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Australian Prudential Regulation Authority

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ASA SUBMISSION – RESPONSE TO APRA CONSULTATION PAPER CPS511 – STRENGTHENING PRUDENTIAL REQUIREMENTS FOR REMUNERATION

Dear Ms Richards

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. The ASA is an independent not-for-profit organisation funded by and operating in the interests of its members, primarily individual and retail investors and self-managed superannuation fund (SMSF) trustees. ASA also represents those investors and shareholders who are not members, but follow the ASA through various means, as our relevance extends to the broader investor community.

In response to APRA consultation paper CPS511 (the paper), ASA makes the points below, in the context of holding companies' directors to account for the remuneration policies and practices on behalf of retail shareholders.

In relation to the core elements of reform as outlines in the paper (and repeated in italics below)

• *strengthen governance of remuneration frameworks and outcomes, in particular through an expanded Board role, where the Board needs to be active and have direct oversight;*

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• *set overarching remuneration objectives that inform design of all remuneration arrangements and influence remuneration outcomes;*

Role of board in setting remuneration

ASA agrees the role of the board includes the development and disclosure of policies and practices for the remuneration of directors, the CEO and senior executives, and as in any decision-making process the evaluation of its effectiveness. The tone set at this level, permeates to all levels of employment within the entity, and its impact should be on the board radar for oversight of the effectiveness of the policies and practice.

We are concerned the emphasis on the board's activity suggested in the paper risks encroaching into management responsibility. We emphasise the board role is oversight of remuneration policies and practices and ensuring adequate reporting to the board to facilitate this oversight.

We are also concerned these guidelines may interfere with the current practice of shareholder approval of remuneration reports.

Remuneration reports - transparency and link between remuneration scheme and behaviour

ASA's 2019 Focus Issue on Remuneration aims to encourage greater transparency and meaningful information in remuneration reports. Companies are encouraged to move away from standard disclosure which simply complies with statutory requirements and draw the link between the scheme and behaviour it is designed to encourage.

More specifically:

Long-term incentive schemes should require behaviour that is measured cumulatively or on average over a number of years, preferably four or five:

• ASA will only support a remuneration scheme where there are long-term hurdles

• Market value should be used to calculate long-term incentives (LTI) grants, not fair value.

• A table of actual CEO and key management personnel (KMP) take-home remuneration should be provided in the remuneration report.

We also flag the importance of definitions of senior executives and other persons who may have a material impact on the entity's soundness (two of the three special role categories), maintaining as much consistency as possible between CPS511, Bank Executive Accountability Regime, Accounting Standards and Corporations Law. Are Key Management Personnel (KMP) equivalent to other persons who may have a material impact on the entity's soundness? We believe the highly paid material risk takers should be included in the KMP, both due to the level of remuneration and level of risk to the company.

Use of discretion

In the table summarising the key proposal at page 7 of the paper Board Oversight is said to impact entities with "Greater use of authority and discretion to achieve objectives". ASA notes we are uncomfortable with upward discretion and maintain an adequately structured remuneration scheme should not require the board use of upward discretion. We are comfortable with the use of downward discretion and highlight an example of a scheme encompassing downward discretion from BHP Annual Report 2019 at page 140:

If this holistic review determined that the scheduled vesting outcome would not be appropriate, the Committee has discretion to reduce vesting. The exercise of discretion – to adjust variable pay outcomes downwards – has been a feature of BHP's approach over many years where the status quo or a formulaic outcome does not align with the overall shareholder experience.

BHP exercised this discretion in 2016, reflecting the dam failure and its consequences at Samarco (a non-operated joint venture in Brazil) in November 2015 and other matters.

Non-financial metrics

• *limit the use of financial performance metrics (share price and profit-based);*

We note the paper is short on specificity in relation to what metrics will be acceptable and note for ASA they need to measurable, auditable and worthy of financial reward. Given that APRA may not want to specifically define outcomes and metrics in relation to each institution its prudential standard will govern, there are useful examples that may be considered as models to ensure adequate oversight is maintained by both the regulator and directors.

The Netherlands Bank's approach to assessing governance and culture involves the setting up of an expert centre resourced from a wide range of backgrounds – including psychologists, change experts and governance experts[1]. Considering Australia's significantly evolved financial, academic, legal and governance sectors, setting up a similar board to assess and identify optimal non-financial measures under APRA guidance would provide useful insights into identifying issues relevant to remuneration design and misconduct risk and create significant value for stakeholders in understanding the complexity and culture surrounding remuneration and risk governance in complex entities.

ASA believes this process would also aid in APRA's review of the effectiveness of the prudential standard and provide concrete, research-based evidence grounded within a specifically Australian financial context to support its development three years from its initial effective date.

ASA's current guideline limits long-term incentive non-financial measures to 30%, and this guideline may need to be reviewed in light of the proposals in this paper. We have historically voted against remuneration reports due to weak non-financial metrics and are struggling to identify robust measures other than the typical lost time injury frequency rates (LTIFR) measures and nil compliance breaches. Any hurdle needs to be measurable and meaningful.

We will not support schemes where the measures appear to either be required to be met to retain employment (where failure should see occupation of the role or employment terminated) or are a lame justification for paying additional variable pay.

ASA's preferred way to achieve balance between the financial and non-financial aspects of an executive role is to impose a gateway of non-financial performance metrics, before any financial award is able to be accessed. The ASA believes that gateways pertaining to specific business groups as a whole instead of concentrating on individuals within an organisation would be more effective in addressing misconduct risk and promoting healthy, ethical behaviours.

Recent research from cases of corporate and financial misconduct has indicated that even if offending individuals are removed from an organisation, the risk of ethical misconduct remains as long as there is no lasting behavioural change within the organisation.[2,3] To successfully reduce the risk of misconduct, managing remuneration design needs to include all business units within an organisation, and address the environment which has led to a toxic corporate culture rather than placing the blame in an individual who when removed leaves the toxic environment to continue.

Balance financial and non-financial metrics using financial gateways

The ASA would support financial gateways being applied to remuneration design in ways that allow the measurable assessment of ethical behaviours within an entire business unit. The aim being to reduce and eventually remove a greater risk of misconduct in the future by affecting behaviours of all employees

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[1] Basel Committee on Banking Supervision, March 2018, *Frameworks for early supervisory intervention,* pp. 14-15, Bank for International Settlements, https://www.bis.org/bcbs/publ/d439.pdf

[2] Scholten W, Ellemers N, 2016, 'Bad apples or corrupting barrels? Preventing traders' misconduct', *Journal of Financial Regulation and Compliance,* Vol. 24, Iss. 4, pp. 366-382.

[3] Van Rooij B, Fine A, 2018, 'Toxic Corporate Culture: Assessing Organizational Processes of Deviancy', *Administrative Sciences,* Vol. 8, Iss. 3.

associated within that business unit. Having a group-based outcome is a possibility that APRA has indicated it will look into at page 25 of the paper).

Following on from various submissions to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, the 2019 AGM season sees ASA aiming for greater clarity from remuneration reports about target remuneration as distinct from minimum reward or fixed remuneration. We understand target remuneration might be considered by companies to be what is expected to be paid for turning up and performing as expected. Reductions from this amount might be considered a consequence of failing to meet particular requirements of a role, which is a distinct contrast to additional reward which is earned due to extra effort and achievement.

Long-term is longer than three years

• set minimum deferral periods (up to seven years) for senior executives to provide more 'skin-in-the-game' through better alignment to the time horizon of risk and performance outcomes.

ASA has long argued that performance measures of three years or less, in no way represents measures of long-term success, and ASA guidelines recommend a minimum of five years measurement, with a concession of four years. The roles of CEOs and key management personnel goes beyond managing the day-to-day operation of their company and includes ensuring its ongoing or sustainable success, so we reject arguments of short CEO tenure. We support the extension of performance measurement to incorporate more truly longer-term metrics and deferral periods.

In summary, ASA supports the focus on cultural change and boards contribution to this change and welcome the possibility of greater scrutiny of remuneration frameworks and policies. However, non-financial performance indicators need to be measurable and meaningful, as per ASA's voting guidelines. ASA questions whether maintaining an ethical culture and ensuring ethical conduct is worthy of additional financial reward. Such behaviours are a core component of the performance of any executive role and should be necessary to retain the role or advance. We believe a gateway of non-financial measures will address the need to balance financial and non-financial aspects of remuneration scheme structures.

If you have any questions about this submission, please do not hesitate to contact me, or Fiona Balzer, Policy & Advocacy Manager on (02) 9252 4244.

Yours sincerely

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Australian Shareholders' Association