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2 August 2017

Manager
Banking, Insurance & Capital Markets Unit
Financial Services Division
The Treasury

Email: bear@treasury.gov.au

RE: Submission on 'Banking Executive Accountability Regime'

Dear Treasury,

Thank you for the opportunity to comment on the Consultation Paper on the proposed Banking Executive Accountability Regime (BEAR). Ownership Matters (OM), formed in 2011, is an Australian owned governance advisory firm serving institutional investors. The opinions contained in this submission are those of OM and not those of its clients. This submission will respond only to the parts of BEAR where OM considers its views are relevant: The changes regime as it relates to executive remuneration arrangements for listed Authorised Deposit-taking Institutions (ADIs). In summary OM does not consider that the BEAR remuneration changes would be overly disruptive for major deposit taking institutions assuming key concepts are appropriately defined.

Current deferral practice for listed ADIs

Table 1 below summarises the current variable pay arrangements for the CEOs of the eight listed Australian ADIs (including the CEOs of Macquarie and Suncorp who technically are the CEOs of NOHC which include an ADI subsidiary). The proposed BEAR pay requirements would see 60% of a CEO's 'variable pay' deferred for at least four years and 40% for other 'accountable' executives.[1] The structure of a CEO's package is usually a decent proxy for other senior executives – for example at ANZ and CBA the CEO and other senior executives have the same general structure. The major differences are that the CEO will generally tend to have the largest proportion of variable, deferred pay.

At present the CEOs of Macquarie Group and Westpac already have more than 60% of their variable pay deferred or assessed over four or more years while the CEOs of CBA and NAB both have more than 50% of their variable pay deferred or assessed over four years. Meeting the BEAR deferral requirement would be more challenging for Bendigo & Adelaide Bank, ANZ, Bank of Queensland and Suncorp.

[1] Based on the principles and definitions outlined in Chapter 5 of the consultation paper 'accountable executives' are likely to be similar to the group of listed bank executives currently defined as 'Key Management Personnel' whose pay must be disclosed in the remuneration report.

Table 1: Listed ADI CEO variable pay deferral[2]

Bank	Annual incentive potential	Long term incentive potential	Deferral for annual incentive	Vesting period for LTI	Proportion deferred for four years or more
ANZ	$3.15mn	$4.2mn	50% deferral; equal annual tranches over four years	Three years	5.3%
BEN	$400,000 plus $852,000 in shares (subject only to continued employment conditions)	$852,000	One-third of annual incentive deferred for two years. Annual share award deferred for two years.	Four years	40.5%
BOQ	$1.96mn	$1.3mn	50% deferral for two years	Three years	0%
CBA	$3.975mn	$4.065mn	50% deferral for one year	Four years	50.6%
MQG	Uncapped; FY17 profit share was $17.2mn.	Set each year; FY17 allocation est. $4.1mn	80% deferral released in equal annual tranches over three to seven years	Three to four years	61.3%
NAB	$4.03mn	$5.008mn	50% deferral; equal annual tranches over two years	Four years	55.4%
SUN[3]	$3.15mn	$3mn	50% deferral released after two years	Three years	0%
WBC	$4.029mn	$6.418mn	50% deferral; equal annual tranches over two years	Four years	61.4%

Note: Long term incentive potential is the 'face value' of the equity allocated.

[2] Based on most recent year for which data is available.

[3] Excludes sign-on equity received by the current CEO on commencement in October 2015.

Consultation Paper Questions

6. Would deferring variable remuneration be likely to result in a shift from variable to base remuneration? Would this be problematic and, if so, can anything be done to prevent this outcome?

The current structure of pay for senior executives of many listed ADIs, as shown in Table 1 above would not need much change in order to conform with the proposed BEAR deferral requirements for variable pay. Therefore it would be difficult for executives at those ADIs that already have met the proposed deferral requirements, or are close to meeting them, to justify higher fixed pay.

OM's understands fixed pay escalation has occurred in foreign jurisdictions where higher deferral requirements have been imposed chiefly in investment banking environments where prior pay arrangements had emphasized substantial up-front cash amounts. Even among the Australian listed ADIs that do not currently meet the proposed deferral requirements, upfront cash incentives are relatively small – for example, at ANZ, only 21% of potential variable pay is paid in cash while at Bendigo & Adelaide Bank one-third of any bonus above $50,000 is delivered in cash (the CEO's 'target' bonus is $400,000).

Should ADIs increase executive fixed pay in response to higher deferral requirements for variable pay this should reduce executive incentives to pursue risky strategies in order to maximise incentives – although it could also lead to executives' 'derisking' by accumulating large cash reserves reducing their potential exposure to their company's future performance. This however is already a significant issue among most Australian ADIs.

In any case the distinction between fixed pay and variable pay at many Australian listed ADIs does not appear real, at least when it comes to annual incentives. Among the 'Big Four' banks only NAB has in recent history paid senior executives' annual incentives well below 'target' levels. CBA paid only one bonus out of 48 below 'target' from FY12 to FY16 while ANZ paid bonuses above 'target' to all senior executives every year from FY12 to FY15 (target annual incentives for senior bank executives are typically equal to annual fixed pay).

Higher fixed pay in response to increased deferral requirements for ADI executives is likely to be problematic for investors in ADIs who are focused on ensuring executive outcomes reflect returns to shareholders. This is less of a concern for regulators interested in system stability or increased accountability for poor conduct, given the proposed higher powers for APRA to deal with senior executives responsible for conduct issues. As such, any problems identified by investors should ADIs respond to BEAR's deferral requirements by increasing executive fixed pay are best dealt with by investors exercising their rights and influence as shareholders.

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

The range of pay practices among listed ADIs is relatively narrow with most senior executives receiving fixed pay, a bonus based on performance assessed over a year and long term incentives assessed based on performance over three or more years. Some variations do exist: For example, Bendigo & Adelaide Bank executives as part of their fixed pay receive allocations of shares that vest based only on continued service with no performance requirements. These shares are variable pay, in that the outcome is not certain, but vesting is effectively guaranteed.

Arrangements where senior ADI executives receive cash payments or shares in lieu of amounts foregone at other employers are also potentially classifiable as variable pay. They are typically paid on achievement of a milestone – usually continued service – and so could be defined as variable remuneration with value determined by reference to share price.

OM notes that any variable remuneration that is subject to the BEAR deferral requirements ought to satisfy the "real risk of forfeiture" test so that any tax attributable to that variable remuneration ought to be deferred until the BEAR deferral requirements have been satisfied.

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

The proposed definition of variable pay in the consultation paper is: "That part of total remuneration that is discretionary and conditional upon performance and the delivery of results, including individual and business performance and results" and notes the definition may also specify that variable pay is "intended to reward performance and the delivery of results in excess of that required to fulfill a job description".

OM agrees that the definition of variable pay should be principles-based and give APRA considerable scope to define what constitutes variable pay (and also issue guidance to ADIs on what constitutes variable pay). The proposed definition has some issues that may conflict with existing ADI practice: For example, as the persistence of annual incentives noted above makes clear, elements of variable pay at many large ADIs appear not to "reward performance" nor "deliver of results in excess of that required to fulfill a job description".

In OM's view a working definition of variable remuneration would be: "Those elements of pay that are not guaranteed and are conditional on achievement of pre-determined objectives in addition to continued service or are at genuine risk of forfeiture".

9. Is the proposal for deferring 60 percent of the variable remuneration of certain executive accountable persons appropriate?

Yes, and as noted above, a number of large ADIs already effectively meet this requirement. Macquarie Group, for example, from FY17 has required 60% of the deferred profit share of all senior executives to be deferred for three to seven years. Deferral of incentive pay significantly reduces executives' incentive to seek unsustainable returns to maxmise pay outcomes given they would be exposed to the associated ongoing risks. As noted above however, ADI executives who receive very large pay packages over time regardless of deferral regimes are able to build significant wealth outside of their ongoing variable pay exposure to their employer and effectively de-risk themselves.

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

Yes, given the proposed expectations required of executives subject to BEAR. It is difficult to see what justification there would be for an executive found by APRA to have breached BEAR expectations to retain any variable pay on their disqualification by APRA under BEAR. A rationale for the large remuneration packages of senior executives of large ADIs is that such executives incur significant responsibilities; it is therefore difficult to see how failure to take "reasonable steps" to carry out these significant responsibilities would allow them to retain any part of their 'in flight' variable pay.

As a final point OM does not see any compelling reason why the register of accountable executives within ADIs including those disqualified executives and the maps of roles and responsibilities should not be publicly available. This information would be beneficial to investor understanding of executive responsibilities and accountabilities within listed ADIs and there appears to be no public interest benefit in keeping these details confidential. If the intent of BEAR is to protect and increase public confidence in Australian ADIs by improving executive accountability for misconduct then refraining to make the register available (including details of when executives are held accountable for breaches) is unlikely to improve public confidence.

Please feel free to contact us concerning any aspect of our submission.

Yours sincerely,

Dean Paatsch & Martin Lawrence

Ownership Matters Pty Ltd