

23 October 2019

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Australian Prudential Regulation Authority
Level 12, 1 Martin Place
Sydney NSW 2000

Dear Ms Richards

Strengthening Prudential Requirements for Remuneration

The Insurance Council of Australia¹ (Insurance Council) appreciates the opportunity to comment on *Draft Prudential Standard CPS 511 Remuneration* (draft CPS 511) and the accompanying Discussion Paper, *Strengthening Prudential Requirements for Remuneration* (the Discussion Paper). We would also like to thank APRA for the meeting of 18 September.

The Insurance Council and its members support reforms aimed at strengthening governance and remuneration frameworks, and we note APRA's view that "recent evidence, as highlighted by the Royal Commission, is that the current approach to regulation in this area is not delivering satisfactory outcomes".² In addressing that deficiency, the Final Report of the Royal Commission included a recommendation that:

"APRA should give effect to the principles, standards and guidance set out in the Financial Stability Board's (FSB) publications"³.

The Insurance Council and its members strongly agree with the approach of the FSB that:

"The Principles ... are *not* intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm".⁴

The remainder of our submission addresses the individual consultation questions contained in the Discussion Paper.

¹ The 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. June 2019 Australian Prudential Regulation Authority statistics show that the general insurance industry generates gross written premium of \$48.4 billion per annum and has total assets of \$128.4 billion. The industry employs approximately 60,000 people and on average pays out about \$151.4 million in claims each working day.

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).

² p6 of the Discussion Paper

³ Recommendation 5.1, p366 Financial Services Royal Commission Final Report

⁴ FSB (April 2019) *Principles for Sound Compensation Practices* (p1) and see the discussion in the Final Report of the Royal Commission at p350

Remuneration framework

(1) Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework?

The Insurance Council agrees that triennially is an appropriate frequency for conducting independent reviews of the effectiveness of the remuneration framework (*CPS 511* para 34). This is consistent with other cyclical review frequencies, such as that under *CPS 220 Risk Management* (para 45).

(2) What areas of the proposed requirements most require further guidance?

Application to third parties

Paragraph 19(d)(ii) of *CPS 511* relates to “a person who is employed by, or a contractor ..., and which has a service contract with the entity, where the services provided by the body, either individually or collectively with like services provided by other bodies, may affect the entity’s long-term soundness or materially affect the management of financial or non-financial risks ...”.

The Insurance Council is concerned about the breadth of this category, in particular that it would require the application of a regulated entity’s remuneration framework to third parties. This will present significant practical and other challenges as general insurers engage a broad range of service providers and the ability to influence the remuneration structures of such third parties may be limited and vary with each third party. We suggest that the existing approach of *CPS 510 Governance* which provides for the risk management framework to address the structure of payments under certain service contracts remains appropriate to manage this risk

If, however, APRA extends *CPS 511* to third parties as proposed, APRA should clarify that any proposed limit on the use of financial measures in determining variable remuneration outcomes does not apply to third party remuneration.

Interaction with the Executive Accountability Regime

APRA acknowledges that aspects of the BEAR differ to the requirements in draft *CPS 511*. When the Executive Accountability Regime is applied to insurance, we would welcome clarity on the way in which it interacts with *CPS 511*.

Board oversight

(3) Are the proposed duties of the Board appropriate?

(4) Are the proposed duties of the Board Remuneration Committee appropriate?

In relation to misconduct risk, the Insurance Council supports the FSB principles on the role of the Board, namely:

“The Board of directors should oversee and hold senior management accountable for implementing and participating in the design of compensation programmes that effectively contribute to preventing and remediating misconduct. Regular monitoring

of the compensation policy and the effective management of compensation and misconduct risk should remain the duty of senior managers.”⁵

We are concerned that *CPS 511*, as currently drafted, diminishes the strategic oversight role of the Board (and the Board Remuneration Committee) and requires Boards to take up responsibilities that better sit with management. For example, paragraph 50 stipulates that “the Board ... must approve the variable remuneration outcomes for persons in special role categories”. Similarly, paragraph 48 describes the duties of the Board Remuneration Committee to assess and make recommendations on the remuneration arrangements and outcomes for persons in special role categories.

At our meeting on 18 September, APRA clarified that it does not intend for the Board to approve individual remuneration for a significantly expanded range of employees. Instead, APRA suggested that the Board directly determine the remuneration of the CEO; was part of the discussion for the next level of management; and needed to approve the principles governing the remuneration of other employees. We would welcome that clarification in the revised *CPS 511*.

Similarly, while paragraph 48(b) and (c) relate to the collective remuneration of other material risk-takers and risk and financial control personnel, paragraph 50 would suggest that the Board responsibility in relation to these employees is at the individual level. It should be clarified that this is not the intent of paragraph 50.

Remuneration design

(5) APRA is proposing that financial performance measures make up at least 50 per cent of variable remuneration measurement and individual financial performance measures are limited to 25 per cent. Is this an appropriate limit, if not what other options should APRA consider to ensure non-financial outcomes are reflected in remuneration?

The Insurance Council notes the statement in the Final Report of the Financial Services Royal Commission that “APRA should set limits on the use of financial metrics in connection with long-term variable remuneration” (p357). However, as APRA acknowledges, the development of non-financial metrics that could be used as objective measures of performance is still evolving. Similarly, ASIC’s Corporate Governance Taskforce found that “companies around the globe face similar challenges in expressing measurable appetites and metrics for non-financial risks”⁶.

In view of these challenges, if financial metrics are to be capped, then we would suggest they be capped at 75 per cent rather than 50 per cent as currently encapsulated in paragraph 38 of *CPS 511*. APRA’s planned review of the effectiveness of *CPS 511*, to be conducted in three years’ time, provides an opportunity to reassess the evolution of non-financial metrics and the appropriate balance between financial and non-financial measures for variable remuneration.

⁵ FSB (March 2018) *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices: The Use of Compensation Tools to Address Misconduct Risk*, p8

⁶ ASIC Corporate Governance Taskforce (October 2019) *Director and Officer Oversight of Non-Financial Risk Report*

Underlying recommendation 5.3 of the Financial Services Royal Commission Final Report is the objective of disincentivising poor practices which pursue profit in ways that are contrary to legal requirements and community expectations. The Insurance Council suggests that this could be better addressed through a principles-based approach rather than by prescribing caps on the use of financial metrics. The inclusion of a principle that entities ensure overall remunerations reflect both financial and non-financial outcomes, accompanied by appropriate guidance, would be consistent with the large range of remuneration practices employed by insurers which includes the use of modifiers and gate-openers rather than just scorecards.

For similar reasons, the Insurance Council suggests that the proposed requirement that each individual financial performance measure must not comprise more than 25 per cent of total measures is unnecessarily prescriptive.

(6) What would be the impacts of the proposed deferral and vesting requirements for SFIs?

Under *CPS 511*, a significant portion of total variable remuneration must be deferred for at least seven years for a CEO (paragraph 52) and at least six years for a senior manager (paragraph 53). Feedback from our members suggests that this is significantly out of step with other jurisdictions where a four year deferral period is at the higher end of what is applied globally for general insurance, and even then it is generally a pro-rata deferral as opposed to a four year period of non-payment. As APRA acknowledges in the Discussion Paper, there can be trade-offs to longer deferral periods including reduced mobility of senior executives (p35).

Longer deferrals further discount the financial value of incentives. This blunts the effectiveness of long term incentives for senior executives, and reduces the desirability of working in the financial services industry, particularly for talent pools critical to customer experience and innovation (e.g. digital), and control functions. The proposals create an uneven playing field for competition for talent, not just between financial services entities and other industries, but also between financial services entities not caught by the proposals; new entrants who are providing financial services type activities and products but are not currently caught under financial services regulations; and even within financial services entities that are contemplated, i.e. between significant financial institutions and non-significant financial institutions.

If insurers cannot compete with other industries to secure the relevant talent, then this may lead to diminished customer experience and outcomes. Alternatively, the insurance industry may be required to move to higher fixed pay arrangements to compete with other industries.

Furthermore, a deferred payment plan could inadvertently create global taxation reporting obligations that extend post-employment, adding to administrative burden.

If deferral periods for executive remuneration are set to reflect the time horizon of the risk faced by an entity, then consideration should be given to the short-tailed nature of the risk in general insurance. Most general insurance policies have a duration of one year, and a lengthy deferral period is not required to align remuneration outcomes with customer outcomes.

(7) *Would the proposals impact the industry’s capacity to attract skilled executives and staff?*

The Insurance Council’s members are particularly concerned about the ability to attract and retain executives and highly skilled staff in areas such as data science, IT, risk and compliance under the proposals.

Remuneration outcomes

(8) *What practical hurdles are there to the effective use of clawback provisions and how could these be overcome? Would requirements for longer vesting where clawback is not preferred address these hurdles?*

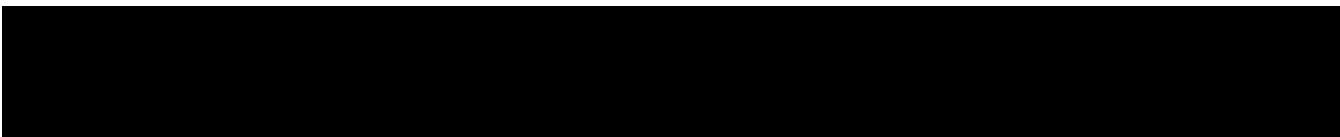
The Insurance Council’s members are concerned that the current legal and taxation frameworks do not support the effective application of clawback provisions, particularly after an employee has left the organisation. We suggest that the use of pro-rated deferral and malus is a more effective tool to address the risk of misconduct identified in the Royal Commission. To the extent that clawbacks are envisaged, they should be “limited to violations of policy by the employee, such as violations of risk management or control policies, fraud, or other malfeasance.”⁷

We also note the FSB’s comments that options that are in-the-money when granted could operate like a clawback by reducing compensation in the event of poor firm performance.⁸ This could be investigated further.

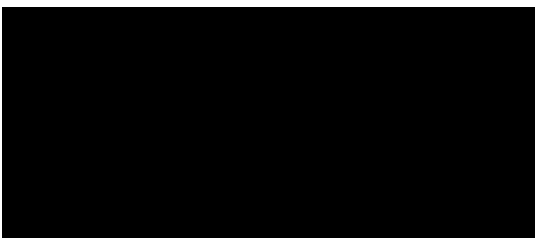
Transparency

(9) *What disclosures would encourage a market discipline in relation to remuneration practices?*

The Insurance Council notes APRA’s intention to consult on additional requirements for reporting and public disclosure following consultation on *CPS 511* (p28 of the Discussion Paper). We also note the view expressed in the Financial Services Royal Commission final report that no public disclosure should be required (p366).



Yours sincerely



⁷ FSB (March 2018) *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices: The Use of Compensation Tools to Address Misconduct Risk*, p13

⁸ FSB (April 2019) *Principles for Sound Compensation Practices*, p11