Australian Institute of Company Directors

18 Jamison Street
Sydney NSW 2000
www.companydirectors.com.au
ABN 11 008 484 197

T: +61 2 8248 6602
F: +61 2 8248 6633

22 October 2019

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

Via email: PolicyDevelopment@apra.gov.au

Dear General Manager, Policy Development

Prudential Standard CPS 511: Remuneration

Thank you for the opportunity to provide a submission on APRA's draft Prudential Standard CPS 511: Remuneration.

The Australian Institute of Company Directors (**AICD**) has a membership of more than 44,000 including directors and senior leaders from business, government and the not-for-profit sectors. The mission of the AICD is to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society.

The AICD supports APRA in its aim to engage in stronger supervision of remuneration frameworks and focus on non-financial risk management.

We acknowledge that APRA's approach to developing the draft standard has been informed by the findings and recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (**Royal Commission**) as well as insights gained by APRA through its prudential inquiry into the Commonwealth Bank of Australia and other regulatory reviews.

Remuneration structures have the power to incentivise misconduct (as was demonstrated by the Royal Commission), but also to drive positive behaviours. The AICD acknowledges the need to review and strengthen the regulatory settings that apply to pay in the financial services sector.

Executive summary

The AICD is supportive of the development of a stand-alone prudential standard on remuneration, recognising the significant impact that remuneration structures can have on firm culture, conduct and performance, and the need to strengthen current remuneration practices.

We also support a number of key aspects of the standard, including requiring board approval of the remuneration policy and active oversight of an entity's overall remuneration framework, adjustments to remuneration outcomes to reflect performance and risk outcomes, and regular compliance and effectiveness reviews.

However, we are concerned that the more prescriptive elements in the standard may ultimately work against APRA's objectives. In some instances, they go well beyond financial services pay regulation in other highly regulated jurisdictions and do not appear to be grounded in a robust evidence base.

As currently drafted, the standard presents particular challenges for boards of listed entities given the “two-strikes rule” on the Remuneration Report, which could lead to an unworkable tension between regulator demands and investor expectations.

Further, while we agree that it is important to have mechanisms such as deferral to ensure alignment between risk and reward, we are concerned that some of the proposals, as currently drafted, could significantly diminish the motivational effect of long-term incentives.

AICD recommendations

In particular, the AICD believes that APRA should reconsider the following proposals:

- the requirement that the board approve the remuneration arrangements and outcomes for an expanded number of people, which, as currently drafted, is impractical and risks blurring the role and accountability of the board and management;
- the imposition of a 50% cap on financial metrics across all variable remuneration, which is a blunt instrument that undermines the board’s role in setting remuneration structures that are tailored to the needs of their organisations. Further, it does not accommodate the range of remuneration models used in the market, many of which may be more responsive to risk and performance outcomes; and
- the lengthy deferral period (with clawback on top) that applies across sectors, which is at odds with our understanding of international practice and is not sufficiently sensitive to differences in entity risk profile and strategy.

We include specific recommendations on alternative approaches to achieve APRA’s objectives in the body of our submission.

Overall, we consider it to be critical that boards retain responsibility and accountability for structuring executive remuneration and setting remuneration frameworks that are tailored to their organisation’s strategy and risk profile. Remuneration is an important lever available to the board to focus executive attention on key strategic, risk and performance objectives.

Boards have important compliance and strategic roles and must balance the two. APRA, through its prudential standards and supervisory approach, is in a position to take a holistic view of governance and should consider its broader expectations of the role of the board.

We also note that while APRA has expressly sought to align with international best practice, there are important nuances to overseas regulation that have not been reflected in the draft standard and which warrant further consideration. We address these in the body of our submission.

Finally, the AICD would support a more targeted sectoral approach, particularly for the superannuation sector given the materially different considerations that apply including organisational structure, risk profile, and approach to remuneration generally.

Our detailed responses to the consultation questions (that cover the issues raised above), along with AICD recommendations in relation to alternative approaches and other comments on aspects of the draft standard, are set out in the attached annexure.

Australian Institute *of* Company Directors

Next steps

We hope our comments will be of assistance. If you would like to discuss any aspect of this submission further, please contact Christian Gergis, Head of Policy, at cgergis@aicd.com.au or Sally Linwood, Senior Policy Adviser, at slinwood@aicd.com.au.

Yours sincerely

LOUISE PETSCHLER
General Manager, Advocacy

Australian Institute of Company Directors

ANNEXURE 1 – CONSULTATION QUESTIONS

1. Remuneration framework

- **Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework?**
- **What areas of the proposed requirements most require further guidance?**

The AICD supports the requirement for triennial operationally independent reviews of an entity's remuneration framework.

Annual compliance reviews and triennial effectiveness reviews will support boards in their oversight role, and test that remuneration frameworks are operating as intended.

We also believe that, if implemented, this proposal mitigates the need for APRA to be overly prescriptive in other areas (including, in particular, remuneration design – discussed further in section 3 below).

We note that paragraph 35 requires the Board Remuneration Committee to "take appropriate and timely action to ensure the findings of the reviews are adequately addressed and implemented". To ensure that the Board and Remuneration Committee have flexibility to take appropriate action, we suggest removing the assumption that the recommendations be implemented. In our view, it is sufficient that any recommendations be considered and addressed.

We also note that paragraph 36 prescribes a relatively sophisticated review. The requirement for the review to be operationally independent means that for many organisations, this will lead to the work being outsourced to independent consulting firms and additional compliance costs being incurred. This is a relevant consideration for APRA when considering the overall compliance burden, particularly for smaller firms.

AICD recommendation

Remove the words "and implemented" from paragraph 35.

2. Board oversight

- **Are the proposed duties of the Board appropriate?**

The AICD supports the proposed requirement that the Board actively oversee an entity's remuneration framework, and approve the remuneration policy.

However, we believe that the current drafting of the standard extends too far. Our understanding of the proposals is that they will effectively require the board to approve the remuneration arrangements and outcomes of an expanded number of people, beyond the accepted scope of the role of the board.

On our assessment, under the draft standard the Board Remuneration Committee would need to assess and make recommendations to the Board on the variable remuneration arrangements and outcomes for senior managers and highly paid material risk takers on an individual basis, as well as for other material risk takers and risk and control personnel on a

collective basis (paragraph 48). This assumes that the Board is then required to approve such arrangements and outcomes (although we note that this is not entirely consistent with paragraph 50, which states that the Board "must approve the variable remuneration outcomes for persons in special roles categories").

This is compounded by the broad definition of a highly paid material risk taker, which is open to interpretation and could result in inconsistent application across the industry.

We have sought feedback from members on the impact of this proposal and understand that for many (although not all) regulated entities it will materially increase the number of individuals that the board would be required to oversee on an individual basis (in some cases, by up to 100+).

Expanding the board's role to approve the specific remuneration arrangements and outcomes for a significantly expanded number of individuals undermines the focus of the board on its core oversight and governance role.

In many cases, the proposed requirements may not be realistic in terms of the breadth and detail of work to be added to the board's role.

This is not to detract from the need to use remuneration outcomes to hold individuals to account, which was a theme of both the Royal Commission and the APRA prudential inquiry into CBA.

Boards must be responsible and accountable for engaging in rigorous analysis to justify executive remuneration outcomes, including through the lens of conduct and risk issues. Similarly, in the context of other employees, clearer expectations may need to be communicated to managers throughout the organisation that appropriate adjustments to variable remuneration need to be made at all levels where risk failures have occurred.

We consider that this approach can be accommodated by the draft standard. For example, we note that paragraph 47 of the draft standard already provides that the Board Remuneration Committee must provide clear guidance to senior management on its expectations in determining the appropriate level and timing of risk adjustment to the variable remuneration outcomes for persons in special role categories.

AICD recommendation

We encourage APRA to provide greater clarity on the intended scope and application of the draft standard to the oversight and governance role of the board. In particular, we recommend drafting changes to ensure that the role of the board is clearly differentiated from the role of management.

This could include, for example:

- emphasising the governance and oversight role of the board;
- revisiting the definition of highly paid material risk-taker which is broad and open to interpretation. For example, it hinges on "maximum potential variable remuneration", which is a problematic concept for companies using profit share or equity plans (neither of which have a "maximum potential" figure). This may cause confusion and inconsistency in approach amongst entities, as well as inadvertently increasing the number of people captured; and

- more closely aligning the categories of people whose remuneration outcomes and arrangements are required to be considered on an individual basis by the board with APRA's current requirements.

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

The AICD supports requiring the establishment of a Board Remuneration Committee and the proposals in relation to Committee composition. We agree that it is important for APRA to be able to approve alternative arrangements where appropriate, so that the standard can operate in a flexible and proportionate manner.

While we agree that information flows to the Remuneration Committee are critical, we are concerned about the reference in paragraph 29 to the Board Remuneration Committee needing to receive "comprehensive" reporting that will allow it to assess whether remuneration outcomes of all remuneration arrangements align with the entity's remuneration objectives.

Information flows were examined in both the Royal Commission final report and the ASIC Corporate Governance Taskforce report on director and officer oversight of non-financial risk, with both reports emphasising, in effect, the importance of "quality over quantity" and the need for analysis and insight rather than excessive information and data. We would be concerned about any requirement that could be perceived as requiring a particular volume or granularity of information.

AICD recommendation

Remove the word "comprehensive" from paragraph 29, and emphasise that information flows should be focused on quality over quantity.

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?**

The role of the board in setting remuneration

Boards should be responsible and accountable for structuring executive remuneration and setting remuneration frameworks that are tailored to their organisation's strategy and risk profile. Imposing a prescriptive design requirement materially hinders the board from exercising an important lever to focus executive attention on key strategic and performance objectives.

The AICD considers that imposing a 50% cap on financial metrics across all variable remuneration (and to all APRA-regulated entities) is a blunt instrument that will not best achieve APRA's objective of promoting effective risk management, sustainable performance and long-term financial soundness.

There are sound reasons why boards should be given wide discretion in framing remuneration policies to ensure they suit the strategy, needs and circumstances of the

company from time to time. For example, there may be times where it may be appropriate for the board to place a high emphasis on financial objectives (such as when a company is in financial difficulty).

That said, it is clearly critical that risk management (particularly non-financial risk management) is adequately incorporated into plan design to ensure that remuneration structures drive the right behaviours, and decision-makers consider "how" performance has been achieved (as opposed to only "what" has been achieved).

Our strong view is that this would be best achieved by APRA focusing its regulatory approach on enhancing accountability and oversight, rather than applying prescriptive requirements to incentive design.

Unintended consequences of cap on financial metrics

APRA's Discussion Paper acknowledges that models other than a "scorecard" approach are currently used in plan design, including the application of gateways that set minimum levels of acceptable performance, modifiers which moderate and qualify scorecard outcomes, and overriding board discretion on all measures.

The AICD is concerned that in practice, the application of a 50% cap would impose a "one size fits all" scorecard approach onto companies as it does not clearly accommodate the alternative models referred to above. It could also result in:

- reduced accountability for the board in setting the appropriate mix of metrics;
- inappropriate vesting outcomes (eg, the 50% tranche based on non-financial metrics may vest despite inadequate financial performance or conversely the 50% tranche based on financial metrics may vest despite poor risk outcomes);
- opportunities or incentives for legal or regulatory "work-arounds", given the prescriptiveness and specificity of the proposed rules; and
- investor discontent, given strongly expressed views against significant weightings on non-financial metrics. This issue is particularly acute for listed boards in Australia given the "two-strikes rule" on the Remuneration Report, which could lead to an unworkable tension between regulator demands and investor expectations (discussed in more detail below).

Shareholders and remuneration

In structuring executive remuneration and setting remuneration policies, boards of listed entities must respond to expectations of investors and proxy advisers, who have strong views on how executive remuneration should be structured (including a strong preference for financial rather than non-financial targets).[1]

The challenges are compounded by the lack of any clear consensus on acceptable non-financial metrics that should be used as primary measures to determine the quantum of an award (as opposed to being used as a gateway, modifier or other adjustment, for example).

---

[1] For example, Institutional Shareholder Services (ISS)' Proxy Voting Guidelines for Australia provide that "*targets should be challenging but realistic and should closely reflect a company's ongoing business expectations. Where non-financial objectives are used as part of the performance conditions, ISS expects the majority of the payout to be triggered by the financial performance conditions. There should also be a clear link between the objectives chosen and the company's strategy*". See https://www.issgovernance.com/file/policy/active/asiapacific/Australia-Voting-Guidelines.pdf at page 18

Compliance with a design requirement that is unlikely to be palatable to investors and proxy advisers would create a tension for boards, given the levers available to shareholders in the Corporations Act, including the "two strikes' rule" referred to above.

Individual proxy advisory firms can hold significant aggregate influence over a company's register. This means that even if an entity were to determine that remuneration structures should change (including because they do not sufficiently align with desired culture), the market reality is that it is very difficult to implement change without investor and proxy adviser support.

Overall, the AICD considers it would be beneficial for APRA to consider this issue in more depth, including engaging with investors and listed boards. If the standard is implemented in its current form, the AICD's view is that it would necessitate a review of the overall framework of remuneration regulation.

Alternative approaches to promoting sound risk management

In practice, boards may wish to rely on a range of tools to support effective risk management through remuneration structures including, for example:

- a "conduct" gateway which would require minimum standards of behaviour, compliance and conduct to be achieved before any variable remuneration vests;
- in-period adjustments to ensure risk outcomes are appropriately reflected in remuneration outcomes;
- the use of risk modifiers/overlays to adjust or forfeit the overall quantum of an award (after a performance condition has been met) as a consequence of inappropriate conduct or risk outcomes. This is an important and positive tool that can address APRA's concerns and give boards the ability to exercise its discretion in a structured manner to take into account non-financial risk; and
- malus to reduce unvested variable remuneration subject to board discretion.

As acknowledged in the Discussion Paper, APRA has not seen evidence that more prescriptive approaches are effective in promoting better outcomes and, indeed, there is some suggestion that a strict rules-based approach is open to circumvention given the fluid nature of labour market dynamics.

Further, as APRA acknowledges, international experience demonstrates that practice is shifting in terms of the use of non-financial metrics (notably, without the imposition of any cap on financial metrics).

AICD recommendation

The AICD believes that a better approach would be for APRA to require entities to:

- design and implement variable remuneration arrangements that take into account the way that executives have managed risk (including compliance risk and conduct risk),[2] for example by using tools such as gateways and modifiers as set out above; and
- demonstrate to APRA how they have done so.

[2] See Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, page 347.

APRA could also provide that variable remuneration must not be determined solely on the basis of financial metrics and must consider performance in a holistic manner. For example, in the UK, variable remuneration must be risk-adjusted and based on an assessment of financial and non-financial performance of individuals, the business unit concerned and the firm as a whole.[3]

Such a principles-based approach could be reinforced through the regular remuneration effectiveness reviews, and APRA's own strengthened supervision and regulatory reviews.

In our view, this alternative approach would be consistent with Commissioner Hayne's recommendations and APRA's objective of encouraging better balanced remuneration frameworks in the sector.

- **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?**

We agree that deferral is an important feature of incentive schemes to align executive pay with a firm's risk horizon and business cycle. We also recognise that deferral is important in the context of financial or conduct failings, which often take some time to manifest.

However, as APRA recognises, there are trade-offs to longer deferral periods. We are concerned that the length of the proposed deferral periods could lead to significant unintended consequences and will diminish the motivational effect and value of long-term incentives. In particular, it could lead to:

- greater variable remuneration opportunities and/or higher fixed pay to compensate for the additional deferral;[4]
- a negative impact on ability to attract and retain executive talent, particularly from other industries or overseas; and
- increased recruitment costs when hiring from other APRA-regulated entities (to compensate for any deferred variable remuneration that is "lost" on resignation).

We also note that entities have unique strategies and face particular risks that crystallise over different time horizons. They also have different customer bases with varying levels of sophistication and vulnerability. These are highly relevant considerations when setting performance and deferral periods. Imposing a uniform approach on all Significant Financial Institutions (**SFI**) will undermine the ability of entities and their boards to align deferral with strategy and risk considerations.

We have addressed the implications for RSE licensees in section 6.2.

International comparison

We agree that it is important to consider international best practice in the context of the proposals in CPS 511. However, there are nuances to the approach taken in the UK and

---

[3] See FCA Handbook SYSC 19D.3.39 (1).

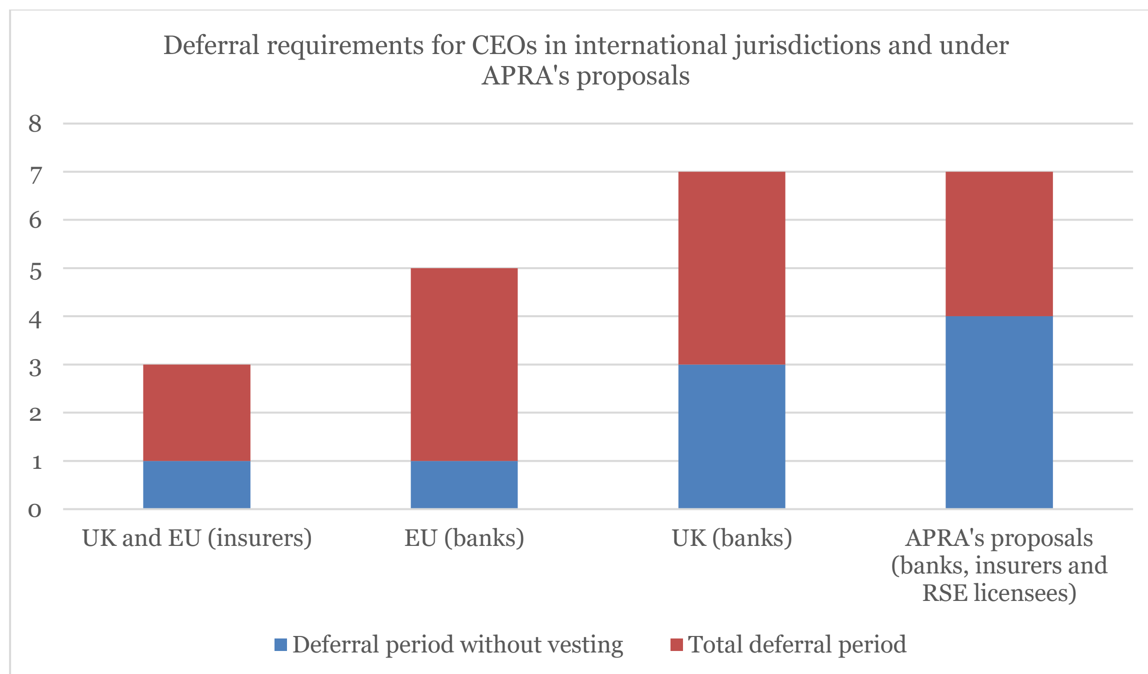
[4] A recent study suggested that executives typically discount the value of long-term incentives at a rate of over 30% per year, reducing the perceived value of a three-year deferred incentive by around 70%. See Pepper, Alexander (2017) *Applying economic psychology to the problem of executive compensation.* The Psychologist-Manager Journal. ISSN 1088-7156.

the EU that have not been reflected in the draft standard and which warrant further consideration.

In our view, there are further aspects to the comparative data used by APRA in the Discussion Paper relevant to the proposals, including:

- the deferral period for banks in the European Union is currently 3 - 5 years, not 7 years as stated in Figure 6 of the Discussion Paper. The European Commission recently reconsidered the length of deferral periods under the Capital Requirements Directive, and agreed to extend the length of deferral to a minimum of 4 - 5 years in December 2020;
- we are unclear of the source for the 3-year clawback period in the EU referred to in Figure 6, as Article 94(n) of the Capital Requirements Directive does not set a minimum clawback period;
- significantly shorter deferral periods apply to insurers in the EU and the UK under Solvency II regulations - 3 years, rather than 7 years. This sectoral approach has not been reflected in Figure 6 or APRA’s draft standard more broadly; and
- while in the UK a 7 year deferral period applies to the CEO, pro-rata vesting is available sooner - after 3 years, rather than 4 as proposed by APRA.

To illustrate these differences, we have set out below a comparison of the deferral periods that apply to banks and insurers in the UK and the EU:



More broadly, the Financial Stability Board’s Sixth Progress Report noted that “three years tends to be the typical requirement [for deferral] with 15 jurisdictions having adopted this requirement”.[5]

[5] FSB Progress Report, page 32. We note that APRA’s Discussion Paper suggests that “Nine out of 20 jurisdictions reported [in the FSB Progress Report] the upper-range for deferral to be between five and seven years.” It is important to note that this was reporting on market practice, not regulator-mandated deferral, and that “the data […] generally reflects the absolute outliers in the number of years in which compensation is

In light of the above, we are concerned that APRA's proposals are not consistent with the stated intention of placing Australia in line with better international practice. This will have a real impact on the ability of Australian financial services to attract and retain talent globally and from other sectors.

Interaction with BEAR

The Banking Executive Accountability Regime (**BEAR**) came into effect last year and included deferred remuneration obligations for certain executives.

We do not believe that further intervention in mandating different deferral periods is necessary or appropriate so soon after the changes introduced by BEAR and before they have had an opportunity to bed down.

We understand that regardless of the approach ultimately taken by APRA, it will work closely with the Government to ensure that there are no direct inconsistencies between legislation and CPS 511. We strongly support this commitment and consider that it will be critical (particularly considering the further changes that are expected with the extension of BEAR to insurance and superannuation entities).

Other comments

We note that paragraph 55 carves out any person with variable remuneration of less than AUD $50,000 in a financial year from the deferral period. It is unclear whether this is intended to solely reference the application of deferral to STI awards or also LTIs.

AICD recommendation

APRA could consider aligning the deferral period in CPS 511 with the deferral periods set out in BEAR. This will drive a real shift in longer deferral periods across financial services and better align Australia with international practice. It will also allow some time for industry to respond to and implement the broader changes in accountability and remuneration.

APRA could consider any need for extension as part of its review of CPS 511 or regulatory reviews more broadly.

Nonetheless, if APRA proceeds with implementing longer deferral periods, we strongly encourage APRA to consider:

- allowing pro-rata vesting earlier in the deferral period – for example, after 3 years for the CEO, and one year for other material risk takers;
- taking a sectoral approach to deferral periods, with shorter deferral periods for insurers (and superannuation entities, if APRA does not take a bespoke approach in the context of superannuation) than for banks, in line with international practice. For further comments on issues relevant to RSE licensees, see section 6.2; and
- clarifying that if an individual works for an APRA-regulated entity in an overseas jurisdiction that is also subject to remuneration regulations, then the foreign requirements will prevail if deemed acceptable by APRA.

---

deferred therefore data could be affected by a small number of employees" (see Graph 2 of FSB Progress Report, page 34).

We also suggest that the approach to the alignment of the BEAR with the draft standard be finalised (with appropriate industry consultation) before the standard comes into effect.

Finally, we believe that the specific criteria for the application of malus listed in paragraph 44 (when combined with the required for an entity to take reasonable steps to reduce deferred remuneration when any of the criteria is satisfied) need to be reviewed. By way of example we note the following:

- paragraph 44(a) ("a specific downturn in financial performance") – this is particularly broad, given the wide range of factors that may have contributed to any downturn;
- paragraph 44(b) ("evidence of misconduct or negligence resulting in losses") – this is loosely drafted. For example, it is also unclear why it is necessary to include "resulting in losses" as a qualifier; and
- paragraph 44(c) ("a failure to meet the entity's code of conduct") – this is overly broad, especially given the range of activities which codes of conduct often cover and lack of any materiality qualification.

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

The AICD has received strong feedback from members that they are concerned about the impact of the proposals on the ability of an organisation to attract and retain high calibre executive talent, particularly in roles that are not industry specific (such as risk, technology, customer and human resources) and from overseas.

Having competitive access to this cohort of talent is crucial to the sector's health and the ability of individual firms to create long-term value.

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?**

It is extremely difficult to implement clawback in practice, including because important employment law considerations come into play.

For example:

- Once variable remuneration has been paid or released, there is an increased likelihood of litigation by executives to contest any attempt to apply clawback.
- There are employment law considerations that entities will need to consider, and that may be ventilated through litigation. For example, an employer must ensure that it does not exercise its discretion "capriciously, unreasonably or arbitrarily" and that the application of clawback does not operate as an "unfair penalty".
- We understand that it many cases that cost of clawing back the remuneration may well exceed the value of the remuneration itself.
- Requiring entities to "take reasonable steps" to apply clawback (see paragraph 59) is therefore problematic, given it could be interpreted as requiring an entity to commence litigation regardless of commercial considerations.

Australian Institute *of* Company Directors

The proposed scope and criteria for the application of clawback is also problematic, particularly when combined with the "reasonable steps" requirement in paragraph 59. Including mandatory criteria relating to, for example, failure of accountability or general breach of compliance obligations is not consistent with the circumstances in which it would generally be appropriate to apply clawback (ie, serious misconduct).

Finally, it is unclear how paragraph 57(b) would operate in practice – at what point is the extended clawback period triggered? For example, in the UK, the clawback period can only be extended if the firm has given notice to the employee no later than 7 years after the variable remuneration was awarded.

AICD recommendation

We are aware of the complexity of the relevant employment law considerations and encourage APRA to engage with employment law specialists in relation to the legal and practical difficulties associated with clawback.

If APRA is minded to mandate the availability of clawback, boards should have discretion as to the criteria that apply and its application.

Amend paragraph 57(b) to make it clear that the extended clawback period is only triggered if the firm has given notice to the person before the expiry of the initial clawback period.

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

We suggest APRA take a phased approach to implementation, similar to the approach taken by BEAR.

We also encourage APRA to consider and make clear whether valid contractual arrangements that are inconsistent with the requirements of the draft standard will be grandfathered.

5. Transparency

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

We acknowledge that better transparency (as well as stronger supervision by APRA) may support APRA taking a more principles-based approach to the draft standard and driving improvements in practice and accountability.

Importantly, however, we also note that APRA expressly acknowledges that:

- it is a commonly expressed view that existing remuneration disclosures are extensive, yet do not contain meaningful information for investors or the community; and
- the Royal Commission highlighted the importance of data to understand the remuneration practices of entities, importantly distinguishing between quantity and quality of data.

AICD recommendation

Before introducing any new disclosure requirements, APRA should engage in detailed consultation to ensure that any proposed requirements will help achieve the desired policy objectives, and interact effectively with the complex body of existing regulation in this area.

In particular, we are aware of concerns that public disclosure of specific performance metrics could discourage firms from setting commercially sensitive, strategic targets. Similarly, detailed public disclosure of remuneration outcomes and consequence management may have privacy and HR implications. These issues should be explored in the context of any proposals on transparency.

Overall, we believe that APRA should also take a holistic approach to transparency, recognising the extensive remuneration disclosure obligations which listed entities must comply with.

We also note that APRA will need to engage with RSE licensees, mutual ADIs and other mutual financial services providers in relation to how additional transparency measures may affect their more limited disclosure and reporting requirements.

6. Other comments

6.1 Proportionality

The AICD supports a proportionate approach to remuneration regulation. As CPS 511 applies to all APRA-regulated entities, it is important that it retains sufficient flexibility and proportionality so that firms can adapt their remuneration structures in a way that is tailored to their size, internal organisation and nature, scope and complexity of activities. As the Financial Stability Board has recognised, "One size does not fit all – financial firms differ in goals, activities and culture, as do jobs with a firm."[6]

We note that at this stage APRA proposes to categorise Authorised Deposit-taking Institutions (**ADI**) with more than $15 billion in total assets; general and life insurers (excluding private health insurers) with more than $10 billion in total assets and RSE licensees with more than $30 billion in funds under management as SFIs, to which the more prescriptive deferral requirements apply.

This is a broad scope, and we are concerned that it establishes too low a threshold relative to BEAR. In effect, it moves focus from complex and systemically important institutions to smaller and simpler institutions. APRA would need appropriate resourcing and capacity to take on such a significant brief.

AICD recommendation

In our view, the current scope and application of CPS 511 is not sufficiently proportionate.

We are concerned with both the breadth and prescriptiveness of APRA's proposals, which do not appear to have been sufficiently tailored to account for the different business models, incentive structures and systemic importance of APRA-regulated entities.

[6] FSB Principles for Sound Compensation Practices.

We also consider that the definition of an SFI is too broad and out of step with other methods of categorising significant institutions, such as the definition of a large ADI under BEAR.

We note that the current definition of a large ADI for the purposes of the BEAR regime is any ADI with greater than or equal to $100 billion of total resident assets on a three year average. The gap between this definition and the definition of an SFI is significant, and the rationale for the inconsistency is not clear.

We recommend that APRA reconsider its approach to proportionality, for example by:

- aligning the definition of an SFI with the definition of a large ADI under BEAR;
- taking a tiered approach to categorising firms (for example large, medium and small), as is the case under BEAR, which will facilitate a more nuanced application of the rules; and/or
- taking a more targeted, sectoral approach that considers the different business models and incentive structures of banks, insurers and RSE licensees. Such an approach would be consistent with international practice, as noted above.

6.2 Application to RSE licensees

Evidence-base for regulatory intervention

It is unclear, from the Discussion Paper, as to what problem the draft standard is seeking to address in the superannuation sector. While Commissioner Hayne concluded that variable remuneration had helped drive poor customer outcomes in financial services, his comments were not targeted at the superannuation sector. Further, although Commissioner Hayne recommended that the BEAR be extended to superannuation, the degree of prescription contained in that regime is far less than that contemplated by APRA's draft standard.

We understand that variable remuneration is less common, and less complex, in the superannuation sector, particularly amongst not for profit funds. For various historical and cultural reasons, it has been much more infrequently used by boards to set the pay of senior executives. Practice is changing and variable remuneration is more common than just a few years ago however it is still more sparingly used and less complex than in other sectors of financial services.

It is AICD's sense, based on consultation with directors of superannuation funds, that the imposition of a prescriptive framework on a sector which is only just beginning its engagement with variable remuneration frameworks is likely to lead to many funds abandoning variable remuneration and sticking with traditional methods of fixed remuneration. This is likely to lead to an increase in fixed remuneration. We note that APRA's Discussion Paper observes that "if an outcome of the proposals was a move to a greater level of fixed remuneration, this could blunt overall performance incentives."

Unlike the ADIs and general and life insurers covered by the standard, very few of the trustees of RSE licensees are listed entities or part of a group of a listed entity (the same is true of mutual ADIs and other mutual financial services providers). Reporting and disclosure requirements, including for remuneration reporting, are less onerous and there is less information publicly available to enable an analysis of trends and practice to be done.

The AICD's own consultation with director members reveals significant differences in practices among RSE licensees. The lack of data on current industry practice is revealed in APRA's Discussion Paper which refers exclusively to practice within banking and insurance. APRA's 2018 *Information Paper on Remuneration practices at large financial institutions*, which makes similar observations to those we have made above, stated that as "there was only a small number of RSE Licensees in the sample, some caution is needed in drawing definitive conclusions".

The AICD recommends that APRA investigate further the practice of variable remuneration within RSE licensees and identify industry practice, trends and likely outcomes. In this respect we note that in his final report Commissioner Hayne stated 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".*[7]

Effect on fixed remuneration

As previously noted, it appears that fixed remuneration remains prevalent among senior managers in superannuation, particularly in the not for profit sector. One issue that requires clarification is whether APRA believes that the payment of fixed remuneration to senior executives and material risk-takers would meet APRA's standard for a remuneration framework as set out in paragraphs 17 to 20 (particularly whether it would meet the remuneration objectives of paragraph 20). These new standards differ to the current wording of paragraphs 27 and 28 of Prudential Standard SPS510 which only refers to the "performance-based components" of remuneration.

If the intent is that entities can choose to continue to pay fixed remuneration, then we suggest that the standard should be explicit on that point in the "Remuneration Framework" section of the document. If not, then this should be the subject of further research and consultation.

Financial performance measures

The AICD supports the standard excluding RSE licensee's investment return measures from the definition of financial performance measures as currently drafted. It is clearly appropriate for employees whose job it is to generate an investment return for beneficiaries to have their variable remuneration largely linked to that outcome.

Deferral and vesting requirements

The deferral and vesting requirements create particular issues for RSE licensees that are not for profit entities i.e. industry, corporate and public sector superannuation funds.

As the Discussion Paper makes clear, the provisions have been based on requirements for large ADIs under BEAR. This assumes that the variable remuneration is largely held as equity and not cash. Not for profit entities self-evidently are not able to utilise equity for the purposes of remuneration and are limited to cash payments. Cash is not suitable for such lengthy deferral and vesting periods. Obviously, depending on inflation, cash might lose a

[7] Final Report: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Volume 1 at p. 352.

substantial portion of its value in six or seven years and that decline in value would not be caused by the performance of an employee in their role. This would also help create an unlevel playing field not only with non-APRA regulated entities but within APRA regulated entities. APRA regulated entities that can use equity for LTIs will be advantaged compared to those who do not have that option.

We note the same considerations apply to mutual ADIs and other mutual financial services providers who similarly cannot use equity for remuneration.

In the event that these provisions are imposed upon RSE licensees in the not for profit sector then, based on our consultation with trustee directors, the AICD would expect that boards would consider moving more towards fixed remuneration and reducing or eliminating variable remuneration.

It is possible that the design of variable remuneration among RSE licensees already meets APRA's need for payout and vesting schedules to be commensurate with the possible range of risk and performance outcomes. For example, arrangements that link investment performance over a multiple year timeframe might address APRA's concerns that remuneration reflect the time horizon of risk, ensures that sufficient time has occurred to uncover misconduct risk and the financial interest and reasonable expectations of beneficiaries are being met. It discourages, for instance, a Chief Investment Officer from over-investing in short-term growth opportunities to maximise performance in a single year at the expense of long-term returns.

The AICD understands from its consultations that such arrangements are not unusual among RSE licensees. However, APRA is much better placed to undertake this detailed analysis to determine whether this type of practice is widespread and whether it would meet APRA's requirements without the need for vesting and deferral periods.

Employees of contractors

RSE licensees make extensive use of contractors to perform functions such as:

- administrators who manage the receipt and reconciliation of payments into client accounts;
- custodians who hold assets on behalf of the trustee; and
- insurance companies, financial advisers and investment consultants.

It is not clear whether these contractors will be caught, or are intended to be caught, by the provisions of paragraph 19(d) of the standard.[8]

AICD recommendation

In AICD's opinion the standard has been designed with the banking and insurance sectors in mind with limited consideration given to its effect in superannuation. Insufficient data has been presented that would enable the effect of the standard in superannuation to be properly evaluated. The likely effect is that the dial will switch from variable remuneration

---

[8] It is acknowledged that this is worded similarly to paragraph 31 of SPS510. However, while SPS510 refers to the remuneration policy covering a "service contract" between an RSE licensee and these bodies, paragraph 19(d) of the standard appears to go further by requiring at a high level a policy setting out the structure and terms of remuneration arrangements.

to higher fixed remuneration. The effect of the standard on other arrangements that are peculiar to superannuation do not appear to have been fully worked through.

In order to provide an opportunity to properly assess the effect of this standard on RSE licensees the AICD suggest that they should be excised from this standard.

This would allow time for APRA to undertake the detailed sectoral analysis and present a clearer picture of current arrangements and the problem which it seeks to address. The outcome of that exercise might be a bespoke standard for superannuation, incorporation within CPS 511 or an exemption for the sector from specific APRA regulation on remuneration.