

## Seven Year Vesting on Financial Services CEO Variable Reward!

On 23 July, 2019 APRA released a discussion draft: "Strengthening Prudential Requirements for Remuneration" in regulated Financial Services entities. The proposed new Standard (CPS 511) is a direct result of recommendations from the Hayne Royal Commission. Specifically the Final Report highlighted that the structure of executive remuneration, and the KPIs driving STIs and LTIs, was implicated in the misconduct that the Royal Commission uncovered.

Two overarching objectives form part of APRA's mandate: Financial safety and the minimisation of financial and non-financial risks and financial stability with a greater focus on non-financial risks.

In drafting its proposed new, stand alone standard, APRA looked to overseas jurisdictions for sound practice including regulatory frameworks in place in the US, UK, Europe and Canada. There are a number of specific changes proposed by APRA:

1. A strengthening of governance oversight of remuneration policy and outcomes for executives (and other staff) with direct board involvement in KPI assessment for executives and greater focus on risk related outcomes.
2. A requirement that financial metrics make up no more than 50% of the KPIs driving STI and LTI schemes.
3. 60% of CEO variable reward to be deferred for a minimum of 7 years from the date of the award with pro-rata vesting after 4 years. For other executives, 40% of variable reward is to be deferred for 6 years with pro-rata vesting after 4 years.
4. Clawback for up to 2 years beyond full delivery and 4 years for a person under investigation (presumably for some form of misconduct or breach of the BEAR).
5. These provisions are to apply regardless of whether an executive remains employed by the institution or not.

No mention is made in the draft prudential standard as to the form of delivery that STIs and LTIs might take. Although the discussion in the draft notes that "skin in the game" is desirable and that performance share rights are generally favoured as the delivery vehicle for LTIs and part of the STI.



In my submission to the Royal Commission of April, 2018 I argued that the structure of executive remuneration in the major banks, and other organisations which follow a similar model, was a contributing factor to the misconduct uncovered. Changing the metrics as proposed by APRA is an improvement, but the continued focus on equity based incentives is not helpful. Changing the KPIs but continuing delivery in equity at best sends a mixed message. At worst it undermines the non-financial KPIs. It is much better to wind back the "at risk component" and reduce delivery in equity.

### Geoff Nunn & Associates

Geoff Nunn & Associates was established in 1993 as an independent provider of services to the government and corporate sectors. We specialise in working with Boards and CEOs in the areas of corporate governance, board dynamics and renewal, governance structures and executive remuneration strategy. Advice has been provided to over 1000 organisations Australia, New Zealand and Singapore.

**Geoff Nunn**

Board Advisor & Governance Specialist

0418 595 107

gtnunn@gna.net.au

[www.gna.net.au](http://www.gna.net.au)

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As it stands the APRA proposals, whilst well intentioned, adds to an already overly complex regulatory and administrative environment around executive remuneration.

### Our View of the Proposed Changes:

1. The strengthening of governance oversight of executive remuneration is positive and most welcome.
2. The move to apply 7 year vesting to 60% of CEO variable reward and 6 years to 40% for other executives is questionable when the average term of a financial services executive is 3-5 years. It effectively means that the departed executive will be relying on the efforts of others to sustain corporate performance in order to realise the reward.
3. Such vesting periods could result in the flight of some high performing executives to other sectors with less restrictive remuneration arrangements (and we need to keep good people in the financial services sector as it forms such a large part of the Australian economy).
4. I support rebalancing the KPIs such that financial metrics make up no more than 50% of the total weighting. However rebalancing the KPIs and continuing delivery in equity related vehicles undermines the re-balancing. The percentage delivered in equity should equal the weighting attached to financial metrics. That is:  $\leq 50\%$  of the reward with the balance in cash.
5. The level of complexity is very high. Compliance costs will increase with questionable benefit to customers, shareholders or other stakeholders.
6. The prescriptive nature of some of the changes undermines the independence of the board and remuneration committee. APRA will argue that financial services boards have failed in their governance responsibilities around executive remuneration. This is no doubt true and shareholder response to the 2018 NAB Remuneration Report was a stark reminder of this. But the big stick approach might not be best. What appears well intentioned might become just another compliance obligation that gets in the way of the main game.
7. The discussion draft is silent on the question of "Minimum Shareholding Requirements (MSR)". We propose a clause in the new standard removing MSR requirements from the remuneration policies of organisations covered by CPS 511.



### Concluding Comments

The impact of executive remuneration strategy on corporate culture cannot be overstated. The way organisations structure the fixed and variable components of executive remuneration, along with the corporate and individual KPIs which drive STIs and LTI, sends a strong message to all stakeholders about what the organisation values.

The changes that have been proposed by APRA and the financial institutions themselves in response to the Hayne recommendations have been largely superficial. Changing the metrics goes some way to shifting focus. Longer vesting is of doubtful value.

Various regulators (and the Royal Commissioner himself) have suggested that bank boards are caught in "Groupthink" and can't see beyond the narrow financial imperatives that drive their business model. However the phenomena of groupthink might not be limited to the boards of financial institutions. Other corporates and the regulators themselves seem wedded to the current configuration of executive remuneration and unable to move beyond it. See our submission to the Royal Commission of April, 2018 and APRA of September 2019: .

<https://www.gna.net.au/royalcommission>

<https://www.gna.net.au/apra-draft-standard-cps-511>

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