

12 February 2021

General Manager  
Policy Development  
Policy and Advice Division  
Australian Prudential Regulation Authority

Dear General Manager

### Submission: CPS 511 draft and response paper

Guerdon Associates appreciates the opportunity to provide its submission on the "*Response Paper- Strengthening prudential requirements for remuneration*" (the response paper) and draft CPS 511.

Guerdon Associates acknowledges that the response paper has addressed a number of industry concerns and issues raised in our earlier submission dated 23 October 2019.

This submission provides summary comments, brief background on our firm, responds to the revisions in the draft regulation, and provides feedback and suggestions where we see the potential to improve the draft standard for better prudential supervision, compliance and effectiveness.

### Summary comments

The less prescriptive nature for requiring non-financial measures to be incorporated into variable remuneration is welcome. However, this could be further improved by permitting remuneration to be configured to recognise a specified role's accountabilities, and the context in which the entity finds itself. We have suggested an approach that will meet this requirement, and still be capable of adequate supervision.

Of concern is the definition of variable remuneration. As defined, variable remuneration includes cash salary, as it is service contingent. We suggest a refined definition.

In addition, and associated with the emphasis on variable remuneration, is the allowance this provides for entities to circumvent the regulation, and unlisted entities in particular to have an unwarranted competitive advantage over listed entities. We have suggested a solution.

Lastly, we explain why the regulation is not sufficient to neutralise conflicts of interest in the oversight and management of remuneration. Again, we believe this can be addressed.

## About Guerdon Associates

Guerdon Associates is an independent<sup>1</sup> executive remuneration and board governance consulting firm. Our clients include a significant proportion of companies in the ASX 300, large private companies and pre-IPO companies. Offices are located in Melbourne and Sydney, with affiliate offices in London,, Zurich, New York, Los Angeles, Singapore and Johannesburg. The firm has worked with the boards of many of Australia’s listed companies including banks, insurers, superannuation funds and other financial services providers.

The firm’s submissions were among the most cited in the Productivity Commission’s review of executive remuneration and, over the years, it has contributed to Treasury, Australian Taxation Office and CAMAC consultations on numerous Corporations Act and taxation legislation changes, as well as regularly engaging with APRA and ASIC on remuneration matters.

As a provider of remuneration and governance advisory services and an expert observer of the impact of executive remuneration internationally, the firm can provide useful insight into:

- the effects of various remuneration frameworks; and
- alternatives or modifications that may more effectively contribute to sound prudential management.

## Feedback & Recommendations

### Consistency issues with the BEAR legislation

***Does not countenance a proportion of Total Remuneration if Variable Remuneration is low or non-existent***

The BEAR recognises that some entities may not have any, or little, variable remuneration that can be deferred and subject to malus in the event of undesirable outcomes. It addresses this by requiring that the greater of a proportion of Variable Remuneration or Total Remuneration be deferred and subject to malus and clawback<sup>2</sup>.

This ensures that the intent of the BEAR, and we contend, CPS 511, cannot be circumvented by providing remuneration primarily as fixed remuneration and little or no variable remuneration. In the fiercely competitive demand for executive expertise, the current draft standard would put ASX-listed and Australian-incorporated SFIs at a severe competitive disadvantage. This is because insitutional investors would not support executive remuneration that does not have a proportion of variable remuneration, whereas there is no equivalent requirement on unlisted SFIs. Amending CPS 511 to apply to either a proportion of Variable Remuneration or Total Remuneration will ensure there is a more

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<sup>1</sup> Independence is defined as a specialist provider of consulting services to boards to minimise conflicts of interest that may otherwise result from being a supplier of multiple services to both management and boards.

<sup>2</sup> The proposed FAR legislation, which will replace the BEAR, only required deferral of Variable Remuneration, consistent with the proposed APRA CPS 511. For reasons consistent with the suggestions in this submission, Guerdon Associates’ FAR submission, suggested a reversion to the BEAR standard. See <http://www.guerdonassociates.com/wp-content/uploads/2020/03/200214v2-Treasury-FAR-submission.pdf>

level playing field between ASX-listed and Australian-incorporated SFIs with their non-ASX listed SFI competitors.

The amendment would also ensure there are consequences for those in specified roles who may not receive any, or much, variable remuneration in the event of undesirable outcomes. These currently exist even in ASX-listed SFIs to individuals in specified roles that do have their remuneration is not subject to disclosure<sup>3</sup>.

In effect, the draft CPS 511 invites circumvention by all SFIs because it does not accept as possible that specified roles in the regulation may not receive Variable Remuneration.

We contend that the suggested approach improves the draft CPS 511, and is superior to other alternatives. In regard to the latter, we considered the UK PRA Rulebook 15.9<sup>4</sup>, which requires a balance between fixed and variable remuneration (whereby variable remuneration is subject to performance). We discounted this alternative because, in practical terms, it is more complex to supervise consistently across entities, as it requires judgment by supervisors for which they are not primarily trained or likely to be adequately equipped.

#### *Guerdon Associates' Recommendations:*

- 1. The new CPS 511 require that the greater of a specified proportion of Variable Remuneration or Total Remuneration be deferred, and subject to malus and clawback provisions.*
- 2. That APRA engage with Treasury to ensure there is consistency in this regard between CPS 511 and the proposed FAR.*

#### Definitional issues

##### ***Variable remuneration – clarification to apply to performance contingent remuneration and not salary and other purely service and time contingent remuneration***

The definition for variable remuneration in CPS 511 (with Guerdon Associates' emphasis in bold) "*means the amount of a person's total remuneration that is conditional on objectives, which include performance criteria, **service requirements** or the passage of time.*"

It is accepted that this definition was intended to capture remuneration arrangements that may otherwise circumvent CPS 511, such as converting incentive opportunities into service contingent equity and/or time vested equity grants.

However, under this definition, cash salary and other fixed remuneration elements will also be variable remuneration, as they are earned on an hourly basis and are hence service contingent.

We expect this is unintentional, as application of aspects of the standard to fixed remuneration would contravene the Fair Work Act (for example, the application of malus and clawback).

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<sup>3</sup> That is, they are not Key Management Personnel (KMP) as referred to in the Corporations Act, defined in AASB 124 [https://www.aasb.gov.au/admin/file/content105/c9/AASB124\\_07-15.pdf](https://www.aasb.gov.au/admin/file/content105/c9/AASB124_07-15.pdf)

<sup>4</sup> [https://www.prarulebook.co.uk/rulebook/Media/Get/35f7f672-25b2-4147-afbe-05165c42bf17/PRA\\_2015\\_53/pdf](https://www.prarulebook.co.uk/rulebook/Media/Get/35f7f672-25b2-4147-afbe-05165c42bf17/PRA_2015_53/pdf)

In any case, Guerdon Associates' Recommendations 1 and 2 more effectively address circumvention by ensuring some remuneration is deferred for malus and clawback purposes, which is not the case with the current draft.

*Guerdon Associates' Recommendation:*

3. *The new CPS 511 define variable remuneration as "the amount of a person's remuneration that is conditional on performance criteria."*

Annual fixed remuneration, while contingent on continued service, is not classified as variable remuneration under this definition, nor will other service contingent or time vested deferred remuneration. But these elements will be captured if recommendation 1 is also adopted.

***Material weight – Do not define material. Instead, substitute 'balanced' for material***

The replacement of a required proportion of Variable Remuneration for non-financial performance measures with a less prescriptive requirement is welcome. However, the method itself raises further issues.

Paragraph 37(a) of the draft regulation requires "material weight" be given to non-financial measures where remuneration is performance related. "Material weight" is not defined. Footnote 11 suggests that a 100% weight on share price or profitability performance does not provide "material weight" to non-financial measures. This is not particularly helpful, as it is likely that a 99% weight on share price or profitability performance would also not be acceptable, or desirable, although this is not indicated in the regulation.

In contrast, the Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices<sup>5</sup>, released by the FSB in March 2018, is more nuanced and helpful. It recommends the integration of non-financial considerations for a "balanced" approach to performance assessment and compensation.

We suggest removing the reference to 'material', and instead require Variable Remuneration to be contingent on an appropriate "balance" of financial and non-financial measures. The balance would take into account the responsibilities of the specified role, and the organisational context.

For example, some positions will have responsibilities that need to focus more on non-financial risk and controls, others will need to focus more on customer outcomes, and others will need to focus more on generating sufficient financial margins within an acceptable risk appetite and protect capital integrity. It is highly unlikely each position will have the same focus or balance of financial and non-financial measures. And, in the context of effective remuneration design, they should not have the same balance.

Organisation context could, for example, take into account that a company under financial stress would, of necessity, focus on financial measures supporting survival. On the other hand, another company responding to enforceable undertakings may weight measures towards non-financial outcomes, while another company requiring customer satisfaction and retention may focus on non-financial outcomes such as net promoter score.

In each case the 'balance' of measures will be dictated by the job responsibilities (clearly required under the BEAR and FAR) and business context.

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<sup>5</sup> See page 2 of <https://www.fsb.org/wp-content/uploads/P090318-1.pdf>, and elsewhere within this FSB supplementary guideline, especially section 2.1 on page 10.

In suggesting this, we have also considered the need for a consistent and high standard from APRA supervisors who may not be expert in remuneration matters. It is considered that a consistent and high standard of supervision can be attained with this approach through the application of centrally and expertly developed remuneration “stress tests”, and by access to the independent review of remuneration effectiveness already specified in CPS 511-32, providing the latter recognises suggestions put forward later in this submission. Our recommendation below also assumes a specified role will have an accountability statement as currently required under the BEAR.

*Guerdon Associates’ Recommendation:*

4. *APRA replace clause 37.(a) with “balance financial and non-financial measures where the remuneration is performance related in accord with specified role’s accountability statement, organisation priorities, and impact on each of **financial** and non-financial risk”;*
5. *Supervisory teams be assisted in their assessment of balance by the application of centrally developed remuneration stress tests*

***Material weight to non-financial measures where performance measures exist<sup>6</sup> applying to each component of variable remuneration***

Clause 37 requires “**each component** of a person’s Variable Remuneration **must** give material weight to non-financial measures”.

This is unnecessarily prescriptive and can require complex performance measures that are not fit for purpose.

The only thing that is important is that unacceptable non-financial risk is minimised with the appropriate application of remuneration. So, if the primary focus of a position in the short term is action to shore up capital adequacy, that should be permitted in annual incentives, providing that, for example, such actions do not in some way impact progress to a longer term improvement in net promoter score in the long term incentives. This, in relation to both the recommendation below, and the recommendation above, is a more “balanced” variable remuneration approach.

Another example could be a balanced approach that emphasises malus for non-financial risk management. That is, an unacceptable non-financial outcome can be discouraged by forfeiture of deferred variable remuneration (or, if recommendation 1 above is accepted, any deferred remuneration).

The clause also fails to recognise that some non-financial measures are better achieved in some components than others. For example, ADI net promoter score improvement probably requires a major, longer term and sustained investment in technology best measured over the long term. It is less effective in short term measures that, in effect, do not reward fundamental improvement over time, but improvement from the prior year’s poor result.

This approach is also recognised in the Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices in its discussion of a “balanced” approach.

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<sup>6</sup> Section 4.3 response Paper Strengthening prudential requirements for remuneration 12 November 2019 page 21

*Guerdon Associates' Recommendations:*

6. *APRA replace CI 37's "The determination of each component of a person's variable remuneration must" with "The determination of a person's variable remuneration must"*
  
7. *The new Prudential Practice Guide 511 acknowledge the use of entity-wide and/or individual gateways, modifiers and inputs in both short and long-term VR plans as being compliant to the extent that the entity can demonstrate there is an appropriate balance in the remuneration design and a robust process to determine individual VR outcomes (refer commentary and recommendation #2 above).*

Requirements of the standard

***Board oversight of remuneration – review of remuneration framework***

The proposed CPS 511 has not tackled the issue of over-reliance on a conflicted source of remuneration advice i.e. management.

Clauses 31 to 35 require regular reviews of the remuneration framework. Clause 32 requires a review every 3 years by "operationally independent" , appropriately experienced and competent persons. In effect, the internal human resources department can conduct this review and the entity will comply. The entity's board receives advice that is conflicted, as it would every year from management reports in response to clause 31.

Clause 33 requires that the APRA-regulated entity must document and report the results of the annual compliance and triennial effectiveness reviews to the board remuneration committee (or the relevant oversight function for a foreign ADI). In effect, the process as outlined is asking the fox to report to the farmer on how many chooks remain in the hen house.

If the review is external, this wording could provide management with the leeway to issue only a carefully messaged summary to the board, whereas the board should have access to unabridged final reports to ensure understanding of nuances not considered to be headline findings.

The remuneration effectiveness review is a key governance tool for the board in a principles-based regulatory environment as it will reveal whether the remuneration framework is appropriate to that entity, operating as intended and delivering the desired outcomes. The review would cover all aspects of the CPS 511 standard (balance, deferral, adjustments etc) and test whether the four key requirements of the Standard are being met by an entity's remuneration framework.

Various enquiries<sup>7</sup> have indicated that many entities have failed in the design of their remuneration framework, or in monitoring it to ensure the design operates as intended.

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<sup>7</sup> These include the following:

- Retail banking Remuneration Review at [https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL\\_Rem-Review-Report.pdf](https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf)
- Prudential Enquiry into the Commonwealth Bank of Australia at [https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry\\_Final-Report\\_30042018.pdf](https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry_Final-Report_30042018.pdf)

As the effectiveness review is required of SFI's only, it is not unreasonable that it be conducted by persons who are independent and free of conflicts of interest.

We also note that the requirement to undertake both compliance and effectiveness reviews has been removed from the requirement for non-SFIs. We are concerned from our consulting observations that while boards will focus on ensuring that a remuneration framework is compliant with laws and regulations, there is rarely thought or analysis provided as to whether a remuneration framework delivers the stated goals, strategy and objectives or is fit-for-purpose for the circumstances of that company. The influence of proxy adviser tick-a-box' remuneration report voting recommendations, the homogeneous design of remuneration frameworks which has emerged in the last 10 years, and the principles-based approach in the revised CPS 511 all point to the need for boards to be engaged and informed via independent, evidence-based advice.

*Guerdon Associates' Recommendations:*

8. *Amend clause 32 from "In addition to the annual review of compliance, the effectiveness of the remuneration framework must be subject to a comprehensive review by operationally independent, appropriately experienced and competent persons at least every three years." To "In addition to the annual review of compliance, the effectiveness of the remuneration framework must be subject to a comprehensive review by independent, appropriately experienced and competent persons **with no conflicts of interest** at least every three years."*
  
9. *Amend clause 33 from "An APRA-regulated entity must document and report the results of the reviews required under paragraphs 31 and 32 of this Prudential Standard, to the Board Remuneration Committee, or relevant oversight function, in a timely manner. The Board Remuneration Committee, or relevant oversight function, must take appropriate and timely action to ensure the findings of these reviews are adequately considered and addressed" to "An APRA-regulated entity must document and report the results of the reviews required under paragraphs 31 and 32 of this Prudential Standard, to the Board Remuneration Committee, or relevant oversight function, in a timely manner. The Board Remuneration Committee, or relevant oversight function, must take appropriate and timely action to ensure the findings of these reviews are **free from conflicts of interest** and adequately considered and addressed. "*

***SFI classification – companies transitioning from non-SFI to SFI status***

Neither the draft regulation or response paper provide a process for calculating compliance with the asset thresholds. We have clients that are or may be on the cusp of the proposed threshold, such that a single acquisition or merger could result in their exceeding threshold. In this situation, an organisation would not be able to implement the SFI requirements immediately. The adoption of the BEAR asset threshold calculation

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- Remuneration Practices at Large Financial Institutions at <https://www.apra.gov.au/sites/default/files/180328-Information-Paper-Remuneration-Practices.pdf>
  - Self Assessments on Governance, Accountability and Culture at [https://www.apra.gov.au/sites/default/files/information\\_paper\\_self-assessment\\_of\\_governance\\_accountability\\_and\\_culture.pdf](https://www.apra.gov.au/sites/default/files/information_paper_self-assessment_of_governance_accountability_and_culture.pdf),

would provide a necessary transition period during which the required changes to the remuneration framework, policies and processes could be executed.

*Guerdon Associates' Recommendations:*

*10. We recommend that the asset threshold applied to CPS 511 draw on the existing averaging methodology supporting the BEAR regulation (averaged over the previous three years where an entity has submitted reports - or less, where fewer than three years have been submitted).*

*For example, where an entity has been in operation for more than three years:*

*General Rule<sup>8</sup>*

*The general rule applies where the ADI has submitted at least three final reports to APRA before the current financial year. The amount included in those final reports as total assets is averaged and the result is the 'total resident asset value'.*

*The average is reduced to two years if the entity has only been in operation for less than three years and two reports submitted, reducing to the 'total resident assets' reported if the entity has submitted only one final report.*

## Concluding remarks

Guerdon Associates trusts that our observations and suggestions are of value, and appreciate the opportunity to make this submission.

We would be pleased to respond to any queries you may have in relation to this submission.

Yours faithfully

Guerdon Associates

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<sup>8</sup> *Banking Act 1959 - Banking Executive Accountability Regime (Size of an Authorised Deposit-taking Institution) Determination 2018*