

22 October 2019

[REDACTED]  
Policy and Advice Division  
Australian Prudential Regulation Authority

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

Dear Ms Richards

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

The Customer Owned Banking Association (COBA) welcomes the opportunity to comment on APRA's Discussion Paper, 'Strengthening prudential requirements for remuneration', and accompanying Draft Prudential Standard CPS 511 Remuneration (Draft CPS 511). COBA appreciated the opportunity to meet with APRA to discuss its proposals at APRA's Sydney offices last month.

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has over \$121 billion in assets, 10 per cent of the household deposits market and 4 million customers.

COBA supports the intent of APRA's proposals. We note from the Discussion Paper that APRA's proposals seek to address recommendations 5.1 to 5.3 of the Financial Services Royal Commission and insights gained from the Prudential Inquiry into the Commonwealth Bank of Australia, APRA's Review of Remuneration Practices at Large Financial Institutions and its summary of industry self-assessments of governance, accountability and culture. We also note that standards and guidance produced by the Financial Stability Board have been incorporated into Draft CPS 511 for alignment.

Customer owned banking institutions bring a different model to the retail banking market where the interests of customers and the institution are better aligned than is the case with their investor owned peers.

Eight of COBA's larger members were asked by the Royal Commission, at an early stage of the process, to provide information concerning instances of misconduct or conduct falling below community standards and expectations that the entity had identified in the past 10 years.

The COBA member responses explained the natural customer focus of the customer owned banking model and indicated that although the customer owned banking sector is not immune from conduct risk, that risk is relatively low. Importantly, the responses emphasised the sector's culture of response and remediation when problems occur.

No customer owned banking institution was called to appear before the Royal Commission, and none were subject to criticism by the Royal Commission.

It is important to emphasise that the inherent customer focus of the customer owned banking sector is one of the key employee value propositions in attracting and retaining talent for the sector.

Recognising the principal aims of APRA's proposals, it is important that each element of the final CPS 511 is appropriately targeted and does not unnecessarily burden APRA-regulated entities, such as customer owned banking institutions, where there is no evidence to justify application.

We note that compliance costs flowing from the new prudential standard will include changes to policies, procedures and practices, additional training and education costs, legal and external consultant costs and new reporting forms and system changes.

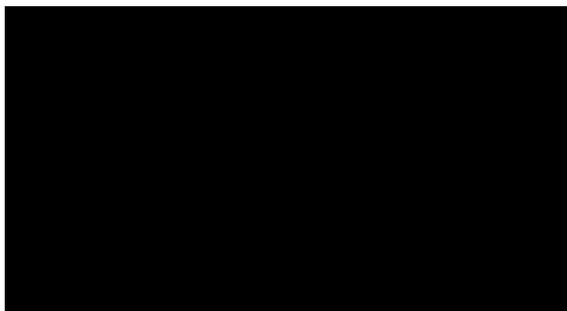
COBA strongly supports APRA's Policy Option 3 – "Proposed changes to the prudential framework for remuneration with proportionality applied", where the provisions of the final CPS 511 would have lower cost effects on smaller entities, as smaller entities would be carved out of the additional requirements applicable to a new category of APRA-regulated entities termed 'significant financial institutions' (SFIs).

The Appendix of this submission provides specific feedback on APRA's proposed approach to identifying SFIs, the expanded role of the board, the interaction of CPs 511 with the Banking Executive Accountability Regime (BEAR), non-financial performance measures and transitioning to the new prudential standard.

COBA looks forward to continuing to work with APRA to help finalise the CPS 511 and facilitate a smooth and efficient transition to the new environment.

If you have any questions about any aspect of our submission, please do not hesitate to contact Luke Lawler (Director – Policy) on 02 8035 8448 or [llawler@coba.asn.au](mailto:llawler@coba.asn.au).

Yours sincerely



**SPECIFIC COMMENTS ON DRAFT CPS 511****1. Approach to Identifying SFIs***Asset Threshold*

COBA notes from the discussion paper that APRA is proposing to categorise large and complex entities as significant financial institutions (SFIs), contemplating that criteria for inclusion could be based on “measurable indicators such as asset size, presence in certain markets, membership of a conglomerate group or the provision of critical services”.

COBA notes that APRA’s proposed starting point is to identify SFIs according to asset size, and that for ADIs, APRA is proposing an SFI asset threshold of >\$15 billion.

While COBA supports the intent of APRA’s proposed separate SFI category, we are concerned that the proposed asset threshold for ADIs is set too low. Also, it is not clear from the Discussion Paper the rationale for >\$15 billion as an appropriate “starting point” threshold.

COBA urges APRA to increase the asset threshold to *at least* \$20 billion.

The proposed >\$15 billion threshold for SFIs – assuming that this remains as the only threshold criterion – would capture one customer owned banking institution and may capture others in the near future.

COBA submits that no customer owned banking institution should be categorised as an SFI, given:

- the principal aims of APRA’s CPS 511; and
- that APRA’s proposed SFI threshold for ADIs is designed generally “to capture publicly listed entities, material foreign-owned banks and others of similar size and sophistication”.

Increasing the asset threshold to at least \$20 billion would provide APRA the opportunity to apply an appropriate level of proportionality and graduation into the final CPS 511.

Increasing the asset threshold to at least \$20 billion would also help maintain the fairness of the CPS 511 in relation to how it would impact the market for executive talent.

Customer owned banking institutions in the \$10 billion to \$20 billion asset category compete in the same market for executive talent with those institutions with less than \$10 billion in assets.

Leaving the proposed threshold unchanged runs the risk of reducing the competitiveness of ‘SFI categorised’ institutions to recruit executive talent.

COBA’s view is that the threshold should be increased to ensure that these peer institutions are subject to the same CPS 511 requirements.

As an alternative option, COBA suggests the inclusion of non-quantitative threshold criteria that would appropriately restrict the SFI category to non-customer owned banking institutions.

*Entity Complexity*

APRA commented during our meeting that while asset size may be a primary indicator for determining SFI status, the complexity of an entity would also be taken into account which may result in an entity with <\$15 billion in assets being categorised as an SFI.

COBA would appreciate further clarification from APRA as to what level of complexity would warrant an SFI categorisation for an entity with <\$15 billion in assets (i.e. what indicators would APRA use to determine complexity and where is that threshold?).

### *Notification of SFI categorisation*

APRA explained at our meeting that for ADIs to be categorised as an SFI, APRA would notify those ADIs in writing. COBA would appreciate clarification on when an ADI would receive this notification, noting that an appropriate lead time would need to be provided prior to the intended July 2021 commencement date.

## **2. Expanded Board Role**

COBA notes that APRA is proposing an expanded board role, where a board would be responsible for the overall remuneration framework and be directly involved in overseeing the remuneration arrangements and approval of remuneration outcomes of persons falling within the special role category (on an individual and collective basis).

COBA notes that APRA's view is that by requiring a board to approve key remuneration decisions, "they will need to be more actively involved in dealing with misconduct or compliance issues when variable remuneration outcomes are being determined".

In terms of impact on entities, we understand from the Discussion Paper that this will mean, for instance, a more direct oversight role for boards and a direct role in setting clear accountability for poor outcomes.

COBA's view is that there needs to be a clear delineation between the roles of a board and senior management. The key role of a board is to develop and set a clear strategy for their organisation, while the role of senior management is to implement the board's strategy.

COBA is concerned that APRA's proposal may not be practicably feasible, given the level of work that would be added to the role of a board. This may operate to dilute the traditional strategic role of boards.

COBA would appreciate it if APRA could more carefully assess the practical impact of this proposal on the operation of boards.

## **3. Interaction of CPS 511 with the BEAR obligations**

It is not clear from the Discussion Paper how CPS 511 would interact with the BEAR. COBA notes from the Discussion Paper that APRA intends to work with the Government to seek legislative amendments to the BEAR and will review any other areas where the BEAR and CPS 511 are not fully aligned.

We understand from APRA at our meeting that the Treasury will release, before the end of this year, proposals for consultation, which will help clarify the interaction between CPS 511 and the BEAR.

As this matter is now contingent on the Treasury's proposal and the outcome of the Treasury's consultation process, it would be appropriate for APRA's consultation on Draft CPS 511 to be extended to allow industry an appropriate amount of time to consider and respond to APRA and the Treasury.

While COBA's view is that no customer owned banking institution should be categorised as an SFI, the inconsistencies between the deferral obligations under BEAR and Draft CPS 511 are significant. If APRA's decision is to not extend its consultation, COBA suggests that:

- the threshold for deferral of variable remuneration be aligned to the BEAR. That is, deferral is only required where *the amount to be deferred* is >\$50,000 (under the Draft CPS 511 it reads as though deferral is required where *the total award* is >\$50,000 which is a much lower bar than what is required under the BEAR), and
- the longer deferral period is phased in over a number of years. That is, rather than going from 4 years to 7 years immediately, phase in the 7-year deferral period over 3 years (i.e. Year 1 = 5 years, Year 2 = 6 years and Year 3 = 7 years). This would reduce the immediate and significant impact on executive pay, particularly if the lower threshold is used (as noted above), as some of COBA's members will have executives who may have had a 2-year deferral prior to the BEAR. As APRA would appreciate, having to then suddenly defer part of their variable remuneration for 7 years would have a significant impact on those individuals.

#### 4. Non-Financial Performance Measures

COBA notes that APRA is proposing that financial performance measures make up no more than 50 per cent of the weighting of total performance criteria used to determine variable remuneration, and that any individual financial performance measure would not be able to comprise more than 25 per cent of the total measures used. COBA notes that this would apply across the entire organisation and across the total amount of variable remuneration (not individual components).

COBA also notes that APRA does not intend to identify which types of non-financial metrics are more appropriate or favourable, and that an entity must be able to demonstrate how its selection of non-financial metrics, along with its financial metrics, drive long-term soundness.

While COBA supports the intent of APRA's focus on non-financial performance metrics, APRA's proposal is very significant. The most challenging aspect from COBA's perspective is the 25 per cent cap, and the application of this cap to roles that are primarily focussed on lending (such as mobile lenders) and where a significant portion of performance measures for those roles are underpinned by financial measures (volume and value).

COBA would appreciate clarification from APRA on why the individual 25 per cent cap is necessary, given there would be an aggregate 50 per cent cap, and guidance on how the former could be applied to roles where a significant portion of performance measures are financial performance measures.

Furthermore, implementing the proposal may be problematic if long-term incentives are mainly based on financial performance measures, even if short term incentives are not. This is because the Draft CPS 511 does not appear to distinguish between long-term and short-term incentives. In this respect, we are concerned that APRA's proposal may increase the complexity of long-term incentive plans and diminish the motivational impact of these plans.

Finally, while not directly relevant to COBA members<sup>1</sup>, the 2017 Sedgwick Review into retail banking remuneration made the following recommendation<sup>2</sup> in relation to financial performance metrics for retail bank staff roles in scope of that review (namely tellers, sellers (including home lenders and in-scope financial advisers) and managers):

“Any financial measures included in an overall assessment consistent with Recommendation 3 should:

- Be product neutral (i.e. not encourage the sale of one product over another); and
- In the case of a scorecard, together attract a maximum effective weight of 50 percent as quickly as systems and other changes can be introduced, falling to 33 percent or less by 2020;”

COBA would encourage APRA to consider the approach in this recommendation as an alternative.

#### 5. Remuneration Design

In relation to paragraph 40 in the Draft CPS 511, concerning the proposed prohibition of accelerated vesting of unvested variable remuneration, we note that the paragraph allows for specific exceptions that have been made in the remuneration policy (in situations outside the control of the individual, being “death, serious incapacity, serious disability or serious illness”).

COBA would appreciate guidance from APRA on how this would apply in situations such as redundancy, change in control, material transactions, and the implications of paragraph 40 on the exercise of Board discretion and provisions in the ‘remuneration policy’.

<sup>1</sup> The Sedgwick Review was commissioned by the Australian Banking Association (ABA). In its 19 August 2019 Financial Services Royal Commission Implementation [Roadmap](#), the Government made clear that its expectation that banks implement the Sedgwick Review recommendations only applies to “ABA member banks” (at Recommendation 5.5).

<sup>2</sup> Sedgwick Review Report, 19 April 2017, Recommendation 4, Section 3.2 Remuneration structures for retail bank staff, page 8.

## **6. Transitioning to the new CPS 511**

COBA notes that following the consultation, APRA intends to publish a Response to Submissions and final CPS 511 by early 2020 and expects an effective date of 1 July 2021. We also note that APRA will determine the effective date based on feedback regarding aspects of the implementation.

COBA welcomes APRA's plan to also consult on an updated prudential practice guide in 2020, to support implementation of the final CPS 511, as well as reporting standards and disclosure requirements.

COBA considers that it would be appropriate for APRA to release the final CPS 511 and final prudential practice guide at the same time to support an informed and smooth transition to the new environment.

The final transition period should appropriately take into account the release date of the final CPS 511 and supporting prudential practice guide, while also taking into account the large volume of financial services sector regulatory reform that is presently being developed and implemented.

COBA strongly supports APRA's plan to conduct a review of the effectiveness of the final CPS 511 three years from its initial effective date. COBA agrees with APRA that a post implementation review would be important given the significance of the proposals and industry impact.