



APRA Discussion Paper: Strengthening prudential requirements for remuneration

AIA Australia submission to APRA

Response to: General Manager, Policy Development, Policy and Advice Division, Australia Prudential Regulation Authority

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AIA AUSTRALIA LIMITED



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Introduction

Thank you for the opportunity to provide feedback on APRA's proposed prudential standard on remuneration (CPS 511).

Performance reward frameworks are a key instrument in achieving growth and financial soundness as well as driving innovation. People will be more inclined to do more for an organisation if they are incentivised to do so.

AIA Australia (AIAA) supports APRA's objective of ensuring that an entity's remuneration arrangements produce appropriate incentives and outcomes. We want to encourage and reward the right behaviours in our staff, as well as take appropriate action to address behaviours that do not meet our Code of Conduct.

This aligns with our operating philosophy: "Doing the Right Thing, in the Right Way, with the Right People... and the Results will come." This is infused in every part of our business, including the way in which we remunerate and incentivise our staff. Every member of staff at AIAA is measured against standards of how they carry out their work, as well as what they do.

We are committed to continuous improvement to ensure our policies and practices meet the expectations of our Board, our regulators and the community.

However, we do not believe that the requirements of CPS 511 will achieve the intended objective of creating appropriate incentives. As drafted, it is likely to inadvertently remove staff incentivisation altogether and create a reliance on higher fixed compensation. We are of the view that this will divert executive talent and investment away from Australian financial services.

Our feedback on key areas of concern is below. In summary:

1. **Global practice:** a global view of remuneration frameworks should be taken
2. **Caps:** we believe the caps on financial metrics are too prescriptive, which may result in unintended consequences
3. **Deferrals:** the combination of a seven-year deferral period and an additional clawback requirement is complicated and onerous
4. **Alignment:** alignment and consistency with existing frameworks (such as the BEAR) is preferable
5. **Role clarity:** the role of the Board and of management should not be blurred
6. **Disclosures:** Additional disclosure requirements are burdensome for non-public companies

1. A global view of remuneration frameworks should be taken

The discussion paper notes that APRA has looked to regulation in overseas jurisdictions, and that "better international practice" has strongly formed the basis of APRA's approach to developing the new standard.

While we support learning from overseas experience, we are concerned that what has been proposed has gone further than international practices, particularly with regard to deferral, vesting and clawback, which are discussed in more detail in section 3. This will likely cause Australia to lag behind in terms of attracting and retaining talent.

Whilst AIAA is locally incorporated and regulated in Australia, it is also part of an international group (AIA Group), with insurance companies in 18 markets across Asia-Pacific. AIA Group has a global remuneration policy that covers its businesses in all 18 jurisdictions. While we understand that this does not preclude APRA imposing new local requirements with which AIAA must comply, by seeking to put in place standards that are more onerous than overseas markets, APRA will put AIAA out of step with our overseas counterparts. Eight of the top 12 life insurers in Australia are foreign-owned, and may be detrimentally impacted by CPS 511.

We currently seek talent on a global scale, including from within the AIA Group; this will be much more of a challenge – right across the industry – if Australia’s remuneration standards are markedly more restrictive than offshore.

Recommended alternative: CPS 511 should align with international standards rather than exceed them.

2. The caps on financial metrics are too prescriptive

APRA has noted that it has relied on its principles-based philosophy where possible. We agree that a principles-based approach is preferred rather than a high level of prescription, the latter of which can result in strict, “tick-the-box” compliance rather than a focus on culture and outcomes.

We are concerned that the proposed standards in CPS 511 do not strike the right balance between principle and prescription, and thus could result in unintended consequences. A regulatory approach that allows for adoption of unique policies and practices consistent with each company’s own strategies, objectives and risk appetites, is preferable in our view. This would need to be paired with a high degree of transparency, governance and accountability, both within an organisation and through to APRA.

For example, we believe that the 50% cap on financial measures and the 25% cap on individual financial measures are too prescriptive across an entire organisation, and do not accommodate the need for flexibility and tailoring as appropriate by role, level and function. It is particularly complex to incorporate non-financial measures into long-term incentives, as opposed to short-term incentives.

We are of course supportive of the use of non-financial measures such as customer satisfaction, ways of working and employee engagement (amongst other factors), as key indicators of a company’s success and future growth, which ensure that the interests of the business are aligned with customers and with staff. APRA may wish to consider using non-financial measures as a “gateway” or a multiplier to financial measures. As an example, customer measures could be applied as a multiplier over financial results or certain events may act as a “gateway” to payment.

At AIAA, our short-term incentives currently incorporate non-financial measures for all staff as part of individual KPIs. However, the weighting and definitions of these are dependent on the employee’s role and the behaviours that we want to encourage. Additionally, as part of the performance assessment process, how an employee carries out their work is given equal weighting as what they do. Together, these requirements result in sound reward outcomes.

Fixed caps on performance measures will limit an organisation’s ability to alter incentive design to align to strategic objectives, which can shift over time.

We support the use of Board discretion to ensure that non-financial risks are appropriately included in remuneration performance measures, using modifiers to determine and make adjustments.

In addition, it is unclear how APRA intends to define risk-adjusted measures, which are excluded from the caps. We consider value-based metrics, such as Value of New Business (VoNB) as currently adopted by AIAA, to be risk-adjusted metrics. VoNB takes into account not only new business, but also looks to the risks of long term profitability of the business being written through measures such as persistency, claims and expenses and the cost of capital requirements. Guidance on whether this is excluded from the caps would be helpful.

The prescriptive requirements may result in discounting the value of incentives in driving desired behaviours, and could cause retention risk as people choose to seek employment in other industries or markets without the same restrictions.

Recommended alternative: CPS 511 should require that every employee's variable remuneration arrangement includes non-financial measures that are appropriate to their role and the incentivisation of good behaviours and outcomes.

3. The combination of deferral length and clawback creates too much risk

As a significant financial institution (SFI) for the purposes of the CPS 511, AIAA supports the use of a deferral period for senior managers and highly paid material risk takers, as this aligns an executive's decisions with the longer-term financial soundness of the organisation in the interests of all stakeholders: customers, owners, employees and society.

However, the framework needs to be reasonable and practical, and we are of the view that a seven-year deferral period, as proposed by CPS 511, is too long. Seven years is longer than average CEO contracts. Compared with overseas jurisdictions, the proposed deferral period would be the most onerous in the world, with the longest current deferral in a major market being six years, and most varying between three and five years.

Similarly, the combination of deferral and clawback requirements proposed by APRA is more onerous than overseas jurisdictions.

The Banking Executive Accountability Regime (BEAR) has established a sound minimum period of deferral aligned to global standards. We believe this is a sufficient and sustainable timeframe.

There are practical difficulties in enforcing clawbacks:

- The requirement that variable remuneration must only be awarded if an amount corresponding to it "can be recovered from the person if recovery is justified..." will be difficult, if not impossible, to implement. Organisations cannot make an assessment about someone's ability to repay remuneration several years ahead of the potential date of clawback, as an executive's financial position and cash flow will change over time. This could also lead to discrimination of employees from less fortunate backgrounds or those having little outside wealth – they may be found to be ineligible for incentive payments due to their greater difficulty in potentially paying back awards, especially as compared with those with independent wealth who could more easily shoulder the financial hardship of the application of a clawback.
- It will be very challenging to keep records of events and decisions made for up to 11 years, so that "procedural fairness" can be achieved in a meaningful and fair way in future.
- There are tax issues in clawing back remuneration on which tax has already been paid.

The spectre of a future clawback may also have the unintended outcome of tempting senior managers to mask adverse outcomes and be less open and transparent, if they are fearful of the financial implications.

APRA has noted in its discussion paper that there are not only practical difficulties with the use of clawback, but also legal difficulties in implementing this in practice in certain jurisdictions and circumstances. It is clear that clawback is a complicated mechanism for adjusting remuneration.

However, we strongly believe that a longer deferral period should not be used as a substitute, for the reasons already stated.

The deferral period and clawback requirements will place Australian financial institutions at a notable disadvantage compared with other industries or overseas jurisdictions when competing for talent, as they will most likely be a deterrent to potential employees. These will cause a reduction in available capability in an industry that is already highly regulated. An exodus of critical and experienced talent has the potential to actually increase industry risks as less qualified talent is forced into critical roles.

At a minimum, industry pay levels will almost certainly be pushed up to counteract the long vesting periods and clawback risk, increasing financial institutions' payroll costs which will no doubt be passed on to customers.

We understand that the UK and US experience has resulted in these unintended consequences.

Paragraph 40 of the draft Prudential Standard places constraints on the ability for an entity to accelerate vesting when an employee exits the organisation. While there are some exceptions given for this – for example, in the case of a death or serious incapacity – we are of the view that the exceptions do not go far enough. We believe that redundancy and retirement should be included in the specified exceptions, to allow an entity to accelerate vesting in these circumstances. To not include these would be unfair to the employee in situations that are out of their control, such as redundancy, and in the case of retirement, could be discriminatory on the basis of age.

Recommended alternative: CPS 511 should require a deferral period of four years rather than seven, which aligns with the minimum standard in the BEAR, and for SFIs to have in place reasonable policies and processes to pursue clawbacks when justified. The accelerated vesting restrictions in CPS 511 should allow for redundancy and retirement to be specified exceptions.

4. Alignment with existing frameworks is essential

It is our view that the standards in CPS 511 and the requirements in the BEAR must align and be consistent. As noted in the previous section in relation to remuneration deferral periods, we do not believe it is in the best interests of the financial system for there to be any inconsistency. We note that APRA has acknowledged this in the discussion paper.

We believe that the BEAR regime should be extended across all financial services (as was recommended as part of the Royal Commission) and be given an opportunity to demonstrate its effectiveness, before CPS 511 is introduced. APRA is proposing to make changes to the BEAR to bring it in line with CPS 511, and we suggest it is premature to be introducing any further changes until the BEAR has been rolled out in full.

Also, in reference to the definition of “special roles category”, we note that there are different definitions of role types used by ASIC. We suggest that these be aligned in order for financial institutions to operate with clarity and consistency, taking into account the increasing role of joint governance and oversight by APRA and ASIC.

Recommended alternative: CPS 511 should be consistent with existing laws and regulations.

5. The role of the Board and of management should not be blurred

APRA is proposing to strengthen Board requirements, by giving the Board responsibility for actively overseeing the overall remuneration framework and its application.

AIAA believes that Boards and Board Remuneration Committees need to broadly understand employee compensation and benefit programs and policies. However, it is unrealistic to expect non-executive directors to be involved in day-to-day operations given the size and complexity of most financial institutions as well as the number of remuneration structures and incentive arrangements in large institutions. This also fundamentally misunderstands the role of non-executive directors, the duties they have under law, and their place in the corporate governance framework.

We are concerned that the proposed standards would impose Board oversight into an area that should properly be the responsibility of management. The Board must be close to, but independent from, management in order for everyone to do their jobs well. Indeed, this is the very reason that APRA's CPS 510 Governance Prudential Standard requires Boards to have a majority of independent directors.

Recommended alternative: CPS 511 should require Boards to have a broad understanding of employee remuneration in order to assess structural risks and ensure appropriate alignment with executive plans and consistency with company strategies and objectives.

6. Additional disclosure requirements are burdensome for non-public companies

APRA's discussion paper suggests the imposition of additional requirements for reporting and public disclosure of executive remuneration. This extends the sort of disclosures required of public companies to all regulated entities.

This places an unforeseen and undue compliance burden on organisations that are not publicly listed in Australia.

AIA is listed on the Hong Kong Stock Exchange, and as such complies with public company regulations and disclosure requirements in that jurisdiction. We do not believe that it is necessary or appropriate to extend the same level of disclosure in Australia, where we are not accountable to local shareholders.

Expecting every financial organisation to publish the specific performance metrics used to set variable remuneration is a level of detail that would be of questionable value to the broader public, and could reveal an organisation's strategy and competitive advantage.

Recommended alternative: CPS 511 should not require regulated entities that are not publicly listed in Australia to disclose the details of their remuneration frameworks.

Conclusion

We appreciate the opportunity to provide you with the above feedback. We would be happy to discuss any of the points raised in this submission in further detail.

If you require any further information please contact in the first instance Sarah Phillips, Senior Manager, Corporate Affairs, at sarah.phillips@aia.com or 0498 494 791.

