industry could potentially lead to a flight of talent from the industry and cause barriers to the industry's ability to attract talent. It may also inhibit movement within organisations. Whilst this flight will likely not occur immediately, there is a real prospect of this dynamic eventuating in the medium to ten year term. The Australian banking industry as the provider of liquidity and credit in the economy and with its significant regulatory obligations needs to attract and retain the best talent to ensure that it can deliver the best outcomes for all Australians.

### **Recommendation:**

*The ABA encourages APRA to adopt a principles based approach to the implementation of Commissioner Hayne's recommendations and the FSB's Principles, to support remuneration structures which are appropriate, and competitive in attracting and retaining the best possible talent to the industry.*

The remainder of this paper will focus on specific instances where the standard would benefit from the adoption of a principles based approach in respect to:

1. Remuneration design
2. Special role categories
3. Deferral and clawback
4. Directors' ability to discharge their duties

## **1. Remuneration Design (Clauses 37-40)**

The ABA acknowledges Commissioner Hayne's conclusion that the existing variable remuneration structures, significantly Long Term Incentives (LTIs), have had a disproportionate emphasis on financial metrics and that non-financial metrics should have a greater emphasis when assessing performance.<sup>9</sup> In bringing about a rebalancing of the metrics, the ABA strongly encourages a principles based approach to remuneration design under CPS 511. This section is structured as follows:

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<sup>9</sup> Hayne (2019) Final Report, Volume 1, p357



- Section 1.1 explains why a principles based approach to remuneration design is appropriate;
- Section 1.2 articulates the challenges in the prescriptions contained in draft CPS 511;
- Section 1.3 provides recommendations for how a principles based approach can be applied to CPS 511.

## 1.1 Why a principles based approach to remuneration design

The ABA's support of a principles based approach to remuneration design is informed by a number of factors: (a) the FSB's own principles based approach to remuneration (b) Commissioner Hayne's commentary on remuneration design and (c) the practicalities of remuneration design needing to be aligned to corporate structure, as well as to the strategy and culture, which are unique to each organisation.

### The FSB's principles based approach

The FSB is clear on the importance of incorporating non-financial metrics into remuneration design. The FSB notes that non-financial metrics *'including conduct related goals, help signal to employees the importance that management places on appropriate conduct.'*<sup>10</sup>

However, the FSB position, whilst supportive of the increasing use of non-financial metrics does not stipulate a required percentage-based balance.<sup>11</sup> In respect to its principles, the FSB noted that *'they are not intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm. However, any compensation system must work in concert with other management tools in pursuit of prudent risk taking.'*<sup>12</sup>

The FSB Principles are<sup>13</sup>:

- Compensation is to be adjusted for risks of all types;
- Compensation outcomes are to be symmetric with risk outcomes;
- Compensation payout schedules must be sensitive to the time horizon of risks; and
- The mix of cash, equity and other form of compensation must be consistent with risk alignment.

The ABA believes that the interplay between financial measures and non-financial measures is more nuanced and more sophisticated than is assumed in draft CPS 511. The draft prudential standard assumes that the two types of measures are mutually exclusive, however, it is not always a simple task to maintain this dichotomy. As an example, the value of the Total Shareholder Remuneration (TSR) takes into account actions which lead to brand damage and an assessment of the internal capability to manage organisational risk. Whilst considered a financial measure, the underlying value of TSR also reflects non-financial considerations.

### Commissioner Hayne's comment on remuneration design

Commissioner Hayne notes the difficulty in measuring some risks. He wrote: *'I say measured "if possible" not only because the FSB's Principles acknowledge that some risks are difficult to measure, but also because, in the end, what is being assessed is not just what people do but how they do it. "What" can be measured; "how" cannot.'*<sup>14</sup>

<sup>10</sup> FSB (2018) Supplementary Guidance, p10. Available at: <https://www.fsb.org/wp-content/uploads/P090318-1.pdf>

<sup>11</sup> FSB (2019) '6<sup>th</sup> Progress Report' page 14

<sup>12</sup> FSF (2009) 'FSF Principles for Sound Compensation' p1 Available at: [https://www.fsb.org/wp-content/uploads/r\\_0904b.pdf](https://www.fsb.org/wp-content/uploads/r_0904b.pdf)

<sup>13</sup> FSF, (2009) 'FSF Principles for Sound Compensation' p2-3 Available at: [https://www.fsb.org/wp-content/uploads/r\\_0904b.pdf](https://www.fsb.org/wp-content/uploads/r_0904b.pdf)

<sup>14</sup> Hayne (2019), Final Report, Vol 1, p351



### **Corporate uniqueness**

As noted in the opening section of this submission, remuneration design is an integral element of the overall system of human resource management. ABA members are structured differently, they have different strategies based on the organisation's current market position, risk appetite and interpretation of future developments in banking. They are also culturally distinct.

This distinctiveness is also evident in the remuneration designs which exist in the ABA membership. There is great diversity amongst the members, for example, the use of executive scorecards is not uniform across the industry. Other levers such as gateways and modifiers are used in ways which are relevant to the respective organisation.

## **1.2 Challenges of the prescriptive approach of CPS 511**

The prescriptiveness of remuneration design requirements in draft CPS 511 introduces several difficulties for the industry.

### **Scorecard primacy**

Draft CPS 511 is premised on a scorecard approach to remuneration design for executives. The effect of this is that scorecards become entrenched and given primacy as a tool of remuneration design. Scorecards are not universally implemented in remuneration design amongst the ABA members for their senior executive teams. While ABA members are implementing the use of scorecards for front-line staff consistent with the recommendations of the Sedgwick Review, it is not the case that scorecards are used at all levels of the organisation.

The ABA appreciates clarification provided by APRA during the consultation process, that in the absence of a scorecard, the onus will be on the Board to demonstrate that due diligence has been undertaken in the awarding of variable remuneration so that non-financial considerations have been taken into account. Whilst the ABA agrees that it is the Board's responsibility to undertake such due diligence, the anchoring of CPS 511 on scorecards means that Boards will be undertaking exception-based consideration and reporting.

A further difficulty with anchoring CPS 511 on scorecards for senior executives is that, as a single tool of remuneration, they may become dated or may evolve into alternate forms of performance measurement. Further and in most cases, scorecards are not applied in a formulaic manner. Scorecards are mostly used as an input into the decision making process. For example, Boards will determine the variable reward outcomes for Key Management Personnel based on factors additional to the scorecard. Anchoring a prudential standard on a single tool which is not uniformly deployed or consistently adopted and used beyond those roles identified by Sedgwick would place ABA members in a difficult position when seeking to comply with CPS 511 in the future. It also distorts the wider market practice in respect to remuneration design by preferencing scorecards.

### **50/50 split is arbitrary**

We acknowledge the challenge faced by APRA in determining an optimal split between financial and non-financial metrics. Matching or exceeding international levels does not necessarily deliver international best practice. The ABA references Commissioner Hayne's comment that the optimal balance will be a process of trial and error and, as such, different for each organisation and at each staff level. For example, under the Sedgwick recommendations<sup>15</sup>, which are currently being adopted by banks, the target financial measures for in-scope roles (e.g. front-line staff in branches) is to be no more than 33 per cent. Given that the 50/50 split is likely to 'not be the right fit' it would seem premature to embed such prescription into CPS 511.

Under a principles based approach the ABA supports APRA taking a view that the Board must define an 'appropriate' mix of financial and non-financial measures that support the execution of the organisation's strategy. The principle of 'appropriate' would still require the use of non-financial

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<sup>15</sup> Note Commissioner Hayne's recommendation 5.5 that the Sedgwick recommendations be implemented



measures – so that the influence of financial measures is moderated for remuneration outcomes – but would not mandate a minimum weighting.

### 50/50 hard to calculate

Not all ABA members use short-term incentives (STI) and long-term incentives (LTI) in their variable remuneration mix. Some members only have an STI component. However, for those members where both STI and LTI form components of the variable remuneration mix, there is significant complexity in the way in which variable remuneration is made available to staff by the organisation. Variable remuneration determination is usually based on a multi-staged process.

As a first stage, a variable remuneration pool needs to be established. This is the pool of monies from which variable remuneration may be paid out to staff. It is common to apply an ‘affordability lens’ to variable remuneration pools. Affordability measures are based on financial metrics such as the organisation’s profitability and retained earnings.

The ABA notes that this is the position of the FSB which noted that *‘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;*
- *consistency with the timing and likelihood of potential future revenues incorporated into current earnings.*<sup>16</sup>

As a second stage, individual variable remuneration structures are designed. Generally, these include a specific proportion of STI and LTI, defined as a percentage of total variable remuneration. The mix and weighting of financial and non-financial measures aligned to each incentive component is then defined in such a way that it supports the individual business strategy, culture and remuneration framework of an organisation.

As a third stage, individuals are awarded variable remuneration based on an assessment of their performance. In respect to STI, the performance metric data is varied amongst ABA members, some of it may be scorecard based, some goals based, others output based. There is a strong non-financial assessment aspect when determining eligibility for STI.

It is important to note that the categorisation of performance metrics as either financial or non-financial is not always straightforward – many measures reflect a balance between both categories or an interplay of performance measure mechanics such as gateways or modifiers.

In respect to LTI much of it will be in the order of a three to five year organisational performance timeframe. There is a requirement to ensure that there is adequate duration matching of the performance target against the metric. Non-financial metrics tend to be of a short-duration as it is challenging to determine appropriate non-financial measures that can be measured in a reliable way over an extended period.

The ABA understands that the investor community has a preference for verifiable quantitative measures which are demonstrably aligned with the organisation’s strategy. However, the development of appropriate non-financial metrics will be a trial and error process. These measures are not readily defined and once developed will take some time to gain general acceptance. This is an outcome that ABA members continue to work towards. The ABA notes the comments of ASIC Chairman, Mr James Shipton, who noted that an option might be for an industry based collaboration to develop these measures.<sup>17</sup>

<sup>16</sup> FSB (2014) Supplementary Guidance, p 15. Available at: <https://www.fsb.org/wp-content/uploads/P090318-1.pdf>

<sup>17</sup> Mr Shipton’s address to the AICD Directors’ Briefing in Sydney 2 October 2019



## Australian Banking Association

As a fourth stage, there is a timing element for when LTI vests. It may be that an LTI may not vest for many years, or in tranches. It is unclear at which point a 50/50 calculation would be applied.

Overall, ABA members question how they can undertake such calculations in order to comply with the prescriptive requirement. It is a significant subjective challenge to align 50/50 (or any other proportionate split) across all the stages of remuneration design simultaneously. Further draft CPS 511 is not clear in respect to which (or if all) stages are in scope.



### **What is a risk adjusted financial metric?**

An additional element in metrics development is the concept of 'risk adjusted financial metrics'. There is a need to more clearly define this term and especially the definition and boundaries of what constitutes 'risk adjustment'.

There is also a need to clarify the place of 'risk adjusted financial metrics' within the taxonomy of metrics. For example, do risk adjusted financial metrics count as non-financial metrics, as a subset of financial metrics or are such metrics considered another metric category? If risk adjusted financial metrics are counted as a third metric category, how does that metric work its way into the CPS 511 requirement for a balance in financial/non-financial metrics when considering performance?

ABA members will provide specific examples of these complexities within their respective submissions.

### **50/50 ignores other levers**

A 50/50 prescription (or other proportionate specification) does not consider the potential that other remuneration levers provide for a risk-based assessment of staff performance. Such levers include malus, modifiers and gateways. As an example, it is possible to devise a combination of non-financial gateways within a financial scorecard and to achieve the outcomes sought by the FSB principles. Examples which are context specific to each member bank will be outlined in their respective submissions. Importantly, the variety of combinations which will be evident within member bank submissions is a marker of the requirement for a principles based prudential standard in order to allow for highly specific and targeted remuneration levers which are appropriate to the individual bank.

### **Board discretion**

The draft CPS 511 50/50 financial/nonfinancial metric prescription removes from the Board the discretion which is assumed in the FBS principles.<sup>18</sup> This is because (a) the Board must apply a 50/50 split where perhaps a different ratio may be more appropriate for a period of time or for a cohort in order to effectively manage risks, and (b) the challenge of accurate calculation for those banks where remuneration is calculated as per the illustration above means that assurance will be a complex and subjective undertaking.

## **1.3 Recommendation for a principles based approach of CPS 511**

The ABA strongly supports a principles based approach to remuneration design in CPS 511. Clause 37 is appropriately structured to support a principles approach. However, clause 38 is regarded by the ABA as unnecessarily prescriptive.

The ABA believes that a prudential standard should be agnostic of remuneration tools and it should allow for the appropriate mix of tools and measures to be deployed for the organisation's circumstances, so as to achieve the goal of assessing the risk outcomes of staff actions with an appropriate duration/risk timeframe. More importantly, it should be recognised that Boards are ultimately accountable for overseeing compensation systems that promote an optimal balance between financial and non-financial measures, and hence effectively incentivise prudent risk-taking behaviours and practices.

If APRA deems it necessary to prescribe specific proportions and anchor the standard on the use of scorecards, the ABA recommends a banded specification. For example, non-financial measures should comprise at least 25 per cent of the consideration criteria for variable remuneration or, alternatively, financial measures should comprise no more than 75 per cent and non-financial measures no less than 25 per cent of the assessment criteria. The ABA notes however, that this option is a very distant second-best solution.

A prescribed approach, such as that envisaged by clause 38 will further require APRA to specify to greater detail to which element of remuneration the proposed limits should apply. The ABA notes that

<sup>18</sup> FSB (2018) Supplementary Guidance. Available at: <https://www.fsb.org/wp-content/uploads/P090318-1.pdf>. Refer to recommendations (1) and (3) in respect to the use of compensation tools in addressing misconduct risk.



although APRA did not wish to prescribe remuneration structure in depth in order to avoid entrenching a remuneration structure within a prudential standard, it is not possible to discuss risk-duration matching of remuneration design without discussing both STI and LTI. Such a discussion within the prudential standard will, however, create a deeper entrenching of a remuneration design which may or may not have longevity.

## 2. Special role categories (Clauses 46-52)

### 2.1 Role definitions

The ABA accepts that there are roles, in this case the Senior Managers and Material Risk Takers (MRT), for which particular remuneration oversight is warranted because these roles can expose the organisation to significant risk outcomes. However, the ABA notes that there is increasing proliferation of roles requiring additional attention. For example, ABA members already capture roles for multiple regulatory purposes. These include:

- Key Management Personnel (AASB 124 Related Parties)
- Senior Manager (Corporations Act and SPS/CPS 520 Fit and Proper)
- Responsible Person (SPS/CPS 510 Governance and SPS/CPS 520 Fit and Proper)
- Accountable Persons (BEAR)

**Recommendation:** The ABA recommends that CPS 511 draw upon the role definitions based in BEAR, where Accountable Persons (including the CEO) are the most senior executives and therefore held to the highest standards. It should be left to the Board's discretion to determine which particular executives within the Senior Manager cohort should be drawn into the BEAR standard. The MRT's, and the remaining Senior Managers would then form the second layer of risk taking personnel of the organisation.

The ABA further recommends that APRA utilise this opportunity to review the roles (as noted above) in order to streamline roles and eliminate the potential for roles falling into multiple categories.

### 2.2 Material Risk Takers

The challenge is in the development of an appropriate definition for MRT, where these roles will indeed be identified. Whilst the UK Prudential Regulation Authority (PRA) and EU guidelines<sup>19</sup> attempt a granular definition of the MRT equivalent, it is the ABA's view that the granularity does not result in greater certainty in respect to which roles are identified as MRT's. It is not the case that a more granular definition will result in standardisation of the MRT roles across the Australian banking sector. This is because roles can be specified differently, in hybrid constructs with other functions, and across other licenses and in different business units. The UK experience has shown that even with twenty qualitative and quantitative MRT criteria, there is still a significant variation across banks on the quantity of MRT being reported.<sup>20</sup>

**Recommendation:** The ABA recommends a principle where the Board<sup>21</sup> is responsible for approving the methodology for the identification of MRTs based on qualitative and quantitative criteria that is developed and maintained by the Board. Such criteria may include (a) a risk driven scan of roles, (b) identification of roles with delegated authorities above a certain financial threshold or ability to

<sup>19</sup> Prudential Regulation Authority Rulebook – Remuneration and Directive 2013/36/EU

<sup>20</sup> **RBS:** Adheres to the EBA definition of MRT which results in 588 MRT's; **HSBC:** Adheres to the EBA definition of MRT which results in 31 MRT's (although there are additional MRT's disclosed in the separate annual reports of its UK regulated subsidiaries); **Barclays:** Adheres to the EBA definition of MRT which results in 1,590 MRT's

<sup>21</sup> The Board may choose to delegate this function to a specialist Remuneration Committee. In such cases, the Board retains ultimate responsibility for the outcomes achieved.



contractually bind the organisation, and (c) a senior manager review for a 'clarity check' that the correct roles have been captured.

## 2.3 Highly Paid MRT

There are two prevailing positions within the industry in respect to the requirement for the Highly Paid MRT (HPMRT) distinction. The positions are driven from a differing perspective on the application of proportionality.

The first position is that the distinction of the HPMRT is not required. This is because:

- if the principles based approach as described in section 2.2 is adopted (i.e. where the methodology underpinning the identification of MRTs is based on both quantitative and qualitative criteria), then the need to overlay a quantitative measure to identify HPMRT is redundant.
- for members where no target and/or maximum opportunity is set for variable remuneration and the awarding of variable remuneration is discretionary, the identification of HPMRT is not possible.
- the argument to base the financial cut-off on the basis of actual remuneration (as opposed to potential remuneration) also runs into challenges because: (a) staff will not be identifiable ex-ante but only ex-post, and (b) year-on-year volatility in variable remuneration outcomes will have a flow on impact to people caught by the threshold (but their MRT status doesn't necessarily change).
- the category of HPMRT may result in sub-optimal talent mix as staff elect not to take roles which may fall into the HPMRT cohort.
- finally, the threshold for a HPMRT will be outdated at the time it is implemented. An outdated dollar threshold will impede the efficient operation of the human resource market as more people become caught by an historically set dollar figure.

The alternative position is that the inclusion of the HPMRT applies an important proportionality mechanism which enables a distinction between organisations based on complexity. This position holds that the potential for poor outcomes for stakeholders eventuating is lower in less complex organisations because (a) executive remuneration levels are relatively lower and (b) that less complex organisations tend not to offer complex LTI arrangements which are financially driven.

This position is supported by the distinction between the remuneration levels of an MRT at a more complex organisation as compared to an MRT from a less complex organisation (which is proxied by the total assets in draft CPS 511). The quantum of distinction in remuneration levels reflects the extent of risk and scope embedded within the responsibility of an MRT. Generally, there is a positive correlation between the extent of scope/risk in a role and the remuneration it attracts. An MRT in a less complex organisation will not necessarily be qualified to undertake their same (or like) role in a more complex organisation. An MRT in a more complex organisation will not necessarily be attracted to the smaller scope of a less complex organisation. Therefore, transferability of MRT's between the two ends of the size-complexity-of-operations spectrum is limited as the quantum of remuneration (which is the proxy for scope of responsibility) acts as a barrier.

## 2.4 Individual vs Collective Assessment by Board (Clause 48)

The ABA requests a drafting clarification on the terms 'collective' and 'individual' in clause 48. This pertains to the requirement that the Board oversees the remuneration arrangements and outcomes for MRT's. This drafting implies that the Board will be required to attend to the specifics of the person's remuneration arrangement and outcomes. The complexity arises where there are in-year adjustments which are needed to be made either because the person has been replaced or because of a performance issue. An individual assessment approach will require extensive Board involvement in the



process and will reduce the Board's role to a shadow management function as opposed to an oversight function. This represents a significant shift from the commonly accepted responsibilities of the Board and it blurs the functions of oversight and management.

The ABA understands that APRA does not envisage the Board undertaking an individual review of each MRT's remuneration arrangements and that it will be sufficient for the Board to satisfy itself that appropriate metrics have been implemented for the MRT's and that remuneration outcomes, collectively for this population, appropriately reflect alignment to risk outcomes. The ABA welcomes this clarification and notes that it would be helpful for CPS 511 to reflect this.

The ABA understands from the current drafting of CPS 511 that HPMRT performance and reward decisions will require individual review by the Board. The ABA submits that this requirement on the Board creates a 'shadow management' function and conflates the Board's governance responsibilities with the function of management. The ABA reinforces the significance of the recommendations contained in sections 2.1 and 2.2 of this submission as a method by which governance and management can be maintained as distinct functions whilst still achieving the requirement to identify the material risk takers in an organisation for additional oversight and accountability.

### 3. Deferral and clawback for SFIs (CI53–59)

The ABA notes the intent of these clauses to match risk duration with remuneration through a combination of malus, deferral and clawback. The prescription of clauses 53-59 will cause the industry some complexity and therefore the requirements of these clauses potentially will be limited in its effectiveness.

#### 3.1 Alignment with the deferral periods in BEAR

The ABA notes the relative newness of BEAR as it has been in effect for less than two years. The ABA believes that it is premature to make adjustments to BEAR given that there is no empirical evidence as to its operation. The ABA is of the view that for deferral and clawback requirements under CPS 511, BEAR should be the 'anchor' for deferral and recommends maintaining the current four-year deferral arrangements for CEOs and other Accountable Persons under BEAR.

#### 3.2 Duration of the at-risk period of remuneration

##### 3.2.1 Accountable Persons including CEOs (BEAR):

The ABA believes that an eleven year at-risk period for variable remuneration is not necessary, as evidence suggests that a more appropriate at-risk period for Accountable Persons' variable remuneration is five to seven years<sup>22</sup>, and shorter at-risk periods are necessary where strong risk identification and management frameworks are in place. In support of this point:

- Given the additional Board oversight of remuneration frameworks that will be introduced as part of CPS 511 as well as the operation of BEAR, such issues will be reported to the Board (or its committees) well within the eleven years of CPS 511.
- APRA's proposal for a nine to eleven year at-risk period for remuneration is premised on the incubation period for risks capable of creating the conditions which can tilt the world's economy into a global financial crisis. The proposed prescription for a nine to eleven year at-risk period for remuneration is appropriate for institutions which the FSB lists as 'Globally Significant Financial Banks' (G-SIBs). No Australian bank has been categorised as a G-SIB and this has been the case since the inception of that list.

<sup>22</sup> Noting that under the recommendations of section 2.1, some Senior Managers will also be deemed to fall within this cohort of most senior and accountable persons within an organisation.



- We note that the six/seven year deferral periods referred to by APRA in other jurisdictions (e.g. the UK) apply to the largest, most complex banks and then only to the most senior executives of those banks. The alignment of the Australian scope/context to international jurisdictions is therefore significantly disproportionate.
- Data retention is such that it may not be possible to reconstruct events from ten years prior. Under the Fair Work Act (Cth) employee records are to be maintained for seven years post-employment termination date (s535). Coupled with staff turnover and business decisions being made atop of previously made decisions the ability to isolate and prove responsibility of an adverse event which occurred ten years earlier will be significantly limited.

**Recommendation:** The ABA recommends that a total at risk period of up to seven years for variable remuneration to be applied which is inclusive of the combination of malus, deferral (including the timing and duration of proportionate deferral) and clawback periods. The specific combination of malus, deferral and clawback should be subject to the Board's determination (provided that the BEAR minimum deferral requirements are adhered to). This recommendation increases the maximum at-risk period from four years (as is currently the case under BEAR) to up to seven years which represents an increase of up to 75 per cent on current requirements.

### 3.2.2 HPMRT's and MRT's:

Given the context presented in the opening section of this submission, there is significant concern within the ABA membership of the detrimental impact that the extensive deferral requirements on HPMRT's/Senior Managers<sup>23</sup> will have on the industry's ability to recruit the appropriately skilled talent. For example, why would an HPMRT/Senior Manager in the technology area choose to work for a bank where a significant portion of their variable remuneration will be deferred for six years when they can join an industry which has no such limitations? The majority of MRT's in overseas jurisdictions are subject to either three or five year deferrals with pro-rata vesting from year one. The requirements of draft CPS 511 on this cohort places Australia's banks at a significant disadvantage and over time will erode the quality of output from the banks.

**Recommendation:** The ABA recommends a principle whereby it is the Board's responsibility to ensure that remuneration frameworks adequately cover the risk duration of the activities of senior managers and HPMRT's/MRT's and that appropriate measures are in place to adjust remuneration where risks eventuate.

### 3.3 Clawback

The ABA notes the recommendation of Commissioner Hayne for APRA to require APRA-regulated institutions to incorporate clawback of remuneration into staff remuneration arrangements.<sup>24</sup>

**Limited application:** The ABA supports a most limited application of clawback. Clawback should be used for egregious behaviour such as fraud, total lack of oversight, severe and gross misconduct. Clawback should not be used for cases where issues have arisen despite following good business practices or when an individual attempted an innovation which led to a financial loss.

Further, the Board is to maintain the discretion to use the most appropriate form of adjustment in the circumstances, i.e. use of 'in-year' adjustments to current year variable remuneration; 'malus' for existing deferred remuneration; and clawback as a last resort for the most serious cases. This will ensure that remuneration adjustments are made with appropriate judgement and the most appropriate (effective and efficient) methods are used.

**Tax considerations:** The ABA notes that ATO rules and taxation law are not aligned to the way in which executive pay is treated. For example, under current tax requirements, executives may be liable to pay tax on deferred variable remuneration upon leaving an organisation even if it has not yet passed

<sup>23</sup> That is, Senior Managers who are not Accountable Persons.

<sup>24</sup> Hayne (2019) Final Report Vol 1, p358



hurdles for vesting. The introduction of clawback will introduce further challenges for employees and organisations in relation to tax on previously paid variable remuneration. The ABA recommends that APRA seeks to achieve a realignment by the ATO in relation to the tax treatment of variable remuneration in order to facilitate the deferral and clawback requirements of CPS 511.

'Reasonable steps': The ABA believes that the concept 'reasonable steps' should be replaced with 'Board discretion to pursue action'. This is in keeping with the overall tenor of the standard to increase Board supervisory activity in respect to remuneration outcomes.

Unintended consequences: ABA members with international footprints note the complexity which deferral and clawback introduces to global staff movements. Many expatriate workers who are assigned to Australia are typically here for two to four years. Variable remuneration deferral will make it unattractive for such international assignments and it will put upward pressure on fixed remuneration and benefits.

### 3.4 De Minimis

The ABA requests clarity as to 'which' de minimis provision will apply:

- Under the current BEAR threshold, if the deferral calculation doesn't result in an amount greater than or equal to \$50,000, then deferral is not required.<sup>25</sup>
- Under draft CPS 511, the minimum for deferral is based on the amount of variable remuneration received. That is, if the person is receiving more than \$50,000 and their function is a 'special role category' role then deferral is to apply.

In keeping with the ABA's position that BEAR should be the anchor for CPS 511, the ABA recommends the de minimis requirements be aligned to BEAR.

## 4. The role of the Board

Draft CPS 511 represents a significant shift in the purpose and function of a Board as a committee of oversight. The Board's function is to set the strategy of the organisation and to set a risk appetite within which that strategy is to be pursued. Further, the Board's role is to oversee the execution of the strategy within the risk appetite and to hold management to account for the achievement of the strategy. A prudential standard which instructs the Board 'what to do and how to do it' in respect to remuneration diminishes that oversight function and sets up the Board to be a shadow management function.

The ABA acknowledges Commissioner Hayne's findings and the findings of APRA's Self-Assessments that Board oversight could be improved. However, imposition of requirements which restricts the ability of the Board to act and make decisions in the best interests of the corporation will not achieve the improvement that both Commissioner Hayne and APRA are seeking.

The ABA supports a principles based approach to Board oversight of remuneration through measures such as:

- Specification that Boards are responsible for approving and overseeing the remuneration framework and policy and retain discretion to determine its features.
- Actively balancing the performance metrics such that non-financial metrics are material in the considerations to vest LTI. It should be left to the discretion of the Board to determine the appropriate mix.
- Active consideration and development of measurably and generally acceptable non-financial risk metrics which can accurately proxy long-term risk. It should be left to the discretion of the

<sup>25</sup>See the following extract from BEAR.37ED. Exemption for small amounts of variable remuneration (1) Paragraph 37E(1)(a) does not apply in relation to the variable remuneration of an accountable person for a financial year if the amount of the person's variable remuneration that is required, or would apart from this section be required, under subparagraph 37E(1)(a)(ii) to be deferred for that financial year is less than: (a) the amount determined under subsection (2); or (b) if a determination under subsection (2) is not in force—\$50,000.



Board to develop the appropriate measures and a trial-and-error approach should be acknowledged and supported by APRA.

- Approval of the methodology for the identification of MRT's and holding management to account for the management of the remuneration of MRT's within the Remuneration framework. It should be left to the Board to demonstrate that they have taken due process in reviewing MRT's that have been identified in accordance with the approved methodology.
- Maintaining the distinction between governance and management by endorsing a collective review of remuneration for special category roles.

The ABA's recommendations are aligned with that of the FSB which notes that it '*is for individual firms to determine how misconduct risk should be incorporated into their risk management framework.*'<sup>26</sup> A principles based approach will achieve the same outcomes sought by CPS 511 and allow the Board the ability to execute its responsibilities.

## 5. Other comments

### Proportionality

Whilst APRA seeks to achieve consistency with international best practice in CPS 511, the ABA notes that no Australian bank ranks inside the top ten of banking institutions by market capitalisation.<sup>27</sup> Individual member responses will highlight the disparity between executive remuneration levels in G-SIB banks relative to non G-SIB bank executive remuneration levels. The application of equal at-risk remuneration duration requirements for Australian non-G-SIB banks in CPS 511 is therefore disproportionate and places the ABA recommendation for a maximum up to seven year at-risk period within the Australian context.

**Recommendation:** The ABA recommends that the Australian banking industry be contextualised within the global banking sector and adjustments be made for proportionate size of the sector as a whole.

### Commencement date

In relation to the commencement date of CPS 511, the ABA recommends that it should from the beginning of the organisation's first full financial year that starts on or after the standard's commencement on 1 July 2021. The commencement should support transition periods to manage the impacts on organisations and employees fairly.

### Independent remuneration reviews

The ABA thanks APRA for its clarifications during the consultation process in respect to the independent review requirements of the remuneration framework. It would be helpful to have confirmation of the clarification in the final form of the standard.

In particular, the ABA notes the following clarifications which were provided:

- That the triennial reviews of the remuneration framework, which are to be undertaken by the Board are to be conducted by independent parties which may be either contracted third parties or internal operationally independent functions within the organisation.
- That the Remuneration Committee and the Board is not obliged to unquestioningly accept the recommendations from the review as this would be a significant restriction of their directors' responsibilities. An '*if not, why not?*' approach to explaining the non-adoption of recommendations is more appropriate under these circumstances.

<sup>26</sup> FSB (2018), p8 <https://www.fsb.org/wp-content/uploads/P090318-1.pdf>

<sup>27</sup> <https://www.globaldata.com/globaldata-announces-top-25-global-banks-by-market-cap-for-2018/>



## 6. Consultation Questions

### 6.1 Remuneration framework

**Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework?**

The ABA believes the proposal for a triennial review is appropriate. Refer to discussion in section 5 of the submission.

### 6.2 Board oversight

**Are the proposed duties of the Board appropriate? Are the proposed duties of the Board Remuneration Committee appropriate?**

The Board's (and Board sub-committees') oversight function which is distinct from the management function should be maintained and appropriate adjustments as recommended throughout this paper and particularly in section 4 should be considered.

### 6.3 Remuneration design

**APRA is proposing that financial performance measures make up at least 50 per cent of variable remuneration measurement and individual financial performance measures are limited to 25 per cent. Is this an appropriate limit, if not what other options should APRA consider to ensure non-financial outcomes are reflected in remuneration?**

Refer to section 1.2 of this submission.

**What would be the impacts of the proposed deferral and vesting requirements for SFIs? For ADIs, what would be the impact of implementing these requirements in addition to the BEAR requirements?**

Refer to section 3 of this submission.

**Would the proposals impact the industry's capacity to attract skilled executives and staff?**

The ABA believes that in its current form CPS 511 will limit the industry's capacity to attract talent from other sectors, internationally, within the sector, as well as potentially within the organisation itself (if the uneven application of Board oversight, minimum mandatory deferral periods and application of clawback remain).

### 6.4 Remuneration outcomes

**What practical hurdles are there to the effective use of clawback provisions and how could these be overcome? Would requirements for longer vesting where clawback is not preferred address these hurdles?**

Refer to section 3.

**What transitional provisions may be necessary for particular components of the new standard or for particular types of regulated entities?**

The new standard should commence as of the performance year commencing on or after 1 July 2021 (as distinct from the performance year concluding in 2021). The commencement should support transition periods to manage the impacts on organisations and employees fairly.

### 6.5 Transparency

**What disclosures would encourage a market discipline in relation to remuneration practices?**



## Australian Banking Association

The ABA looks forward to engaging on this topic with APRA during the next phase of consultation. However, as a guiding principle, APRA may wish to consider how disclosure could be made clear and simple for the range of stakeholders requiring the information. The ABA notes that much is already disclosed by organisations.