Insurance Council of Australia

13 August 2021

Director
Regulatory Powers and Accountability Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: FAR@treasury.gov.au

Dear Sir or Madam

Financial Accountability Regime – July 2021

The Insurance Council of Australia **(Insurance Council**) welcomes the opportunity to comment on the package of documents issued under the heading *Financial Accountability Regime – July 2021* (**FAR Package**), including *Exposure Draft Financial Accountability Regime Bill 2021* (**FAR Bill ED***)*, *Exposure Draft Explanatory Memorandum Financial Accountability Regime Bill 2021* (**FAR EM ED**), *Joint administration of the Financial Accountability Regime between APRA and ASIC – Information Paper, 16 July 2021* (**FAR Joint Admin Paper**), *Financial Accountability Regime – List of prescribed responsibilities and positions - Policy Proposal Paper,16 July 2021* (**FAR PRP Paper**) and Exposure Draft Legislation Q&A – Financial Accountability Regime.

The Insurance Council is the representative body of the general insurance industry in Australia and represents approximately 95 percent of private sector general insurers. As a foundational component of the Australian economy the general insurance industry employs approximately 60,000 people, generates gross written premium of $53.9 billion per annum and on average pays out $166.2 million in claims each working day ($41.5 billion per year).

The Insurance Council appreciates the continued engagement with Treasury on the development of this important piece of reform. In particular, the industry appreciates Treasury reconsidering the impact of a personal liability regime for Accountable Persons (**APs**) given the challenges of obtaining appropriate insurance cover. The industry continues to support the objective of the Financial Accountability Regime (**FAR**) to ensure there are clear lines of accountability to support robust organisational governance.

However, the Insurance Council remains concerned that key aspects of the regime will impact on the successful implementation of the reforms and provide an outline of these concerns in this submission.

Key areas of concern

1. Deferred Remuneration

Para 1.94 FAR EM ED states:

> *"The deferral period is intended to be consistent with provisions of APRA's proposed prudential standard to regulate remuneration in APRA regulated industries (Prudential Standard CPS 511 Remuneration) that would also require deferral of variable remuneration for an overlapping class of persons in those industries".*

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Although the FAR proposes a minimum deferral period of four years, the minimum deferral periods in Draft Prudential Standard CPS 511 Remuneration (**CPS 511**) can be longer (depending on the class of persons) and for the majority of APs, given they will generally be the CEO and direct reports, will in practice be longer. We understand that where the FAR and CPS 511 do not align the longer deferral period will apply.

The general insurance industry has consistently indicated to APRA that the proposed deferral periods in CPS 511 are too lengthy and are significantly more onerous than in other jurisdictions. Accordingly, the proposed deferral periods would impose a significant disadvantage on the industry's ability to attract and retain key talent, particularly when competing for talent in both the global financial services markets and in industries where similar requirements do not apply (such as data and technology).

The Insurance Council strongly recommends that there is alignment between the FAR and CPS 511 and that the deferral period for all classes be no more than four years. The industry is of the view this would to some extent mitigate the competitive disadvantage issue and would more closely align with equivalent overseas regulation where it exists.

2. Significant Related Entities (SRE) of an Accountable Entity (AE)

The FAR EM ED notes that the FAR *"is designed to improve the risk and governance cultures of Australia's financial institutions by imposing a strengthened responsibility and accountability framework for those institutions and the directors and the most senior and influential executives (accountable persons) of those institutions."* However, the FAR also extends to SREs, with the FAR Bill ED (subsection 9(6)) specifying the circumstances in which an individual is an AP of an SRE. The FAR EM ED also indicates that SREs *"will not generally be subject to direct legal obligations under the Regime"*.

Whilst the application to AEs and their SREs will depend on the relevant group's structure and how accountabilities and responsibilities are allocated, given the above context the Insurance Council suggests it would be appropriate to limit application to the most senior person responsible for an SRE. For instance, this may be the CEO rather than potentially significantly widening the scope to executive teams of SREs, including foreign SREs. This would have the benefit of remaining consistent with the objective of the FAR and would also ensure the application does not become overly complex and burdensome. We note this matter was raised during the Treasury Roundtable on 3 August (attended by the Insurance Council and members) (the **Roundtable**).

The provisions in the FAR Bill ED that would potentially result in widening the scope of the FAR include, for example, the key personnel obligations of an AE (subsection 21(1)(a)) being to ensure the responsibilities of the accountable persons of the accountable entity and its SRE cover: (i) all parts or aspects of the operations of the accountable entity's relevant group and (ii) each of the prescribed responsibilities. It is therefore unclear if the intention is that each prescribed responsibility be allocated at the SRE level. Further, the accountability obligations of an AP apply to APs of an SRE (section 19). The accountable persons of an SRE must also be registered with the Regulator (and subject to the threshold, may or may not require accountability statements and maps to be submitted).

General insurers would welcome further clarity on the intended scope of application to SREs. In addition, an example in the FAR Bill EM to indicate in principle that an AP of a significant related entity of an AE may be limited to the CEO would assist.

3. End-to-end product responsibility

The Insurance Council notes that the government intends to consult further on the proposed list of responsibilities and positions to be prescribed by the Minister. The Insurance Council will be pleased to participate in that consultation. At this stage however, we seek to highlight the industry's ongoing

concern as to the potential practical challenges associated with the proposed end-to-end product responsibility.

We appreciate the expectation is that accountable entities will not need to decentralise their support functions, as indicated in the FAR PRP Paper. However, there are concerns some re-structuring will still be necessary. Some issues include:

- The ability to limit the application to "the most senior and influential executives". We are concerned there remains a lack of clarity, and potentially conflicting expectations, as to the level at which it is intended that accountability and responsibility under this proposed responsibility should reside.

  During the discussion at the Roundtable there was a suggestion that end-to-end responsibility for an entity's product governance will rest with the person(s) responsible for the organisational frameworks within which an insurer develops, delivers and maintains insurance products. However, there was also a suggestion that in circumstances where, for example, there was a failing in the organisation's IT systems then the expectation would be that the person responsible for the organisation's IT systems would be accountable (appearing to be a focus on the person responsible for execution rather than on the person(s) responsible for the organisation's frameworks). This appears to blur the lines of accountability between those responsible for frameworks versus those responsible for execution and also indicates potential for accountability to be devolved to an operational level.

  Clarity as to how this in practice may operate to exclude those executives with responsibility for executing or performing the relevant functions, consistent with the objective of limiting the FAR to the most senior executives, would therefore be welcome.

- It is unclear how this prescribed responsibility would interact, align or be distinguished from other prescribed responsibilities that form part of the end-to-end product value chain (e.g. claims handling, dispute resolution, remediation programs incl. hardship). This may create ambiguity as to how regulators and entities would approach the apportionment of liability in the event of a failure in one or more parts of the end-to-end value chain. It is important that the mapping and prescription of accountabilities needs to be clear at the outset if the FAR and CPS 511 are to serve their purpose of improving governance and risk culture in the financial sector. Such ambiguity creates a risk of potential conflicts and/or siloed approaches between APs within the entity.

- The intended scope of "delivery and maintenance" as used in the description of the end-to-end product responsibility. Clarity would be welcomed as to what this encompasses. For example, is it intended to cover all forms of advice, sales and distribution? As the Insurance Council has previously suggested to APRA, the scope of this obligation should align more closely with the Government's Design & Distribution Obligations (**DDO**) reforms. The DDO requires issuers and distributors to have an adequate product governance framework to ensure products are appropriately targeted. Particularly, ASIC's Regulatory Guide RG274 also outlines the requirements at each stage of developing and distributing a product (product design, product distribution, and monitoring and review) in order to deliver good customer outcomes.

- Whilst this prescribed responsibility is framed broadly, being "*management of the accountable entity's end-to-end product responsibility",* the guidance in the FAR PRP Paper indicates that it is *"not necessary for an individual holding end-to-end product responsibility to have the technical expertise on every stage of the product value chain".* This potentially creates a friction point for the relevant AP, noting the obligation for each AP to act with due skill, care and diligence. Again, this highlights the challenges in defining such a broad responsibility and we suggest consideration be given to narrowing and clarifying the scope.

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In summary, if the intent is for the end-to-end product responsibility to apply to the person(s) accountable for an entity's product governance (rather than others responsible for the operational execution of activities within the product value chain), then this should be articulated clearly and the broad description of end-to-end responsibility should be narrowed and sharpened.

4. Joint APRA-ASIC administration of FAR

As Treasury notes in the FAR Joint Admin Paper:

> *"one of the key areas of concerns raised by industry in response to the proposals paper was the lack of details on the manner in which the regulators would administer the FAR and exercise the powers conferred under the regime."*

The industry appreciates the additional information that has been provided and recognises that the approach to joint administration continues to be developed, however this remains an area of concern.

We support the view that "efficient and effective joint administration of the FAR between the regulators would need to be underpinned by robust collaboration and coordination". The Insurance Council also believes it will be critical to ensure that any potential duplication is minimised so that the regime does not become administratively burdensome and overly costly. It would be helpful for Treasury to articulate its expectations as to how the regulators will implement the FAR in a specific and clear way. We would welcome further consultation on the details of the proposed joint administration approach as it develops.

5. Implementation timeframe

The proposed commencement date of the FAR for general insurers is the later of 1 July 2023 or 18 months after the FAR legislation receives royal assent. In addition, we note that APRA's present intention is that CPS 511, which will also likely require significant changes to insurers' remuneration arrangements, will commence from 1 July 2023. Given the many interlinkages between the FAR and CPS 511, it remains appropriate that these regimes commence at the same time.

However, until the regulatory changes are finalised insurers are not able to commence implementation of the remuneration requirements given a range of matters still require further clarification. Even once the regulatory requirements are known, introducing new or significant changes to variable remuneration arrangements will require a reasonable lead time (not least to communicate such changes to impacted individuals) and, as incentive plans are typically annual, will also be dependent on the timeframes of plans which will differ across the industry (i.e. depending on whether an entity starts its performance period on 1 July or 1 January).

Treasury sought feedback at the Roundtable as to whether the general insurance industry would be able to implement the FAR earlier than currently proposed. We confirm the view orally communicated that this will not be feasible, particularly given the aforementioned factors relating to remuneration arrangements. In addition, the industry is still dealing with a significant workload in implementing and bedding down other Financial Services Royal Commission reforms and there are a range of other significant challenges facing the insurance industry in the current COVID-19 pandemic context, including supply chain disruptions.

Further, we suggest that if the FAR commencement date for insurers is later than 1 July 2023, for instance due to a delay in the FAR legislation receiving royal assent, that APRA defer implementation of CPS 511 to ensure alignment.

Appendix 1 details additional issues or areas where the industry would welcome greater clarification in relation to the FAR Package.

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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, Policy – Regulatory Affairs, on telephone: 02 9253 5176 or email: areddy@insurancecouncil.com.au.

Yours sincerely

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Executive Director and CEO

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Appendix One

Financial Accountability Regime – Additional Feedback

Listed in this appendix are issues which members have raised with the Insurance Council in relation to the proposed regime.

1. **Role categories:** currently there are several different role categories specified within the FAR, APRA Prudential Standard CPS 511 Remuneration and APRA Prudential Standard CPS 520 Fit and Proper to which similar or overlapping requirements apply (e.g. APs, Senior Managers, Material Risk Takers and Responsible Persons). General insurers strongly recommend that Treasury and APRA review these role categories with a view to reducing complexity and administrative burden.

2. **Application to significant related entities:** we understand the Treasury would welcome feedback in relation to the types of significant related entities that would fall within the scope of the FAR. At this stage, general insurers have identified the following related entities that may potentially fall within scope: foreign general insurers and service companies.

3. **Foreign significant subsidiaries – conflicts with foreign laws:** the FAR Bill ED provides for circumstances in which a conflict may arise between the FAR and a foreign law (sections 13(3), 15, 16(3) and 17). General insurers would welcome clarity on the application of these provisions from a timing perspective. That is, will a written notice from a regulator be required before the AE or AP is not required to comply with an obligation in the FAR or can the AE or AP act so as not to breach the foreign law even in the absence of a written notice from a regulator? It is currently not clear if sections 15(2) and 17(2) FAR Bill ED obviate the need to wait for the written notice.

4. **Reasonable steps**: in the event an AP breaches their accountability obligations, it is currently unclear how a regulator will assess if an AE has taken reasonable steps to ensure that each AP meets their accountable obligations. Expressed conversely, it is unclear whether a breach of the accountability obligations by an individual will automatically trigger a breach of accountability obligations by the entity therefore exposing the entity to a penalty. Or will the type or character of the individual failure (e.g. an inadvertent failure as contrasted to deliberate or wilful misconduct) to comply with accountability obligations be taken into account when determining or considering whether there is a breach by the entity?

5. **Particular responsibilities – applicability:** section 10 of the FAR Bill ED provides for circumstances when persons are not APs and provides the Regulator with the power to exclude certain responsibilities held by an AP for this purpose. This approach appears to apply to responsibilities already held by an AP but does not appear to contemplate circumstances where a prescribed responsibility is not applicable to a general insurer and therefore not allocated to an AP.For example, the prescribed responsibility relating to the anti-money laundering (AML) functionwhere general insurers are not subject to AML requirements in Australia. General insurers would welcome clarity as to whether the Regulators' power will extend to such circumstances.

6. **Responsibility for remediation:** as noted in the FAR PRP Paper, senior executive responsibility for management of the AE's client or member remediation programs (encompassing hardship considerations where relevant) will be a prescribed responsibility. We suggest that remediation should be defined to clearly exclude the day-to-day remediation processes and activities AEs have in place to address customer complaints and disputes. These types of activities are quite distinct from remediation programs entities may conduct to compensate consumers who have suffered loss due to a breach or other failure, as described in ASIC's Regulatory Guide RG256. Including entities' day-to-day remediation processes for addressing customer complaints and

disputes will create an overlap with the other prescribed responsibility for managing an entity's internal and external dispute resolution processes.

7. **Variable remuneration definition**: the definition of variable remuneration in the FAR Bill ED is "*so much of the accountable person's total remuneration as is conditional on the achievement of objectives*". The FAR EM ED provides further detail by stating *"such as performance metrics and service requirements".* It would seem that variable remuneration is intended to include all forms of **variable** remuneration, including payments such as sign-on, retention and buy out awards, consistent with CPS 511. However, sign-on awards for instance are typically designed to compensate for remuneration not received from a previous employer when an individual resigns to join a new organisation and are often critical to secure key talent. The proposed definition of variable remuneration will therefore capture, and subject to the deferral requirements, payments that typically have a different purpose to more traditional variable remuneration designed to reward performance. Consistent with feedback provided to APRA, the industry believes this definition is too broad and may have unintended consequences (e.g. one-off cash payments made as an alternative).

8. **Deferred remuneration amount**: the FAR EM ED states that the amount of variable remuneration that must be deferred is "*based on the value it would have had if it was paid at the start of the minimum deferral period and is calculated based on maximum opportunity*" (para 1.87). The reference to **maximum** opportunity (rather than **actual** remuneration paid) makes sense if entities are using a Long-Term Incentive (**LTI**) to meet the deferred remuneration obligations. This allows entities to set up their variable remuneration frameworks to ensure they meet the minimum deferral requirements year on year (regardless of actual outcomes) and is consistent with most existing LTI arrangements.

   However, the approach is less clear where entities intend to use Short-Term Incentive (**STI**) to meet the deferral requirements, and where deferral is typically applied based on the actual STI paid. This may be the case where an entity doesn't operate an LTI, or where an employee is 'acting up' in an AP role (for longer than the minimum threshold of 90 days) and doesn't normally participate in the LTI.

   The use of the "maximum opportunity" means it is very likely that the deferred remuneration of an AP will be more than 40% of their actual variable remuneration.

   For example, an AP could have a maximum short-term incentive opportunity of $300,000, however, the award made at the end of the performance period may have only been $200,000 (in consideration of performance outcomes). Based on the proposed requirement, 40% deferral would be applied to the $300,000, resulting in $120,000 being deferred (representing 60% of the actual award paid, rather than 40%). Had the calculation been based on the actual award of $200,000, then $80,000 would be deferred.

   This approach appears inconsistent with the proposed requirement in CPS 511, which is based on the total value of variable remuneration awarded in the financial year. General insurers recommend alignment between the FAR and CPS 511, such that the deferral be applied to amounts awarded.

9. **Deferral requirements for a new AP:** subsection 26(2) FAR Bill ED provides for when a deferral period for variable remuneration of an AP commences. In the circumstance where an AP commences part way through a performance year (e.g. a newly hired AP), subsection 26(2)(b) could be interpreted as the day that person commenced in an AP role and therefore could result in their variable remuneration being deferred for a longer period than other employees awarded payments in respect of the same performance period. We would welcome clarity on the treatment of the deferral period for APs who commence during a performance year.

This problem is illustrated in the following example.

Existing employees

The deferral period would commence at the start of the performance period for the STI Plan (e.g. 1 January 2023). An employee receives 60% of their 2023 STI award in cash in early 2024, and 40% of the award would be deferred for ***3 years*** following the conclusion of the performance period and would be able to vest from December 2026.

Newly hired AP on 1 July 2023

The deferral period would commence on the AP's start date (i.e 1 July 2023). The employee would receive 60% of their 2023 STI award in cash in 2024, and 40% of the award would be deferred for ***3.5 years*** following the conclusion of the performance period (31 December) and would be able to vest from 30 June 2027. The deferral period for the same incentive awards would therefore differ based on employee start date. Ideally the deferral period would align with the start of the performance period of the incentive plan to ensure consistency of treatment with existing employees.

10. **Variable remuneration adjustments**: general insurers note that the FAR, as compared to CPS 511, does not prescribe the adjustment lever entities are to use to respond to various categories of accountability breaches. Rather, the FAR Bill ED focuses on the **quantum** of the adjustment, which "must be proportionate to the failure to comply with the person's obligations" (subsection 23(1)(b)).

    The FAR also does not prescribe when the Board must apply the adjustment (only that the entity must notify APRA/ASIC of the adjustment applied within 30 days). General insurers consider this is the more appropriate approach as it leaves it up to the Board to determine how and when to apply adjustments, taking into account the specific circumstances of each case. We also understand that APRA/ASIC are able to intervene in circumstances where they consider the remuneration adjustment made is insufficient. General insurers would welcome guidance as to what factors the joint regulators will take into account when assessing proportionality and what information an entity is expected to retain to support its assessment as to the appropriate adjustment.

    The requirements and expectations around variable remuneration adjustments within CPS 511 and FAR should be aligned so that entities are able to apply adjustments using a consistent approach that is determined by the entities. This will enhance consistency in outcomes, particularly where an entity is seeking to apply consequences for multiple individuals involved in an event, including both APs and other employees. To be clear the more flexible quantum focused approach in FAR should prevail and APRA should amend its views in CPS 511 to align with the FAR.

11. **Implementation of 1 July 2023 – application of deferred remuneration requirements:** for general insurers that operate on a financial year other than 30 June, clarity on the application of the deferred remuneration requirements would be welcome. Currently it is unclear whether the expectation is that deferral would apply to all awards paid after 1 July 2023. For example, a general insurer with a balance date of 31 December may pay an award in March 2024 in respect of the full 2023 performance period. The alternative is that deferral applies to awards earned post 1 July 2023. That is, a pro rata amount of the award paid in March 2024 in respect of the half year 2023 performance period. Similarly, clarification as to the commencement of the deferral period would also be welcome (for example, whether the period commences from the start of the performance period, i.e. 1 January 2023, or from the implementation date of 1 July 2023).

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12. **Notifications:** the proposed AP registration process includes a new dependency on the declaration that the individual is suitable for position. The Insurance Council recommends that this requirement, and any subsequent rules or guidance relating to it, take into account practical considerations as to how this will operate in conjunction with existing regulations related to suitability (APRA Prudential Standard CPS 520 Fit and Proper and ASIC Regulatory Guide RG105 Responsible Managers). This should include relevant processes, notification events and timing etc.

    The timeframe for Regulators to complete AP registration activities has been extended from 14 days prior to the APs effective start date (under BEAR) to 21 days under the FAR, which is helpful. However, the continued lack of alignment with other appointment notification obligations creates practical issues in finalising employment contracts (or appointment letters for Non-Executive Directors) with appropriate start dates that provide sufficient time for Regulator registration activities to be completed in order to avoid an individual starting in an AP position without first being registered. For example, under CPS 520 Fit and Proper assessment and notification is ordinarily required within 28 days after the person becomes the holder of the responsible person position.

[Document ends.]