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**Strengthening Prudential Requirements for Remuneration**

Industry Super Australia (ISA) undertakes policy research and advocacy on behalf of over five million members of industry superannuation funds, to ensure that the policy settings for superannuation are consistent with the objective of maximising their retirement incomes.

ISA welcomes the recognition by the Royal Commission and APRA that how remuneration systems operate within financial entities has important implications for how those entities behave and treat their customers and members. We therefore welcome consultation on APRA's proposed reforms to the prudential regulation of remuneration design and implementation.

In this submission we comment on a number of issues raised by the draft of CPS 511 and APRA's Discussion Paper. We argue that several important matters remain unclear and unresolved. ISA would therefore welcome further opportunities to engage with APRA on these matters before a final CPS 511 is issued.

In addition to the matters discussed below, ISA notes that APRA intends to consult at a later date on introducing enhanced disclosure requirements relating to the publication of each entity's remuneration policy and the use of specific performance metrics. ISA supports enhanced disclosure and looks forward to engaging with the consultation when it takes place.

Key Points

- In the final standard and related guidance APRA should make explicit that it has no preference or expectation that entities should be making use of variable remuneration arrangements. In addition, wholly fixed remuneration arrangements should be acknowledged as a legitimate means of rewarding senior employees and material risk takers that is consistent with effective management of financial and non-financial risks.

- To help design standards of stronger relevance to RSEs, APRA should develop a more comprehensive evidence base of current remuneration practices relevant to licensees. This should be completed prior to the finalisation of CPS 511.

- Remuneration standards for RSE licensees should give clear priority to promoting long-term net returns to members, and should prohibit any remuneration arrangement that operates to prioritise the interests of any entity over those of the members.

- Consideration should be given by APRA to capping the proportion of variable remuneration that is dependent on financial measures for individual employees who fall within APRA's "Special Role Category."

- APRA should set standards that apply to front-line staff in all regulated entities that ensure no remuneration arrangement operates to prioritise the interests of the entity over those of the customers, and which prohibit the use of any variable, discretionary or sales/referral-based component in how front-line staff are remunerated.

- In an RSE context, APRA's definition of a "Significant Financial Institution" (SFI) should be based on each entity's recent compliance history, their use of related party service providers, and the extent to which variable remuneration forms part of how executive and non-executive staff are paid. Alternatively, the enhanced remuneration requirements attached to being defined as an SFI could be applied to any entity where the $50,000 variable remuneration threshold is satisfied.

- APRA should consult further on the risk that the current and likely future use of 'buy-outs' will undermine the effectiveness of measures such as malus and clawback, and canvass options to mitigate this risk that include prohibiting their offer.

<u>Clarity on Variable and Fixed Remuneration</u>

In part, APRA is proposing to establish standards that will apply when entities choose to make use of variable remuneration to reward certain categories of employees, and has stated during the consultation process that it is neutral on whether entities make use of such arrangements.

However, the heavy focus on variable arrangements in the draft standard and Discussion Paper has given rise to some concern within the not-for-profit superannuation sector that APRA may view variable remuneration as an industry norm that it expects entities to be making use of. Many not-for-profit funds do not make extensive use of variable arrangements, consistent with the Royal Commission's view that there are many ways to encourage employees to act appropriately that do not necessitate routinely putting some of their pay at risk.[1]

ISA would welcome explicit confirmation in the eventual final standard and related guidance that APRA has no expectation or preference that variable remuneration arrangements are implemented by entities, and that the use of wholly fixed forms of remuneration is an entirely legitimate means of rewarding senior employees and material risk takers consistent with the effective management of financial and non-financial risks.

<u>Weak Evidence Base</u>

In developing its proposals for RSE licensees, APRA appears to be working with a limited amount of evidence about how remuneration systems are currently designed and implemented across the superannuation sector, including the differences between the not-for-profit and for-profit

[1] Final Report of the Royal Commission, p. 369.

segments. APRA's recent Information Paper, *Remuneration Practices at Large Financial Institutions*, acknowledges that RSEs comprised only a small part of the overall research sample used to develop the paper, and so urged caution about drawing definitive conclusions about what RSEs currently do.[2]

This lack of grounding in evidence means that some of the discussion and proposals appear ad hoc. For example, it is not clear why a highly paid material risk taker is defined by reference to a $1 million remuneration threshold, or why RSE asset size in excess of $30 billion is regarded as an appropriate proxy for enhanced risk. We discuss some of these issues in more detail below.

For new standards to be relevant and effective in an RSE context, it is important APRA has a better understanding of current practices, how they vary across RSEs, and how they relate to factors such as underlying business models.

However, APRA has set itself a demanding timeline that may involve finalising CPS 511 by the end of this year.

We urge APRA to pause and take the time to develop a comprehensive evidence-base of remuneration practices relevant to RSE licensees, using the results of the current round of consultation to help design a review of a sufficiently large and representative sample from which strong conclusions can be drawn.

Stronger Standards for RSEs

Much of the Discussion Paper and draft CPS 511 is concerned with the banking and insurance industries. However, APRA acknowledges that RSE licensees operate within a distinctive legal framework of fiduciary obligations to members. Considering this framework APRA is seeking views on whether there should be a separate remuneration standard for RSE licensees.

More important than the form that the eventual standard takes is that it establishes rules that operate to ensure how remuneration is designed and implemented serves to prioritise the financial interests of members above all others.

The Royal Commission noted the distinctive legislative framework within which RSE's operate and the covenants contained in section 52(1) of the SIS Act that, among other matters, specify that where there is a conflict of interests and duties between trustees and beneficiaries priority must be given to the interests of beneficiaries.[3]

It is clear from the findings of the Royal Commission that some trustees have not observed these covenants or the related prudential standards. The design and implementation of remuneration has an important role to play in helping to mitigate these conflicts of interest. This should be reflected in prudential standards. To this end ISA recommends a number of changes to draft CPS 511:

a) Give clear priority to long-term net returns

[2] APRA (2018) Remuneration Practices at Large Financial Institutions, p. 14.
[3] Final Report of the Royal Commission, pp. 224-225.

Sections 20(c), 37(b), 41(b) and 42(b) specify that for an RSE remuneration arrangements must "promote the financial interest, and reasonable expectations, of beneficiaries."

Promoting "the financial interest" is an insufficiently precise definition of how remuneration arrangements should operate to the benefit of members. For example, it potentially allows trustees to interpret promoting "the financial interest" in terms of charging a low fee to members. While RSEs should be concerned with keeping a downward pressure on fees, this counts for little if low fees are accompanied by relatively poor long-term net returns.

Section 52(12) of the SIS Act contains a new covenant that obliges each trustee "to promote the financial interests of the beneficiaries of the entity who hold a MySuper product or a choice product, in particular returns to those beneficiaries (after the deduction of fees, costs and taxes)."[4]

The final version of CPS 511 should help give effect to section 52(12) of the SIS Act by making explicit that remuneration arrangements in an RSE context should operate primarily to promote long-term net returns to members. "Long-term" should mean at least 10 years, or for the life of the product if it has existed for a shorter period. The significance of specifying "long-term" is that it prevents trustees from claiming to have satisfied their obligation on the basis of an unrepresentative and unsustained bounce in net returns over a relatively short time period.

b) Prohibit remuneration arrangements that harm members

In a fiduciary context where trustees are required by law to give priority to the interests of beneficiaries over all others, it would be inappropriate to allow remuneration arrangements for any employee or group of employees that operate to prioritise the interests of any entity over those of members.

The final version of CPS 511 should therefore expressly state that any remuneration arrangement which generates such conflicts is prohibited. This prohibition should apply to arrangements for all employees of APRA regulated entities whose responsibilities wholly or partly involve operating an RSE licensee. This ensures coverage of those employed by an RSE licensee and those employed by any entity that is part of a group that owns an RSE licensee.

Capping Financial Measures

Where variable remuneration is utilised by APRA regulated entities, ISA supports the imposition of limits on the use of financial performance measures to help manage risks. However, the current draft of CPS 511 may not reliably achieve this. Section 38 of the draft states that:

> "For any variable remuneration arrangement of an APRA-regulated entity, financial performance measures must not comprise more than 50 per cent of total measures used to allocate variable remuneration."

The Discussion Paper adds:

[4] http://www8.austlii.edu.au/au//legis/cth/consol_act/sia1993473/s52.html

> "This requirement would apply across the entire organisation and across the total amount of variable remuneration (not individual components)."[5]

This would mean that if entity X has a total of $10 million in a year to allocate to employees in the form of variable remuneration, it will comply with the standard if $5 million or less is determined by employees meeting financial measures.

However, this would also appear to allow the entity to skew the distribution of that $5 million to particular employees or groups of employees in a manner that results in some having their total remuneration heavily dependent on a variable component related to financial outcomes. This could then generate powerful incentives for some key employees to engage in behaviours that involve taking levels of risk at odds with the broader intent of the new remuneration framework.

A more effective approach would be to cap the proportion of variable remuneration dependent on financial measures for those individual employees who fall within APRA's "Special Role Category." This covers persons in the category of senior manager, material risk taker (including highly paid material risk takers) and risk and financial control personnel.[6]

There does not appear to be conclusive evidence in the corporate governance and remuneration literature about what level of cap may be sufficient in this context. Before deciding cap levels for Special Role Category employees it would therefore be appropriate for APRA to undertake further research and consultation on the issue.

<u>The Importance of Front-Line Staff</u>

The Royal Commission recognised the importance of how front-line (or customer-facing) staff are remunerated, noting that:

> "[the Sedgwick Review] has documented instances in retail banking *and across the financial services sector more broadly*, both in Australia and abroad, in which incentives have at least appeared to drive behaviour that was not in the best interests of customers and, on occasion, scandalously so." (p. 343, emphasis added)

Drawing then on its own findings the Commission stated:

> "Much of the evidence the Commission obtained about remuneration of front-line staff related to the front-line or 'customer-facing' staff in banks. Much of the discussion below is framed with that context in mind. *But what is said applies to any financial services entity that provides products or services to customers*." (p. 367, emphasis added)

The Commission then made two recommendations specific to front-line staff. Recommendation 5.4 states that all financial services entities should review at least once each year the design and implementation of their remuneration systems for such staff to ensure sufficient focus "on not

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[5] APRA Discussion Paper, p. 31.
[6] Ibid, p. 11.

only what staff do, but also how they do it."[7] Recommendation 5.5 states that banks should fully implement the recommendations of the Sedgwick Review.

This raises a number of concerns.

Firstly, APRA's Discussion Paper is silent on recommendation 5.4 and how the draft standard gives effect to it. It may be that APRA regards the implementation of 5.4 as being a supplementary aspect of implementing recommendation 5.3. However, 5.4 recommends measures that are specific to front-line staff and potentially more prescriptive than the general requirements to conduct periodic compliance and effectiveness reviews. We would welcome clarification of APRA's thinking on this.

Secondly, the Discussion Paper is also silent on recommendation 5.5. The Sedgwick Review was commissioned by the ABA and made recommendations specific to retail banks. It has been left to the ABA and its members to progress those recommendations. However, the Royal Commission clearly regarded the issues raised by Sedgwick (along with its own findings) as having relevance "to any financial services entity that provides products or services to customers."[8] This includes front-line staff employed by insurers and wealth managers, neither of whom are covered by Sedgwick and the ABA.

In relation to the Sedgwick Review, we note concerns expressed by those who represent many front-line staff in retail banking that the recommended reforms are taking place in a self-regulatory context that lacks prudential oversight and enforcement. Some entities are therefore re-badging the use of sales targets and leaderboards to give the appearance they are giving effect to Sedgwick's recommendations, while conflicted remuneration and miss-selling continue as before.[9]

Given these concerns and those raised by the Royal Commission, it is important that APRA take the initiative in this area and set standards that apply uniformly across all regulated entities, and which will operate to mitigate the risks and poor behaviours identified by the Commission.

Standards should aim to ensure that no remuneration arrangement for front-line staff, regardless of label, operates to prioritise the interests of entities over those of customers. To help achieve this aim the use of any variable, discretionary or sales/referral-based component in how front-line staff are remunerated should be expressly prohibited.

Significant Financial Institutions

APRA is proposing to be more prescriptive in relation to larger and more complex entities, introducing a new category of entities labelled "Significant Financial Institutions" (SFIs). Once classified as an SFI by APRA, an entity would be subject to additional prudential requirements in relation to deferral and clawback for those CEOs and senior managers whose variable remuneration amounts to more than $50,000 in a financial year.

[7] Final Report of the Royal Commission, p. 375.
[8] Ibid, p. 367.
[9] See: https://www.afr.com/policy/economy/actu-to-pressure-labor-for-worker-representatives-on-private-boards-20180718-h12udh and https://www.smh.com.au/business/workplace/just-rebranding-banks-accused-of-continued-upselling-to-customers-20180718-p4zs8a.html

The argument appears to be that because of their size, complexity and potential opacity, the failure of SFIs to effectively manage financial and non-financial risks will impact more on system stability and customer interests than similar failures by smaller entities. More prescription in relation to variable remuneration within SFIs is therefore justified.

APRA is seeking feedback on how such SFIs should be defined but is currently proposing that as a starting point they could be defined by reference to asset size. In a superannuation context this means RSE licensees with assets of $30 billion or more would be regarded as SFIs.

ISA supports APRA having the discretion to apply more prescriptive remuneration requirements to those entities it judges as presenting significant risks to system stability and the financial interests of customers/members. However, a focus on defining SFIs by reference to asset size would likely lead to misallocation of regulatory resources and focus.

APRA data indicates that there are currently 16 RSE licensees with assets in excess of $30 billion.[10] Of these, 6 are for-profit and 10 are not-for-profit. This raises a number of issues.

Firstly, several RSE licensees that were subject to criticism during the Royal Commission have assets of less than $30 billion and so would not currently be defined as SFIs. It would be a perverse outcome if entities with a record of poor behaviour were exempt from more prescriptive remuneration requirements that are intended to better protect the interests of members.

Secondly, asset size is not a reliable correlate of complexity and potential opacity. Large not-for-profit RSE licenses are typically less complex in terms of their ownership structures, business operations and product offerings than smaller retail funds. A key driver of complexity and potential opacity is not the quantum of assets, but whether an RSE licensee forms part of a broader corporate structure with overlapping personnel who are simultaneously engaged in managing members' money while generating revenues for the corporate parent.

For the purposes of identifying which RSE licensees should be subject to enhanced remuneration requirements ISA recommends that each entity be evaluated by APRA by reference to a range of criteria. Such criteria should reflect the likely sources of misconduct risk and related risks to members. Criteria should include:

- Compliance history – Those entities that have a record of misconduct should receive greater regulatory scrutiny of their remuneration policies. If an RSE licensee has demonstrated through recent prior behaviour that it has cultural, governance or compliance problems then the amount of its assets is not relevant.
- Related party service providers – In its Final Report the Commission was clear that the use of related party service providers by trustees greatly increased the risk of conflicts of interest. A parent company's desire to maximise profit and a trustee's obligation to act in the best interest of members stand in obvious tension. As a result, the Commission stated that regulators need to ensure that trustees are giving priority to their members' interests when these arrangements exist.[11] Greater regulatory oversight

[10] Table 1 APRA Annual Fund-Level Superannuation Statistics June 2018, issued December 2018.
[11] Royal Commission Final Report, pp. 230-232

of RSEs that make extensive use of these arrangements would therefore be appropriate.

- Extent of variable remuneration use – The extent to which variable remuneration is actually utilised to shape the behaviour of executive and non-executive staff within individual entities should be a more relevant concern for regulators than asset size. Practice varies considerably across the industry, with some entities limiting its use to a handful of executive positions while others apply it much more extensively throughout the staffing structure. There appears to be no evidence of a correlation between assets and remuneration design. However, as a first approximation it seems reasonable to assume that there may be a relationship between the extent of variable remuneration and risk to members that is worth priority regulatory attention.

Alternatively, if APRA believes the enhanced requirements will help to make a material improvement to how financial and non-financial risks are managed within those entities to which they are applied, then they could be applied to the CEOs and managers of all entities were the $50,000 threshold is satisfied, without utilising any other qualifying criteria.

Deferral Periods

Where an entity is designated a Significant Financial Institution, APRA is proposing that a proportion of the variable remuneration for CEOs and senior managers (including highly-paid material risk takers) is subject to minimum deferral periods of 7 and 6 years respectively.

Our understanding is that under APRA's proposals if a senior SFI employee leaves employment before the minimum deferral period is exhausted, they will continue to be paid the deferred remuneration on a pro-rata basis (subject to any malus applied by the board after they leave). We would welcome confirmation from APRA that this is how they see deferral operating in this context.

Managing Variable Remuneration Risks

The Royal Commission highlighted that variable remuneration plays a particularly potent role in communicating to employees how the entity wants them to behave. Consequently, such arrangements have the strong potential to generate high-risk behaviours by those senior employees covered by them. There are a number of ways these risks can be mitigated.

Firstly, there is a role for the board. ISA strongly supports an enhanced role for boards in designing, operating and monitoring an entity's remuneration framework. However, because variable arrangements can incentivise inappropriate behaviour, where such arrangements are 'extensive' (i.e. they extend beyond those in Special Role Categories) there is a strong case for more active oversight by the board.

In such cases the board should be required to annually review all variable arrangements, and record whether it considers those arrangements are operating in a manner consistent with the interests of customers/members and the entity's obligations to regulators.

Secondly, deferral should have wider application. If deferral can serve to better align the behaviours of CEOs and highly-paid material risk takers with the interests of stakeholders (as

APRA proposes), then there is a case for applying deferral to all those in Special Role Categories who are covered by variable arrangements.

Applying Malus and Clawback

ISA supports the effective use of malus and clawback to better align the operation of remuneration arrangements with the interests of stakeholders, and in particular those of members and customers. Many entities already make use of them. However, applying these tools in practice is not always a straightforward process. Defining, measuring and applying relevant variables can be a complex and contested process.[12]

In light of APRA's emphasis on the use of malus and clawback, we hope APRA will use the eventual Prudential Practice Guide as an opportunity to advise entities of good practice in applying these tools, what problems can arise, and how those problems can be avoided or mitigated.

The Problem of Buy-Outs

A 'buy-out' in a remuneration context is when an employee who has deferred bonus awards cancelled by their employer when they resign is paid the cancelled awards by their new employer. This practice became a matter of regulatory concern in the UK in the context of broader efforts following the 2008 crisis to better align the interests of material risk-takers in financial entities with those of customers, shareholders and the broader public. The Bank of England Prudential Regulation Authority identified the problem that buy-outs present:

> "The practice of buy-outs undermines the effectiveness of malus and clawback. By moving employers and having their cancelled bonuses 'bought-out', individuals are effectively able to insulate themselves against an *ex-post* risk adjustment of their past awards as risks crystallise or the consequences of poor risk management emerge at their old employer."[13]

Following consultation, the Bank has implemented new rules that constituted a compromise between the need to act in response to a recognised risk and a degree of industry resistance to prohibiting buy-outs. In brief, for certain classes of entities the new rules require that when a previous employer determines that it would have operated malus/clawback had the departing employee remained in their employment, the new employer must make reasonable efforts to recover the amount determined by the previous employer from the incoming employee. It remains to be seen how effective these new rules will be.

In an Australian context there does not appear to be a public evidence-base on the extent to which buy-outs are used to encourage material risk takers to move between employers. APRA's 2018 Information Paper, *Remuneration Practices at Large Financial Institutions*, makes one reference to buy-outs and the fact that they are "less frequently observed" in superannuation than elsewhere.[14]

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[12] Some of the potential problems of design and implementation are discussed by the Basel Committee on Banking Supervision (2011) Range of Methodologies for Risk and Performance Alignment of Remuneration.
[13] Bank of England Prudential Regulation Authority (2016) Buy-outs of variable remuneration, Consultation Paper CP2/16, p. 3.
[14] APRA (2018) Information Paper: Remuneration Practices at Large Financial Institutions, p. 15.

It is therefore difficult to estimate the extent to which buy-outs may undermine the integrity of what APRA's proposals are seeking to achieve. Looking forward, there is the plausible risk that the use of buy-outs in Australia may increase significantly in response to new deferral/clawback requirements.

The actual and potential use of buy-outs presents a risk that should be of concern to APRA. ISA recommends APRA publishes an Information Paper on their current use and consults on options to stop them from undermining the integrity of the current remuneration reform proposals. Options canvassed should include prohibiting entities from offering buy-outs.

Please contact me if you have any questions in relation to this submission.