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Proposed extensions to governance requirements for APRA-regulated institutions

The Finance Sector Union (FSU) represents 50,000 members employed in the finance sector across Australia, with the majority of these employed in the major banks. The FSU welcomes the opportunity to comment on the proposed extensions to governance requirements and supports initiatives to ensure responsible remuneration practices are observed throughout the finance industry.

In our first submission we acknowledged that overall we were supportive of the view APRA had adopted. We did, however, have some concerns about the policy scope and lack of disclosure requirements and suggested solutions to these issues. It is with disappointment that we observe a significant weakening of the original policy positions. The FSU made eight recommendations that aimed to improve transparency and increase consultation with stakeholders. We will further highlight our recommendations and the problems we believe will arise if these are not implemented. In summary, the FSU believes:

1. Requirements in the *Corporations Act* and accounting standards¹ that apply to auditors should be applied to remuneration consultants through the proposed Governance Standards,² to improve independence and accountability;
2. The independence of Board Remuneration Committees would be improved by creating a position for employee representatives. Should actual membership of the Committee not be prescribed then genuine involvement with employee representatives during and after the review process should be prescribed by the Governance Standards;
3. The third group of persons covered by the proposed Governance Standard should be redefined to reflect the intention of the Prudential Practice Guide;
4. The requirement for adequate remuneration for risk and financial control personnel should be broadened to all roles covered by the Governance Standards;
5. Employee-related risk measures from the Global Reporting Initiative should be recommended in the Prudential Practice Guide;

¹ *Audit-related disclosure requirements of the Corporations Act and accounting standards*, Australian Government Financial Reporting Council.

http://www.frc.gov.au/reports/2007_2008_AAIR/2007_2008_AIR-11.asp

² Draft APRA Prudential Standards 510: APS 65-73, GPS 69-77 and LPS 65-73

6. The use of escrow accounts for holding executive performance based payments that gradually vest during tenure and after retirement should be recommended in the Prudential Practice Guide;
7. Regular consultation with Employee Representatives about potential issues in APRA-regulated institutions will assist the supervisory process;
8. The Governance Standards should explicitly state the additional disclosure requirements that the proposed extensions require.

It may be some time until another opportunity for significant change emerges, so it is critical that rigorous and comprehensive changes are made now.

Recommendation 1: Requirements in the Corporations Act and accounting standards³ that apply to auditors should be applied to remuneration consultants through the proposed Governance Standards,⁴ to improve independence and accountability.

The process by which remuneration decisions are made is inherently subjective. The market for executives is an imperfect one and there is a large amount of discretion afforded to Remuneration Committees in determining pay. Decisions about selecting a comparator group and at which level to benchmark are not made using a scientific or reproducible process; rather it is a process that is susceptible to the bias of the person conducting the review and perpetuates the current flaws and inequalities in wage determination.

Remuneration consultants are at the core of this problem and have historically facilitated aggressive pay-rises and bonuses to executives. In our first submission we highlighted the extreme reliance that boards had on consultants in relation to remuneration setting. At the AICD information session on the proposed governance changes in Melbourne, Patricia Cross indicated that as Chairman of the NAB Remuneration Committee she will be using remuneration consultants more going forward.

The lack of disclosure related to remuneration consultants is concerning. The board will be able to justify their recommendations based on the use of these 'experts' without disclosing which consultants were used and the degree to which their advice was relied upon. In addition, there are no disclosure requirements around conflict of interest and how managing the inherent 'rational bias' of consultants pursuing economic advantage is managed. It is incomprehensible to imagine shareholders and other stakeholders would accept this as an adequate level of disclosure, consistent with the intent of the ninth Financial Stability Forum principle. Remuneration consultants should be subject to rigorous disclosure requirements.

We note and endorse the Productivity Commission's draft recommendation on the disclosure of remuneration consultant use⁵:

³ *Audit-related disclosure requirements of the Corporations Act and accounting standards*, Australian Government Financial Reporting Council.

http://www.frc.gov.au/reports/2007_2008_AAIR/2007_2008_AIR-11.asp

⁴ Draft APRA Prudential Standards 510: APS 65-73, GPS 69-77 and LPS 65-73

⁵ 'Executive Remuneration in Australia', Productivity Commission Discussion Draft. September 2009

“that companies disclose the expert advisers they have used in relation to remuneration matters, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.”

This endorsement should appear as an additional subsection in the Governance Standards⁶ and also explained within the Prudential Practice Guide.

Recommendation 2: The independence of Board Remuneration Committees would be improved by creating a position for employee representatives. Should actual membership of the Committee not be prescribed then genuine involvement with employee representatives during and after the review process should be prescribed by the Governance Standards.

We maintain the view that a position for employee representatives on the Remuneration Committee would be an appropriate way to increase the independence of the board for the reasons outlined in our first submission. In lieu of membership, we believe that consultation between employee representatives and the Remuneration Committee is critical.

The right of employees to collectively bargain wages has the potential to be undermined by not requiring the Remuneration Committee to consult with the employees’ bargaining representative. The requirements of good faith bargaining are clearly defined in the *Act*⁷ and contain the following obligations:

- attending and participating in meetings at reasonable times
- disclosing relevant information (other than confidential or commercially sensitive information) in a timely manner
- responding to proposals made by other bargaining representatives in a timely manner
- giving genuine consideration to the proposals of other bargaining representatives and providing reasons for responses to those proposals, and
- refraining from capricious or unfair conduct that undermines freedom of association or collective bargaining.

The expansion of the Remuneration Committee’s scope to beyond executives will result in a situation whereby many employees who are covered by industrial agreements that we negotiate will also be bound by policies or contracts that the Remuneration Committee will determine. To ensure that good faith bargaining occurs the bargaining committee requires access to the Remuneration Committee’s deliberations. This should be recommended as an area to consider in the Prudential Practice Guide.

Recommendation 3: The third group of persons covered by the proposed Governance Standard should be redefined to reflect the intention of the Prudential Practice Guide.

There is still a significant inconsistency between the language used in the Prudential Practice Guide and the scope of application in the Governance Standards. The Guide

⁶ Draft APRA Prudential Standards 510: APS 50, GPS 49 and LPS 47

⁷ Fair Work Act 2009 s228(1), Commonwealth of Australia

acknowledges the risk posed by groups of employees who collectively affect the risk position of an organisation. The Governance Standards do not adequately cover this risk, by limiting the scope to employees who receive a 'significant' portion of performance pay.

In our first submission we highlighted the immense pressure our members face within the finance sector to reach sales targets which most believed were unreasonable and unachievable⁸. Due to an aggressive sales culture and having targets linked directly to a performance management system, our members are pressured to push debt on to customers in order to maintain their employment. A combination of tightened lending criteria and less customers seeking credit has made the task of reaching targets more difficult, but 80% of members indicated that their targets had not reduced since the global financial crisis⁹. The 'distorting affect' of sales targets on the provision of financial products was highlighted by ASIC during their appearance at the inquiry into recent financial organisation collapses¹⁰. Furthermore, our members have observed hundreds of their colleagues be made redundant which has made them even more determined to reach performance targets and avoid performance management.

Many of these employees who could collectively affect the financial position of their employers may not receive a 'significant' amount of performance pay. For members who are feeling vulnerable to unemployment in a competitive job market of displaced workers, it is not the size of the incentive but rather the consequences of not reaching targets which drives behaviour. If these employees are not covered by a Remuneration Committee policy, we believe that banks will continue to exploit job security concerns. The policy should be applied to all groups of employees who could individually or collectively affect the risk position of the financial institution, regardless of whether or not their performance pay is significant.

Recommendation 4: The requirement for adequate remuneration for risk and financial control personnel should be broadened to all roles covered by the Governance Standards.

The FSU believes that all employees should be paid fairly and adequately for the skill and responsibility that their role requires. In respect to Financial and Risk staff, the first draft Governance Standards described a responsible approach to avoiding conflict of interest and ensuring remuneration was adequate for the skill required to competently manage risk across the organisation. It is disappointing that the clauses from the draft Governance Standards have been moved to the Prudential Practice Guide and a 'conflict of interest' clause has been inserted in their place, in effect weakening the original policy standard.

⁸ FSU Member Surveys: 2009 (1710 member responses so far), 2007 (2000 members) and 2005 (3000 members).

⁹ FSU Member Survey 2009

¹⁰ Inquiry into 'Issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses', 16 September 2009, pg26. Transcript available: <http://www.aph.gov.au/hansard/joint/commttee/J12399.pdf>

At the AICD information session, Patricia Cross highlighted the challenge of obtaining skilled risk employees who are familiar in all areas of the business. Ms Cross acknowledged the benefit of broad business knowledge in making good risk decisions. Although industry representatives are highlighting the significance of experienced and knowledgeable staff in executing their role, organisations are failing to implement appropriate cross-the-board standards of training which puts this into practice.

Across the finance sector, the FSU has noted the ‘de-skilling’ of labour and the reduction in training provided to staff to ensure they can confidently and competently execute the functions of their role. We are concerned by the aggressive sales focus of financial institutions and how this undervalues the consequences of consumer debt. Banks have increasingly been poaching sales staff from retail stores and providing them with the legislative minimum level of training in non-sales information. Committing someone to debt they will have difficulty servicing is significantly different to selling clothes or other consumables.

We believe that workers who individually or as a group could affect the financial position of their employer should be adequately trained and remunerated to recognise the skill required to exercise risk judgements. The Prudential Guide and Governance Standards advice in respect to adequate levels of remuneration for finance staff should be broadened to include all staff covered by the Governance Standards.

Recommendation 5: Employee-related risk measures from the Global Reporting Initiative should be recommended in the Prudential Practice Guide.

In our first submission we raised a concern that the risk-alignment discussion in the Prudential Practice Guide failed to acknowledge employee-related risk. This oversight fails to acknowledge avoidable situations related to the management, training, diversity and safety of employees working within the finance sector. For example, it may be reasonable to assume that risk decisions made by employees who work for extended periods of time without breaks are inferior to those made by employees who work shorter hours and are given breaks. Other examples could be the risk of poor decisions by inadequate training or the influence of unethical or inappropriate management tactics. The Global Reporting Initiative¹¹ provides examples of performance indicators that are relevant to employees. These areas include:

- Diversity and Equal Opportunity
- Training and Education
- Occupational Health and Safety
- Employee / Management Relations

Recommendation 6: The use of escrow accounts for holding executive performance based payments that gradually vest during tenure and after retirement should be recommended in the Prudential Practice Guide.

¹¹ *Labor Practices & Decent Work Performance Indicators*, Global Reporting Initiative, Version 3.0, 2006

The FSU is supportive of the approach APRA has taken in its view on long-term performance incentives for executives. We believe this could be strengthened by detailing different practical ways to achieve this. In our first submission we identified an innovative way of utilising an escrow account to make regular payments to an executive during their tenure and into their retirement¹². At the AICD information session, Erik Mather detailed another system which achieves similar objectives. Whilst APRA may not want to endorse a particular model, it may help boards to detail components of effective systems in achieving long-term payments to executives.

Recommendation 7: Regular consultation with Employee Representatives about potential issues in APRA-regulated institutions will assist the supervisory process.

As the new Governance Standards are introduced, we believe that it is important for APRA to consult with all stakeholders about any concerns or issues the new Standards raise. As the main focus of APRA's initial review will be at the organisation and policy level, there may be situations when implementation at an individual employee level is inconsistent with the Remuneration Policy. As the employee representative for many people employed in the Finance Sector, we believe that it will be important to have an open dialogue during this process.

Recommendation 8: The Governance Standards should explicitly state the additional disclosure requirements that the proposed extensions require.

As highlighted in our first submission, disclosure is one of the key ways that boards will be accountable to their stakeholders. The Financial Stability Forum was clear that it "should cover all the elements of the Principles and extend well beyond the details of the compensation of a handful of senior executives"¹³. Without adequate disclosure, constructive engagement with stakeholders is impossible due to the information asymmetry and a lack of trust. We believe that the only way to ensure that adequate disclosure occurs is to explicitly identify what must be disclosed, when and how.

If you have any questions in relation to this submission please contact Rod Masson, National Communication and Policy Manager, on (03) 9261 5330 or Keegan Hayden on (03) 9261 5342.

Yours sincerely



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National Secretary
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¹² 'Dynamic Incentive Accounts', *Edmans, Alex, Gabaix, Xavier, Sadzik, Tomasz and Sannikov, Yuliy*, (June 29, 2009). Available at SSRN: <http://ssrn.com/abstract=1361797>

¹³ 'FSF Principles for Sound Compensation Practices', *Financial Stability Forum*. Pp 13-14. 2 April 2009