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Executive Pay & Board Governance

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Submission on Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017

Guerdon Associates appreciates the opportunity to provide a submission on the Exposure Draft of the Treasury Laws Amendment (Banking Executive Accountability and Related measures) Bill 2017 (the ED or BEAR). As an external provider of remuneration and governance advisory services to ADIs, and with observations on the impact similar regulation has had internationally, it is believed that the firm can provide useful insight into the application of the proposed legislation.

Given the limited time available to review the ED and prepare our submission, it is necessarily concise and brief.

The purpose of this submission is to alert you to matters for your consideration before finalisation of the Bill to be introduced into Parliament.

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.

[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.

Matters of definition

Accountable person:

The definition of accountable person builds on existing concepts of accountability and responsibility, such as 'responsible person', 'director' and 'senior manager' that are defined in APRA's prudential standards and the Banking Act. Under the general principle, a person having significant influence over the conduct and behaviour of the entity where that person's behaviour or conduct could pose risks to the business and its customers will be an accountable person. This could include the head of a business line or a position in the parent entity if the parent is not an ADI.

Similarly, an accountable person could also be a mid level manager who manages a small subsidiary in wealth management. Such a person may not ordinarily be considered a 'senior executive' as the ED anticipates, but would be treated as an accountable person in terms of the drafting.

Total remuneration:

While there are constant references to total remuneration, there is no definition of total remuneration nor how that amount is to be calculated.

For example, total remuneration could be calculated as the cash components plus the fair value of the equity components at the time of grant of the equity opportunity. The economic fair value of the equity component is the most accurate measure of the value of that component to the individual.

However, investors and other stakeholders insist on companies 'valuing' the equity component of remuneration at a face value at the time of grant of the equity opportunity. Treasury's Explanatory Memorandum indicates that the face value approach will be used, yet this is not in the draft legislation.

There is a range of ways in which the value of total remuneration can be determined. The absence of a definition of total remuneration and the way in which it should be calculated means ADIs and accountable persons will have no certainty they are compliant.

Variable remuneration:

The definition of variable remuneration does not explain how it is to be valued, for the same reasons as outlined above. The equity component of variable remuneration can be calculated in a range of ways delivering different amounts depending on the method used.

The inclusion of sub-paragraph 37EA(1)(b) could be considered redundant as a "retention bonus" is remuneration that is conditional on the achievement of a specific objective (i.e. service), and, as such, is a component of sub-paragraph 37EA(1)(a). If retained, it needs definition.

Significantly, and in respect of both total and variable remuneration, there is no capacity to calculate the deferral percentage for those ADIs that determine their variable remuneration on a profit share basis (e.g. Macquarie Bank). Such ADIs are unable to determine the total remuneration or the variable remuneration for an individual at the beginning of the financial year.

Additionally, the ED does not provide for the scenario where the executive's variable remuneration is subject to shareholder approval and that approval is not received (and there is no cash alternative). For example, an executive's total remuneration opportunity may be offered at the beginning of the financial year with the equity components conditional on subsequent shareholder approval. If shareholder approval is not received, the cash component of any variable remuneration is all that remains available for deferral. This would seem to be outside the intention of the ED.

Granting: section 37EB sets out the amount of variable remuneration that is to be deferred and, for example, says "….*60% of the CEO's variable remuneration for the financial year (the relevant financial year) in which the decision was made granting the variable remuneration; or (b) 40% of the CEO's total remuneration for the relevant financial year………..*"

It is not clear whether the reference to 'granting' is the time at the beginning of the financial year when an executive is advised of the opportunity to be subsequently awarded variable remuneration when objectives have been achieved[2], OR the time when the award is actually granted (typically within 3-4 months after the end of the financial year.

The times at which the equity component of a deferred short term incentive and a long term incentive for the financial year is *'granted'* can be two different dates and may be up to 18 months apart. However, the executive may be offered the short-term incentive and the long-term incentive opportunities for the financial year at the same time (i.e. at the start of the financial year).

Minimum period of deferral:

The minimum period of deferral required under section 37EC is 4 years. However, the interaction of sub-paragraph 37EC(1)(a) with sub-subparagraph 37E(1)(a)(i) does not enable the period to be determined with certainty. Is the start of the 4 year period the date on which the executive's equity component is 'granted', or is it the date on which the executive is offered the opportunity to be awarded the equity once the objectives have been achieved (i.e. the start of the financial year)?

Sub-section 37EC(1) states that the period starts *".... on the day after the day on which the decision was made granting the accountable person the variable remuneration".* For the reasons explained above, the absence of a definition of 'grant' can result in different start dates in respect of the same financial year's variable remuneration.

Accountability obligations

It is not clear how an ADI or an accountable person can be in contravention of, for example, paragraph 37(c) and section 37CB if the ADI has met its notification obligations under section 37F.

[2] This is the generally accepted basis for accounting expense accrual purposes

It seems that an ADI must be regarded as having taken reasonable steps in conducting its business to prevent matters from arising that would adversely affect its prudential standing or reputation if:

- it has given APRA the requisite accountability statements and accountability maps; and
- APRA has not rejected the statements and maps on the basis the arrangements were insufficient.

Is it correct to assume the legislation is drafted in a way that ensures an ADI will not be subject to penalties if it has fully met its notification obligations and they have been accepted by APRA in respect of an area of the ADI that causes, say, reputational damage?

It is accepted that an ADI will contravene the legislation if, for example, there is a prudential failing in a business unit of the ADI that was not included in the ADI's notification obligations.

Ministerial exemptions

The ED provides for the Minister exempting an ADI or class of ADIs from the obligations under the legislation, rather than APRA exercising its judgement as an independent statutory body. This in effect makes exemptions a political, rather than a prudential judgement. For example, it has not been unusual for politicians to be critical of banks increasing interest rates against their wishes, yet such increases are necessary to remain “unquestionably strong” prudentially.

It seems highly unusual that an independent statutory body established for the purpose of prudential regulation and oversight not have full power under the legislation.

It is noted that paragraph 1.37 of the Explanatory memorandum states:

- *The Minister must make a decision which balances a range of competing considerations and interests, which is* ***informed by its unique position as the prudential regulator; …..***

The EM appears to contemplate APRA as the appropriate body to determine exemptions.

Penalties and clawback

The ED has not made provision for the reduction of variable remuneration or clawback (i.e. repayment) of variable remuneration in circumstances when an accountable person at the time a prudential or reputational failing was caused is not an accountable person when the issue surfaces. If the accountable person has left the ADI and has no deferred remuneration on foot (because it was forfeited on departure), there is no provision for clawback.

While APRA can ban the person from becoming an accountable person, the individual may no longer be working in ADIs. For example, an executive may be two years into a deferral period and leaves the ADI insurance subsidiary for a similar role in an insurance company that is not an ADI subsidiary. The insurance company provides the individual with a 'sign-on' equity component to compensate for the variable remuneration foregone. This executive may have been the accountable person responsible for the prudential failing at the ADI and has effectively maintained the deferred remuneration by moving to a non-ADI.

In the absence of contractual provisions requiring repayment (which may not, in any event be effective), there is no recourse for clawback. Consideration could be given to statutory provisions imposing financial penalties on accountable persons even if they are no longer accountable persons, or, has been suggested by others, extending the provisions to all APRA regulated entities, rather than ADIs.

Concluding remarks

The foregoing comments and suggestions are provided with a view to ensure the final legislation is both workable and achieves its intended effect.

We would be pleased to respond to any queries you may have in relation to this submission. As indicated earlier, we will provide a more detailed and comprehensive submission for publication next week.

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