

SUBMISSION

Submission to APRA —
Consultation on
remuneration
requirements for all
APRA-regulated entities

23 October 2019

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Via email: PolicyDevelopment@apra.gov.au

23 October 2019

Dear Sir/Madam

Consultation on remuneration requirements for all APRA-regulated entities

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to APRA's Discussion Paper: Strengthening prudential requirements for remuneration and Draft Prudential Standard CPS 511 Remuneration.

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its \$2.9 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing almost 90 per cent of the 16 million Australians with superannuation.

Yours sincerely



General comments

ASFA is supportive of APRA's consideration of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) recommendations on remuneration. Remuneration, and how it is structured, is fundamental in supporting an organisation achieve its business goals.

The proposed Prudential Standard CPS 511 is quite complex in that it applies to all APRA-regulated entities, with specific additional requirements for RSE licensees. As such, given CPS 511 has specific requirements for RSE licensees, it would be beneficial for the remuneration requirements imposed on RSE licensees to be in a stand-alone prudential standard.

A separate prudential standard would provide more clarity on the requirements of RSE licensees, particularly given their unique structure and responsibilities can be quite different to other APRA-regulated entities. For example, CPS 511 excludes an RSE licensee's investment return measures as a 'financial performance measure'. This directly and correctly reflects the uniqueness of RSE licensees, as most would consider this contrary to the common understanding of what financial performance is for a superannuation fund. In considering a stand-alone remuneration prudential standard, APRA may also want to consider whether all the provisions in the current CPS 511 are appropriate for RSE licensees.

The definition of 'variable remuneration' is quite ambiguous within CPS 511. The wording of the definition could encompass almost all employees' remuneration arrangements, whether they be fixed or variable. Almost all employees are required to meet Key Performance Indicators (KPIs) in order to receive fixed and variable remuneration as part of ongoing employment. The meeting of KPIs could fall under the definition of 'variable remuneration'.

As another example, some employees are required to achieve a certain minimum level of performance during the year in order to be eligible to receive an annual market-based adjustment to their salary. Even though the salary would be considered 'fixed' remuneration, it could be captured under the proposed definition of 'variable remuneration' within CPS 511. As such, ASFA recommends the definition of 'variable remuneration' be tightened to ensure it targets the intended remuneration.

CPS 511 is proposed to commence on 1 July 2021. There may be a number of employment contracts, already in place, containing agreed terms that create legal difficulty in applying some provisions of CPS 511. ASFA encourages APRA to take this in consideration when considering compliance with the proposed CPS 511.

CPS 511 indicates that variable remuneration is an accountability component for an organisation, implying that it might be required for RSE licensees to ensure that appropriate incentives are set for employees. Not all RSE licensees have variable remuneration. The choice of having (or not) variable remuneration is made by each RSE licensee based on their individual circumstances. ASFA considers that APRA should be absolutely clear that variable remuneration is not a requirement.

Overall, ASFA is concerned about the ability of RSE licensees to compete for talent with other financial services industry participants (for example, private equity funds), as well as participants in other industries. There are many other industries that are not regulated by APRA and therefore would not need to follow CPS 511, particularly with regard to the composition of their variable remuneration.

For example, an investment management professional might have a choice between doing essentially the same job at a superannuation fund, where their variable remuneration will be partly deferred under CPS 511, or at a fund manager where their variable remuneration will be paid in full upon vesting.

Recommendations

- ASFA recommends that a standalone prudential standard addressing remuneration arrangements for RSE licensees be drafted.
- ASFA recommends that the definition of 'variable remuneration' be tightened to ensure it targets the intended remuneration.
- ASFA encourages APRA, in enforcing compliance with CPS 511, to consider an entity's ability to comply with parts of CPS 511 where an existing employment contract's terms prevent compliance.
- ASFA considers that APRA should be absolutely clear in stating that RSE licensees are not required to have variable remuneration.

Detailed comments

Deferral and clawback of variable remuneration

The deferral periods for variable remuneration proposed within CPS 511 are significant. For a significant financial institution (SFI), CPS 511 proposes deferring 60 per cent of total variable remuneration for at least seven years for a Chief Executive Officer (CEO) and 40 per cent for at least six years for a senior manager or highly-paid material risk-taker.

For an SFI these deferral periods apply to the CEO, senior managers and highly paid material risk takers with variable remuneration of more than \$50,000. ASFA considers that it is not an appropriate outcome for someone with \$50,000 in variable remuneration to be subject to the same deferral requirements as an employee with \$500,000 in variable remuneration. ASFA considers either a higher variable remuneration threshold should be applied, or a shorter deferral period would be more appropriate.

Clawback, as APRA mentions, is one way to mitigate risks and poor outcomes. Clawback provisions should only be used where there has been serious misconduct by the individual. However, sub-paragraph 58(a) is quite broad and open to multiple interpretations.

Responsibility for material financial losses can often be allocated to a number of factors and/or individuals, generally with the benefit of hindsight. The wording of sub-paragraph 58(a) could capture a wide range of behaviours which, so long as the appropriate due diligence and care was taken in making the decision, could have resulted in an organisation innovating or growing. Sub-paragraph 58(a), as it is currently worded, could disincentivise legitimate risk taking with the purpose of innovating and improving the organisation.

APRA's proposed clawback period is longer than other comparative jurisdictions, such as the UK. ASFA does not consider a longer deferral period than currently proposed would be beneficial, given the current deferral period proposed aligns with other jurisdictions. Competition for talent is now no longer limited to domestic markets. As such, it is vital APRA does not create onerous requirements for RSE licensees that would detrimentally affect their ability to compete for talent both domestically and internationally, particularly given employee movement commonly occurs every 4 or 5 years.

Remuneration design

CPS 511 proposes limits on the use of financial metrics in variable remuneration. While the overall amount of variable remuneration is not limited by CPS 511, ASFA believes a more principled approach would be

more appropriate for RSE licensees rather than hard limits on financial metrics. This could be through the use of modifiers or requiring RSE licensees to have an appropriate balance between financial and non-financial measures under variable remuneration.

ASFA notes that an RSE licensee's investment return measures are not included in measurement of financial metrics for the purposes of variable remuneration. ASFA considers this could be made clearer within CPS 511. That is, that superannuation investment return measures do not fall under the definition of 'financial performance measures' and, therefore, would not be subject to the 50 per cent limitation on financial metrics.

The use of modifiers, instead of hard limits on metrics, will allow RSE licensees to tailor their variable remuneration to their structure and individual performance measures. A modifier could be used where, for example, an employee has met all their performance-based measures, but their team was responsible for poor member outcomes. Their variable remuneration could be modified to reflect this. By using modifiers there is a greater use of discretion in the rewarding of variable remuneration, and employers can take into account a broader set of measures.

Modifiers could also allow RSE licensees to largely continue with similar variable remuneration frameworks currently in place, decreasing the need for unnecessary compliance costs. RSE licensees have quite varied operational structures, making the implementation of hard limits on various variable remuneration components difficult.

Classification as a significant financial institution

APRA proposes to use the level of funds under management (FUM) to identify an RSE licensee as an SFI. An RSE licensee with FUM greater than \$30 billion is proposed to be classified as an SFI, with the level of FUM an indication of complexity of in-house operations.

Firstly, given being classified as an SFI imposes additional requirements upon the RSE licensee under CPS 511, it is important the SFI classification process is transparent and clear. ASFA understands APRA proposes to notify whether an entity is an SFI via correspondence, but that classification can include considering criteria outside of just FUM levels.

The proposed definition of an SFI in CPS 511 only states that it is an APRA determination. To help RSE licensees understand their requirements under CPS 511, and to ensure they are preparing for the provisions that will be applied to them, it is vital that the SFI classification process is clearly communicated to all stakeholders. It would be unreasonable for an entity to receive notification that they have been classified as an SFI for reasons that are only known by APRA.

Secondly, the SFI notification process should be completed in a timely manner so that RSE licensees have sufficient time to comply with requirements that apply specifically to them and are cognisant of APRA's expectations of them as a result. If APRA is undecided whether an entity should be classified as an SFI, given FUM will not be the only consideration, it is important APRA communicate with the entity to clarify any outstanding questions they might relating to SFI classification.

Application of remuneration framework

CPS 511 requires a remuneration framework, which sets out the structure and terms of remuneration arrangements, to be applied to an employee of an entity that has a service contract with an APRA regulated body (sub-paragraph 19(d)). A number of RSE licensees outsource services to other corporate bodies. It would be quite difficult for RSE licensees to have a framework that sets out the remuneration structures for employees that are outside the remit of the RSE licensee and are, in fact, employees of other businesses.

An RSE licensee would not be able to directly influence nor set the structure or terms of remuneration for employees that work for a third party. As such, ASFA is concerned about the feasibility of sub-paragraph 19(d) being applied in practice as it is currently worded.

RSE licensees could instead be required to ensure that appropriate due diligence was conducted, and controls have been put in place, in the payment terms of contracts with third-party service contracts. This could be done by, for example, adding a sub-paragraph to paragraph 18.

Interaction with the Banking Executive Accountability Regime (BEAR)

The Royal Commission also recommended extending the current Banking Executive Accountability Regime (BEAR) to the superannuation sector (recommendation 6.8).¹ While Hayne recommended changes to the BEAR regime, and its applicability to other sectors including superannuation, occur over time there is a question as to how the BEAR will apply in tandem with the proposed prudential standard on remuneration.

The Government has advised that the proposed legislation that is intended to fulfil recommendation 6.8 will be consulted on and introduced by end-2020. The proposed CPS 511 is expected to come into effect on 1 July 2021 but is intended to be finalised in early 2020. The finalisation of the remuneration prudential standard is prior to the expected finalisation date for the BEAR legislation. ASFA recommends the introduction of the proposed CPS 511, as it applies to RSE licensees, be considered in light of the new legislation to be introduced by Government by end-2020.

As an option, the finalisation of the prudential standard for RSE licensees could occur once the proposed BEAR legislation has been passed by both Houses of Parliament. The risk in finalising the prudential standard prior to the legislation being passed is that there may be contradictions between the two, creating confusion within the superannuation sector and possibly preventing compliance with either the legislation and/or the prudential standard.

Recommendations

- ASFA considers either a higher variable remuneration threshold should be applied or a shorter deferral period would be more appropriate for an SFI.
- ASFA considers that sub-paragraph 58(a) should be reworded to ensure it does not inadvertently capture normal business risk taking behaviour, so long as the appropriate due diligence and care was undertaken during the decision-making process.
- Rather than the use of hard financial metric limits in variable remuneration, ASFA considers the use of modifiers to be more capable of adapting to different operational structures.
- ASFA strongly recommends a transparent and clearly communicated process be applied in the classification of entities as SFIs.
- ASFA considers that sub-paragraph 19(d), as currently worded, should be removed.
- ASFA considers that the requirements under CPS 511 should align with the proposed BEAR legislation as it applies RSE licensees.

¹ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final report, pages 408, 455