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Dear General Manager, Policy Development

Prudential Standard CPS 511 Remuneration (Revised Draft)

The Australian Banking Association (ABA) welcomes the Revised Draft Prudential Standard CPS 511 (**revised draft CPS 511**) released in November 2020. Revised draft CPS 511 relies on a principles-based approach that allows for variations in the way remuneration frameworks are embedded within entities.

In particular, the ABA supports the principles-based definition of Specified Roles such as Material Risk Takers (**MRT**) and Risk and Financial Control Personnel (**RFCP**). It will be within the remit of each bank to identify key staff in accordance with the risk, accountability, and remuneration levels attributed to existing and newly developed job descriptions. Further, the ABA is supportive of the revised definition of Highly-Paid Material Risk Takers (**HPMRT**), which is now based on the 'awarded variable remuneration'.

The ABA provides additional comment on the revised draft CPS 511 in the annexure which is structured into *priority matters*, where the ABA believes it requires further policy iteration, and *clarification matters*, where the policy setting is supported by the ABA but requiring clarification in either the instrument or the Prudential Practice Guide (**PPG**).

The ABA highlights the following as priority matters for further policy consideration:

- The timeframes proposed in the Response Paper will result in significant rework of entities' self-assessments and implementation plans and may impact their ability to meet the compliance date.
- The performance year commencing after 1 January 2023 should be designated as the appropriate obligation timeframe, not the performance year straddling 1 January 2023.
- The current scope of service providers is too broad and requires narrowing with consideration to materiality. Further, the due diligence required for in-scope service providers is significant.
- The need for clarity and guidance in respect to the level of acceptance of non-financial gateways and modifiers when used in conjunction with a single financial metric (such as Total Shareholder Return (TSR), Return on Equity (ROE), or Earnings Per Share (EPS), in the context of determining the appropriate material weighting of non-financial measures or components of variable remuneration such as a Long-Term Incentive (**LTI**).
- The challenge of defining the difference between a 'material' and a 'significant' trigger event for malus and clawback in practice.
- The need for clarity regarding the scope of collective reporting of "Remuneration arrangements" for Specified Roles.

The ABA thanks the Australian Prudential Regulation Authority (**APRA**) for their continued engagement on the development of Prudential Standard CPS 511.

Kind regards



ABA Policy Director




Annexure

1. Priority matters

1.1 Self-assessments

The Response Paper¹ notes that upon finalisation of the Prudential Standard CPS 511 (**CPS 511**) in Quarter 2 2021, Significant Financial Institutions (SFIs) will be expected to undertake self-assessments and develop implementation plans to align remuneration practices with CPS 511.

However, most of the technical guidance required for the self-assessments is anticipated to be contained in the PPG, which is planned to be released in final form in Quarter 4 2021. As such, the proposed timeline requires entities to undertake the self-assessment without appropriate guidance, which could potentially lead to the need to redevelop implementation plans post the PPG release.

The ABA strongly recommends aligning timeframes such that self-assessments and implementation plans are required to be completed after both CPS 511 and its PPG are issued in final form, preferably by either bringing forward the PPG or delaying the implementation date.

1.2 Commencement (paragraph 9)

The commencement date for CPS 511 (1 January 2023) will, in some cases, be in the middle of a bank's financial (and performance) year. The ABA understands that it is APRA's intention that entities comply with the requirements as soon as possible and for the performance year which spans the 1 January 2023 date. This means that some ABA members will need to be CPS 511 compliant by 1 July 2022 and at least one member will need to be compliant by 1 April 2022. Some members will have less than four months to be compliant if the PPG is finalised in December 2021. Even if the PPG were to be finalised concurrently with CPS 511, some members will have less than 12 months to comply. The ABA notes this timing is inadequate for transitioning to the new standard.

The magnitude of change indicated in revised draft CPS 511 is significant. CPS 511 is complex and wide in scope; there are multiple interdependencies across remuneration adjustments and employee groups which need to be undertaken. Notably for the additional roles which are to be in scope for the first time, new reports will need to be developed and, systems changed to enable extraction of the data for the report, it will all require testing and an appropriate sign-off and approval process. Similarly, the requirement to undertake risk assessments of the remuneration frameworks of service providers as currently drafted will need to be scoped, templates developed, service providers identified and engaged, and the respective due diligence will need to be undertaken.

Assuming that the Prudential Standard and the PPG are finalised by 1 July 2021, members will require at least 18 months to undertake the self-assessment, to identify gaps, project plan and implement the new requirements.

The ABA appreciates that APRA recognises the nature of the remuneration cycles require a longer time to implement and that the intention of APRA is to provide a 12- to 18-month transition period. The ABA supports a transition timeframe of a minimum of 18 months from when both CPS and the PPG are finalised. Therefore, the ABA strongly recommends an obligation date for the performance year which commences after 1 January 2023.

1.3 Remuneration framework – Service providers (paragraph 20)

The ABA understands that the intention of paragraph 20(c) is to ensure that entities undertake appropriate risk assessments of the remuneration arrangements of third-party providers that might impact the bank's outcomes (including for customers). The ABA understands, from its discussion with APRA on 3 February, that it is not the intention for entities to reach into the operations of their service

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https://www.apra.gov.au/sites/default/files/%5Bdate%3Acustom%3AY%5D-%5Bdate%3Acustom%3Am%5D/Response%20Paper%20-%20Strengthening%20prudential%20requirements%20for%20remuneration_0.pdf



providers for the purposes of influencing their remuneration outcomes, nor for contractual arrangements to be renegotiated because of this requirement.

The ABA has identified two issues, which it believes will preclude entities from practically achieving the intended outcome. First, paragraph 20(c) appears to capture all service providers irrespective of their size or type of service offering to the entity.

The ABA strongly recommends the adoption of a 'materiality threshold' like that in CPS 510 paragraph 58 where service providers which could impact the financial soundness of the entity are considered in scope ('**Key Service Providers**').

APRA could consider developing principles to enable entities to identify their Key Service Providers. Applying the terminology of CPS 510 Governance a '**Key Service Provider**' is an organisation where:

- CPS 510 - 58(a) the primary role of the body is to provide risk management, compliance, internal audit, financial control or actuarial control services to the institution; or
- CPS 510 - 58(b) the services provided by the body, either individually or collectively with like services provided by other bodies, may affect the financial soundness of the institution and, under the services contract with the APRA-regulated institution, a significant portion of the total payment to the body is based on performance.

Second, paragraph 20(c) requires significant due diligence to be undertaken for each service provider. The elements set out in paragraph 19 must be assessed for each service provider to evaluate consistency with the entity's remuneration framework. These include:

- remuneration policies, procedures and processes and their alignment with the bank's business plan, strategic objectives and risk management framework;
- the effectiveness of the service provider's financial and non-financial risk management; and
- the service provider's approach to preventing and mitigating conduct risk, defining sustainable performance measures and the impact of these on the bank's overall long-term financial soundness.

This is a significant assessment which will require access to each service providers' remuneration framework, associated documentation, and potentially human resources staff. It may also require collecting qualitative information from service providers, such as culture surveys, to validate that their remuneration framework is achieving the intended outcomes and is aligned to CPS 511. This data and documentation will need to be assessed against each element listed in the preceding paragraph. In addition, an assessment will need to be made as to the risk level that the service provider's remuneration framework poses to the business outcomes of the bank.

In the event of inconsistencies and/or an unfavourable risk assessment of the service provider's remuneration framework, paragraph 20(c) requires action to be taken to address the risk.

However, the ABA recognises that in engaging with service providers, entities ought to be cognisant of the potential risks those service providers' remuneration frameworks may pose to the bank. On this basis, an alternative approach to achieve the same purpose would require entities to seek assurances from Key Service Providers that their remuneration structures are aligned to paragraph 19. To achieve this, the ABA suggests the following rendering of paragraph 20 (c):

*c) a process by which the board of the APRA-regulated entity receives assurances from **Key Service Providers** with regard to the alignment of their variable remuneration practices with paragraph 19 of this Prudential Standard; and*

1.4 Non-financial measures (paragraph 37)

Section 4.3 of the Response paper notes that

'entities that have adopted non-financial measures in short-term incentive (STI) plans will now be required to incorporate non-financial measures in long-term incentive (LTI) plans as well.'



Additionally, footnote 11 of Revised Draft CPS 511 states:

‘For the avoidance of doubt, a component of variable remuneration that is entirely dependent on share price performance or profitability would not be permitted’.

From our discussion on 3 February, the ABA’s understanding is that gateways and modifiers as non-financial metrics are not precluded from use in LTI structures, however, when used, entities will be required to provide a clear rationale in applying them and demonstrate their effectiveness.

Some LTI structures reflect a combination of both financial and non-financial metrics which are triggered at a specific point in time and are not necessarily formulaic. For example, when financial metrics (e.g.: TSR, ROE, EPS) are specified as the performance hurdles and non-financial metrics are considered at either the time of grant or, at or before vesting (for example: malus for non-financial risk matters), it is important to understand whether such a structure meets on the ‘material weight’ requirement for non-financial metrics.

The ABA recommends that the PPG should cover different examples of LTI structures and addresses the matter of time-based triggers of metrics in the assessment of ‘material weight’. For example, the PPG could comment on the appropriateness use of gateways, modifiers and/or pre-grant assessments in this context. The ABA is of the view that the assessment of ‘material weight’ should consider the totality of remuneration structure elements, including for instance gateways/modifiers, which depending on design may provide for an effective non-financial weighting of up to 100% in some instances.

1.5 Malus and clawback (paragraphs 38 and 55)

The ABA considers the distinction between ‘significant adverse outcomes’ for malus (paragraph 38) and ‘material adverse outcomes’ for clawback (paragraph 55) challenging in practice. What is ‘significant’ and how it differs from ‘material’ is unclear.

When considering any adjustment mechanism for variable remuneration in general, the ABA suggests the following principles:

- Variable remuneration adjustment may apply to both current and former employees
- Entities will develop a hierarchy or ordering of variable remuneration adjustments which aligns to their remuneration frameworks. For example:
 - First in-year for variable remuneration that has yet to be granted and malus for granted but unvested variable remuneration² and
 - Second clawback as a source of adjustment to be reserved as a last resort only for the most significant cases and involved by a decision of the Board³.

When determining the quantum of any malus and/or clawback adjustment, consideration will be given to the nature and severity of the circumstance or event, accountability for such an event; and the total value of any variable remuneration awarded (or to be awarded) to relevant current or former employees of the APRA-regulated entity.

The ABA recommends that the CPS 511 reflects this suggested principle-based approach.

1.6 Cohort basis assessments by Board (paragraphs 47-49)

The ABA is supportive of the treatment of in-scope roles on an individual basis for senior managers and executive directors and a cohort basis for Specified Roles (HP MRTs, MRTs, and RFCP). However, in practice, reporting remuneration arrangements on a collective basis for Specified Roles represents a challenge.

The issue arises from the definition of ‘remuneration arrangement’ provided in the revised draft CPS 511 which not only includes variable remuneration outcomes, but also other elements such as

² Depending on the timing of the accountability matter and the available variable remuneration to adjust.

³ That is, only to be considered where the Board deems it justified due to the materiality and seriousness of the matter once the application of any in-year adjustments and malus have been considered and are regarded as insufficient



measures of performance, the mix of forms of remuneration and timing of eligibility to receive payments.

For those roles which are reported to the Board on a cohort basis, the ABA seeks confirmation from APRA that practically this means that only relevant remuneration arrangements (as distinct from all remuneration arrangements) which provide context to the remuneration outcome and demonstrate alignment to risk outcomes, will be reported Board

In addition, ABA believes any such review should be provided to the Board no more than once per year, unless determined otherwise by the Board.

2. Clarification matters

2.1 Scope of variable remuneration (paragraph 18)

The ABA considers that some remuneration payments which are made to executives require additional consideration for how they will be treated under CPS 511.

The ABA would like clarification in relation to new hires, as to whether the definition of variable remuneration (that is subject to deferral requirements under CPS511) includes replacement deferred awards which recognise previously awarded deferred remuneration that is forfeited on termination from a prior employer.

The ABA recommends that such remuneration be excluded from the definition, particularly given the potential impact of being classified as a HPMRT for the first year of employment only due to such a replacement award. The ABA does not believe that making replacement deferred awards subject to CPS 511 deferral is aligned with APRA's policy intent.

Recipients of awards granted on appointment may often be moving from one bank to another, and 'restarting the clock' on the deferral period will be unfair under CPS 511 as recipients will be subject to a longer deferral period than peers. This would likely constrain talent mobility, and each entity's ability to attract key executives.

The ABA recommends that such awards granted on appointment be subject to vesting no earlier than the awards they replace and excluded from consideration of first year deferral requirements under CPS511.

Other types of awards to new hires, including those recognising variable remuneration forgone (such as current year STI) or any additional amount not related to amounts forgone or forfeited, would otherwise meet the CPS 511 variable remuneration deferral requirements in the first year at the new employer.

2.2 Board responsibility (paragraph 34)

As ultimate accountability for an appropriately structured remuneration framework rests with the Board, the ABA suggest a small edit to paragraph 34 (c) to reflect this responsibility.

The ABA recommends the following edits to paragraph 34(c):

appropriate remuneration adjustment tools, that include but are not limited to ~~overriding~~ ultimate board discretion at each....⁴

2.3 Variable remuneration (paragraphs 37 and 51)

The ABA notes the definition of 'Variable Remuneration' in paragraph 18(u) and suggests that the use of the term in the revised draft CPS 511 requires further clarification at two points.

⁴ Red font denotes suggested additions, text which is struck suggests deletion.



First, paragraph 37 refers to 'each component of variable remuneration'. Some members have components 'STI' and 'LTI'⁵ In this situation, the ABA understands a 'component' to be a sub-category of variable remuneration (for example LTI). Some members will not have 'LTI' or will not have 'STI' meaning that their remuneration structures will not contain sub-components. In this situation, the ABA understands that the entirety of the variable remuneration structure will be taken as a component.

Second, paragraph 51 specifies the rules for deferral of variable remuneration. Variable remuneration can be represented in several ways: '*variable remuneration opportunity*'⁶ and '*variable remuneration awarded*'. The Bank Executive Accountability Regime (BEAR) bases the deferral requirement on '*variable remuneration awarded*'. It is noteworthy that there is significant diversity in members' variable remuneration practices. Where some members refer to variable remuneration in the context of 'target' or 'awarded' a significant portion of members only refer to 'remuneration awarded' because they have no targets.

The ABA recommends that either the instrument or the PPG provide appropriate clarifying commentary as to the 'type' of variable remuneration envisaged in paragraphs 37 and 51.

2.4 Deferral period (paragraph 52)

Whilst revised draft CPS 511 defines the deferral period as including '*the period over which performance is assessed only where measures of performance are forward-looking*' (Paragraph 52), the Response Paper states that "*For a STI, the deferral period would include the 12-month performance period*"⁷. The ABA requests clarification in respect of which version is relevant for the purpose of CPS 511.

2.5 Deferred portions of variable remuneration (paragraph 53)

The ABA thanks APRA for confirmation of its intention for CPS 511 to align to the threshold deferral amounts of variable remuneration under BEAR. The ABA notes paragraph 53 remains 'stand-alone' in that it does not reference the intention to align with the *Banking Act 1959* clause 37ED. Under clause 37ED, the threshold for exemption for small amounts of variable remuneration applies to the portion of the person's variable remuneration which is required to be deferred (currently \$50,000). The current drafting of revised draft CPS 511 paragraph 53 can be read differently by some to mean a total deferred variable remuneration of \$50,000.

The ABA recommends for the avoidance of doubt aligning the wording with that in BEAR.

2.6 Board oversight of senior officers outside Australia (footnotes 13 & 14)

The ABA interprets footnotes 13 and 14 to mean that the Board Remuneration Committee must make recommendations to the Board on the remuneration arrangements and variable remuneration outcomes for senior officers outside of Australia on an individual basis but that the Board does not need to approve these.

The ABA is seeking clarification on whether this is the intended outcome and if the footnotes could be clearer in clarifying that the observations in them apply to:

- senior officers outside of Australia of all APRA regulated entities;
- senior officers of a Foreign ADI; and
- senior officers of a Category C insurer.

If APRA intends that the commentary in footnotes 13 and 14 only applies to senior officers of Foreign ADIs and Category C insurers who are outside of Australia (and not senior officers of all APRA regulated entities who are outside Australia), the ABA suggests the removal of the comma following '*...outside of Australia*' in both footnotes may be clearer.

⁵ The terminology 'LTI' and 'STI' is reflective of current practice and cannot be assumed to continue as remuneration structures evolve to meet market conditions.

⁶ Some members distinguish further between 'variable remuneration opportunity' and 'variable remuneration target'.

⁷ Section 6.1.2



2.7 In-year commencements

The ABA notes that on-boarding takes place throughout the performance cycle and therefore many CEOs, senior managers, executive directors, MRTs, HPMRTs, RFCP which are subject to CPS 511 will, in their first year of employment, be subject to a partial year of performance. It is important to maintain a steady and regular cadence on deferral timings and to keep alignment with the common performance year. Therefore, the ABA suggests that, depending on the outcome of point 2.4 above, a partial first year employment at an entity will count as year 1 of the deferral period and that a clarification be made in the PPG.

2.8 Disclosure requirements

The Response Paper seeks feedback in respect to improvements on the remuneration disclosure regime. The following is an initial list of principles that the ABA recommends be considered:

- Disclosure requirements should be set out in one standard and either update or replace those in APS 330, rather than having multiple sets of requirements.
- Companies should be able to choose where they publish the required disclosures. For example, some companies may wish to publish APRA disclosures in a separate document on their website while others may include alongside the Corporations Act requirements of the Remuneration Report
- Disclosure requirements should accommodate various remuneration frameworks and be flexible in format
- Disclosure requirements should consider the confidentiality of commercially sensitive information and the privacy of individuals.
- Disclosure requirements should be in line with global standards to reduce the operational burden for international banks (e.g. the Basel Committee on Banking Supervision's Standards on Pillar 3 disclosure requirements).