

12 February 2021

General Manager, Policy Development Policy and Advice Division
Australian Prudential Regulation Authority
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By email: Policy.Development@apra.gov.au

Dear Sir or Madam

Revised Prudential Standard CPS 511 Remuneration

The Insurance Council of Australia (**Insurance Council**)¹ welcomes the opportunity to engage with APRA on the proposed revisions to *Prudential Standard CPS 511 Remuneration (Draft CPS 511)* as released for consultation on 12 November 2020, together with the *Response Paper: Strengthening prudential requirements for remuneration (CPS 511 Response Paper)*.

The Insurance Council and its members, as noted in our earlier submission of 23 October 2019, support reforms aimed at strengthening governance and remuneration frameworks. We acknowledge the view expressed in APRA's 2019 discussion paper that the current approach to regulation in this area is not delivering satisfactory outcomes.² However, we also note recent APRA comments that the Banking Executive and Accountability Regime (**BEAR**) has improved board oversight of ADIs through increased accountability.³

The Insurance Council observes that in strengthening governance of regulated entities' remuneration frameworks, it is important APRA's revised prudential expectations strike an appropriate balance when setting an "effective" remuneration framework. It is important to recognise that Draft CPS 511 does not exist in a regulatory vacuum. CPS 511 will operate alongside and not separate to common law directors' duties, ASX listing requirements, BEAR

¹The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent approximately 95 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

September 2020 Australian Prudential Regulation Authority statistics show that the general insurance industry generates gross written premium of \$51.8 billion per year and has total assets of \$136.5 billion. The industry employs approximately 60,000 people and on average pays out about \$171.4 million in claims each working day. Over the 12 months to September 2020 the industry's net profit after tax (NPAT) was \$0.9 billion - a 73 per cent decrease from the prior year's NPAT of \$3.4 billion. The industry's underwriting result was \$1.6 billion, falling by 16 per cent from \$1.9 billion in the prior year.

²Page 6, Discussion Paper: Strengthening prudential requirements for remuneration, 23 July 2019.

³See for example Mr Stuart Bingham, GM Governance Culture Remuneration and Accountability comments to Macquarie University webinar "The BEARS bite ... can you regulate accountability", 10 am, Thursday, 4 February 2021.

and in time, Financial Accountability Regime (**FAR**)⁴ obligations. Draft CPS 511 will form part of this broader regulatory fabric within which regulated entities have to establish their remuneration and risk management frameworks.

While the focus of draft CPS 511 is “prudent incentive structures and clear accountabilities”,⁵ there is a need for the remuneration framework to be: proportionate, genuinely motivating, market competitive, and not unnecessarily burdensome. In terms of market competitiveness, the market for many roles extends beyond the financial services industry and Australia.

Therefore, it is important that APRA ensures Draft CPS 511 will integrate into the overall regulatory fabric in a coherent manner, without creating undue complexity that could put at risk the competitiveness of the Australian financial services sector. Increased complexity could impede the fundamental purpose of these frameworks to remunerate and motivate staff in alignment with positive consumer and shareholder outcomes.

The revised proposals in Draft CPS 511 include:

- the introduction of a more principles-based approach;
- greater recognition of the differing responsibilities of the board and management;
- a step back from fixed percentage caps on the use of financial performance measures in determining variable remuneration; and
- a better understanding of the practical and legal difficulties of designing effective clawback arrangements.

The result is an improved, more realistic and achievable balancing of relevant factors than the initial Draft CPS 511.

However, the Insurance Council remains of the view that further substantive revisions to Draft CPS 511 are necessary to achieve an optimal outcome. In particular:

- the revised proposed deferral periods are still excessive and should be amended to align with the deferral periods required under the BEAR and in due course the FAR;
- the revised proposed deferral percentages for variable remuneration are still excessive and should be amended to align with the deferral percentages required under the BEAR and in due course the FAR;
- guidance is required as to how regulated entities will be expected to give material weight to non-financial remuneration measures given the lack of clarity and standardisation of non-financial metrics across different industries and countries;
- further consideration should be given as to how highly paid material risk-takers (**HPMRT**) are identified given frequent year-on-year income fluctuations and resultant administrative complexity and increased operational risk. Consideration should also be given to removing this category in its entirety;

⁴On 4 February 2019 the government announced that it would extent the BEAR to certain other financial services entities, including general insurers, via the FAR. The FAR has yet to be finalised and enacted. It will incorporate and supersede the BEAR which commenced on a staggered basis on 1 July 2018.

⁵Para 1, Executive Summary, CPS 511 Response Paper.

- the revised Draft CPS 511 will still impose an excessive workload on both boards and board remuneration committees eroding the strategic oversight role of the board;
- APRA should amend Draft CPS 511:
 - to explicitly state that regulated entities are only required to apply clawback in exceptional circumstances after other adjustment tools have been exhausted;
 - to include a list of criteria which regulated entities are to take into account when determining if exceptional circumstances exist; and
 - to permit regulated entities not to pursue clawback when it is unreasonable to do so;
- APRA should amend Draft CPS 511 in relation to third party suppliers to reflect APRA's intent (as stated in the meeting of 29 January) that the obligation only applies to the regulated entity's remuneration of third parties and to reinsert a materiality threshold; and
- APRA should defer timetable for implementation until the regulated entity's first financial year commencing two years after the final practice guide is released.

The rationale for the Insurance Council's views is outlined in Appendix 1.

We trust that our observations are of assistance. If you have any questions or comments in relation to our submission please contact Aparna Reddy, the Insurance Council's General Manager, Regulatory Policy, on telephone: 02 9253 5176 or email: areddy@insurancecouncil.com.au.

Yours sincerely



Andrew Hall
Executive Director and CEO

CONSIDERATION OF DRAFT CPS 511

1. Introduction of a more proportionality-based approach

The Insurance Council notes the introduction of a more proportionality-based approach in Draft CPS 511, including:

- a tiered model which accommodates the differing commercial realities of the largest and most complex regulated entities, to be known as Significant Financial Institutions (SFIs), and other financial institutions competing in the financial services market; and
- a shift away from a prescriptive fixed-percentage based ceiling approach, to identifying the component of variable remuneration subject to deferral, to an approach focused on giving material weight to non-financial measures, subject to risk adjustments.

The Insurance Council in our 23 October 2019 submission strongly emphasised the importance of a principles-based approach in line with that recommended by the Financial Stability Board (**FSB**), and in accordance with recommendation 5.1 of the Financial Services Royal Commission Final Report.

Therefore, the Insurance Council supports this more proportionality-based approach, but remains of the view that Draft CPS 511 is still too prescriptive.

SFI threshold

APRA intends to relevantly define SFIs as:

- for ADI groups which include general insurers with more than \$15 billion in assets; and
- general insurers with more than \$10 billion in assets.

Our members do not have any concerns with this threshold.

2. Deferral

The Insurance Council noted in its 23 October 2019 submission that the then proposed deferral periods were out of step with other jurisdictions and that longer deferrals:

- blunt their effectiveness;
- reduce the desirability of working in the financial services industry; and
- make it harder for general insurers to compete to recruit from talent pools which are not restricted to financial services.

Members were particularly concerned about their ability to attract and retain executives and highly skilled staff in areas such as data science, IT, risk and compliance, and most senior executive roles.

APRA has acknowledged *“that overly long deferral periods can have unintended consequences such as on an entity’s ability to attract and retain certain staff.”*⁶ As a result APRA proposes to slightly pare back the deferral period and allow pro-rata vesting for:

- CEOs – at least 60% of variable remuneration from 7 years to 6 years (with pro-rata vesting in years 4, 5 and 6 permitted);
- Senior managers and executive directors – at least 40% of variable remuneration from 6 years to 5 years (with pro-rata vesting in years 4 and 5 permitted); and
- HPMRTs who are not senior managers – at least 40% of variable remuneration from 6 years to 4 years (with pro-rata vesting in years 3 and 4 permitted).⁷

APRA also includes a table in the CPS 511 Response Paper which compares APRA’s revised deferral requirements for CEOs as against the United Kingdom, Europe, the BEAR, Hong Kong and Singapore.⁸

The Insurance Council remains of the view that the deferral periods for CEOs, senior managers and executive directors proposed by APRA are excessively long – as illustrated by APRA’s table which shows that only the United Kingdom (and home to the City of London the world’s current preeminent financial centre) will have a longer deferral period.⁹ This will have a material impact on general insurers capacity to attract and retain executives and highly skilled staff in key areas.

The diminution which this will cause in the capacity for general insurers, particularly smaller general insurers, to compete for and retain critical executive staff is more than an incidental “unintended consequence”. It could well have a material impact on their capacity to operate their businesses in a consumer centric manner.

Our view that that the deferral periods proposed under CPS 511 are excessively long is illustrated not only by the international comparisons noted above, but also by domestic comparisons.

The FAR, which will apply to general insurers, only proposes a minimum four-year deferral period for 40 per cent of the variable remuneration of accountable persons,¹⁰ in line with the BEAR. The imposition of deferral obligations in Draft CPS 511 beyond that of the BEAR and FAR will impose unnecessary complexity, duplication of effort and expense on regulated entities. While the CPS 511 response paper states that “upon finalisation of the FAR legislation APRA will review whether any changes to CPS 511 are required”, we propose that the better approach would be to align CPS 511 with FAR.¹¹

The Insurance Council recommends that APRA further refine the intended deferral of variable remuneration to align with the FAR and the FSB principles as follows:

⁶See 6.1.2, page 25, CPS 511 Response Paper.

⁷Para 51, Draft CPS 511.

⁸Figure 3 CEO deferral of international peer banking regulators, page 28, CPS 511 Response Paper.

⁹The City of London’s leading global status allows the UK to have a longer deferral period than normal without arguably detracting from financial services firms’ capacity to recruit and retain senior executive talent because it is such a desirable market in which to work.

¹⁰Deferred remuneration obligations, page 6, Implementing Royal Commission Recommendations 3.9, 4.12, 6.6, 6.7 and 6.8 Financial Accountability Regime Proposal Paper, 22 January 2020.

¹¹1.3 The Financial Accountability Regime, page 15, CPS 511 Response Paper.

- CEOs – at least 40% of variable remuneration from 6 years to 4 years (with pro-rata vesting in years 3 and 4 permitted);
- Senior managers and executive directors – at least 40% of variable remuneration from 5 years to 4 years (with pro-rata vesting in years 3 and 4 permitted); and
- HPMRTs who are not senior managers – at least 40% of variable remuneration for 4 years (with pro-rata vesting in years 3 and 4 permitted).

3. Limit on financial measures

We appreciate that the feedback in our submission of 23 October 2019 was taken into account and that APRA has changed its approach in reverting “to first principles” as a means of finding the optimal balance between financial and non-financial metrics.¹²

APRA’s revised proposal is that the remuneration framework for SFI regulated entities should, for each component of a person’s variable remuneration, “*give material weight to non-financial measures where the remuneration is performance related*” and be subject to adjustment “*for adverse risk and conduct outcomes, based on clearly defined risk criteria*”.¹³ This revised proposal is better than the original proposal, but is nonetheless still not supported by all general insurers.

The Insurance Council and its members seek APRA’s guidance as to matters SFI regulated entities are required to take into account when giving material weight to non-financial measures. Members remain concerned as to the lack of clarity and standardisation of non-financial metrics across different industries and countries. We seek confirmation that this guidance will be given in the proposed new prudential practice guide to be consulted on in early 2021.

4. Definition of highly-paid material risk-takers

APRA has made some adjustments to the definition of HPMRT. The definition of HPMRT has been amended to refer to “*a material risk-taker whose total fixed remuneration (which includes salary, superannuation, allowances and benefits) plus actual variable remuneration is equal to or greater than 1 million AUD in a financial year of the entity.*”¹⁴ The refinement of the definition to focus on “actual” variable remuneration was made to accommodate the reality that there can be a significant difference between a person’s potential and actual variable remuneration, amongst other issues.¹⁵

The Insurance Council, however, remains concerned as to how the threshold will impact individuals. Members have noted that there can be considerable variation in a person’s actual variable remuneration from one year to the next due to a range of factors, such as fluctuations in foreign exchange rates or a change in the business unit performance. As a result there will be a group of people who move in and out of the HPMRT cohort from one year to the next. Monitoring compliance for these individuals will add to the administrative burden of the reform. The approach adopted also means that many individuals will not know

¹²Per para under heading “Limiting the use of financial measures”, page 21, CPS 511 Response Paper.

¹³Para 37, Draft CPS 511.

¹⁴Para 18(f), Draft CPS 511.

¹⁵See 5.2 and 5.3, page 23, CPS 511 Response Paper.

until after the financial year whether their total relevant income falls on the wrong side of the line and that they are subject to income deferral, or not.

The Insurance Council recognises that these types of issues often arise at the margins of a legal threshold. Nonetheless, and recognising that it is individuals who will suffer the adverse consequences of not being able to immediately receive and enjoy the benefits of their income (and in some instances motivating them to leave the industry or Australia), the Insurance Council queries whether the definition of HPMRT could be even further refined.

One possible option is the inclusion of an averaging mechanism, much like happens when determining the taxation of farmer's income, another group of individuals whose income fluctuates from one year to the next. For example, average fixed and actual variable remuneration of 1 million AUD or more over two out of every three years. This might also mitigate against remuneration planning by some individuals to realise total remuneration just below the 1 million AUD threshold. However, it will also result in increased administrative complexity which usually equates to increased operational risk.

Other feedback from Insurance Council members is that the inclusion of superannuation, allowances and benefits within the fixed component of the total \$1 million AUD threshold already adds a significant administrative burden.¹⁶ A better approach might be to remove the fixed component from the definition of HPMRT (thereby only encompassing variable remuneration) with a corresponding downward adjustment to the threshold e.g. to AUD 500,000.

In conclusion, the Insurance Council considers that the changes to the definition of HPMRT are an improvement, but that there are still significant difficulties and, as yet, no clear way forward to resolve those difficulties. In this circumstance some of our members are quite reasonably of the view the HPMRT category should be removed, given it appears to be of little value and will be highly complex.

5. Role of board and the board remuneration committee.

The Insurance Council acknowledges APRA's objective is to strengthen board governance and oversight of an entity's remuneration framework and APRA's view that boards have not been sufficiently engaged on remuneration and focused on compliance.¹⁷ To that end Draft CPS 511 makes the board "of an APRA-regulated entity ultimately responsible for the entity's remuneration framework and its effective application."¹⁸ Thereafter the precise approval, reporting and review obligations for regulated entities differ depending upon whether the regulated entity is an SFI or a non-SFI.

The Insurance Council shared the widespread concern that Draft CPS 511, as originally drafted, would diminish the strategic oversight role of the board (and the Board Remuneration Committee) and require boards to take on responsibilities that better sit with management. In our submission of 23 October 2019, we note APRA's stated intent in the 18

¹⁶This is particularly challenging where an insurer has cross-border operations and typical local remuneration packages are included. Examples of issues arising include, should FBT be included for AU based employee benefits? How to cost superannuation/pension contributions? Will actuarial calculations be necessary? etc.

¹⁷Page 16, CPS 511 Response Paper

¹⁸Para 21 for SFIs and para 63 for non-SFIs, Draft CPS 511.

September 2019 meeting with the ICA and members that it was not intended that the board approve individual remuneration for the expanded range of persons. Rather, APRA intended that the board would approve the principles governing the remuneration of these additional persons.

APRA indicates in the CPS 511 Response Paper that it has addressed industry concerns about this burden on regulated entity boards by way of “amended HPMRT recommendations and approvals to be on a cohort basis and ... the definition of HPMRT has also been narrowed”:¹⁹ See the Insurance Council’s earlier comments in relation to HPMRTs.

In the Insurance Council’s view, the clarification that the remuneration committee of a SFI regulated entity’ board “*must make recommendations ... annually on the remuneration arrangements and variable remuneration outcomes ... on a cohort basis for HPMRTs, other material risk-takers and risk and financial control personnel*”²⁰ goes some way towards redressing the blurring of board and management roles and not imposing an excessive workload on the remuneration committee.

However, this change falls short of adequately addressing the design flaw in Draft CPS 511, as originally drafted, since:

- the requirements imposed on remuneration committees go well beyond approving the principles to apply to the remuneration of this cohort as evidenced by the obligation to be imposed on the remuneration committee that it “*must obtain sufficient information to enable*” the committee to “*determine*” if this cohort’s “*variable remuneration arrangement[s are] appropriate to meet [their] intended purpose and expected remuneration outcomes and [to] support the entity’s compliance with [the required APRA objectives of its remuneration framework]*”;²¹ and
- there remain approval requirements on an individual basis, namely for “senior managers”. For entities with complex organisational structures, including those with international operations, the senior manager population could be a sizeable group of persons. Requiring individual board approval for persons in this group will, in these circumstances, impose a significant compliance burden on the group remuneration committee and board.

The net position is that remuneration committees will still likely be required to perform a role which properly belongs with the regulated entity’s management. Nor will the revised requirements do much to diminish the new workload to be imposed on the remuneration committee, which will continue to be excessive under revised Draft CPS 511.

The Insurance Council therefore considers that further refinement is needed to this aspect of Draft CPS 511. The Insurance Council recommends that:

- the requirement for individual board approval be aligned to the BEAR and, in due course, the FAR by removing the category Senior Manager and replacing it with Accountable Person; and

¹⁹Para 2.2.2, page 17, CPS 511 Response Paper.

²⁰Para 47, Draft CPS 511.

²¹Para 48, Draft CPS 511.

- boards should be free to delegate responsibility for certain responsibilities to their Board Remuneration Committee. For example, in relation to the category of Risk & Financial Control personnel accountability to the Board Remuneration Committee for the majority of these employees should be via management.

6. Clawback

The Insurance Council highlighted in its 23 October 2019 submission, the substantive legal and practical problems in applying clawback provisions, particularly after an employee has left the organisation, given that current legal and taxation frameworks do not support clawback. Hence, the Insurance Council considered the use of pro-rated deferral and malus to be a more effective tool to address the risk of misconduct identified by the Royal Commission.

APRA acknowledges the real problems in applying clawback provisions due to the legal and taxation frameworks, but then side steps resolution of those real problems by stating that the *“policy intent [is] that clawback would only be considered for exceptional circumstances”*.²²

Draft CPS 511 should be amended to:²³

- state that regulated entities are only required to apply clawback in exceptional circumstances and “after other adjustment tools have been exhausted”;
- list criteria which regulated entities are required to take into account to determine if exceptional circumstances exist; and
- permit regulated entities not to apply clawback in exceptional circumstances when it is unreasonable for them to do so.

7. Application of Draft CPS 511 to third party service providers

Draft CPS 511 requires both SFI regulated entities and non-SFI regulated entities to maintain a process within their documented remuneration policy which *“identif[ies] and address[es] inconsistencies with [the APRA prescribed remuneration framework] that may result from the remuneration arrangements of a service provider that is [a third party]”*.²⁴

We appreciate confirmation from APRA at our meeting on 29 January that the intention is for Draft CPS 511 to apply to a regulated entity’s remuneration of third party service providers, and not for Draft CPS 511 to apply to the third party provider’s remuneration of others.

The Insurance Council agrees with this intended approach, which is consistent with our understanding of the policy intent to ensure third party remuneration is designed to disincentivise behaviour that may result in poor consumers outcomes. Applying Draft CPS 511 to a third party’s remuneration of others, including the third party’s employees and contractors, is unnecessary to achieve this objective and may be unfeasible given the confidential nature of such remuneration.

²²6.2.2 APRA’s response, page 29, CPS 511 Response Paper.

²³The relevant paras being 55 and 56, Draft CPS 511.

²⁴Paras 20(c) and 62(c), Draft CPS 511.

The Insurance Council submits that Draft CPS 511 needs to be refined to make clear APRA's intent to apply the standard to the regulated entities' remuneration of third parties only. As drafted, Draft CPS 511 applies to "remuneration arrangements of a service provider", which can be interpreted to include the service provider's remuneration of others. The Insurance Council submits that it would be clearer to omit the word "arrangements" so that only "remuneration of a service provider" is within scope.

In addition, the Insurance Council submits that a materiality threshold should be re-inserted into Draft CPS 511, such that only third-party remuneration which may materially affect the management of financial or non-financial risks are captured. Such a materiality threshold was originally proposed but it is unclear why this has been removed. As drafted, Draft CPS 511 contains no materiality threshold and therefore applies to all service arrangements no matter how large or small. Accordingly, the measure may:

- introduce a regulatory bias for larger regulated entities to self-supply services currently purchased from third party suppliers by bringing that service in-house to the detriment of competition in the market; and
- increase cost pressures on smaller regulated entities who lack the capacity to self-supply and who will have no alternative but to continue to purchase these services.

We understand APRA's expectation is that insurers should implement arrangements that disincentivise the remuneration of third parties, for example insurance brokers, purely on the basis of sales and at the expense of consumer outcomes. We note that designing appropriate remuneration arrangements would differ substantially depending on the product and intermediary to which the remuneration applies.

While APRA should not take a prescriptive approach that would constrain the ability of regulated entities to determine how best to remunerate third parties, further guidance would help bring to life APRA's expectations on third party remuneration.

8. Implementation issues

The Insurance Council notes the implementation timetable proposed in page 7 of the CPS 511 Response Paper. The approach is essentially to develop the prudential standard and the prudential practice guidance in sequence with a limited period of overlap sometime in the first half of 2021 with the practice guide not being finalised until Q4 2021 after consultation. The timetable outlined in the CPS 511 Response Paper proceeds, as already noted, without regard to the government's timetable in relation to the FAR.

From a general insurer implementation perspective, it will be difficult for SFI general insurers to develop comprehensive revisions to their existing remuneration framework and arrangements before the prudential practice guidance is released. Further, as already noted the development and finalisation of CPS 511 in advance of, and beyond, the FAR is only likely to lead to duplication of work and unnecessary cost.

The Insurance Council therefore considers APRA's proposed implementation timetable to be somewhat ambitious and therefore suggests regulated entities should not be required to comply with new CPS 511 until:

- the first financial year commencing two years after the release of the final practice guide.

[End]