



Response to Submissions II

Remuneration

Extensions to governance requirements for APRA-regulated institutions

30 November 2009

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Preamble

Following two rounds of consultation, APRA has finalised the extensions to its prudential standards on governance and an associated prudential practice guide (PPG), dealing with remuneration. The revised governance standards come into effect on 1 April 2010. Contracts in force at that date must be fully compliant with the standards at the first opportunity for renegotiation, and in any event by 31 March 2013. APRA expects regulated institutions to use the period from 1 December 2009 to 1 April 2010 to begin the transition for existing arrangements that would not meet the revised standards.

Accompanying this response paper are:

- *Prudential Standard APS 510 Governance, Prudential Standard LPS 510 Governance and Prudential Standard GPS 510 Governance* (collectively referred to as the **governance standards**); and
- *Prudential Practice Guide PPG 511 Remuneration* (PPG 511).

By way of background, on 28 May 2009 APRA released its consultation package on remuneration,¹ on which 51 submissions were received. APRA released a second consultation package² on 3 September 2009 which, amongst other matters, clarified that APRA's proposals on remuneration could encompass group arrangements and would apply to foreign branches.

APRA received 19 submissions on its second consultation package and met with a number of regulated institutions and industry groups. The submissions and meetings broadly supported the approach and intent of APRA's proposals but raised some questions and sought clarification on certain aspects of the governance standards and PPG.

This paper discusses the main issues raised during the second round of consultation and provides further detail on APRA's supervisory approach to the remuneration requirements.

¹ www.apra.gov.au/Policy/Remuneration-requirements-consultation-May-2009.cfm

² www.apra.gov.au/Policy/Response-to-submissions-Remuneration-Proposed-extensions-to-governance-requirements-for-APRA-regulated-institutions.cfm

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Glossary

APRA	Australian Prudential Regulation Authority
AICD	Australian Institute of Company Directors
ADI	An authorised deposit-taking institution under the <i>Banking Act 1959</i>
APS 510	<i>Prudential Standard APS 510 Governance</i>
APS 520	<i>Prudential Standard APS 520 Fit and Proper</i>
ASX	Australian Stock Exchange
Corporations Act	<i>Corporations Act 2001</i>
FSB	Financial Stability Board
General insurer	A general insurer authorised under the <i>Insurance Act 1973</i>
GPS 510	<i>Prudential Standard GPS 510 Governance</i>
GPS 520	<i>Prudential Standard GPS 520 Fit and Proper</i>
Life insurer	A life company, including friendly societies, registered under the <i>Life Insurance Act 1995</i>
LPS 510	<i>Prudential Standard LPS 510 Governance</i>
LPS 520	<i>Prudential Standard LPS 520 Fit and Proper</i>

Chapter 1 – Background

APRA has completed the consultation process on its approach to remuneration for authorised deposit-taking institutions (ADIs) and both general and life insurance companies. The extensions to APRA's governance standards address the risk that poorly structured remuneration practices may result in excessive risk-taking by individuals and undermine institutions' risk management systems.

There is now general acceptance that inappropriate remuneration practices contributed to significant losses at some major international institutions and, in turn, to the severity and duration of the global financial crisis. Increased awareness of this risk has prompted regulators globally to publish principles and guidance for the effective management of remuneration arrangements.

APRA's requirements on remuneration take as their starting point the Financial Stability Board's (FSB's) *Principles for Sound Compensation Practices* (FSB's Principles)³ published in April 2009. In September 2009, the FSB published its *FSB Principles for Sound Compensation Practices – Implementation Standards*³ (Implementation Standards) aimed at strengthening adherence to its Principles. These Principles and Implementation Standards have been endorsed by the Leaders of the G-20. A number of major advanced countries, including the United States, United Kingdom, France, Netherlands and Switzerland, have published detailed guidance on the implementation of the FSB's Principles. The most recent is the US Federal Reserve Board's proposed guidance, *Sound Incentive Compensation Policies*⁴, released in October 2009. The Basel Committee on Banking Supervision is seeking confirmation that banking regulators are acting on these principles. APRA is monitoring international developments and is satisfied that its approach is consistent with the FSB's Principles. The UK Financial Services Authority, in its Policy Statement on *Reforming remuneration practices in financial services*⁵, acknowledges that the Australian standards are well matched to the Principles.

3 www.financialstabilityboard.org

4 www.federalreserve.gov

5 www.fsa.gov.uk

Chapter 2 – Review of submissions

In May 2009, APRA released a discussion paper entitled *Remuneration – Proposed extensions to governance requirements for APRA-regulated institutions*, for ADIs, general insurers and life insurers. The discussion paper was accompanied by drafts of proposed extensions to APRA's standards on governance and a draft prudential practice guide (PPG). In September 2009, APRA undertook a second round of consultation on proposed changes to the governance standards and the draft PPG as a result of submissions made during the first consultation. APRA received 19 submissions on the second consultation package.

This paper reports on the second-round feedback received and the decisions APRA has made in finalising its remuneration requirements. APRA's approach remains unchanged in most respects but some requirements have been modified. The key modifications are:

- narrowing the group of 'responsible persons' for whom the Board Remuneration Committee must make individual recommendations to the Board;
- removing the requirement that the Board of a foreign branch approve the Remuneration Policy. Instead, the senior officer outside Australia with delegated authority from the Board may approve the Remuneration Policy;
- clarifying in the PPG that basing the remuneration of risk and financial control executives on the performance of the institution is acceptable where there are proper safeguards to ensure that the integrity of their functions is not compromised; and
- excluding contractual arrangements with third parties from the coverage of the Remuneration Policy where the risk from incentive payments is explicitly addressed in the institution's risk management framework and overseen by another Board Committee.

APRA remains committed to a principles-based approach in this area. By doing so, Boards will be able to design remuneration arrangements that suit the structure of their own institution. Boards of regulated institutions will be held accountable for compliance with APRA's prudential requirements for remuneration.

Chapter 3 – Areas discussed in submissions

Scope of requirements

APRA's remuneration requirements are consistent with the FSB's Principles and are also closely aligned with the Implementation Standards. These Implementation Standards are intended to apply to 'significant financial institutions' and provide guidance on remuneration governance, structure and disclosure to strengthen adherence to the FSB's Principles. APRA's remuneration requirements will apply to all ADIs, general insurers and life insurers.

Comments received

Several respondents expressed concern that most countries are proposing to apply the FSB's Principles only to the banking industry. This is in contrast to Australia, where APRA proposes to include the general insurance and life insurance industries. There have also been concerns expressed that foreign branches may be subject to regulatory overlap.

APRA's response

Whilst the global banking industry has been the most affected by poor remuneration practices, APRA considers that its proposals are equally applicable to other prudentially regulated industries. It is APRA's practice to ensure, to the extent reasonably practicable, that its behavioural standards are harmonised across all supervised institutions; this approach minimises unnecessary complexity and encourages competitive neutrality. Nothing about APRA's remuneration requirements suggests that APRA should vary from this approach. Further discussion of the coverage of foreign branches is included below.

Responsible persons

The governance standards identify 'responsible persons', as defined in APRA's fit and proper Standards (APS 520, GPS 520, LPS 520)⁶ as a distinct category of persons to be covered by a regulated institution's Remuneration Policy. APRA proposed that recommendations on the remuneration of such individuals must be made by the Board Remuneration Committee to the Board.

Comments received

Submissions accepted that senior executives must be covered by the Remuneration Policy and that the APRA-defined term 'responsible persons' covers such persons. Some submissions, however, suggested that this definition of 'responsible persons' captures a wider group of individuals than senior executives. These submissions suggested that the requirement for the Board Remuneration Committee to recommend, and the Board to approve, the individual remuneration for all 'responsible persons' places an unnecessary burden on the Board Remuneration Committee and the Board.

APRA's response

It is APRA's intention that the remuneration requirements apply, generally, to senior management. APRA notes that some regulated institutions have applied its 'fit and proper' prudential standards to a much wider group of 'responsible persons'. APRA acknowledges the potential burden and has revised the governance standards by narrowing the range of persons for whom the Board Remuneration Committee must make an individual recommendation to the Board.

The Board Remuneration Committee will now be required to make annual recommendations to the Board on the individual remuneration of persons holding the following positions: Chief Executive Officer (CEO), direct reports of the CEO (excluding administrative direct reports), persons performing the same or substantially the same functions and duties, and other persons whose activities may in the Committee's opinion affect the financial soundness of the institution. APRA retains the right to specify any other person to be the subject of an individual recommendation from the Board Remuneration Committee to the Board.

Other 'responsible persons' will still need to be covered by the Remuneration Policy but APRA will not require Board-level approval of their individual remuneration. Such persons may be treated as one or more categories of persons.

⁶ Prudential Standard APS 520 Fit and Proper, Prudential Standard LPS 520 Fit and Proper and Prudential Standard GPS 520 Fit and Proper.

Groups with foreign parents

In the September consultation package, APRA clarified that regulated institutions that are part of a corporate group may use a group Board Remuneration Committee and a group Remuneration Policy. This amendment would streamline the requirements for groups as remuneration issues are often dealt with at the group level rather than at each subsidiary or branch. The amendment would apply to all groups, whether headed by an Australian parent or an overseas parent.

Comments received

Submissions acknowledged that APRA had recognised group arrangements and had significantly streamlined the remuneration requirements for groups. However, some submissions raised additional questions over the ability to rely on a group Remuneration Policy when the parent is based overseas, particularly where an offshore group Remuneration Policy may not address all of APRA's requirements. Submissions suggested that if a group Remuneration Policy adheres to the FSB's Principles, APRA should allow this Policy to be used for the Australian operations, even though it may not meet all of APRA's requirements.

APRA's response

It is not APRA's general practice, in remuneration or any other matter, to waive its prudential requirements because a regulated institution claims to meet an offshore standard.

Prudentially regulated institutions in Australia must comply with APRA's prudential requirements, to ensure that competitive neutrality and APRA's expectations of prudential soundness are maintained. APRA's intention is that, where subsidiary Boards can usefully 'import' group policies from parent Boards, they may do so to minimise duplicated effort. However, subsidiary Boards and, in the case of a foreign branch, the senior officer outside Australia are responsible for ensuring that APRA's prudential requirements are met. Where necessary, group policies must be amended to ensure compliance.

The Leaders of the G-20 have endorsed the FSB's Principles and Implementation Standards. As a result, there is an expectation of a high degree of global convergence which should minimise any regulatory overlap and areas of divergence between jurisdictions. Where APRA's requirements are more demanding or specific than the FSB's Principles and Implementation Standards, the local board of a foreign subsidiary must approve a version of the group Remuneration Policy that complies with APRA's requirements.

Role of senior officer outside Australia

APRA's September consultation package confirmed that its remuneration requirements were intended to apply to branches of foreign-based banks and insurers ('foreign branches'). This would create a level playing field for regulated institutions in Australia and deliver consistency of risk management.

For foreign branch ADIs and general insurers, the senior officer outside Australia (SOOA) acts as a representative of the Board. Accordingly, the draft governance standards required the SOOA, in place of a Board Remuneration Committee, to conduct reviews of the Remuneration Policy, including an assessment of its application, effectiveness and compliance with the requirements of the governance standards. However, the September 2009 draft standards required that the overseas Board of the foreign branch, not the SOOA, must establish, approve and maintain a written Remuneration Policy.

Comments received

There were several comments about SOOAs. Some submissions suggested that whilst a SOOA is a responsible person, he or she should be excluded from the Remuneration Policy on the basis that the SOOA would be required to review his or her own remuneration. Other submissions suggested that the SOOA should stand in place of the Board on all issues relating to remuneration as this is the approach taken in other APRA prudential standards such as those relating to risk management, outsourcing and 'fit and proper'.

APRA's response

APRA agrees that the SOOA should not be covered by the Remuneration Policy and the governance standards have been amended accordingly. In excluding the SOOA from the group of 'responsible persons', APRA considers that the SOOA with delegated authority from the Board is able to perform the role of the Board.

APRA's expectation is that a foreign branch will be covered by a group Remuneration Policy and the SOOA, as the Board's representative, will be required to ensure and sign off that the application of this Policy in Australia meets APRA's requirements. Where it does not do so, the SOOA must have the delegated authority to amend the Policy for any particular requirements relating to the Australian operations. However, even though the SOOA may approve the Remuneration Policy, the Board retains responsibility for the institution's compliance with it.

Risk and financial control personnel

APRA's September consultation package required that the Remuneration Policy apply to three categories: 'responsible persons' (with some exclusions); persons whose primary role is risk management, compliance, internal audit and financial control (collectively 'risk and financial control personnel'); and all other persons for whom a significant portion of total remuneration is based on performance and whose activities, individually or collectively, may affect the financial soundness of the institution.

APRA proposed that the Remuneration Policy ensure that the structure of the remuneration of risk and financial control personnel does not compromise their independence in carrying out their risk or financial control functions.

Comments received

Submissions acknowledged that APRA's prudential requirements for risk and financial control personnel, as explained in the September consultation package, were more readily applicable than the May version. However, it was suggested that the governance standards and the PPG were not necessarily aligned, with the PPG containing some more unduly detailed elements. Clarity was sought on whether risk and financial control personnel could receive a bonus.

Some submissions argued that the Remuneration Policy should be limited only to risk and financial control personnel who are 'responsible persons'. Furthermore, it was argued that APRA's remuneration requirements create impractical outcomes for executive-level risk and financial control personnel such as the Chief Financial Officer (CFO) or Chief Risk Officer (CRO). These submissions requested greater clarity from APRA regarding the treatment of executive-level risk and financial control personnel who have oversight of the business as a whole, rather than of a particular business unit.

APRA's response

Risk and financial control personnel have a critical role in maintaining the financial soundness of any regulated institution.

APRA does not accept the view that the Remuneration Policy should only cover risk and financial control personnel who are 'responsible persons'. APRA's view is that all risk and financial control personnel (i.e. those whose primary role is a risk and financial control function) need to be considered as a distinct class. Such personnel need to maintain independence in their decision-making and oversight roles. If remuneration structures compromise this independence at any level, conflicts of interest can arise where risk and financial control personnel may no longer be relied on to act effectively in their control functions. APRA recognises that executive-level risk and financial control personnel who have oversight over the institution's business as a whole (e.g. the CFO or CRO) present particular issues,

and further guidance has been provided in the PPG to address such cases. APRA considers that the award of bonuses to executive-level risk and financial control personnel based on the performance of the business as a whole is acceptable practice, as long as there are processes in place that ensure no conflicts of interest and maintain the independence of such persons in performing their control functions. Such processes will need to cover the measurement of financial results, the checks and balances applied in decision-making and perhaps other matters.

Third parties

In APRA's September consultation package, the extent to which its remuneration requirements apply to non-employees was addressed and updated from the May consultation package.

The September draft governance standards and PPG proposed that, where a regulated institution enters into contracts with third parties to undertake functions on its behalf and those functions can expose the institution to risk, the remuneration of such third parties should take account of this risk. In these circumstances, the contractual terms with the third party, rather than the remuneration of individuals employed by that third party, must comply with the governance standards.

Comments received

Submissions acknowledged that APRA had addressed earlier concerns by clarifying that contractual arrangements with third parties needed to be covered by the Remuneration Policy rather than the third party's remuneration policy for its own personnel. However, some submissions suggested that arm's-length business contracts should be excluded. In particular, a number of formal and informal submissions to APRA asserted that, variously, financial planners, mortgage brokers and insurance brokers cannot act in a manner that threatens the financial soundness of a regulated institution and that these distribution channels should not be included in the Remuneration Policy.

APRA's response

In relation to intermediaries such as financial planners, mortgage brokers and insurance brokers, APRA believes that there is sufficient evidence, including some domestic examples of third-party distribution channels creating losses for a regulated institution, to support its position.

Accordingly, APRA maintains the view that payment arrangements with third parties can give rise to inappropriate risk-taking behaviour. However, APRA notes that regulated institutions may have or may introduce other processes that already address such risks. Where the risk management framework explicitly addresses such risks and there is another Board Committee that oversees these arrangements, such arrangements do not need to be included in the Remuneration Policy. In such cases, APRA is not seeking to preclude commission-based arrangements but expects regulated institutions to be able to demonstrate that the matters detailed in the governance standards are being adequately addressed by those processes.

Incoming and termination payments

APRA provided guidance in the September consultation package that guaranteed or up-front cash payments beyond normal remuneration for incoming executives or other staff would generally be inconsistent with prudent practice. It would be more appropriate for incoming staff to receive remuneration undertakings that are consistent with the deferral and risk adjustment elements of the institution's Remuneration Policy as it applies to existing staff. Regulated institutions would be expected also to undertake due diligence on the deferred remuneration from an incoming staff member's previous employer and take the results into account in establishing the new remuneration package.

APRA's draft PPG stated that it would not be prudent practice for deferred payments to vest automatically upon cessation of employment with a regulated institution. 'Golden parachute' cash payout arrangements are generally inconsistent with prudent practice.

Comments received

Submissions commented that market practice is to make cash payments to incoming executives and that if APRA does not allow such payments, regulated financial institutions in Australia would not be competitive in a global marketplace. APRA provided guidance in the September response paper about incoming payments but did not include that guidance in the PPG, and submissions requested that this guidance be incorporated formally into the PPG.

APRA's response

APRA has clarified its position on this issue by including the guidance in the September consultation package in the PPG. In particular, APRA considers that the balance between ensuring sound remuneration practices across the institution, compared with the incremental ability to attract or retain individual employees, can only prudently be resolved in favour of sound remuneration practices across the institution. APRA also notes that the G-20 countries have all agreed in principle to move towards more prudence in remuneration practices. APRA recognises that competition in recruiting may encourage some regulated institutions to provide cash payments or cash bonuses to incoming staff. APRA nevertheless expects institutions to place suitable deferral and performance hurdles on such payments.

There is no prohibition in the governance standards or PPGs on making financial commitments to incoming or outgoing staff. The prudential requirements apply to cash payments which have not been appropriately risk-adjusted or performance validated, for example through deferral.

Chapter 4 – APRA’s supervision of remuneration arrangements

APRA’s prudential framework is based on the Board of directors of regulated institutions having ultimate responsibility for the sound and prudent management of their institutions. Consistent with this, APRA’s supervisory focus in respect of its remuneration requirements will be on genuine Board involvement and engagement, demonstrating independence from management, gauging the adequacy and appropriateness of the Remuneration Policy (especially in its linkage to risk) and actively monitoring the implementation of the policy.

In the first six to 12 months, APRA will be seeking information on the implementation of APRA’s remuneration requirements (particularly from larger institutions) and will assess peer institutions together. This approach will assist in developing better guidance, expectations and benchmarks, providing consistent feedback and identifying remuneration practices that are outliers.

In future, APRA will generally review an institution’s Remuneration Policy at the same time as looking at other governance issues, for example, when undertaking Board paper reviews. APRA may seek more detail on the application of the Remuneration Policy in human resource policies and procedures. APRA does not expect to consider individual employment contracts as a matter of course but it may seek more detail on individual employment contracts if it requires clarification about the Policy, if doubts exist about the translation of the Policy into practice or if APRA is alerted to outcomes that seem inconsistent with policy.

APRA’s principles-based approach, together with its active supervision of regulated institutions will be aimed at ensuring compliance with the intent and the substance of its remuneration requirements. Where APRA judges that the remuneration arrangements of a regulated institution are likely to encourage excessive risk-taking, APRA has several supervisory options, including the power to impose additional capital requirements on that institution.

Chapter 5 – Implementation

The revised governance standards will come into effect on 1 April 2010. APRA recognises that regulated institutions may face some practical issues in meeting all of its remuneration requirements as at that date. Accordingly, APRA expects that by 1 April 2010, the Board Remuneration Committee, with appropriate composition and charter (or terms of reference), will be established and a written Remuneration Policy that is largely compliant with the governance standards will be in place. APRA expects that those regulated institutions that are unable to comply in full by the commencement date will have conducted a self-assessment of their current practices against APRA's requirements by that date and will have a plan for addressing the deficiencies.

Regulated institutions that require shareholder approval for changes to their Remuneration Policy should seek this approval at the earliest possible opportunity.

Regulated institutions must ensure that contracts in force as at 1 April 2010 are fully compliant at the first reasonable opportunity for renegotiation, and in any event by 31 March 2013. In addition, it is APRA's expectation that regulated institutions negotiating or renegotiating contracts between the release of the revised governance standards (1 December 2009) and their commencement date will be fully cognisant of APRA's requirements and will begin the transition during this period for existing arrangements that would not meet the revised standards. Any attempts to circumvent APRA's requirements during this time will expose the relevant institution to a supervisory response from APRA.

APRA recognises that some regulated institutions may have a genuine case to be exempted from aspects of the remuneration requirements. Institutions in this position should contact their responsible supervisor as soon as possible after the governance standards are released.

Chapter 6 – Request for cost-benefit analysis information

As part of the consultation process, APRA requested respondents to provide an assessment of the impact of the proposed changes and, specifically, the marginal compliance costs regulated institutions are likely to face. Given that APRA's proposed requirements may impose some compliance costs, respondents were also asked to indicate whether there were any other regulations relating to remuneration that should be improved or removed to reduce compliance costs.

APRA did not receive any submissions on this topic.



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