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Manager
Banking, Insurance and Capital Markets Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Submission on Banking Executive Accountability Regime Proposal

Guerdon Associates appreciates the opportunity to provide a submission on the Banking Executive Accountability Regime (BEAR). As an external provider of remuneration advisory services to ADIs, and with observations on the impact similar regulation has had internationally, the firm believes it can provide useful insight.

Given our specialist focus, we have restricted our comments to remuneration matters.

This submission provides brief information regarding our firm and then reviews matters for consideration arising from Treasury's consultation paper on the BEAR.

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, and private 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 ADIs that will be covered by the BEAR.

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 and Australian Taxation Office consultations on numerous Corporations Act and taxation legislation changes, as well as engaging with APRA on remuneration matters.

Remuneration

The remuneration elements of the BEAR ensure there are financial consequences for conduct that does not meet the new expectations. The BEAR is intended to build on, rather than replace APRA's existing prudential standards on remuneration.

At least 40% of variable remuneration is to be deferred for 4 years. The deferral of 60% of variable pay will only apply to CEOs. However, Treasury will consider submissions on increasing the extent of deferral to other senior executives, as in the UK.

For the deferral period, there are a number of questions as to precisely how the four-year deferral should operate. For example, what happens if employment ends before the

[1] Independence is defined as a specialist provider of consulting services to boards to minimise conflicts of interest that may result from being a broad-based supplier of multiple services to both management and boards.

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end of the four-year period? Can tranches of the deferred amount vest over the period, or must there be a deferral of the full amount for the full 4 years?

The consultation paper makes no mention of clawback (i.e. recovery of monies paid) provisions that are already a policy of many ADIs and how the BEAR will interact with such policies.

Overall, the BEAR places too much emphasis on variable pay, not unlike the UK senior manager regime on which it is modelled. There is not a balanced view of remuneration as a whole, lacks recognition as to how remuneration frameworks may change, and does not recognise the role an integrated remuneration framework can have on executive accountability and prudential management.

For example, there are currently significant reviews by major listed companies to "simplify" remuneration. In concert with UK trends, it is likely that the extent of variable remuneration may reduce in many industries. This is already evident in the UK financial services sector, and appears to be as much in response to regulation as it is to external investor issues with "complexity". If variable remuneration as a proportion of total remuneration declines, so will a BEAR with a focus on variable remuneration have less impact on executive accountability.

The mandatory deferral and deferral term mandated by BEAR could hasten the extent that ADI variable pay proportion will reduce in favour of fixed remuneration, which may cascade through all levels of the ADI. This will increase an ADI's fixed costs, making it more vulnerable to cyclical downturns, or another financial crisis.

In addition, the effectiveness of remuneration to encourage better risk management via incentive remuneration will reduce in proportion to the extent that variable remuneration is also reduced. There is already a view that current high levels of variable remuneration in the major banks have contributed to low earnings volatility and hence sound prudential management[2]. If the mandatory requirements of the BEAR serves to discourage the application of variable remuneration, as we suspect it will, then the BEAR's effectiveness for better executive accountability and prudential risk management will have an effect opposite to what is intended.

The Treasury paper does pose questions on causes for concern. Guerdon Associates' responses are below.

Would deferring variable remuneration be likely to result in a shift from variable to base remuneration?

GA answer – Yes. The mandated deferral under BEAR will make remuneration packages less attractive due to an effect known in behavioural economics as hyperbolic discounting. That is, the value of a reward is discounted when it is deferred. A dollar deferred is not as valuable as a dollar now. So, for a given company expense, there would be higher utility and more effectiveness in paying the dollar now, rather than deferring it. Higher utility will be achieved by "bypassing" BEAR requirements through higher fixed pay, in lieu of variable pay. Smaller ADIs (such as credit unions), with little

[2] This has been an outcome to initial criticism from 2 proxy advisers and some institutional investors that ASX listed bank incentive pay was really "fixed pay in drag". An analysis of performance parameters and outcomes indicates that low incentive pay variability is an outcome of low earnings volatility (or vice versa). Given both APRA's capital requirements, and investors' needs for yield, this is an outcome that appears to meet the needs of both stakeholders, despite the criticism.

or no deferred remuneration and relatively modest levels of fixed and variable pay, would be immediately tempted to do away with variable pay completely. However, the same impetus would apply to all ADIs.

Would this be problematic?

GA answer – Yes, for these reasons:

1. *A pay component that is variable with results buffers a bank from dipping into its capital, ensuring it is more robust. Limiting or reducing this for any staff is not a positive development. The European experience shows us that variable pay is likely to be converted to fixed pay once regulation focuses on limiting variable pay.*
2. *With the emphasis on variable pay and none at all on other pay, APRA would be relatively powerless to consider adjustments if banks just move to fixed pay. The focus should not be limited to variable pay.*
3. *Variable pay has a direct and powerful impact on behaviour. As such, it could be a mechanism for effective prudential outcomes, i.e. it could vary with prudential results/quality. Its reduction or elimination would rob the board, regulators, depositors and owners with a powerful tool to focus executive attention.*
4. *ADIs will be less able to attract executives with otherwise suitable experience from non-ADIs, or countries with less onerous regulation. A reduction of the talent pool will be detrimental to all stakeholders.*

If so, can anything be done to prevent this outcome?

GA answer – No, unless the BEAR focus is on total pay, and not just variable pay. Otherwise the response to reduce variable pay will be a function of the economic utility of the remuneration package in a competitive banking environment. We saw this in Europe and UK when maximum incentive pay was mandated to a maximum of 1 times fixed pay, and the requirement under CRD IV to defer a significant proportion of variable remuneration for up to 5 years. The outcome was a reduction in incentive pay opportunity and large increases in fixed pay.

What are the complexities in defining variable remuneration, including in relation to non-cash remuneration?

GA answer – this is not complex. However, it is acknowledged that many confuse the vehicle of remuneration with its primary purpose. That is, variable remuneration is remuneration that is contingent on performance. This is independent of the payment vehicle, which could be cash, equity, bank bonds, or other non-monetary benefits. Many may call equity remuneration a long-term incentive (LTI). This is incorrect. An LTI is a payment for performance measured over a period that is greater than 12 months. Equity is a payment vehicle that can be paid as part of fixed remuneration, short-term incentive (STI) or LTI.

Does the proposed principles-based definition of variable remuneration provide sufficient clarity as to the application of the BEAR to current and potential future remuneration structures?

GA answer - The definition in the Treasury paper is that it includes "that part of total remuneration that is discretionary and conditional upon performance and the delivery of results, including individual and business performance and results."

This definition is poorly drafted, and could be simplified. For example, remove unnecessary and limiting conditional requirements so that the definition is simply: "that part of total remuneration that is conditional upon performance". This is all that needs to be said to define variable remuneration.

Is the proposal for deferring 60 per cent of the variable remuneration of certain executive accountable persons appropriate?

GA answer – no, it is not appropriate. It is too prescriptive. For example, if a bank already defers a part of fixed pay in equity (e.g. The CEO of Bendigo and Adelaide Bank has 40% of fixed pay deferred), does it need to defer any variable pay? One advantage of deferring pay is that it can be forfeited in specified circumstances (i.e. malus is applied). The source of deferral i.e. fixed pay or variable pay, need not necessarily be a concern. Another example is where an executive has accumulated a majority of his/her net personal wealth in bank equity, savings deposits or bank bonds. Would it be as necessary for this executive to have as much remuneration deferred?

APRA already has powers to compel a bank to amend pay policy, and its PPG 511 has well-regarded guidelines. Given that ADIs number in the tens, and not thousands, this is not too much to get across, while it enables banks to tailor policies to meet strategic ends and apply good prudential controls given their circumstances.

Are the proposed enhancements to APRA's remuneration powers appropriate?

GA answer – not enough information has been provided in the Treasury paper on what these powers could be.

Suggestions

1. Do not require a mandatory deferral of variable pay, as variable pay may reduce, with unintended consequences for accountability and prudential management.
2. Require APRA to consider all elements of executive and risk taker remuneration for prudential risk management purposes, rather than just variable pay, to better cope with changes in remuneration frameworks stemming from regulatory and market forces.
3. Request APRA amend PPG 511, which currently suggests deferral of variable remuneration for later *ex-post facto* adjustment in light of excessive risk taking. Replace with a preference for deferred remuneration (either fixed or variable) which can be reduced if outcomes from poor prudential management come to light. This is a broader application that goes beyond "excessive risk taking" to the key focus of better prudential management. This amendment would reflect evidence from behavioural research that indicates people are more likely to respond more strongly to the risk of loss than the opportunity of gain, all else being equal. The guidelines may also require that a bank consider the extent that an individual executive is personally exposed to bank risk (e.g. through the proportion of net assets in savings deposits, equity or bonds; time to retirement etc.).
4. Rather than blanket mandatory deferral and deferral periods, require APRA to certify that each ADI's executive remuneration framework and policy encourages

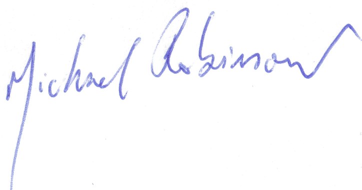
sound prudential management[3]. That is, ADI's will be freer to develop remuneration frameworks that suit their circumstances, which APRA would compare against the data is has collected to ensure it addresses areas of concern or weakness. This will require APRA to develop and apply a certification process to take into account the many factors that could contribute to excessive risk-taking, or conversely, sounder prudential management. It will also take time and resources to certify remuneration for the 144 Australian ADIs currently supervised. However, Guerdon Associates believes that this tailored approach will result in more effective prudential management than a mandated "one size fits all" remuneration requirement irrespective of ADI circumstances.

5. In order for APRA to meet the requirement in (5) above, authorise APRA to mandate the provision of data from ADIs to permit a more effective and nuanced approach to each ADI's executive remuneration. This data may include personal data from executives in addition to the data for "fit and proper" assessment, such as a register of pecuniary assets. For example, a bank CEO who has 60% of his/her personal wealth in bank equity will have a different perspective on bank risk taking than a bank CEO with 5% of his/her personal wealth in equity. The data are necessary for the formulation of an effective policy tailored to each bank. In the examples above, the first bank would not require the executive to defer as much pay into equity, while the second bank may need to require both a much more significant payment in deferred equity (or bank bonds) and the imposition of a high CEO share ownership requirement. These and other data that behavioural research has shown to have major influences on risk taking behaviour are currently not collected or considered by prudential authorities, or most bank boards. The specific data requirements based on behavioural research will be subject to refinement over time, as more research becomes available. For this reason, the specific data required should not be hard wired in legislation.

Concluding remarks

Guerdon Associates acknowledges that the suggested approach for the BEAR to require APRA to take into account each ADI's circumstances for certifying its remuneration is appropriate, and will require more resourcing than is currently the case. However, this tailored approach would result in better executive accountability for prudential management than mandating a "one-size fits all" method of paying key executives.

We would be pleased to respond to any queries you may have in relation to this submission.



Michael Robinson

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[3] We acknowledge that some remuneration frameworks that provide for the most effective prudential framework may not meet publicly listed entities' shareholder requirements for remuneration report and equity grant voting purposes. However, Guerdon Associates believes that there will be sufficient "APRA certifiable" alternatives for each entity that would also receive sufficient confidence from shareholders, providing there are good levels of engagement between stakeholders.

Director