

DRAFT PRUDENTIAL STANDARDS CPS 511
SUBMISSION TO THE AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

12 February 2021

INTRODUCTION

1. ANZ thanks the Australian Prudential Regulation Authority (**APRA**) for the opportunity to comment on the Response Paper *Strengthening Prudential Requirements for Remuneration* (**Response Paper**) and the accompanying revised Prudential Standard CPS 511 (**CPS 511**). All references to paragraphs and defined terms in this submission are to those of CPS 511 unless otherwise indicated.
2. We welcome the draft CPS 511. It provides a robust and flexible standard for remuneration practices that can support better governance, executive accountability and customer outcomes across the financial services industry. We look forward to implementing its requirements to further consolidate the steps taken to act on the recommendations of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*.
3. At this stage, we have several substantive points that may assist APRA in finalising CPS 511. Some of these continue the observations we made in our October 2019 submission (**2019 Submission**) on the prior draft CPS 511 (**2019 CPS 511**). The most salient of these points for APRA's consideration are:
 - **Regulatory imbalance** – CPS 511 sets up a significant regulatory imbalance between significant financial institutions (**SFIs**) and non-SFIs. Most significantly, this provides less protection to customers of non-SFIs and, secondarily, gives those entities an advantage in the employment market. The same requirements should apply to all APRA-regulated entities. If they do not, the requirements should at least start at the same time.
 - **Board independence** – We remain concerned that the Board will be required to implement the findings of the triennial reviews. We think the Board's independence should be maintained by allowing it to judge which of the findings should be implemented.
 - **Buy-outs** – The definition of variable remuneration should clearly exclude buy-outs of equity for employees who move from one employer to another. This is to avoid these individuals becoming 'highly-paid material risk takers' due to the buy-out alone.
 - **Deferral period – alignment with BEAR / FAR** – We note that the CPS 511 deferral period commences with the start of the performance period. This is different from the Banking Executive Accountability Regime (**BEAR**), which sees the deferral period start when the decision is made to grant the remuneration (which is typically one year later). This means that the minimum CPS 511

deferral period (i.e. from when pro-rata vesting can commence) will effectively need to be five years after the start of the performance period, rather than the four years contemplated by paragraph 51 of CPS 511. We would ask that APRA consider working with the Treasury in the development of the Financial Accountability Regime (**FAR**) so that FAR's deferral periods commence in the performance period, consistent with CPS 511.

- **Start date** – The start date for CPS 511 could mean that it bisects performance periods. It would be better if the standard applied to all financial years that commence on or after a specified date (or which included a specified date).

SUBSTANTIVE POINTS

Regulatory imbalance between SFIs and non-SFIs

4. Consistent with our 2019 Submission, we believe that all APRA regulated institutions should be subject to the same remuneration requirements. The regulatory gap between SFIs and non-SFIs has widened with the current draft of the CPS 511. Remuneration requirements will be quite different depending on the size of the institution. In particular, non-SFIs do not need to apply the prescribed deferral and clawback periods.
5. We continue to believe that the same requirements should be applied for two reasons. Most significantly, the protections that CPS 511 offers should be available to all customers, regardless of the size of the entity serving the customer. Secondly, without a uniform application of the standard across the APRA regulated population, institutions that are not 'significant financial institutions' may be preferred by employees. This is because they do not need to impose long deferral and clawback periods. This would be detrimental to the ability of other institutions to attract the best talent. In short, we are concerned that the proposed distinction could expose some customers to the effects of less stringent remuneration practices, defeating the purpose of the proposal, and would also create a competitive imbalance across the APRA population.
6. If APRA is minded to impose different requirements for SFIs and non-SFIs, we would ask that they be implemented at the same time. The implementation date proposed for the non-SFI requirements will delay the point at which customers of non-SFIs may benefit from the remuneration requirements (relative to customers of SFIs) and opens up a window in which non-SFIs would have a competitive advantage in the employment market. We note that the requirements proposed for non-SFIs are likely to be significantly simpler to implement.

Board independence – triennial reviews

7. We note that paragraph 33 of CPS 511 requires that Boards ‘...must take appropriate and timely action to ensure the findings of [the triennial reviews] are adequately considered and addressed’. While this language has moderated somewhat from the 2019 CPS 511, we remain sensitive to an expectation that the Board *must* implement the findings of the reviews. Boards should be allowed to exercise independent judgment as to whether the findings are appropriate.
8. We note that paragraph 45 of APRA’s *Prudential Standard CPS 220 Risk Management* requires that the triennial review be *reported* to the Board Risk Committee. The Board is then responsible under paragraph 9 of CPS 220 for the institution’s risk management framework. Paragraph 87 of *Prudential Practice Guide CPG 220 Risk Management* states that the review ‘...is intended to *assist* the Board Risk Committee...to oversee the implementation and appropriateness of the institution’s risk management framework’ (emphasis added). This approach makes clear that it is the Board that is ultimately responsible for managing the risks faced by the institution.
9. Consistent with our 2019 Submission, we would suggest that either:
 - The language of CPS 511 is amended to allow Boards to implement the findings of the reviews on an ‘if not, why not’ basis; or
 - The guidance that accompanies CPS 511 makes clear that such a basis of implementation would be sufficient for the Board to have ‘adequately considered and addressed’ the findings.

Buy-outs – variable remuneration definition

10. The definition of ‘variable remuneration’ would benefit from clarity as to whether it captures remuneration such as retention and sign-on bonuses and equity buy-outs of new hires. Clarity is needed as these forms of remuneration are often conditional on the employee remaining with the organisation for a defined period of time. Because of this conditionality, these payments could be caught by the definition of variable remuneration. If this occurs, then it is possible, for example, that new hires could be ‘highly-paid material risk takers’ for their initial year of employment even if they would not otherwise be so classified (e.g. absent the sign on bonus or in subsequent years).
11. To allow APRA entities to compete for talent, we would submit that, in respect of variable remuneration components that are forfeited on resignation with a prior employer (e.g. equity buyouts of previously awarded remuneration):

- Such remuneration should be excluded from the definition of variable remuneration as applied by the new employer; or
 - If it is included, the deferral periods that apply should be those that applied with the prior employer so that the clock does not start again for the transferred remuneration.
12. We ask that this remuneration be excluded from the definition of variable remuneration as it could mean that individuals would be 'highly paid material risk-takers' with their new employer solely because of the buy-out. For example, an individual may be hired with a total remuneration opportunity of less than \$1 million (and thus would not meet the definition of a highly paid material risk-taker) but may receive an equity buy-out from the new employer upon transfer from the old to the new employer that would push them above that threshold for that financial year. These individuals would not, without the buy-out, be 'highly-paid'. We do not think that making them subject to the rules is consistent with APRA's policy intent.
13. For clarity, this reasoning only applies to situations where a new employer makes the employee whole for any remuneration that is forfeited as a result of shifting employers. It does not apply to sign-on bonuses (which are effectively pay at the discretion of the new employer) that otherwise meet the definition of 'variable remuneration'. Also, any deferral periods that applied to the forfeited remuneration under the terms of the old employment contract should carry through to the terms of the new employment contract (but should not recommence).

Start date

14. We note that CPS 511 is scheduled to commence for significant financial institutions on 1 January 2023. Paragraph 10 indicates that CPS 511 does not apply to variable remuneration if the opportunity to earn it arose before 1 January 2023. This could mean that variable remuneration paid for a performance period that includes 1 January 2023 could be partly subject to CPS 511 and partly not. APRA's guidance on how this should work would be appreciated. We also note that employees who commence with an APRA-regulated entity after 1 January 2023 will be wholly subject to CPS 511 while existing employees may be only partly subject to it.
15. It would be simpler if CPS 511 applies to all performance periods (or financial years) that commence on or after 1 January 2023. If APRA is concerned that this may delay the commencement of CPS 511 too much, the date could be brought forward to 1 July 2022. Alternatively, CPS 511 could apply to performance periods in full if they include the date of 1 January 2023. These latter two options would bring the implementation date of CPS 511 forward for many APRA-regulated entities.

Deferral period definition

16. Paragraph 52 indicates that '[t]he deferral period must include the period over which performance is assessed, only where the measures of performance are forward-looking.' On page 27 of the Response Paper, APRA indicates that:

For a STI, the deferral period would include the 12 month performance period but not precede that, even if one or more measures look back beyond this date. For a LTI the deferral period may include the period over which the performance is assessed and any service period required.

17. We would support the sentiment expressed on page 27 of the Response Paper. For ANZ, the award of short-term incentives (**STI**) is determined at the end of the performance period based on how the employee has performed during that period against performance metrics set at the start of the period.
18. We note that there seems to be tension between paragraph 52 and the statement in the Response Paper in so far as the Response Paper would seem to allow 'in-year' performance measures even if they are assessed by considering what has happened through the performance period.
19. We would suggest that paragraph 52 incorporate concepts from page 27 of the Response Paper. For example, paragraph 52 could say:

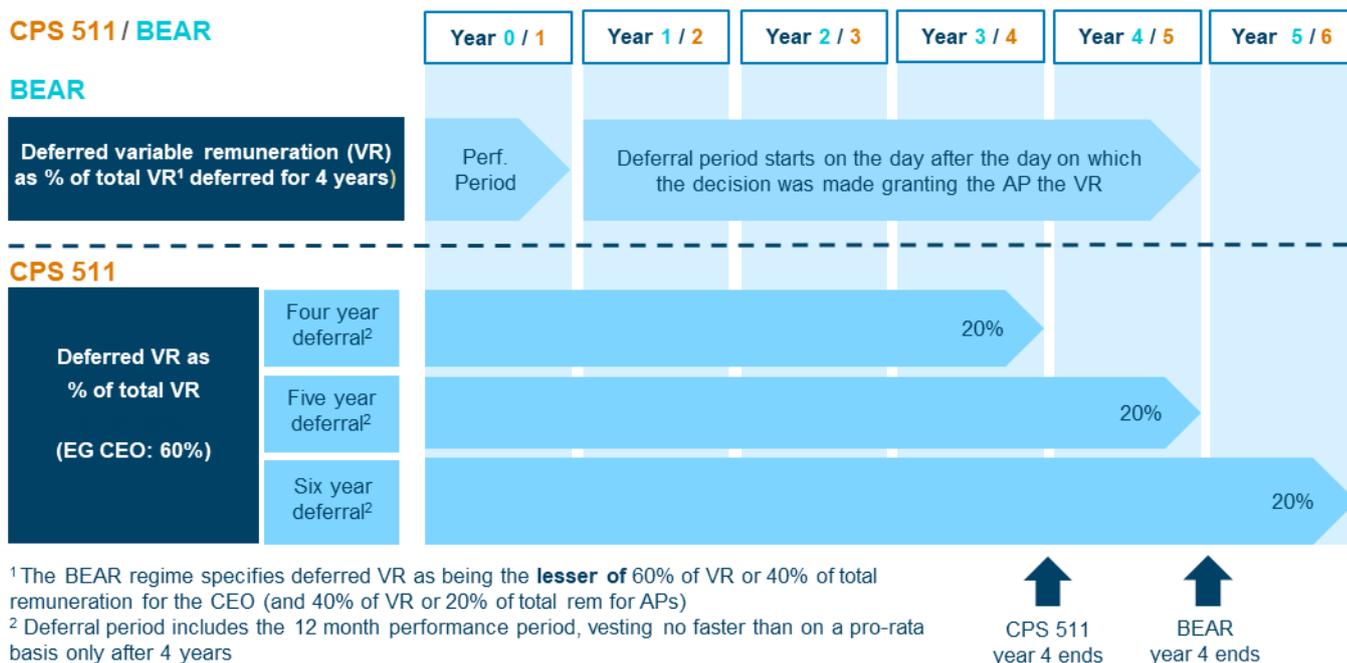
The deferral period includes the period over which performance is assessed where the assessed outcomes occur primarily in that period or in subsequent periods.

This proposed drafting would make clear that performance measures that concern the current performance period are allowable, even if they are assessed at the conclusion of the period rather than its commencement.

Deferral period – alignment with BEAR / FAR

20. As noted above, paragraph 52 appears to require that deferral period includes the performance year. This is supported by commentary in the Response Paper. We note that this is different from the requirements of the BEAR under section 37EC of the Banking Act 1959 (Cth). This section requires that the deferral period starts when the decision to grant the variable remuneration is made. This means that the deferral periods under CPS 511 and the Banking Act will have different commencement points. See the graphic below for a depiction of this issue.
21. This means that the four-year deferral for CPS 511 for the first pro-rata component that may vest would be overridden by the BEAR requirement. Pro-rating vesting would only be able to commence at CPS 511's year 5. We would ask that APRA consider working with the

Treasury in the development of the FAR so that FAR's deferral periods commence in the performance period, consistent with CPS 511.



Adjustment for adverse risk and conduct outcomes

22. Page 22 of the Response Paper indicates that the assessment of whether variable remuneration needs to be adjusted for adverse risk and conduct outcomes should occur '...prior to the grant being made for an LTI'. We had two thoughts on this for APRA's consideration:

- First, we cannot see a specific obligation in CPS 511 that would require this (paragraphs 36, 42 and 43 do not seem to include an obligation this precise); and
- Second, the appropriate time to modify a LTI would vary at any time before it is *received* (which may be grant or vesting).

APRA may like to consider how to appropriately reflect the expectation expressed on page 22 in CPS 511.

Clawback

23. While we remain cognisant of the difficulties of applying clawback in practice, we note the changes made to the clawback requirements. As a residual observation, the standard does not appear to take into account that employees will likely have paid tax on the vested variable remuneration at the time we seek to apply clawback. Does APRA expect entities to seek the originally paid variable remuneration or a quantum that makes an allowance for taxes that the employee has paid?

Non-financial measures

24. We note the observations in the Response Paper and footnote 11 of CPS 511 going to APRA's view of total shareholder return as a financial measure. We continue to hold the view that the performance of a company's share price must necessarily reflect how well it manages risk. This is because poor risk management can clearly impact the soundness and viability of an institution, as well as potentially reducing dividends available for distribution to shareholders (e.g. if a significant fine is paid or a material loss is incurred).
25. We look forward to any guidance APRA may provide on appropriate non-financial measures for the purposes of CPS 511. It will also be important to consider whether the measures need to be homogenous across relevant individuals, or whether the measures can be tailored to the businesses that those individuals manage or operate within. For example, the issues and risks faced by institutional banking businesses can vary from those faced by retail banking businesses. Guidance from APRA on whether individually-tailored measures are permissible would be appreciated.

Board oversight of senior officers outside of Australia

26. We interpret 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.
27. We wondered:
 - Whether this is the right drafting outcome; and
 - If the footnotes could be clearer in clarifying that the observations in them apply to:
 - a. senior officers outside of Australia of all APRA regulated entities;
 - b. senior officers of a Foreign ADI; and
 - c. senior officers of a Category C insurer.
28. On the second point, 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), then the removal of the comma following '...outside of Australia' in both footnotes may be helpful. It would be even clearer if the words '...of a Foreign ADI or of a Category C insurer' were repositioned to follow '...is a senior manager'.

Service providers

29. Paragraph 20(c) requires that APRA-regulated entities have a process to identify and address inconsistencies with paragraph 19 that may result from the remuneration arrangements of service providers. We interpret this as allowing a risk-based assessment of those arrangements. We do not understand this paragraph to require that each service provider contract needs to be reviewed individually, regardless of the materiality of the contract to the question of whether a remuneration framework meets the expectations of paragraph 19 of the CPS 511. The discussion on page 19 of the Response Paper supports this interpretation.
30. We note that there could be some tension between this risk-based assessment approach and the requirement in paragraph 40 that APRA-regulated entities take appropriate steps to assess and mitigate conflicts of interest in the design of its remuneration arrangements, including service contracts. Paragraph 40 could be interpreted as requiring that each service contract be influenced so that conflicts of interest are mitigated. However, such a granular approach would appear to be contrary to the more risk-based approach contemplated by paragraph 19. We believe that paragraph 40 needs to be complied with in light of the expectations set out in paragraph 19. If APRA believes that paragraph 40 requires a more granular approach, it may be useful if this were set out specifically.

Specified roles

31. As we noted in the 2019 Submission, we remain concerned about the number of definitions that will now exist through the APRA regulatory framework concerning individuals. We would encourage APRA to work with the Treasury on rationalising these as the FAR is designed. For example, the concept of 'senior manager' in CPS 511 could be replaced with the concept of a FAR 'accountable person'.

ENDS