GRG Remuneration Review

APRA Executive Remuneration Guidelines

Remuneration Review No 21, March 2010

Introduction

Companies regulated by APRA have been busy implementing Australian Prudential Regulation Authority **(APRA), Prudential Practice Guide PPD 511 – Remuneration**, dated 30 November 2009. Whilst compliance is only required for APRA-regulated companies we believe the guidelines provide some useful reference points for all companies, including those outside the financial sector, in corporate governance of executive remuneration, in particular the treatment of risk and implications for bonus/short-term incentives (STI). Key elements and implications of the guidelines are outlined below. A separate Remuneration Review No.22 covers the **Productivity Commission's** subsequent report and recommendations, which have some degree of overlap.

APRA Key Elements

We caution that the table below shows only key aspects: several aspects of the prudential requirements have been omitted because they relate to matters that are not relevant to many companies.

Key Element	Detail	Discussion/ Comments
The Board should retain ultimate responsibility for remuneration.	The Board should ensure that **executive directors** are not placed in a position of actual or perceived **conflict of interest**.	Policies are commonly in place already but there may still be some tussles over the way in which executive directors (typically the CEO) and/or HR executives attend the meetings and participate in discussions and decisions on pay. Most boards find it very valuable to have CEO input on the performance of his/her direct reports, but there are differing ways in which this can be achieved.

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Key Element	Detail	Discussion/ Comments
Boards should have a **Remuneration Committee** which should set and periodically **review the Remuneration Policy**, to ensure that it remains appropriate for its intended purpose. Even if a company has little or no performance-based components of remuneration it should have a written Remuneration Policy which explains the objectives and the structure of the remuneration arrangements.	In particular: • The Remuneration Committee would be expected to identify material deviations of remuneration outcomes from the intent of its policy. • The Remuneration Committee would also be expected **to identify unreasonable or undesirable outcomes** that flow from existing arrangements. • The review should be undertaken **at least every three years.** The Remuneration Committee would be expected to identify material deviations of remuneration outcomes from the intent of its policy. The Remuneration Committee would also be expected to identify unreasonable or undesirable outcomes that flow from existing arrangements.	At a simplistic level the Committee may asses both of these aspects by reference to whether the remuneration policy has been effective in helping to attract, retain and motivate executive talent. At a more sophisticated level the Board would need to give consideration at the time of setting the Policy as to: • What remuneration outcomes (probably expressed in value derived by executives) it expects given various performance scenarios; • What are the performance scenarios it is expecting and how are the performance outcomes going to be expressed? • If expected outcomes are not defined at the commencement of the performance period then what basis will the Committee use to assess performance at the end? • In both the establishment of Remuneration Policy and in the assessment of its operation the Committee will need to take into account the **degree of acceptable risk** involved in the business plans and strategies as well as variances in the risk exposure that emerged.
The Committee needs to ensure it has the **necessary experience and expertise** to perform its duties and: • The Remuneration Committee may rely on administrative support from internal or external parties when conducting reviews. • If a Remuneration Committee engages external advisers, the governance standards require that the advisers be commissioned in a manner that ensures that their engagement, including any advice received, is independent. • The Committee should not engage an adviser who is acting concurrently or has acted recently on behalf of management or of any executive.	As a minimum: • Committees should require an advisor to not engage in discussion with management about other possible work while the advisor is appointed by the Board. • For clarity it may involve formal appointment of Board advisors for specific periods. An alternative may be to engage an individual independent expert and have as a condition that the person not be permitted to provide advice to management during the period of appointment to the Remuneration Committee	The Committee must be confident it is served by an independent advisor, focussed on long term, robust pay implementation and who will not risk that success on short-term or opportunistic pay solutions. We interpret the APRA framework as providing for acceptable instances of single consultancy firms bridging the provision of advice to both management and boards, but we believe that ultimately the most effective and transparent way to ensure independence is for the Committee to have an adviser firm free of commercial engagements by management on any form of professional advice. GRG is one of only a few firms to offer this positioning, coupled with the deep capability required in the structure and governance of executive reward. A key decision for Committees will be whether they should have, in addition to engaging with the advisor enmeshed with management on remuneration designs, a separate 'health-check' adviser who can provide arms-length insight on remuneration practice and risk. This also places the onus on the latter adviser to contain their scope and resist detailed design, but rather act as a counsellor to the Committee.

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Policy Coverage: should be comprehensive and include **all persons or classes of person whose actions could put the company's financial soundness at risk.** In this regard, there are three groups that should be considered for the purposes of the Remuneration Policy: • **'Responsible persons'** including directors (excluding non-executive directors), executives and senior managers who make or participate in making decisions that affect the whole, or a substantial part, of the business of the regulated institution. • Those whose primary role is **risk and financial control** (including risk management, compliance, internal audit, financial control and actuarial control roles). • Those **persons who receive a significant proportion of performance-based remuneration** such as through bonuses or commissions.	The Policy should also cover persons who are not directly employed by the entity but provide services to it and who may, individually or collectively, be able to affect the financial soundness of the entity. Risk and financial control personnel (except those that have risk or financial control for the total entity e.g. CFO & CRO) should be remunerated in a manner that does not compromise their independence in carrying out their risk or financial control functions. Generally, the variable remuneration received by such personnel would not be predominantly determined by either the managers or the financial performance of the business areas they monitor.	This element potentially expands the workload of the typical Remuneration Committee, which has traditionally focussed on the policy for (and individual outcomes of) responsible persons and then applied general oversight of policy and budgetary implications for the wider populations. The new guidelines require that Committees (and therefore companies) demonstrably bring remuneration and risk assessments together in an integrated way. At GRG we have the view that there are relatively few companies with a strong history of doing this, plus there is limited capability of reward practitioners in doing it. APRA's guidelines will encourage organisations to tread this path more forcefully and again our view is that Remuneration Committees will look to advisers who can most efficiently and effectively integrate advice covering both risk and reward factors. To this end GRG has sought out and allied with a 'deep experience' risk specialist in financial services. On projects we can apply an approach where our key findings on the business context and risk factors attaching to reward in key roles are documented and cross-checked/challenged by this specialist.
The Remuneration Committee should make recommendations to the Board on the **individual remuneration** of, at a minimum : • The Chief Executive Officer (CEO), • The direct reports other than administrative direct reports, and • Other persons who may be **able to affect the financial soundness of the company** in the Committee's view.	The Committee is also required to make annual decisions on the remuneration **of all of the categories of persons** required to be covered by the Remuneration Policy (other than those persons for whom individual recommendations are required).	It is likely that Committees will now need to spend more time on the pay of at least the following groups of management: **Risk and financial control roles:** some organisations will need more sophisticated means for recognition of performance in these roles without a 'freezing up' of the appropriate risk–taking which is the lifeblood of banks and financial services firms. **Sales and/or Trading Roles**: to ensure that the inevitable pressures for volumes and profits are appropriately balanced by sustainability assessments. **Investment Managers**: the usage of performance incentives features strongly in the market and therefore need careful review by committees on both risk and market competitiveness.

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Performance Pay Policies and Measures: in general, it is desirable to set performance thresholds and targets **prior to the start** of any performance period. It is also desirable not to reset performance-based remuneration components involving performance hurdles, strike prices and the like due to company, industry, economic or share market adverse performance.	In rewarding individual performance, the Remuneration Policy should be designed to encourage behaviour that supports the risk management framework of the entity. Measuring performance by some version of **profits or earnings** may be appropriate in some cases but effective remuneration arrangements will **include adjustments for risk, including future risks** not identified or measured by accounting profits. Where the institution makes adjustments to the statutory accounts for these purposes and these adjustments affect remuneration arrangements, the adjustments would be expected to be properly documented and substantiated.	The global financial crisis (GFC) showed that most Australian financial services firms have enjoyed the fruits of sound risk management functions, so these are fairly obvious requirements on a sector that has, on average, avoided many of the excesses of the global banks.
Hindsight Review and Deferral: measuring results with the benefit of hindsight allows the Board and the entity to assess the consequences of the risks to which the entity has been exposed.	This is particularly relevant where there are uncertainties in the accounting measures applicable to the period in which business is written or generated (e.g. assessing the repayment prospects of loans written during the current year). If there is no deferral, a margin for measurement uncertainty might well be incorporated into performance measurement.	Whilst APRA does not specifically mandate deferral of annual STI/bonus awards it seems clear that the onus is on Boards to ensure that appropriate mechanisms such as deferral or hindsight 'claw-back' provisions are in place to avoid unsustainable risk outcomes. Many Investment Banks have already moved, both globally and locally, to increase the deferred proportion of STI to around 50-60% for senior executives.
Remuneration Mix and Adversity: the Policy needs to define in advance how the institution will **respond to uneven performance** across the institution, including circumstances where the whole institution faces material adversity. It is desirable that base pay comprise a sufficient proportion of total remuneration to enable the Board to **make performance-based components genuinely discretionary**.	Policy should provide for and enable the Board to adjust downwards and, where appropriate, eliminate payment of performance based remuneration for two reasons. • One is to protect the financial soundness of the regulated institution in adverse circumstances. Examples include an institution experiencing losses, not meeting prudential capital requirements or relying upon public sector capital injections. • The other reason is broader and is for circumstances where material unexpected outcomes arise.	These are fairly onerous requirements on a sector that has on average been building the proportion of incentive pay in the pay mix over a number of years, or faced market-competitive practices which have emphasised very large proportions of STI outcomes relative to base pay (such as trading roles). It is also anathema for many executives who for years have fought to maintain the certainties of formula-based pay rather than discretionary assessment by Committee members. Whilst there are many transitional issues still to be resolved it is clear that many Investment Banks have already moved, both globally and locally, to change the pay mix by increasing base and re-weighting incentives.

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Use of Equity: having a sizeable component of the deferred component of remuneration paid as equity-related benefits for executives, vested over an extended period, can be useful to encourage longer-term risk stewardship by executives. The use of (Equity) **options** in performance-based remuneration need to be considered carefully due to their high risk nature.	APRA falls short of mandating the use of equity in remuneration, but describes it as useful. For a number of reasons there has been a pattern for many executives to 'discount' equity pay in relation to hard cash, but it appears that executives will be required to bear more equity risk going forward. Timing and valuation are, however, still crucial and ironically some companies who upped stock grants around the September-December 2009 window now face major 'windfall' reward outcomes as the market soared in first quarter 2009.	Our assumption is that many financial services companies have undertaken a program of de-risking and de-leveraging the business profile to adjust to the new state of financial markets and a more subdued growth profile for some business areas. One important implication of this context for executive reward is the long term incentive (LTI) value of equity, given that share prices are typically influenced by business growth potential. Less risk can at times mean slower share price growth. There is also the wider issue, outside the scope of this short paper, on potential new approaches to disclose 'actual' share plan remuneration if Productivity Commission recommendations are accepted. For more detail see GRG Remuneration Review No. 22.
Recruitment and Termination pay: APRA expects any remuneration paid to incoming staff as compensation for deferred remuneration forfeited at a previous employer to be subject to performance validation or risk adjustment and deferral. Accelerated or unusually large payments to terminating executives, such as 'golden parachute' cash payout arrangements, are generally inconsistent with prudent practice and may expose a regulated institution to considerable risk.	APRA expects institutions to place suitable deferral and performance hurdles on incoming and termination payments. It would not be prudent practice for deferred payments to vest automatically upon cessation of employment with a regulated institution. It is preferable for deferral and vesting arrangements to remain in place. The fact that cessation of employment is the taxation point for deferred share schemes has the potential to cause conflict between prudent deferral and taxation requirements. Nevertheless, APRA remains of the view that a prudent remuneration policy will include deferral of some benefits to dates that are independent of and beyond cessation of employment. A Board Remuneration Committee will therefore need to consider how to conform to the spirit and principles of APRA's standards as far as possible while also meeting taxation requirements.	This will lead to some considerable changes since it was not uncommon in the Financial Services sector for deferred payments to vest automatically upon cessation of employment with a regulated institution. APRA correctly notes that the Federal Government's drafting of legislation in reward and taxation has arguably been un-coordinated and full of unintended consequences, not least that an increase in equity pay is preferred by APRA whilst the taxation of such is more onerous and complex. Remuneration Committees are left to wrestle with the consequences.
Partial Vesting: Entities may permit partial vesting of an amount to cover taxation obligations of the employee arising from the deferred component.	A perverse outcome could be where an employee ends up receiving a benefit that they are otherwise not entitled to and the company is out of pocket for the amount of the tax liability.	Many share-based plans will need review. Whilst companies will still have to live with the seven year duration cap there are new ways to amend share-based LTIs so that potentially adverse effects on termination can be mitigated.

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Hedging: The Remuneration Policy should prohibit 'responsible persons' from hedging their unvested equity exposure to the institution. The standards also require that the Remuneration Policy set out the actions that would be taken where a person is found to have breached this requirement.	An executive may contemplate taking excessive risks near the end of his or her employment with the regulated institution if the option is available to hedge deferred equity exposures upon leaving the institution. A Board will normally consider this risk in establishing the institution's remuneration arrangements.	Most companies have already moved to document policy in regard to hedging, but there may be some tightening required on hedging deferred equity exposures after leaving the institution.

GRG Contacts

GRG is well positioned to assist Boards and Remuneration Committees in reviewing their company's remuneration strategies, incentive plans and employment contract terms. Many of the top Australian listed companies are among our substantial client base.

GRG maintains databases on director and executive remuneration. We capture all the aspects required to be covered in Remuneration Reports and therefore provide an authoritative source of advice in relation to market practices and emerging trends.

Please feel free to call any of the following consultants on **02 8923 5700**

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