Insurance Council
of Australia

23 July 2021

[redacted]
General Manager, Policy Development Policy and Advice Division
Australian Prudential Regulation Authority
Level 12, 1 Martin Place
SYDNEY NSW 2000

By email: [redacted]

Dear Mr [redacted]

Prudential Practice Guide CPG 511 Remuneration

The Insurance Council of Australia **(Insurance Council**) welcomes the opportunity to comment on draft *Prudential Practice Guide CPG 511 Remuneration* (**CPG 511**) which sets out principles and examples of better practice to assist regulated entities meet APRA's expectations in relation to the requirements proposed in the new prudential standard, *CPS 511 Remuneration* (**CPS 511**).

The Insurance Council is the representative body of the general insurance industry in Australia and represents approximately 95 percent of private sector general insurers. As a foundational component of the Australian economy, the general insurance industry employs approximately 60,000 people, generates gross written premium of $53.9 billion per annum and on average pays out $166.2 million in claims each working day ($41.5 billion per year).

The Insurance Council makes two initial high-level observations in relation to CPG 511.

First, the Insurance Council wishes to reiterate comments made in its 12 February 2021 submission in relation to CPS 511, namely that APRA's prudential expectations as to what constitutes an effective remuneration system is just one set of expectations which general insurers need to take into account when setting responsible remuneration systems. Further, domestic general insurers do not only compete with other APRA regulated entities for executive talent. This too is a relevant consideration and we have a concern that APRA does not have a full appreciation of this context. This, for example, can be seen from APRA's intent to press ahead with obligations beyond those to be imposed by the proposed Financial Accountability Regime (**FAR**).

Second, as highlighted by the Australian Law Reform Commission as a part of its review of *Review of the Legislative Framework for Corporations and Financial Services Regulation,*[1] there is a tendency in Australia for regulated entities to treat regulator guidance material as if it were law rather than an expression of the regulator's opinion. Larger regulated entities with more financial resources and expertise will be better placed to treat regulator guidance for what it is – an expression of the regulator's views, but even these organisations like smaller regulated entities will find this a challenge.

[1] ALRC Webinair, *The Regulatory Ecosystem for Financial Services in Australia*, 17 May 2021.

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It is therefore important that when regulators express their views they do so with utmost clarity. In CPG 511 APRA uses a number of different terms to express its expectations: “a prudent entity would”, “good practice is”, “APRA expects”, “in considering … an entity would”, “an entity is expected”. It is unclear what the distinction is between these different but similar terms, which makes it harder for regulated entities to assess whether they will meet their obligations under CPS 511.

For example, does the term “good practice is” connote a rebuttable presumption, such that an entity should ordinarily act in this manner unless it has formed the considered view this practice should not be adopted for good reason in its circumstances? In contrast, does the term “APRA expects” indicate that regulated entities must always act in this manner to meet their obligations regardless of the entity’s assessment (i.e. it is a non-rebuttable presumption)?

The Insurance Council is of the view that APRA should review CPG 511 to ensure consistent terminology is used to express its expectations. APRA should also define its expectation of entities in relation to each term, in the manner highlighted in the preceding paragraph.

Further specific comments are:

- APRA’s expectation that the Board, in addition to the Board Remuneration Committee, should review and approve remuneration outcomes for specified roles, will duplicate work for little benefit.
- We remain concerned that the range of persons impacted by APRA’s expectations in relation to remuneration will extend beyond the most senior executives of a regulated entity, for example, given the interaction between the removal of the quantitative criteria in Prudential Standard CPS 510 and the approach taken to identification in paras 24 and 25 of CPS 511.
- We remain of the view that APRA should abandon the highly paid material risk-taker (**HPMRT**) category. The category serves little purpose and will be administratively cumbersome and expensive. Regulated entities will first be required to establish a regime for HPMRTs and then an additional regime to monitor those individuals who are not presently HPMRTs but who might become HPMRTs in the future.
- Paragraphs which do not actually provide any guidance, such as para 38, should be deleted.
- APRA’s expectation that the Board review remuneration outcomes for **all** risk and financial control personnel is excessive, given the three lines of defence model.
- APRA’s approach to third party service providers remains problematic. APRA should specify the categories of material third party service providers of which it wants regulated entities to conduct a risk assessment (e.g. brokers). APRA should explicitly insert a materiality threshold in Prudential Standard CPS 511.
- If APRA retains the current approach in relation to third party service providers and inserts a materiality threshold, then APRA should provide guidance in CPG 511 as to the matters which regulated entities should take into account when establishing their materiality threshold level and performing their risk assessment. Such guidance will help minimise the risk of the measure creating inefficiencies and adding needless expense to supply chains.

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- We agree, in principle, that Boards should be aware of matters throughout the year and ready to deal with them as required under any other related obligations (e.g. FAR). However, APRA appears to expect regulated entities to make in-period risk adjustments outside of the performance assessment cycle, which is impractical. APRA should clarify its expectations in relation to the time at which in-period risk adjustments are made.
- APRA should amend the approach to “malus” and “clawback” in CPS 511 to align with the more flexible and practical guidance on the use of these measures in CPG 511. Boards should be able to use whichever mechanism they deem fit to apply an adjustment.
- APRA’s expectation that “all” persons involved in the design of a regulated entity’s remuneration framework should be excluded from the annual compliance review is impractical and will only lead to an unnecessary increase in regulatory costs. The scope of this limitation should be amended so that it only applies to senior executives involved in the design of the remuneration framework.

The rationale for the Insurance Council’s views is outlined in Appendix 1.

We trust that our observations are of assistance. If you have any questions or comments in relation to our submission please contact [redacted] the Insurance Council's General Manager, Policy - Regulatory Affairs, on telephone: [redacted] or email: [redacted].

Yours sincerely

[redacted]

[redacted]
Executive Director and CEO

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Appendix 1

Consideration of Draft CPG 511

1. Role of the Board

The Insurance Council's principal concern in relation to APRA's expectations of a regulated entity's Board as indicated in Draft CPG 511 is that it will duplicate effort where the Board of a "significant financial institution" (**SFI**) establishes a Board Remuneration Committee as required by CPS 511, or on its own volition by the Board of a non-SFI.

The requirement for Board approval of remuneration outcomes for all Specified Roles in this circumstance adds another layer of review to remuneration decision making, thereby putting further pressure on both management and directors' time and focus during the busy year end process. Member experience suggests that the Board will likely agree with the Board Remuneration Committee's recommendations given that the committee has deliberated and considered the materials before it. It is unnecessary for the Board to duplicate those deliberations. As a consequence, there is the risk that this additional requirement will in practice become little more than "a box ticking exercise" of little value.

APRA expects that Boards and Board Remuneration Committees will assume a greater functional decision-making role in relation to remuneration framework setting than in the past. This will be matched by a corresponding diminution in the functional decision-making role of management. It is noted that this will also result in an increased volume of information which has to be prepared, collated and transmitted to the Board and the Board Remuneration Committee to enable them to meet the level of oversight of the remuneration framework expected of them by APRA.

In the Insurance Council's view, it is sufficient for the Board to set an entity's remuneration framework and approve remuneration outcomes for the most senior employees. Board approval of remuneration outcomes of all Specified Roles is unnecessary as the Board Remuneration Committee has the right expertise and information at hand to make decisions on the Board's behalf, within the remuneration policy and guidelines set by the Board.

2. Remuneration framework

Material risk-takers

As noted in the cover letter, APRA's expectations as outlined in CPS 511 and CPG 511 are just one set of regulatory expectations which general insurers need to take into account when setting remuneration practice and governance procedures for Senior Managers and Material Risk Takers. Regard also needs to be had to CPS 510 and CPS 520, as well as the FAR, so that these different sets of expectations operate in a coherent manner.

In this regard, we observe that when read together the effect of having removed the quantitative criteria within CPS 510 in combination with the approach to identification in paras 24 and 25 of CPG 511 will potentially lead to less consistent identification of such persons across the industry.

In the Insurance Council's view, it is important that consistent identification occur and that APRA's onerous accountability and remuneration obligations be limited to the most senior decision-makers in an organisation, and not be cascaded down through the organisation to lower levels of management which is the likely outcome if the definitions remain broadly expressed. As highlighted multiple times this excessive scope will ultimately impact on the ability of the general insurer to attract and retain talent.

In the Insurance Council's 12 February 2021 submission we highlighted our continuing concerns as to:

(i) the impact of the HPMRT designation on individuals; and

(ii) the administrative burden placed on regulated entities in monitoring the threshold, given variable remuneration can fluctuate significantly from one year to the next, even if only due to exchange rate fluctuations.

Accordingly, we recommended that APRA give further consideration to the definition of highly-paid, for example:

- removing the fixed component from the $1 million AUD threshold, so that the threshold is based on a variable remuneration amount only (along with a downward adjustment to that threshold); or
- removing the HPMRT category altogether, given that it appears to be of little value and will be highly complex to administer.

In this regard we note APRA's comments at para 28 that good practice is for a regulated entity to monitor both HPMRT and non-HPMRT "with remuneration close to" the threshold. It would seem from para 28 that APRA's response to these concerns is that regulated entities should double up their monitoring processes, to monitor both HPMRT and this new category of near HPMRT employees, thereby adding expense, complexity and administrative burden.

APRA's guidance at para 38 serves to reinforce the Insurance Council's view that the more sensible approach is to abolish the HPMRT category altogether.

Risk and financial control personnel

APRA at para 30 makes the redundant observation that "a prudent Board would closely monitor the remuneration of all risk and financial control personnel, to ensure arrangements are adequate to attract and retain suitably qualified, skilled and experienced staff".

All regulated entities endeavour to have remuneration arrangements which enable them to attract and retain suitably skilled and experienced staff in order to conduct their business and remain in business. This is true of personnel across all three lines of defence as well as customer service staff, legal, marketing and the myriad of other staff who are necessary for a business to function. Given that this statement at para 30 does not provide any guidance it should be removed.

Further and more importantly, the Insurance Council considers that the requirement that Boards review remuneration outcomes for "all" risk and financial control personnel is excessive, given APRA's promotion of the three lines of defence model, even if only on a cohort basis. One consequence of APRA's emphasis on this model is that regulated entities have in recent years tended to significantly increase the size of their Line 1 Risk/Compliance teams, which provide an advisory role rather than control function, so as to meet APRA expectations. The proposed CPS 511 and CPG 511 do not appear to fully contemplate these kinds of roles, including the interdependence of reporting lines and responsibilities. For example, a Line 1 risk/compliance professional will typically report to the

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managers of the business unit they monitor (para 32), and as such their variable remuneration outcomes will be approved by those managers.

It is sufficient, in our view, that there be central oversight over the design of remuneration for these types of roles to preserve their independence. The most senior risk and finance control personnel will be captured by the Specified Roles definitions (and therefore will be subject to Board and Board Remuneration Committee level oversight), whereas for all other levels other mechanisms/design elements can support the intent of APRA's principles.

Service providers

The application of Draft CPS 511 to third party service providers has been and remains an issue of considerable concern to the Insurance Council's members. In our 12 February 2021 submission we expressed our concern that the requirement in CPS 511, as drafted, for a regulated entity "to identify and to address inconsistences" as between the regulated entity's remuneration framework and a third-party service provider's remuneration framework would:

- apply to all remuneration arrangements of that third-party service provider and not only to the specific remuneration of that service provider by the regulated entity (to which APRA provided verbal assurance that this was not the case); and

- impose an excessive burden given the volume of third-party service arrangements and the removal of the materiality threshold from Draft CPS 511, which we submitted should be reinserted.

Para 34 of CPG 511 could be read as implying that Draft CPS 511 is to be amended to reinsert a materiality threshold, but this is not clear. Para 34 states that "A prudent entity *would* take reasonable steps to identify which service providers may give rise to conflicts of risks. This *may* include a materiality threshold or definition…". (emphasis added).

The uncertainty arises from the use of the permissive word "may" and a lack of explanation as to the circumstances where a prudent entity does not establish a materiality threshold or definition, but nonetheless takes reasonable steps. What are these other reasonable steps which a prudent entity can take to identify a service provider with whom it contracts? And which contracts may give rise to a conflict or risk, given the many thousands of third-party service provider arrangements a regulated entity typically enters into, if not via a materiality threshold or definition?

APRA should make the requirement for a materiality threshold or definition mandatory, and as a matter of good regulatory practice that mandatory requirement should be stated in the prudential standard CPS 511 and not in the prudential guide CPG 511.

A further practical matter arises in relation to materiality thresholds. APRA at para 35 leaves it to the regulated entity to develop that materiality threshold or definition subject to approval by the Board with little guidance. Accordingly, there will be a diversity of industry practice and approaches will vary from entity to entity. This outcome will have the advantage of allowing each entity to develop a materiality threshold which is appropriate for each entity's unique risk profile, size, scope, complexity etc. However, it also true that smaller entities are less well-placed to perform this work. Accordingly, the Insurance Council considers that APRA should also provide more detailed guidance as to approaches a regulated entity might adopt when determining an appropriate materiality threshold for their business.

Alternatively, APRA should adopt an alternative drafting approach to capturing those third party-suppliers it wants caught by this regime, which appear to be product distribution intermediaries, and specifying them by class rather than capturing all third party-suppliers and then leaving it to regulated entities to sort out who is in and who is out of the regime. From the Insurance Council and industry perspective it is this product distribution area where poor governance, culture, remuneration and accountability practices are likely to have a higher risk of causing poor customer outcomes and detrimentally impacting an entity's long-term soundness.

We recommend APRA update CPS 511 to require entities to conduct a risk assessment of the remuneration framework of material providers within their sales, distribution or customer service channels.

The Insurance Council is also of the view that, if APRA persists with the current approach then it also should provide guidance as to how regulated entities conduct the actual risk assessment to identify material conflicts of interest. A consistent approach across the breadth of the financial services industry will be helpful in avoiding a situation where service providers are having to respond to different approaches from different entities, thereby creating complexity, slowing down procurement processes and driving yet more regulatory cost into the Australian economy.

3. Remuneration design

Defining non-financial measures

As commented in the Insurance Council's 12 February 2021 submission, members remain concerned as to the lack of clarity and standardisation of non-financial metrics across different industries and countries. This reflects their relative newness and, at times, arguably subjective nature. Hence, in that submission we sought confirmation from APRA that guidance on these matters would be given.

APRA at para 47 of Draft CPG 511 provides that requested guidance:

> "APRA expects an entity to define non-financial measures that best suit their particular strategy and risk objectives, and reflect their specific risk profile… A prudent entity would be able to **demonstrate** how non-financial measures support their desired risk culture and promotes the prudent management of key risks." (emphasis added)

APRA then provides an illustrative list of examples of non-financial measures in Table 3 below para 48, and then again at para 50 states:

> "A prudent entity would be able to **demonstrate** how non-financial measures incentivise risk management …" (emphasis added)

The Insurance Council submits that the threshold of "demonstrate" is too high a threshold given the use of non-financial metrics is still an evolving area of organisational management and their presently non-standardised nature. It will be difficult for entities to demonstrate the effect discrete measures have on behaviours and outcomes, given all the other factors (internal and external) influencing performance outcomes and behaviours during the performance period.

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In the Insurance Council's view an appropriate standard would be that a prudent entity is able to provide a reasoned and rational argument as to why the non-financial measures selected are likely to support the entity's desired risk culture and promote the prudent management of key risks.

We also note that while regulated entities may be able to tailor non-financial measures and weightings to individual roles for their short term incentives (**STI**), this would not be possible for any long term incentives.

4. Risk and conduct adjustments

APRA appears to express the view at para 71 that it expects regulated entities to make in-period risk adjustments on a timely basis and not only as a part of the regular performance assessment process. If so, then this view seems conceptually flawed and practically difficult to implement. Boards should have the freedom to apply adjustments as they see fit. In an extreme situation where there has been misconduct a Board may elect to act immediately to terminate that person's employment. In the event of a lesser, but still material, matter it is arguably more appropriate for actions to be incorporated into the annual review process. This also allows for the Board to consider all matters arising during the year simultaneously, facilitating greater consistency in how similar matters are dealt with.

As a practical matter in period risk adjustments outside of the regular performance assessment cycle will be challenging to implement in the absence of full year information on performance and variable remuneration outcomes, given that STI outcomes for the relevant performance year will likely not yet have been determined.

Pending the release of the final FAR legislation, it will be important for regulated entities to align their approach to risk adjustments with the FAR requirements i.e. where an Accountable Person will potentially have their variable remuneration reduced if they breach their accountability obligations. It is not yet clear whether the reduction will need to be applied immediately following the entity being made aware of the breach, or in line with the end of year process. However, similar to the above it would make sense to conduct the risk/accountability assessment first and then, unless it is a termination type event, apply the adjustment at year end.

Alternatively, it may be that APRA's expectation, as expressed at para 71, is that the consideration of an in-period risk adjustment is "to be made on a timely basis" outside of the regular performance assessment process, but that the quantification and imposition of any downward adjustment would ordinarily occur as a part of the regular performance assessment process. If so, this expectation should be more clearly expressed.

Assessing severity

The Insurance Council considers APRA's approach to assessing severity in CPS 511 and CPG 511 to be overly prescriptive.

APRA in CPS 511 sets out specific criteria for the application of "malus" and "clawback", with malus to be applied where the event is "significant" and clawback where the event is "material".

However, APRA in CPG 511 at para 73 provides more general guidance to the effect that the use of in-period risk adjustments, malus or clawback is to be guided by an assessment of the severity of the adverse risk or conduct outcome. This is a better approach as it allows entities to determine what mechanism is most appropriate, based on their internal risk framework and criteria for assessing severity, rather than the imprecise criteria in CPS 511.

The Insurance Council considers that an even better approach would be to use the severity assessment to define the quantum of the adjustment required, and then leave it to the entity to determine which mechanism to use to apply the adjustment (which in order of ease of application would likely be in period, malus then clawback). In a high-performance year, with corresponding high STI outcomes an in-period adjustment might be sufficient and commensurate to deal with even severe events. This approach is consistent with the practice in the United Kingdom where Boards have the discretion to choose the adjustment mechanism they deem appropriate.

5. Review of the remuneration framework

SFIs will be required under CPS 511 to conduct an annual compliance review and a triennial review of the design of their remuneration arrangements and the effectiveness of their risk and conduct adjustments. APRA at para 81 states that under CPS 511 the triennial review must be conducted by “operationally independent” persons. APRA states at para 78 that the annual review is not “to be conducted by staff that were [] involved in, or reporting to those involved in, the design of the remuneration framework”.

It is unclear to the Insurance Council how a SFI will meet these requirements for an annual compliance or a triennial review without engaging a third-party service provider, thereby driving increased cost into the provision of financial services which cost will ultimately be borne by consumers. If APRA’s intent is that an internal (or external) audit should perform the annual compliance review, similar to its expectations at para 44 of Prudential Standard CPS 220 Risk Management, then it should state this explicitly. The optionality of engaging a third-party service provider in relation to the triennial review is commented upon in para 81.

The Insurance Council recommends that only senior executives involved in the design of the remuneration framework be precluded from conducting the annual compliance review. This approach should enable an SFI to perform an annual compliance review without having to engage a consultant.

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