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Thank you for the opportunity to submit our views on the draft prudential standard related to remuneration requirements in APRA-regulated entities, CPS 511. We are pleased to provide comments from an investor perspective.

About Regnan

Regnan was established to investigate and address environmental, social and corporate governance (ESG) related sources of risk and value for long term shareholders in Australian companies. Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors invested in S&P/ASX200 companies. Regnan's clients are interested in knowing that the ASX-listed companies in which they invest have adequate controls in place to mitigate those risks potentially material to financial value.

In this capacity, Regnan has been a close observer of governance practice since 2007, and during this time has argued for a fresh approach to executive remuneration, as outlined in its position paper on the subject matter (Please find link here, also attached as a PDF). Regnan maintains a view that the remuneration of executives should be, first and foremost, fit for purpose. This is likely to mean in practice that pay arrangements can and should differ according to organisational circumstances and the specific requirements of the role.

Regnan offers a number of observations on the draft CPS 511. We believe that many of the governance approaches outlined with respect to board oversight of remuneration generally support enhanced governance practices. However, we offer comments on a number of features of the current draft prudential standard. Broadly these comments are with respect to:

- Acknowledgment of the limitations of non-financial measures
- Comments on specific design features
- Entities covered
- Alternate remuneration structures for risk roles

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- Areas where additional clarification would be useful
- Areas for ongoing monitoring of implementation, particularly with respect to the possibility of market distortions relative to other sectors

Limitations of non-financial measures

Whilst we support the inclusion of metrics that are aligned with strategy, whether they are financial or non-financial measures, we note that non-financial measures are not without limitations, including:

- the potential for any metric to result in unintended consequences, including misconduct. For instance customer metrics may encourage practices with the potential to compromise compliance objectives in favour of customer satisfaction. In our view the board has a responsibility to be attentive to the potential for misalignment irrespective of the types of measures used, in part, via the implementation of a governance approach consistent with that outlined in the standard
- the potential for measures to be "gamed", for instance the timing of survey-based instruments relative to major organisational announcements, expected adverse or positive media coverage etc. In addition is the potential for gaming of metrics such as employee engagement.
- the need for effective oversight and critique of these measures, may require upskilling on non-financial measures and/or a broader range of skills and professional backgrounds on the board, in particular, the remuneration committee. For instance, our ongoing engagement on conduct culture and strategic human capital has highlighted gaps amongst some market participants in interpreting HR related data.
- In our view, appropriately selected "non-financial" measures will often translate into financial outcomes over the very long terms contemplated by the draft standard. In this way, these two aspects of the standard could be considered to be overlapping and duplicative. APRA's objectives may be achieved by focus on *either* deferral *or* non-financial metrics, rather than both. We consider the deferral proposals simpler to implement.

Other potential design features

The standard is silent on the use of gateways required to access non-financial components of the plan. In our view, financial and non-financial gateways are a helpful and underused mechanism in remuneration arrangements and could be considered within the final standard.

We hold concerns that features within the draft may have an inflationary impact on executive pay. In particular the extended deferral and clawback terms have the potential to lead to excessive discounting by recipients thereby placing an upward pressure on pay quantum as a result.

Entities covered

Whilst the standard applies to APRA regulated entities we note that the restriction to RSE licensees creates different standards across a number of listed financial stocks which has the potential to create distortions within what are essentially peer entities.

Alternate remuneration structures for key risk roles

We would encourage the standard to consider the potential for alternate remuneration structures for those in internal governance roles, for instance risk and compliance roles or general counsel. In these roles individuals can be required to provide frank and fearless advice *counter* to the financial or non-financial objectives of the business. Therefore it is questionable as to whether these roles should be remunerated in a manner consistent with other executives given the potential for conflict. This may include consideration the types of measures included in at risk remuneration as well as the proportion of overall remuneration at risk.

Areas for additional clarification

There are a number of areas within the draft standard where additional information would be of value to the creation and assessment of remuneration structures, including assessment by the investment community.

- The standard is highly prescriptive on the structure of pay plans. We reiterate our position is that pay plans should be fit for purpose and should therefore differ according to organisational circumstances and the specific requirements of the role. While the standard does not prescribe specific metrics it does place limits on the use of financial metrics (capped at 50%). This may not always be appropriate.
- We are of the view that pay plans should be fit for purpose and aligned with company strategy, thereby differing according to organisational circumstance and the specific requirement of the role. Therefore should the requirement that 50% be retained we would recommend that flexibility is given as to how this is distributed across both STI and LTI (an item not clarified in the current draft)
- The standard would benefit from clarification as to how it interacts with the existing 'two-strikes' rule given the very real possibility that listed companies covered by the standard may face a situation where investors vote down a remuneration plan that complies with the standard at the company's AGM.
- Further, clarity would be beneficial as to what constitutes financial and non-financial measures – for instance "volume" measures are provided as an example of financial measures.
- Finally, it is unclear whether the thresholds for individuals to be covered by the standard apply to target remuneration or total potential remuneration.

Areas highlighted for the monitoring of implementation

Given the potential for the standard to create distortions between sectors there are a number of areas where it would be helpful to monitor implementation to minimise the potential for unintended consequences. In our view these are most likely with respect to minimum deferral periods, vesting arrangements and clawback provisions to the extent that they may constrain talent attraction and retention within the sector and/or place upward pressure on pay given the potential for discounting. We note that this may constrain talent attraction and retention in the financial services sector and we recommend that implementation be monitored and adjusted in the event that such distortions are observed.

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Yours sincerely

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About Regnan

*Regnan-Governance Research and Engagement Pty Limited (**Regnan**) was established to investigate and address environmental, social and corporate governance (ESG) related sources of risk and value for long term shareholders in Australian companies. Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors invested in S&P/ASX200 companies.*

*Pendal Group Limited (**Pendal**) assumed full ownership of Regnan in February 2019, after being a founding co-owner and client. Regnan continues to operate as a leading ESG service provider. While Regnan utilises administrative and operational support from Pendal, it operates as an independent business unit of Pendal and continues to serve its clients and produce content independently.*