22 July 2009

Mr. David Rush
General Manager
Policy Development
Australian Prudential Regulation Authority
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By email: remuneration@apra.gov.au

Dear Mr. Rush

Remuneration: Proposed extensions to governance requirements for APRA-regulated institutions - Submission by Guerdon Associates

Guerdon Associates’ response to the consultation package issued by APRA on proposed extensions to governance requirements for APRA regulated institutions appears under the sub-headings below.

Summary

The draft APRA remuneration amendments to the prudential standards and accompanying discussion guide, in Guerdon Associates’ opinion, are:

• Consistent with FSF Principles for Sound Compensation Practices
• Appropriate for facilitating better sector risk management
• Reasonably flexible to allow competitive differentiation across the sector
• Capable of implementation
• But need monitoring for unintended consequences

There is no doubt that the regulation will add considerably to the workloads of independent non executive directors (NEDs). The impact that this will have on demand and supply of suitably qualified NEDs for this sector is, in itself, a risk factor that needs to be monitored.

Suggestions for improvement in the standards and/or discussion guide include:

• A requirement that NEDs actively maintain or improve expertise in remuneration matters
• A requirement that NEDs be aware of and acknowledge difficult to eradicate adviser conflicts of interest
• A refinement of remuneration aspects to be considered to include fixed and at risk mix, equity to non equity mix, type of equity,
aspects of performance measurement, timing, calibration and payment
• A refinement of the understanding of reward symmetry to not exclude relative performance, while also considering absolute performance
• Clarification and amendment of common misunderstandings on options usage, form and appropriateness
• Recognition that a tax “remedy” could have the unintended consequence of payment for failure

About Guerdon Associates

Guerdon Associates is Australia’s largest independent consulting firm specialising in board and executive remuneration matters. Our mission is to provide executive and director remuneration, performance measurement, management and governance advice, and employee equity data and solutions that contribute to improved total shareholder returns.

Clients are mainly board remuneration committees of listed and unlisted Australian companies. These include a significant proportion of Australia’s largest ASX listed companies.


Introduction

Our view of APRA regulated company remuneration is primarily informed by our dealings with boards on these issues, including remuneration’s impact on organisation strategy and execution, performance measurement and assessment, and risk. While we have primarily provided services to larger listed financial services companies, our work has included APRA regulated building societies, mutuals and cooperatives.

In our experience, boards considering remuneration within the organisation undertake a careful and broad review of relevant factors, including the need to balance the interests of shareholders, customers, employees and the wider community.

Relative to practices in Europe and the USA, Australian remuneration practices have been balanced and reasonably effective, with a bias towards conservatism in APRA regulated organisations\(^1\).

APRA regulated remuneration in context

It is important to keep in mind that remuneration was not a primary cause of the global financial crisis (GFC), nor was it a necessary pre-condition.

Lord Turner, the chairman of the FSA, admitted it is difficult to gauge the extent of the role of remuneration in the crisis, but said it is reasonable to

\(^1\) Interestingly, this is less evident in non-APRA regulated financial services organisations. In particular, “investment” banking offshoots of global players have remuneration structures imported from their overseas parents.
suggest that "while inappropriate remuneration structures played a role, they were considerably less important than other factors - inadequate approaches to capital, accounting and liquidity"\(^2\).

He added: "It is indeed likely that the regulatory responses which will have greatest influence on future remuneration levels will not be the specific remuneration-related policies. The major increases in capital required against trading book activity are likely to play a much more significant role in reducing the aggregate scale of trading activity, and so the aggregate remuneration of people involved in those activities, than any policies designed directly to influence remuneration."

He noted the need to be "realistic" about the ability of remuneration policies to ensure "sensible" employee behaviour and to compare the importance of remuneration policies with other regulatory tools. "Excessive risk taking, at least at the top management level, may be driven more by broad behavioural and cultural factors than by a rational consideration of the precise incentives inherent within remuneration contracts: dominant executive personalities have a strong tendency to believe in their own strategies. And the reality of excessive risk can often only be spotted at a systemic level."

The implication of Lord Turner’s comments is that good risk management is more a function of an effective board, than specific remuneration regulation.

Many of the proposed solutions on pay already featured in the pay packets of failed executives. For example, most failed bank CEOs received significant equity based pay, with a relatively large deferred component, and in many cases were required to hold an amount of vested equity as a multiple of their annual pay.

Nevertheless, while the focus on remuneration is probably out of proportion to its impact on the GFC, Guerdon Associates does not believe that additional attention to remuneration matters is misplaced. We recognise that it must feature as part of APRA’s purview if it is to properly meet its charter. In addition, it will highlight an aspect of remuneration management that we have identified and commented on as an essential and missing ingredient of executive remuneration since our firm was founded, and has been a feature of all client incentive plan advice since then. That is, the requirement to manage risk as well as return.

The APRA prudential standards go a long way to redress this imbalance. Whether, in the total scheme of good economic management, APRA and other agencies around the world have got the regulatory balance right is an unknown. But the attention on remuneration’s role in the management of risk is welcome.

\(^2\) "A regulatory response to the global banking crisis", FSA, March 2009 (see [HERE](#))
Consequences overview

Guerdon Associates has reviewed the draft APRA remuneration amendments to the prudential standards and accompanying discussion guide relative to other regulatory standards published in the UK and European Union. In Guerdon Associates’ opinion the APRA standards are superior in that the principles they encapsulate better allow competitive differentiation across the sector, while staying true to the FSF Principles for Sound Compensation Practices.

However, there is no doubt that the standards will impose significant additional costs associated with employing external advisers, employment of additional internal risk management and remuneration personnel, record keeping, administration and controls. Executive fixed pay levels may increase, and become less variable with annual financial outcomes. These additional costs will probably be passed through to consumers of financial services.

There are also implications for the demand for, and supply of, suitably qualified NEDs. The supply side will be affected by:

- Significant additional workloads on board remuneration committee and board risk committee members
- The requirement for NEDs with expertise in remuneration

Given the scope of the standards we would expect that the workload of the chairman and members of the remuneration committee will double. The additional requirements would also add to the workload of the board chairman. This would go some way to realising predictions that some NED roles, such as the board chairman, will become full time independent director roles3.

We are also aware of the views held by some governance experts that the supply of potential NEDs could be greater if the “clubby monopoly” is broken down. This additional workload may lead to that breakdown.

While Guerdon Associates does not believe there is sufficient data to opine on NED supply, we point out that there could be a risk if supply as a result of these additional requirements is not sufficient. So, while there is no doubt that the regulation will add considerably to the workloads of independent NEDs, the impact that this will have on demand and supply of suitably qualified NEDs for this sector is, in itself, a risk factor. This unintended consequence needs to be carefully monitored.

Another “known unknown” is associated with the supply of independent external advice4. In the specialist field of remuneration this is currently

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3 “The regulator's role in judging competence”, Speech by Hector Sants, Chief Executive, FSA Securities & Investment Institute Conference 2009, 7 May 2009. See [HERE](#).

4 Defined as a provider of services to boards only.
limited to two main suppliers⁵. In accounting, taxation and legal matters there are no advisers, to our knowledge, that can position themselves as free of conflicts of interest⁶ in these matters. Obviously, this lack of supply will require most boards to continue to rely on conflicted advice.

APRA could require advice to be unconflicted. If this were to be the case, it would precipitate a major industry shake up as non-independent firms restructured (or, as in the US, decided to be advocates for management), and laid off staff put out shingles as independents, albeit without the infrastructure and support present in broad based firms that often adds value. There is risk in such a regulatory requirement, and so it is not advocated by Guerdon Associates. Instead, we suggest that board remuneration committees acknowledge and monitor conflicts in order to acquire the full range of services they need. This is reflected in our detailed suggestions.

Lastly, we have reviewed APRA requirements in terms of executive supply. Many Australian APRA regulated organisations participate directly in global labour markets for executives. Given that most global financial services cities will be subject to national remuneration guidelines or regulation that respond to FSF requirements, we believe that the APRA regulations and guidelines allow sufficient flexibility to allow adaptations for key employee attraction and retention from outside Australia.

Comments on particular sections of the PPG 511 draft

We have prepared comments on certain aspects of the APRA Prudential Practices Guide for Remuneration, referencing the paragraph numbering in the APRA document. Our comments are intended to suggest a few key ways in which the regulations and guidelines could be refined or varied, in order to meet their intention more successfully.

**Paragraph 3: director conflicts of interest**

The wording of this paragraph suggests that it is the responsibility of independent directors to ensure executive directors are not exposed to conflicts of interest. In the Corporations Act it is clearly the responsibility of all directors, including executive directors, to ensure they are not exposed to conflicts of interest.

We suggest that the paragraph be re-worded reminding directors of this obligation, and then proceed with the guideline that the board remuneration committee only be comprised of independent directors, or that in the approved absence of such a committee, that only independent directors be engaged in the approval of remuneration matters.

⁵ Guerdon Associates being one of these.

⁶ This could be defined, as implied by US congressional hearing chaired by Henry Waxman on executive remuneration, as arising from being actual providers of services to both management and the board. However, a more stringent definition would be, in this case, or having the potential to be, suppliers of services to management and the board.
Paragraph 10: Internal advice and remuneration committee expertise

This paragraph deals with two distinct and important issues. We suggest that it be split into two paragraphs for emphasis.

Our experience is that there are significant variations in NED remuneration expertise. On some boards the expertise is uniformly poor, and was not considered to be an important requirement for selection. The prevalence of uniformly poor expertise may result in a failure to recognise that the level of expertise is poor, given that a comparison of relative expertise within and often across boards does not reveal much variation. APRA may like to consider adding a requirement that the remuneration committee dedicate time to improving levels of expertise to overcome these situations. Such a requirement would also benefit remuneration committees where there is a relatively good level of expertise.

Paragraphs 11 and 12: Use of external consultants

The requirement that the board remuneration committee directly commissions advice from external advisers “independently of management” may need further clarification. There are already instances whereby a remuneration committee directly commissions work. However, it is often from a short list (or very short list) prepared by management. The remuneration committee needs to be satisfied that the process for selecting external advisers is appropriate for it to be deemed “independent” of management.

The guidelines also do not recognise that independent commissioning of external remuneration advisers does not preclude potential conflicts of interest. The remuneration committee must commission this advice after satisfying itself that it is fully cognisant of consultant conflicts of interest. This should include recognising conflict not only when a consultant already provides services to management, but also where the consultant has the potential to provide services to management.

A clarification of the guideline in this way recognises the practical reality that in a market as shallow as Australia’s, there can be very few consulting firms that can meet this independence test (i.e. that they do not and will not in the future provide services to management). However, this does not preclude the remuneration committee instituting a process so that they are fully aware of these conflicts and their extent.

Paragraph 19: remuneration of financial and risk control personnel

We note that it is suggested financial and risk control personnel receive higher fixed “salary”. We suggest salary be replaced with “remuneration”, as such a term would encompass receiving payment in equity and non-monetary items.

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7 This can be in non remuneration services, found to be a source of conflict by the US congressional committee investigating executive pay setting processes, chaired by Henry Waxman.
Paragraph 22: adjusting remuneration for risk

There are two bullet points. We suggest splitting the 1st bullet point for both emphasis and design considerations and adding an additional bullet. That is, remuneration considerations should include:

- The balance between fixed and at risk remuneration
- The time perspective mix of current and deferred remuneration\(^8\)
- The balance between cash and equity and their terms of entitlement including vesting and deferred arrangements
- The balance between “at the money” option like equity payments\(^9\) and non-option like equity payments\(^10\)

Paragraph 29: Measuring performance

As a consulting firm Guerdon Associates has not consistently advocated the application of relative TSR measures, mainly because:

1. The shallowness of the Australian market does not allow a fair comparison group to be assembled
2. Such measures in their traditional form did not take account of risk management

Despite this, we can envisage situations where relative TSR could be applicable in some form.

There are several issues associated with using relative TSR that need to be taken into account. Firstly, relative TSR takes no account of a company’s response to general market risk. For example, over time, companies with a lower beta will deliver lower relative TSR rewards than companies with higher beta\(^11\). Yet these lower beta companies are better for overall system stability than high beta companies. The non-recognition of their better risk management (e.g. through product or regional diversification) can be countered by risk adjusted relative TSR\(^12\).

Secondly, the last sentence of paragraph 29 assumes that delivery of a significant reward when an absolute return is negative is inappropriate. The contrary could be argued. That is, in times of major economic or system recession, a well managed company with lower risk will conserve

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\(^8\) Both fixed and at risk remuneration can have current elements (e.g. annual bonus or salary) and deferred components (e.g. multi-year service and/or performance contingent vesting)

\(^9\) These are risk encouraging equity vehicles that may include options (where exercise price approximates market price at grant), share appreciation rights, and limited recourse loan backed plans. The latter two alternatives may increase markedly given what is known of the government’s share scheme tax proposals.

\(^10\) Shares, performance share rights (i.e. ZEPOs), restricted share units (RSUs), phantom shares and shadow shares

\(^11\) That is, more volatile companies will more often have higher percentile vesting, all else being equal

\(^12\) That is, by calculating alpha TSR taking into account the “beta” of the peer group to which it is being compared.
far more capital than its more risky competitors. The management of this better risk managed company should be rewarded.

One of the reasons for inserting this last sentence of paragraph 29 may be the FSF reference to reward symmetry\textsuperscript{13}. However, this section of the Principles appears to refer to short term bonus and not longer term incentives, on which most relative TSR measures are applied. In addition, there should be recognition that reward symmetry is optimal when both relative and absolute performance are taken into account. That is, multiple but valid measures of performance (including risk) diversify risk\textsuperscript{14}. Optimal performance and reward outcomes would occur over time if an executive manages to achieve consistently good results over time and:

- These results measure both relative and absolute performance
- These results are measured over different time scales

Given the above, we suggest that this last sentence of paragraph 29 be deleted.

Paragraph 40: partial vesting for taxation

Paragraph 40 recognises that it may be desirable to partially vest rewards to meet taxation obligations. Companies could apply this if the government’s proposed share scheme taxation proceeds as announced. However, there are dangers in this approach that have not been recognised adequately\textsuperscript{15}. For example, an executive retires and receives partial vesting to pay the taxation on performance contingent equity pay due to vest 3 years after retirement. But performance after three years is found to be poor. The remainder of the equity does not vest. But the executive asks for and receives tax back from the ATO. Hence the reward for poor performance could be equal to that for good performance.

We suggest deletion of the third sentence of this paragraph.

Paragraph 46: Business unit versus corporate performance

FSF principles appear to support recognition of relatively good individual or business unit performance when the corporation as a whole has not done well (e.g. see page 3 of the FSF principles). While the paragraph rightly recognises there could be problems (also recognised in the FSF principles), it does not suggest uneven reward could be inappropriate (subject to paragraph 47 requirements). We suggest that a sentence be inserted to that effect, otherwise there may be an interpretation that uneven reward may be too difficult and therefore not appropriate.

\textsuperscript{13} FSF Principles for Sound Compensation Practices, 2 April 2009, pages 1-12

\textsuperscript{14} Assuming discrete rewards are applicable to each measure.

\textsuperscript{15} We note that the Treasury submission on share scheme taxation to the Senate Economics Committee still advocates this alternative, saying that it meets APRA requirements.
Paragraph 49: Fixed pay components

Paragraph 49 does not recognise that fixed pay could be comprised of service contingent equity\textsuperscript{16}.

We suggest that the word “statutory” (prior to “superannuation”) be deleted.

Paragraphs 54, 55 and 56: Use of options

Paragraph 54 presumably refers to options that are issued “at the money”\textsuperscript{17}. This should be clarified. We can envisage uses for discounted options (e.g. with an exercise price discounted 50% from market price at grant) that efficiently combine downside risk and upside reward leverage. That is, an executive is not encouraged to take significant risk to receive any reward outcome, as there is sufficient value in the options to provide reward from a lower risk strategy (see our article \textit{HERE}). That discounted options are not used reflects current market zeitgeist rather than reward wisdom\textsuperscript{18}.

We suggest APRA insert “at the money” before the word “options” in paragraph 54.

The first half of the second sentence in Paragraph 55 has, given the explanation above, a poor rationale, and should be deleted.

Paragraph 56 supports use of “in the money” options, and should be included as one of the examples to challenge current thinking.

Comments on remuneration regulation in draft prudential standards LPS 510, GPS 510, and APS 510

We have prepared comments on certain aspects of the draft standards, referencing the paragraph numbering in the APRA document. Our comments are intended to suggest a few key ways in which the regulations could be refined or varied, in order to meet their intention more successfully.

Paragraphs 35 (APS 510), 32 (LPS 510) and 36 (GPS 510): Performance based remuneration arrangements

We suggest inserting the words “periods and calibration” after “measures”. The full wording (with additional words underlined) would be as follows:

\textsuperscript{16} It is common to confuse the nature of service contingent equity. In the US these awards are generally considered to be a long term incentive, despite the absence of performance requirements.

\textsuperscript{17} I.e. not discounted or ZEPOs

\textsuperscript{18} Option practices globally have been heavily influenced by US practices over the past 2 decades. As discounted options are income taxable in the year of grant they have not been popular in the US, and so this may explain why they have not been applied elsewhere. It is of course subject to Australian share scheme tax changes which, it appears from the information published to date, will not encourage any option grants.
The Remuneration Policy must ensure that the design of each relevant individual’s performance-based remuneration arrangements allows for adjustments to reflect:

(a) the risks arising from the business activities in which the individual is engaged;
(b) the controls in place to mitigate those risks;
(c) the time necessary for the outcomes of those business activities to be reliably measured; and
(d) the capital allocated to those business activities.

For these purposes, performance-based remuneration arrangements include measures, periods and calibration of performance, the mix of forms of remuneration (such as fixed and variable components, and cash and equity-related benefits) and the timing of when the individual becomes eligible to receive payment.

While the timing of payments is noted, this may differ from the performance period over which performance is measured. For example, all incentive payments could be based on short term performance periods, with payment deferred with service over a longer period. All else being equal, this arrangement still encourages a focus on short term outcomes. The regulation as it is currently written does not refer specifically to the performance period being a consideration, only the period until payment is received.

While many companies take care to get the measures right, we find too little attention is paid at policy approval level to getting the performance calibration right. In this context, performance calibration refers to the required quantitative outcome and the relation between progression on the performance outcomes and reward outcome. If the performance requirement is too difficult it will either not motivate, or encourage excessive risk taking (if risk is not an integral component of the measure). Wherever possible, there should be probability analyses underlying calibration.

Examples of calibration may include a threshold requirement at which the employee receives 100% of the incentive payment, a threshold requirement over which an incentive payment increases progressively with improved performance to a maximum, or a threshold requirement over which an incentive payment increases progressively with improved performance with no maximum specified for performance (and hence payment).

Paragraph 35 (LPS 510): Persons covered by policy

There is a typo in the second line. Insert “be” after “may”.

Melbourne o Sydney
Paragraphs 48 (APS 510), 45 (LPS 510) and 49 (GPS 510): Board remuneration committee expertise

Insert the words “and maintain” after “possess”, so that the paragraph reads:

"Members of the Board Remuneration Committee (or the independent Board members where APRA has granted the regulated institution approval not to have a Committee) must collectively possess and maintain appropriate expertise to perform their function. The Committee may supplement its knowledge and expertise through the use of independent experts on remuneration and risk issues.”

Executive remuneration is complex, and has been evolving rapidly for at least two decades. It is also subject to change from regulatory, tax, and governance guideline changes from various stakeholder groups. Given that there is no indication that this rate of change is slowing, we suggest that it be incumbent on board remuneration committees to collectively maintain expertise. While this could be assumed by the word “possess”, so that the words “and maintain” are redundant, it could also be assumed that expertise, once obtained, is static. In our experience, this is not the case. Guerdon Associates’ senior consultants, who have each been experts in this discipline for over two decades, are constantly engaged in development activities to maintain the relevance of their expertise. A similar expectation could be incorporated in APRA guidance.

Conclusion

Guerdon Associates supports the overall approach by APRA to strengthen the principles-based prudential standards for regulation of remuneration in accord with FSF Principles.

We appreciate the opportunity to provide these comments, and would be happy to elaborate further if you wish.

Yours sincerely

Michael Robinson     Peter McAuley
Director      Director