Guerdon Associates
Executive Pay & Board Governance

14 February 2020

Manager
Redress and Accountability Unit
Financial System Reform Taskforce
The Treasury
Langton Crescent
Parkes ACT 2600

By email: FAR@treasury.gov.au

Dear Manager, Redress and Accountability Unit,

Financial Accountability Regime (FAR) Proposal Paper Submission

Guerdon Associates appreciates the opportunity to provide its submission on the *"Implementing Royal Commission Recommendations 3.9, 4.12, 6.6 6.7 and 6.8 Financial Accountability Regime"* (the proposal paper), noting that a focus on how the proposal is best implemented is being sought.

To that end, this submission describes our firm, and identifies and expands on aspects of the proposal that are considered positive developments for efficient and effective implementation.

About Guerdon Associates

Guerdon Associates is an independent [1] executive remuneration and board governance consulting firm. Our clients include a significant proportion of companies in the ASX 300, large private companies and pre-IPO companies. Offices are located in Melbourne and Sydney, with affiliate offices in London, Paris, Zurich, New York, Los Angeles and Beijing. The firm has worked with the boards of many of Australia's listed companies including banks, insurers and other financial services providers, as well as superannuation funds.

The firm's submissions were among the most cited in the Productivity Commission's review of executive remuneration and, over the years, it has contributed to Treasury, Australian Taxation Office, and CAMAC on numerous Corporations Act and taxation legislation changes, as well as regularly engaging withASIC and APRA on remuneration matters.

As a provider of remuneration and governance advisory services and an expert observer of the impact of executive remuneration internationally, the firm can provide useful insight into:

[1] Independence is defined as a specialist provider of consulting services to company boards only, and not management, to minimise conflicts of interest that may otherwise result from being a supplier of multiple services to both management and boards.

- the effects of various remuneration frameworks; and
- alternatives or modifications that may more effectively contribute to sound prudential management.

Objectives of proposed regulation and means to achieve it

The FAR is 'intended to increase the transparency and accountability of financial entities in these industries[2] and improve risk culture and governance of both prudential and conduct purposes'.

We offer the following observations:

1. that the deferred remuneration obligations could be enhanced by focussing on total remuneration, rather than variable remuneration;
2. the definition of variable remuneration appears to provide a sound basis for consistent, transparent and more easily administered regulation. Further clarity and internal consistency would provide for cost effective administration, communication and supervision;
3. the scope of ministerial discretion, while efficient, would appear to extend beyond organisations with financial services licenses, and requires clarity and probably limitation; and
4. regulatory scope encompasses the ability to refine and adjust deferral proportions and periods for various types of Accountable Persons, and entities in which they reside, to reflect the cyclicality of the business, and the tail of each business's obligations and impact.

The matters where we suggest refinements are described more fully below.

Limitation of deferral to only variable remuneration

The BEAR legislation required deferral of the greater of a proportion of variable remuneration or total remuneration.

The FAR proposal limits deferral to 40% of variable remuneration.

Capturing variable remuneration only may encourage entities to abandon variable remuneration as a component of total remuneration. As a consequence, the entity will have no recourse for remuneration adjustments for redressing misbehaviour, non-compliance, and excessive risk-taking. The unintended consequence is that a central plank of the accountability provisions is rendered mute.

To cost-effectively compete for human resources, entities will be encouraged to provide remuneration that has less variable remuneration and, consequently, higher fixed remuneration.

[2] All APRA regulated industries.

The experience in the UK and Europe, which prescribed limits on variable pay[3], was that fixed pay filled the gap. We would expect market forces to have a similar response as a result of the legislation in Australia, i.e. higher fixed pay as a result of prescribed limitations on variable pay.

This will mean that:

1. An expense that was variable with results (i.e. variable pay) will become a higher fixed expense. This will have the effect of reducing the ability of regulated entities to respond to cyclical fluctuations and poorly performing businesses. The consequence is balance sheets that are not as strong and surpluses that are not as sustainable.
2. There will be an uneven playing field where overseas-owned and other non-ASX listed entities can respond more readily to change the components of executive remuneration than ASX-listed companies that are subject to closer shareholder scrutiny. These companies will suffer loss of talent and/or higher total costs in order to compete.
3. There will not be the key redress and control mechanism required to minimise the excesses observed by the Hayne Royal Commission.

The issue can be remedied by requiring deferral of a proportion of variable remuneration, or total remuneration, whichever is the greater.

Definition of variable remuneration

The definition on page 7 promises to be an improvement on the BEAR, but requires clarification so as to ensure the intent of what is captured is clear.

For example, under APRA's interpretation of the BEAR, deferral applies to the theoretical value of the long term incentive (LTI) grant[4], and the actual award of short term incentive (STI) awarded once performance has been ascertained. This interpretation arising from how the BEAR is drafted conflates a theoretical proportion of pay and an actual award of pay.

It is better to have a basis that is consistent. That is, the definition of variable remuneration could be based on either

1. the potential maximum LTI opportunity and STI opportunity, or
2. the actual awarded STI and actual vested LTI.

If the intent is to capture all remuneration that is subject to meeting pre-determined performance criteria, the deferral proportion would be applied to the maximum variable remuneration possible prior to an award being made.

[3] http://www.guerdonassociates.com/articles/eu-agreement-to-cap-banker-bonuses-will-affect-australian-financial-services-sector/
[4] Based on the face value of underlying shares

That is, the deferral proportion would be calculated on the maximum STI opportunity that is notified at the beginning of the year along with the maximum LTI opportunity that is granted at the beginning of the year (the first alternative).

This is the inference in the discussion paper's definition on page 7. This is considered to be a definition that ASIC, APRA and regulated entities could probably work with for consistent interpretation and straightforward administration.

For the first alternative, there may be some further work to clarify when the deferral period begins. For example, to be consistent between STI and LTI, deferral could be considered as started as soon as the performance period begins, such that STI would be deferred three years post the end of the performance period and if LTI performance period is three years, it is deferred for one further year.

In the variable remuneration definition were to vary from the inference on page 7, the most viable other alternative would be to base it on the actual awarded STI and actual vested LTI. Any vesting period that has elapsed prior to the assessment of the STI and LTI against performance measures can be credited to the required deferral period.

Treatment of malus within variable remuneration definition

Both the proposed CPS 511 and the Proposal Paper place much emphasis on *variable* remuneration. It may be preferable to require remuneration to have an appropriate balance of *curren*t and *deferred* remuneration.

The following discussion explains the problem, and the rationale for Guerdon Associates' suggested solution.

In the UK some entities provide for time-vested deferred remuneration[5]. This *deferred remuneration* is usually in equity for listed entities. If this is subject to malus, is it contingent on achieving objectives, and hence variable remuneration? It is. It would be a concern if this example was not considered to be *variable* remuneration, as then the board would have delivered more pay as fixed remuneration without consequences for misconduct or unacceptable risk.

As noted above, an alternative to prescribing deferral of a proportion of variable remuneration is to instead require remuneration to have an appropriate balance of *current* and *deferred* remuneration. The *deferred* remuneration, or a component of it, could be subject to performance conditions or purely to malus at the discretion of the company. The latter would be suitable for not-for-profit entities. It may also feature in a remuneration framework for difficult-to-acquire talent who could be employed in other industries. These individuals could be provided with deferred remuneration that would only be reduced in instances of undue risk-taking or misconduct.

Another alternative is to revert to the BEAR requirement that deferral apply to the greater of a defined proportion of variable remuneration or total remuneration.

---

[5] See page 68 of the 2018 RBS annual report, for example CEO received £1m pound as a 'Fixed Share Allowance'

Scope of ministerial discretion

The discussion paper states that an extension of FAR beyond all APRA-regulated entities is proposed to be facilitated by providing the Minister a power to make a legislative instrument that would allow solely ASIC-regulated entities to be brought into the scope of the FAR.

There is no mention that this power will be limited to ASIC-regulated entities that have a financial services license. If the power extends beyond this, the Minister could presumably apply discretion to apply regulation to all companies that may, at particular times, become subject to political and public scrutiny, which may be ephemeral. Examples may include energy retailing companies, gaming companies, resources companies, food manufacturers, power generators, and the list can go on. This scope may be considered too sweeping without a more considered public debate. Hence, we suggest ministerial power be limited to ASIC-regulated entities with financial services licenses.

Concluding remarks

Guerdon Associates trusts that our observations and suggestions are of value. We would be pleased to respond to any queries you may have in relation to this submission.

Yours faithfully

Michael Robinson
Director