

23 July 2021

██████████
General Manager Policy
Australian Prudential Regulation Authority

Dear ██████████

Submission: Draft Prudential Practice Guide CPG 511 – Remuneration

Guerdon Associates appreciates the opportunity to provide its submission on the "*Prudential Practice Guide – Draft CPG 511 Remuneration*" (the Guide).

Guerdon Associates acknowledges that the Guide is based on the draft and not final version of CPS 511 prudential standard on remuneration. While the most recent version of the prudential standard addressed several industry concerns and issues raised in our earlier submission dated 23 October 2019, it has, in our view, still not sufficiently addressed several issues. These have been described, with suggested alternatives, in our submission of the 12 February 2021.

This submission responds to the draft guide, providing feedback and suggestions where we see the potential to improve the draft for better practice, prudential compliance and effectiveness.

Summary comments

The less prescriptive requirement for non-financial measures to be incorporated into variable remuneration is welcome. So is the guidance that the deferral period for any variable remuneration is from the beginning of the performance period.

The guidance on assessing the materiality of non-financial measures can be enhanced by recommending organisations take into account the relative weight of non-financial measures across the entity and across cohorts. This would permit better organisation and position design, with clearer accountability mapping, as well as more variability in relative weighting within specified roles.

The most pressing need is more guidance on what constitutes variable remuneration. The regulation as it stands can permit any remuneration to be variable remuneration, and provides no exemption for salary and ordinary earnings, as provided by the recently released draft FAR legislation.

Some of the guidance introduces further obfuscation rather than clarity, by citing examples of variable remuneration that do not have any reference to "time, service, or performance".

About Guerdon Associates

Guerdon Associates is an independent¹ 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, Kiev, 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

Aligning remuneration and risk

Paragraph 12 suggests assessment of performance and risk in determining remuneration outcomes using two sources:

- self-assessment, and
- risk management personnel

This is too limiting. As a guide, it may be reworded to suggest that assessment must include input from risk management personnel, and may also include:

- Self-assessment
- Supervisor assessment
- Peer assessment
- Customer assessment
- Subordinate assessment
- Independent external assessment
- Board remuneration committee assessment

Board oversight and discretion

¹ 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.

Paragraph 15 suggests board intervention and discretion is particularly relevant in unusual or exceptional circumstances in order to exercise downward discretion. It is recommended that an additional paragraph be added to include in the oversight function the need for the remuneration committee to ensure active application at all times, even when over-ride discretion is not necessary.

This would see a reasonable proportion of employees receiving adjustments that, while not material to many, signify high standards of risk management and active application. This will ensure adjustments are made to as a matter of course for all specified roles, and is more likely to embed the importance of risk management in entity culture.

The additional paragraph would require the Board to actively oversight the application of remuneration adjustments to ensure the vigilant application of high risk management standards. The paragraph would complement paragraphs 18 and 19 and would not be considered to be a “high reliance on downward adjustments for adverse risk and conduct outcomes” described in paragraph 59, which APRA stated should lead to consideration of a higher weighting for non-financial measures.

Remuneration design

Paragraph 38 appears contradictory. On the one hand it suggests a prudent entity will have an appropriate balance between fixed and variable remuneration to ensure there are appropriate incentives for performance and risk management. On the other hand, it recognises that entities may decide not to offer variable remuneration, if this does not support their objectives or business model.

In our submission on the CPS 511 regulation we noted that entities may consider not providing variable remuneration so as to circumvent the remuneration requirements applying to an SFI. This would not support the prevention and mitigation of conduct risk. We further suggested that regulation emulate the BEAR, and require deferral of the greater of an amount of variable remuneration or total remuneration.

Table 2 in paragraph 40 recognises time-based awards as variable remuneration, consistent with APRA definitions in the past, even if they are in effect not variable. Time vested remuneration does not feature in the draft FAR legislation released on the 23rd of July which presents an anomaly between the two regulations.

The table also notes “incoming and termination” awards as variable. As practised now, this is often not the case. For example, a buy-out of an incoming recruit’s deferred STI is likely to be paid as cash or replicated with an award which will vest in line with the original vesting timing. It would be difficult to justify this as part of variable remuneration requiring 40% deferral for 4 years. We suggest a refinement on guidance on this matter later in this submission. The same table also categorises these payments as “more complex” to “be avoided”.

It is suggested the table be revamped for clarity to:

- only include those that are unambiguously “common forms of variable remuneration”
- relabel “more complex” arrangements to “less acceptable forms of remuneration”
- only include those that are unambiguously “less acceptable forms of remuneration”

- remove repetition²

An example is below.

<i>Common forms of acceptable variable remuneration</i>	<i>Cash, non-cash and equity-based remuneration; Service, time-based or project completion awards; Short-term incentives, which reward performance over a period of 1 year or less, and longer term incentives for periods beyond this</i>
<i>Unacceptable variable remuneration</i>	<i>Lending and leveraged arrangements, such as shares funded by a concessionally priced loan, which can be highly sensitive to movements in share prices; Equity options, which can generate highly geared incentives on the upside and limited downside; and Hedging arrangements for equity-based remuneration, which are prohibited under CPS 511 as they undermine the purpose of deferral.</i>

Revamping the table, as per the above example, to remove ambiguities still does not assist entities in identifying what is variable remuneration for the purposes of compliance. In this regard the draft guidance is lacking. As it stands, variable remuneration can be anything. For example, unlike FAR, CPS 511 and this draft guidance does not specifically exclude ordinary earnings. Ordinary earnings are contingent on service, and so are considered variable remuneration. Even if this is carved out of the definition, as per the draft FAR, there is still difficulty in establishing if something is variable remuneration. For example, in what manner can "Guaranteed cash payments, which are not performance related, or up-front payments, which are not deferred" be considered variable within the current definition of variable remuneration of CPS 511? Yet, these examples appear in the paragraph 40 table.

Paragraph 45 suggests that the use of gateways, modifiers and other remuneration adjustment tools can be effective, but would be unlikely to meet the expectations above if used only in cases of significant adverse risk and conduct outcomes. This is worthy of extension, in so far as the use of modifiers:

- can be a very effective method of emphasis on a key aspect of performance (financial or non-financial),
- can be applied to recognise above or below expectations of performance, and
- can be graduated for the full range of adjustment in accord with performance.

As currently worded, paragraph 45 could dissuade entities from applying a very effective mechanism to reward for performance improvement. As an alternative, it is suggested that paragraph 45 be split, and a new paragraph be worded along the following lines:

“(new) 46. The use of gateways, modifiers and other remuneration adjustment tools can be effective, but would be unlikely to meet the expectations above if used only in cases of significant adverse risk and conduct outcomes. To meet expectations they need provide for a graduated and variable reward for risk and conduct outcomes both above and below expectations.”

² For example, deferred awards, including amounts that remain on foot following termination are a subset of service, time-based or project completion awards, and or long term incentives

Defining non-financial measures and Determining a material weight

A critical aspect of CPS 511 on which entities require more guidance is assistance with determining a material weight. In Guerdon Associates' prior submissions we have suggested that "material" be replaced with "balanced". This permits a more holistic view of organisation and job design, enabling an integrated management of risk.

The draft recognises, to an extent, that "material" should promote a "balanced" approach to incentives in paragraph 46. This guidance can be extended by suggesting that materiality be assessed holistically across all specified roles such that a balance is achieved in terms of materiality across the entire cohort. This is implied in paragraph 59, but could be made more explicit in this paragraph as a means to determining material weight.

This enhanced guidance would permit risk and control functions to focus more, and subsequently have most or all of their weighting on non-financial measures, while other positions in, say, sales or branch management, could have a greater weight on financial outcomes. The risk aspect of this is described in paragraph 57, although it is not explicit that the balance of "materiality" can swing the other way for other positions.

All specified roles could remain subject to significant consequence management adjustments on deferred remuneration for undesirable non-financial outcomes. Likewise, modifiers could be applied to heighten non-financial measure importance. But each role could have an appropriate weighting to measures pertaining to the position's primary purpose, and be consistent with, as well as complement, the accountability maps required under FAR. With some roles the weight of KPIs may remain financial. But across the entity there would be an appropriate balance as well as materiality of non-financial measures. This is noted in paragraph 51(b), but could be first introduced in paragraph 46.

It is believed this enhanced guidance will encourage more attention on organisation design, providing balance and sound prudential management across organisations as a whole in an efficient manner.

Deferral

Paragraph 63 is welcome guidance, in that it reinforces the improvement in the CPS 511 regulation from earlier drafts. That is, it confirms that the deferral period starts from the beginning of the performance period, whether that be an annual incentive ("STI) or long-term incentive. However, some qualification may be needed in reference to sign-ons and buy-outs, by saying these would be variable to the extent that they replicate variable remuneration terms and remaining vesting periods from prior employment.

Review of the remuneration framework

Paragraph 81 requires that where a triennial effectiveness review is conducted by internal staff a *"prudent Board would gain assurance that they are operationally independent and are able to provide an objective review, with the requisite skills, experience and expertise"*. We suggest that this be enhanced. Any staff eligible for variable remuneration and in a specified role would have a conflict of interest in conducting such a review. While we would expect that an individual capable of a triennial review would most likely already be in a specified role, the only way to ensure there is no conflict of interest, would also to ensure that the individual is also not eligible for any variable remuneration, as permitted under paragraph 38.

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