



AUSTRALIAN INSTITUTE of  
SUPERANNUATION TRUSTEES

23 October 2019

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Policy and Advice Division  
Australian Prudential Regulation Authority  
GPO Box 9836  
SYDNEY NSW 2001

Email: [PolicyDevelopment@apra.gov.au](mailto:PolicyDevelopment@apra.gov.au)

Dear Mr Brennan,

#### **Proposed Prudential Standard CPS 511 Remuneration**

**In brief:**

AIST concurs with the proposal that the board of APRA-regulated entities should be responsible for the remuneration framework and its effective application. We support the principle that remuneration outcomes must be commensurate with performance and risk outcomes and that higher standards must be met for key roles.

AIST is concerned that the content of the draft Standard is based exclusively on variable remuneration practices which while prevalent in banking and insurance, are inconsistent with practices in the profit-to-member superannuation sector. Moreover, it is our view that the proposed Standard does not reflect the overarching obligation of trustees to act in their members' best interests.

#### **RE: Draft Prudential Standard CPS 511 Remuneration**

The Australian Institute of Superannuation Trustees (AIST) welcomes the opportunity to respond to the Prudential Standard CPS 511 Remuneration.

AIST strongly supports a new and more robust prudential standard on remuneration arrangements across the financial services sector.

To provide context for the positions we have taken in this paper, AIST wishes to highlight that the remuneration landscape in the profit-to-member superannuation sector is different than elsewhere in the financial sector.

Unlike the commercial ownership structures of the for-profit retail superannuation funds, profit-to-member (P2M) funds were not set up to return profits to shareholders. All profits are returned to members. This, together with representative governance, drives robust board oversight and

promotes remuneration arrangements across profit-to-member funds that are squarely aligned with members' best interests.

While variable remuneration is becoming more common in the P2M sector than a few years ago, it remains less common and less complex than in other financial institutions whose remuneration structures were found wanting in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

We are concerned that the Standard has been drafted without a firm understanding of P2M remuneration practices and therefore it is unclear what problems the proposed regulation is seeking to address.

AIST believes the current draft Standard to be unworkable for the P2M sector for several reasons which are described in this paper.

It is recommended that APRA pause in its work on the Standard and engage with the P2M super funds that it supervises in order to gain an understanding of P2M sector remuneration structures. Once a solid understanding of practices is in place APRA can then formulate a revised draft standard that reflects the practices of the sector. AIST seeks to constructively engage with APRA in this process.

In addition to these general observations, this submission provides feedback on the following topics:

1. Variable remuneration bias;
2. The proposed deferral structure;
3. The proposed 50 per cent maximum weight for financial performance measures;
4. Practical limitations on Board accountability proposals;
5. Practical limitations on clawback;
6. Buyouts may undermine the integrity of the proposals;
7. Areas where further guidance is required and;
8. A separate remuneration standard for superannuation.

### **1. Variable remuneration bias**

The current draft Standard is implicitly biased towards a variable remuneration model over a fixed pay model. While APRA has signalled a neutral stance toward fixed versus variable remuneration during verbal consultations, this is not borne out in the draft. It could be read to discourage, or even prevent superannuation funds, only paying fixed remuneration. For example, paragraph 20 of the draft standard provides:

*The remuneration objectives of an entity must:*

- (a) align with the entity's business plan, values, and compliance obligations;*
- (b) promote effective management of both financial and non-financial risks, sustainable performance and the entity's long-term soundness;*
- (c) for an RSE licensee, promote the financial interest, and reasonable expectations, of beneficiaries; and*
- (d) support the prevention and mitigation of misconduct risk.*

APRA's current Prudential Standard SPS 510 provides that these types of considerations only apply to the 'performance-based components' of remuneration. It could be read that fixed remuneration does not, for example, promote effective management of both financial and non-financial risks. The current drafting seems to suggest that APRA considers that fixed remuneration does not, for example, promote effective management of both financial and non-financial risks.

The new standard should clarify that fixed remuneration models are effective and are satisfactory to employ.

## **2. The proposed deferral structures**

The draft standard requires deferral of variable remuneration in significant financial institutions (SFIs are defined to be funds with more than \$30 billion of funds under management).<sup>1</sup> In drafting this requirement, APRA has not allowed for the fact that incentives are cash (not equity) based in the P2M sector. Even if the cash incentives were indexed, the value could not be influenced by the performance of an employee in their role and therefore, do not function in the same way.

While we recognise that employees are motivated by a broad range of factors, including the culture of an organisation, six and seven-year deferrals for APRA-regulated entities (instead of four-year deferrals in the current Bank Executive Accountability Regime) may have the effect of driving talent outside the APRA regulated sector where such strict deferrals do not exist. We would not want to see superannuants negatively affected by poorer relative fund performance as a result of an inability to attract the best talent into the sector.

Deferral structures can be used in the sector; however, they should be shorter in duration – three or four years are more workable.

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<sup>1</sup> AIST notes that in discussions with APRA it has been recognised that it is not just the funds under management but the complexity of the business (including the scope of different service offerings) that should influence a designation of a 'significant financial institution' in the final version of the Standard.

### **3. The proposed 50 per cent maximum weights for financial performance measures**

Most P2M funds support the proposed 50 per cent maximum weight for financial performance measures for variable remuneration and a proportion of funds already, in effect, meet this requirement. However, when this requirement is combined with other proposed restructures – the cap for financial measures for individual metrics of 25 per cent and the proposed deferral periods, the recommendations become unworkable.

More than one fund commented that the 50 per cent cap would be too difficult to administer with the additional 25 per cent restriction on financial performance measures for individuals. Another fund commented that a cap of 75 per cent should be permissible for some roles and that the board should have discretion to adjust the cap to suit individual roles.

A possible solution to the design challenges arising from the maximum weights on financial measures and the deferrals would be a mix of medium-term deferral periods (similar to BEAR) and long-term performance measures that stretch across a number of years. For example, investment returns over a one, three, five and/or ten-year period can be employed as a performance metric rather than a deferral period.

While the Royal Commission has recommended limits be set on the use of financial metrics in connection with long term variable remuneration, we note that APRA has not distinguished between long or short-term variable remuneration components in mandating the 50 per cent cap on financial performance measures. APRA position on this should be clarified in the final standard.

### **4. Practical limitations on Board accountability proposals**

While AIST supports the governance role for Boards in remuneration policy setting and oversight of remuneration for all employees as well as those in outsourced service contracts in principle, there are some significant practical challenges that must be recognised, and additional guidance provided by APRA.

In the case of remuneration policy being applied to all staff – it is not clear what level of detail is expected by APRA. How do enterprise bargaining agreements and negotiations fit with this requirement? A materiality lens could be helpful.

In the case of third-party arrangements, the RSE licensee may have little influence over the service providers' remuneration and human resource practices as their fund's proportion of the business may be very small. If there is a requirement to drill down deeply into the remuneration structures of service providers, the obligations of the RSE licensee regarding remuneration arrangements and consequence management needs to be made clear.

One AIST member fund (which does not have variable remuneration for its staff) noted that in regard to negotiated workplace agreements, the requirement for board approval could add in an impractical and unnecessary secondary level of approval during negotiations.

In regard to front line staff, the Royal Commission recommended that all financial services entities should review the design and implementation of their remuneration systems to ensure that the design and implementation of those systems focus on not only what staff do, but also how they do it, at least once each year. This issue has not specifically been examined in the APRA proposals and AIST believes this matter should be considered.

#### **5. Practical limitations on clawback and malus;**

Human beings are inherently motivated more by positive reward rather than negative reinforcement or punishments so it is not clear how much effect clawback and malus clauses may have. Moreover, in practice, clawback and malus can be difficult to implement.

Clawback and malus provisions would need to be included in executive contracts and phased in over time. The difficulty with clawbacks is that SFIs must set specific criteria for the application of clawback in contracts including responsibility for material financial losses, misstatement in financial statements or other criteria on which the variable remuneration determined was based, including in relation to misconduct risk and failure of fitness and propriety. It is not uncommon for clawbacks and malus to be legally contested and, as such, they can be costly to administer and not always successful.

In applying the clawback there is a requirement that “reasonable steps” must be taken to recover an appropriate amount corresponding to some or all paid or vested variable remuneration. This applies even where employment of the relevant individual has ceased and may require protracted legal action if they have ceased. It can be difficult – or even impossible - to retrieve money – particularly if staff have departed the organisation - without legal processes that come at a cost to members.

#### **6. Buy-outs may undermine the integrity of the proposals**

A buy-out occurs when an employee resigns and has their deferred bonus(es) cancelled by their employer. The cancelled award(s) is then ‘bought-out’ by the new employer. It is not known how much of an issue this is in Australia and therefore to what extent it might undermine the integrity of what APRA’s proposals are seeking to achieve.

The practice of buy-outs became a regulatory concern in the UK following the Global Financial Crisis. The actual and potential use of buy-outs is a risk that APRA should assess and consider in light of the new Standard.

## 7. Areas of the proposed requirements requiring further guidance

**Non-financial criteria:** More clarity is needed on what is covered by 'non-financial'. AIST believes that non-financial considerations should include as a minimum the quality of risk management, the fair treatment of customers and broader conduct objectives such as the demonstration of the values and behaviours (culture) set by the fund.

**Avoidance of conflicts of interest:** AIST supports inclusion of the reference to assess and mitigate conflicts of interest in remuneration arrangements. Further guidance is needed to help strengthen this requirement.

**Alignment of incentives to longer time frames:** APRA needs to provide more clarity on what data will be used to assess that longer timeframes have been taken into account and are, in reality, driving employee behaviours.

**Material risk takers:** APRA found<sup>2</sup> that there was a variety of approaches to the concept of 'material risk taker'. AIST believes that the terms 'material potential impact' and 'promoting the financial interest and reasonable expectations of beneficiaries' require clarity.

Regarding 'material potential impact', guidance should provide examples of the types of criteria which might be used. AIST suggests that there should be a mix of both quantitative and qualitative criteria with an explanation of how the weighting of these criteria might be undertaken. For example, the criteria could include:

### *Qualitative*

- The potential impact of employees on the entity's risk profile based on their authority, responsibility, the employee's contribution to and impact on the business, and the entity's performance indicators.

### *Quantitative*

- The size of the incentive compensation.
- The amount of risk to which an individual can expose the organisation.
- The amount of risk to which an individual as part of a group can expose the organisation.
- Complexity of the product.

Several AIST members had additional questions which we request to be answered in subsequent consultations:

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<sup>2</sup> Australian Prudential Regulation Authority (2018). *Information Paper - Remuneration Practices at Large Financial Institutions April 2018*. [online] Available at: <https://tinyurl.com/y3jenq88> [Accessed 31 Aug. 2019].

- What constitutes “reasonable steps” and how is this determined?
- What additional information needs to be provided to satisfy the definition of “comprehensive information” to support Board decisions?

### **8. A separate remuneration standard for superannuation**

One of the key questions posed in the paper is whether a separate remuneration standard should be designed and implemented for superannuation. SPS510 was put into place in November 2013 and, along with SPG 510 and SPG 511, applies to RSE licensees.

AIST is concerned that a separate standard for superannuation may not fully address variable remuneration in the group structure of retail super funds – i.e. some executives in the retail super funds may not be covered by the standard. However, we also note the distinct differences in approach for remuneration practices between P2M funds and other financial services industries, such as banks.

AIST recommends that the next version of the Standard be principle based and recognize both fixed remuneration and variable remuneration structures. Provided that there is enough flexibility within the Standard, there it will not be a need for a separate standard for the superannuation sector.



Yours sincerely,



**Chief Executive Officer**

*The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.*

*As the principal advocate and peak representative body for the profit-to-members superannuation sector, AIST plays a key role in policy development and is a leading provider of research.*

*AIST provides professional training and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.*