BlackRock

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Submitted via email to: PolicyDevelopment@apra.gov.au

Dear APRA

RE: Strengthening prudential requirements for remuneration

BlackRock Investment Management (Australia) Limited (**BlackRock**) is pleased to have the opportunity to respond to APRA's discussion paper dated 23 July 2019 on strengthening prudential requirements for remuneration (**Discussion Paper**).

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this consultation paper and contribute to the thinking of the APRA on any issues that may assist in the final outcome.

Terms used in this response have the meaning given to them in the Discussion Paper, unless otherwise defined.

About BlackRock

BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

BlackRock's purpose is to help more and more people experience financial well-being. As a fiduciary to investors and a leading provider of financial technology, our clients turn to us for the solutions they need when planning for their most important goals. As of 30 June 2019, the firm managed approximately AUD$10.19 trillion in assets on behalf of investors worldwide.

Executive summary

BlackRock welcomes APRA's initiative to strengthen prudential requirements for remuneration.

The key purpose of remuneration is to attract, reward and retain executives and other staff who are fundamental to the long-term sustainable growth of shareholder value, with reward for executives contingent at least in part on controllable outcomes that add value. Each company faces different issues at different times, has its own unique strategic goals and value proposition. Therefore, each company should structure its remuneration policies and practices in a manner that suits the needs of that particular company and reflect its stated long-term strategic objectives.

We support incentive plans that foster the achievement of long-term sustainable value creation. Whilst companies should identify those performance measures most directly tied to its strategic objectives and shareholder value creation, the emphasis should be on those factors within management's control to create economic value over the long-term.

We agree with APRA's aim of ensuring that an entity's remuneration arrangements produce appropriate incentives and outcomes. In our experience, most governance issues require board leadership and oversight. We also agree with APRA that the Board needs to be active and have direct oversight. Furthermore, we agree with APRA that a deferral period helps build alignment between executives, shareholders, and rewards sustainable long-term value creation. However, we do have concerns with certain aspects of APRA's proposal, specifically around the demarcation of financial and non-financial risks.

Our concerns lie in setting an overly prescriptive framework which results in a delineation between financial and non-financial risk rather than viewing the two as symbiotic and necessarily embedded throughout a firm's strategy. Non-financial risks such as customer outcomes, conduct, compliance and reputational risk should be at the forefront of any firm's strategy as better outcomes in these measures equals better financial outcomes. Attempts to separate this from strategy runs the risk that compliance is seen in a more adversarial way rather than as a core, integrated part of a firm's strategy. Ultimately, we are concerned with the move away from a principles-based approach towards more prescriptive regulation.

We recognise that each company's strategy is unique and will evolve over different stages in its lifecycle. Against this backdrop we have concerns that setting a fixed limit to the design of variable remuneration has the potential to result in a 'one-size fits all' approach which could lead to unintended consequences. Overly formulaic structures could also lead to attempts at circumvention, i.e. they can be more prone to gaming. These types of arrangements can make it more difficult for shareholders to assess on merit and delivery from the outside.

Instead, we favour a more flexible approach that allows companies and shareholders to recognise the unique features of each company and select the right weighting between financial and non-financial measures. Under this approach, companies should explain the rationale for selecting the weighting between financial and non-financial metrics as well as explain how these metrics reflect the long-term sustainable strategic objectives of the company. We recommend regulatory guidance that aims for financial measures to constitute a majority of metrics as these are quantifiable, measurable, and importantly reflect the company's financial success and/or viability. Within this context, we are wary of using only "output" metrics such as earnings per share or total shareholder return. Our preference is for "input" metrics as these are within management's control. Furthermore, we believe that non-financial metrics, which have the potential to become significant financial risks over the longer term, should also be measurable and quantifiable.

Similarly, when considering APRA's three policy options outlined in Attachment A to the Discussion Paper, we acknowledge that the status quo is not an option. In terms of the key proposed changes outlined in the table below, we agree with the majority of the recommendations. However, we are concerned with the prescriptiveness of the "variable remuneration design" option which we elaborate further in the body of the submission. In terms of the policy options, our recommendation would be for option 2: i.e. proposed changes without proportionality applied while highlighting the concerns mentioned above around the prescriptive nature of the variable remuneration design.

Key Area	Key proposed change
Remuneration Framework	Remuneration policy for all arrangements, supported by remuneration objectives and a broad framework
Board Oversight	The board must approve the remuneration policy, actively oversee the remuneration framework, approve the remuneration of senior executives and other roles and ensure risk outcomes are reflected in remuneration outcomes
Variable Remuneration Design	Minimum design requirements for all employees, which promote prudent risk management and support remuneration objectives. Financial measures limited to 50% and individual capped at 25%. Constraints on deferral and vesting set for significant financial institutions (SFIs).
Outcomes management	Require adjustments to remuneration outcomes so as to align with risk outcomes; stronger review & oversight. Clawback to apply to senior roles in SFIs.
Review	Annual compliance reviews and triennial effectiveness reviews of the remuneration framework .
Transparency	APRA to consult on measures in 2020.

Annexure A of this document provides our response to certain specific questions raised by APRA in Table 10 of the Discussion Paper.

We hope these comments are helpful to APRA's deliberations. We appreciate the opportunity to address and comment on the issues raised by the Discussion Paper and will continue to work with APRA on any specific topics which may assist in the discussions of revising the Remuneration Framework.

Yours faithfully,

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Annexure A: Response to Consultation Questions

Remuneration framework

Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework?

We support APRA's objective to strengthen board requirements with respect to accountability and oversight of remuneration, and in this regard, we believe triennial independent reviews are appropriate and consistent with the requirements for APRA-regulated institutions to review risk frameworks. In setting related guidance, we encourage APRA to consider how this could complement existing regulation such as under the Banking Executive Accountability Regime (**BEAR**). It is also important, as recognised by APRA, to provide alignment and consistency on matters such as deferral periods described under BEAR. There could be an opportunity to provide guidance to permit companies to adopt deferral periods of four years or longer as appropriate to the company's circumstances and business cycle.

A review of the effectiveness of a company's remuneration framework is consistent with the discipline of regular board effectiveness reviews. Whilst companies could be afforded a degree of flexibility on how to approach this review, further principle-based, proportionate guidance could be useful to explain:

- what is in scope and out of scope;
- independence of management in performing the review;
- board discretion and disclosure in responding to findings;
- dealing with any commercial sensitivities of the findings; and
- consistency with requirements under BEAR and the Corporations Act in terms of the current requirements for information that members may obtain about directors' remuneration.

Board oversight

Are the proposed duties of the Board appropriate?

Are the proposed duties of the Board Remuneration Committee appropriate?

The role of the board is to oversee management's implementation of long-term strategy and reinvestment in the business for future sustainable growth. Boards should be mindful of the delicate balancing act between oversight and straying into day-to-day management. Our concern with the language in the current proposal is the potential to extend the responsibilities of the Remuneration Committee too deeply into the organization and the potential blurring of oversight responsibilities versus day-to-day management. The Board's main responsibility should be to provide the appropriate remuneration framework. We discuss further our views on this below.

Remuneration Committees are in the best position to make remuneration decisions and should maintain significant flexibility in administering remuneration programs, given their knowledge of the strategic plans for the company, the industry in which the company operates, the appropriate performance measures for the company, and other issues internal and / or unique to the company.

The responsibilities of the Remuneration Committee should include a review of and recommendations to the board on issues including but not limited to:

- the company's remuneration, recruitment, retention and termination policies for senior executives;
- executive director and senior executive fixed and performance-based remuneration to ensure that executives are motivated to pursue the long-term growth and success of the company;
- superannuation arrangements;
- the remuneration framework for non-executive directors;
- direct consultation with institutional shareholders, i.e. not through the use of consultants or management;
- the chairman of a committee should be independent. It is preferable for the chairman of the board not to chair board committees as this may lead to a concentration of power in a single director;
- apply discretion where appropriate to model outcomes that may not reflect the broader context, e.g. the ability to use downward discretion; and
- provide good disclosure to describe the rationale for the proposed framework, an explanation of targets and performance achieved on financial and non-financial metrics.

Remuneration design

APRA is proposing that financial performance measures make up at least 50 per cent of variable remuneration measurement and individual financial performance measures are limited to 25 per cent. Is this an appropriate limit, if not what other options should APRA consider to ensure non-financial outcomes are reflected in remuneration?

BlackRock's position is that all executive remuneration beyond salary and benefits should comprise variable pay based on relevant and challenging performance criteria that are clearly linked to the strategic objectives set by the management team and supported by a cogent explanation for the approach. BlackRock considers pay from the perspective of performance. Executive pay should be closely linked to performance, by which we mean strong and sustainable returns over the long-term, as opposed to short-term hikes in share prices.

As previously mentioned, we believe there is significant value in incorporating non-financial metrics into remuneration frameworks. However, as discussed previously, our concern with the current APRA proposal is the prescriptiveness of the approach and the potential unintended consequences of delineating financial and non-financial metrics. In addition to this concern, given the uniqueness of each listed company, there is unlikely to be a suitable "one size fits all" approach to the structure of executive remuneration. Rather, in our view, each company should structure their remuneration policies and practices in a manner that suits the needs of that particular company given the broader context and environment it operates in.

We support APRA's efforts to create a framework which encourages companies to consider the split between fixed and variable pay and the relationship between short- and long-term incentives. Consistent with the APRA proposal, we believe the use of multiple performance measures in a long-term incentive plan will avoid focusing management on a single performance measure and that a range of performance measures is sound practice.

APRA's recommendation that financial performance measures make up no more than 50 per cent of the weighting of total performance criteria used to determine variable remuneration measurement can be viewed as overly prescriptive and limiting in its definition. As mentioned above, there is no one-size that fits all in respect of executive remuneration arrangements. Companies should have flexibility to determine the metric split that are appropriate for the sustainable long-term objectives of the company. From our review of remuneration practices over many years, we observe, broadly speaking, that financial performance measurements make up at least 50 per cent of company's strategic KPIs.

In similar markets to Australia where we have been more specific in our guidance, such as our UK voting guidelines, we provide for greater variability than the current APRA proposal. For instance, in our UK voting guidelines, we recommend that performance measures should be majority financial and at least 60% should be based on quantitative criteria. Variable pay should be based on multiple criteria. We expect full disclosure of the performance measures selected and the rationale for the selection of such performance measures. We are wary of companies using only "output" metrics such as earnings per share ("EPS") or total shareholder return ("TSR"). Our preference is for "input" metrics as these are within management's control such as return, capital efficiency, economic profit, and operational metrics. If the board decides to use non-financial metrics such as ESG-type criteria, these criteria should be linked to material issues and they must be quantifiable, transparent and auditable. These criteria should reflect the strategic priorities of the company. For that reason, we believe the inclusion in ESG-indices is not an appropriate criterion. Where financial measures constitute less than 60% of performance measures a cogent explanation should be provided. We reference our EMEA voting guidelines to highlight our philosophy on this matter (https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-emea.pdf).

Remuneration outcomes

What practical hurdles are there to the effective use of clawback provisions and how could these be overcome? Would requirements for longer vesting where clawback is not preferred address these hurdles?

Whilst supportive of clawbacks, effective clawback can be difficult and costly to enforce. We believe consideration should be given to building performance adjustment (often referred to as malus) and/or clawback provisions into incentive plans to allow for awards to be forfeited before vesting, or to allow for executives to be required to repay rewards, in circumstances where the awards / rewards would not be appropriate. Situations in which such provisions are commonly triggered include cases of gross misconduct and misstatement of financial results. We expect the company to explain how it has determined that circumstances are appropriate for these provisions to apply, and to explain the steps it has taken to ensure the provisions are enforceable. Any subsequent changes to the stated operation of the provisions should also be clearly disclosed and explained.

Broadly speaking, both clawback provisions and vesting schedules have a role to play in ensuring there are sufficient safeguards in place. In our view, vesting schedules help to create further alignment with the interests of long-term shareholders. We expect the performance duration to be in line with the business cycle of the company. When the vesting period is two years or less, due to a short business cycle, an explanation should be provided and there should be a sufficient subsequent holding period beyond the vesting of awards to ensure the long-term focus by management.

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Transparency

What disclosures would encourage market discipline in relation to remuneration practices?

In terms of disclosure, we believe companies should explicitly disclose how incentive plans reflect strategy and incorporate long term shareholder value drivers. This disclosure should include a discussion about the commensurate metrics and timeframes by which shareholders should assess performance. Remuneration committees should clearly disclose the rationale behind their selection of pay vehicles and how these fit with intended incentives and expected outcomes.

Benchmarking tools should be used in a transparent manner, i.e. we expect the results to be disclosed by the company, especially the peer group selected. We expect companies to select peers that are broadly comparable to the company in question, based on objective criteria that are directly relevant to setting competitive remuneration; we evaluate peer group selection based on factors including, but not limited to, business size, relevance, complexity, risk profile, and / or geography.

In case of a significant pay increase year-on-year that is out of line with the rest of the workforce, BlackRock expects the company to provide a strong supporting rationale.

Disclosure to the ASX

Upon appointment of an executive director or where there have been material changes to the terms of an executive director's contract of employment, BlackRock expects disclosure of the key features of contracts to the ASX. Such disclosure should include, but not be limited to, the following features of the contract of employment:

- period of the contract;
- quantum of fixed remuneration;
- structure of any performance-based remuneration;
- notice period and termination provisions;
- sign-on remuneration;
- retention provisions;
- post-employment restrictions on trade and consideration paid;
- post-employment consulting or advisory relationships;
- post-employment vesting of payments granted during employment;
- contractual provisions for conflicts of interest, including acceptance of payments from shareholders, employees, suppliers, customers and others with a pecuniary interest in company activities;
- change of control provision and the impact on variable remuneration; and
- any other material issues which will assist shareholders to fully understand the terms.

Short term incentives (STI)

STIs should be linked to performance. Disclosure in the remuneration report should provide shareholders with an understanding of the maximum amount of STI award an executive can earn in a given year. For example, this may be expressed as a percentage of fixed remuneration.

The remuneration report should clearly state the performance measures and the hurdles that are required to be met for an STI to vest. BlackRock does however accept that in the case of STIs, performance measures may involve commercially sensitive information. In such cases, BlackRock will accept non-disclosure of future performance targets. However, BlackRock expects companies to retrospectively disclose the nature of the performance measure, the performance hurdle met and the percentage of the award that vested on an annual basis.

The remuneration report should also explain why each STI performance measure was selected and the relationship of each performance measure to the company's stated strategy. It should clearly disclose the performance measures that were met, the performance hurdle that was achieved and the amount of remuneration rewarded in respect of each performance measure for each KMP.

BlackRock also encourages companies to defer a significant portion of an annual performance-based award into equity which may vest over a period of around three years from grant date. Deferring a significant portion of an STI will encourage management to consider decisions that have implications beyond the initial 12-month performance period.

Disclosures should indicate if any discretion has been applied and an explanation of how discretion was applied. It should also include any change in policy from prior years and any exceptions to policy in the reporting period and reasons for such departure.

BlackRock is always concerned where executives appear to have been rewarded via an STI when short term performance has been prima facie poor. In such situations BlackRock expects a cogent explanation regarding why management appears to have been rewarded for poor performance.

Long-term Incentives

Blackrock expects a clear link between the structure of a company's long-term incentive plans and the company's strategy. The link between executive remuneration structure and strategy should relate to the performance period and performance measures used. Explanations should address risk management.