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Response to Strengthening Prudential Requirements for Remuneration Discussion Paper

Thank you for the opportunity to provide comments on the consultation draft of the document '*APRA Discussion Paper: Strengthening prudential requirements for remuneration*' dated 23 July 2019 (the Paper) and the proposed draft *Prudential Standard CPS511* (CPS511).

As the peak body for 27 not-for-profit, member owned and community based health insurers, Members Health advocates for a successful and vibrant private health insurance industry (PHI) supported by robust and fit-for-purpose policy frameworks and efficient processes.

We have reviewed the Paper and CPS511 and conducted an extensive survey of our Health Funds and take this opportunity to bring to your consideration a number of issues which have surfaced as key concerns. Most prominently among them is the potential for significant additional costs to be incurred by our members to meet the additional compliance requirements. While many of these costs would be incurred in the initial compliance phase, there would also be additional ongoing costs incurred as many of our members have limited resources and would need to add additional resources or rely more heavily on external advisors to comply with ongoing review and reporting requirements. Any increase in regulatory costs would by necessity, have to be passed on to consumers, further eroding affordability and impacting participation.

We offer the following comments for your consideration (using the sections from the Paper).

- 1. Significant Financial Institutions.** Our Funds felt it would be beneficial to have a two-tiered approach for PHI as this would allow for proportionality to be applied and minimise the additional compliance costs for smaller entities. We

offer the suggestion that APRA consider identifying significant financial institutions within the PHI industry as:

- a) For-profit health funds that hold 5% or more of the ‘total policies held’ market share; or
- b) Those that hold >\$7.5 billion in assets.

- 2. Remuneration Frameworks.** The extended scope of components expected within Remuneration Frameworks would impose a cost impost on our Funds as many would need to review and rewrite current Frameworks in order to comply. Our Funds seek greater clarification of the reporting requirements of ad hoc rewards.

Our Funds also suggest that section 19(d) be clarified to exclude service providers relating to risk, auditing and actuarial services. Our Funds raised concerns about the ability to influence, or monitor the remuneration arrangements of an external party, and the additional governance impost this would impose on small Funds.

The requirement for more comprehensive internal reviews, and triennial external reviews will increase the costs for our Funds. It is suggested that APRA consider a longer time frame for external reviews, such as every five years, given the infrequency of changes to remuneration arrangements among our Funds.

- 3. Transparency.** Concerns were raised about the transparency requirements. While not immediately relevant to PHI, our Funds would prefer it were limited to the structure and design of remuneration components and measures, rather than individual measures or outcomes.
- 4. Board Oversight.** It is suggested that the CROs role be limited to the design, operation and monitoring of compliance to the Framework, but be excluded from the determination of remuneration outcomes for individuals.

It is also suggested that the requirement for the Remuneration Committee to approve remuneration arrangements be applicable only to roles with variable pay components and limited to the CEO and the CEO’s direct reports.

- 5. Remuneration Design Elements.** Many of our Funds offer variable pay components but few would currently meet the proposed balance between financial and non-financial measures. It is suggested that APRA increase the cap on an individual financial measure to be 33% of total measures, providing greater flexibility for smaller Funds.

Our Funds raised concerns that the proposed lengthening of deferral periods will require changes to existing structures. Concerns were also raised that this would increase the likelihood that LTIs will no longer be as valued by the individual and this may negatively impact the perceived value of total remuneration. This in turn has the potential to negatively impact recruitment and retention.

It is suggested that APRA consider introducing a higher threshold, such as \$100,000 for consideration.

- 6. Outcomes Management.** Introducing additional adjustment requirements, including clawback and malus, increases the complexity of current structures and will require changes and redesigns, and therefore incur additional costs. It is suggested that APRA introduce a minimum financial threshold to apply STIs before clawback provisions are required, such as \$50,000. If it were to apply to lower thresholds, our Funds prefer a deferred payment structure for STIs rather than a clawback requirement.

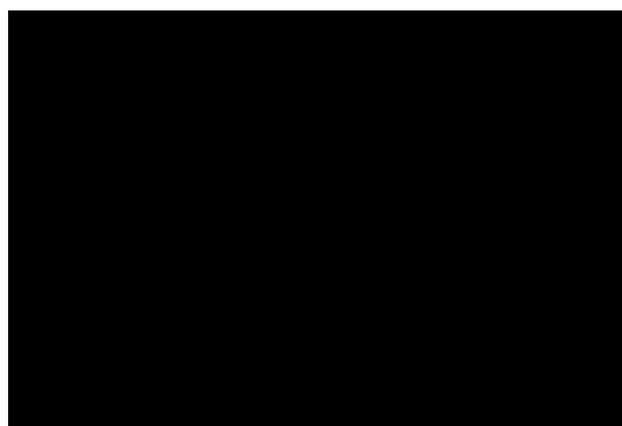
Given the significant financial impact on our Funds, we are advocating for no changes to the prudential framework relating to PHI. In the event that APRA chooses to impose new prudential standards, we seek APRA's support to introduce the framework with proportionality applied to minimise the impact and impost on our Funds.

Members Health look forward to working with APRA on improving this process for the benefit of the consumer and the insurer.

Attached is a more detailed summary of the concerns and recommendations submitted by Members Health Funds on the Rebate process.



Yours sincerely



1. Scope of Application: Significant Financial Institutions

We note that APRA is proposing to introduce additional accountability requirements on ‘*significant financial institutions*’. While APRA is proposing not to include private health insurers (PHI) in this categorisation our Funds believe there is benefit in having a two-tiered approach applied to PHI industry as there are significant structural differences in the industry. Currently, the PHI industry can be segmented as:

- Five funds who are accountable for 80% of total policies held, and over 70% of assets
- Of these large funds, four are for-profit funds with the remaining funds are either not-for-profit or mutual funds.

We offer the suggestion that APRA consider identifying significant financial institutions within the PHI as:

- c) For-profit health funds that hold 5% or more of the ‘total policies held’ market share; or
- d) Those who hold >\$7.5 billion in assets.

2. Remuneration Frameworks

2.1 Capturing arrangements

We note that in CPS511, APRA is proposing to expand the scope of the remuneration framework to ensure it captures all remuneration arrangements, including links and references to all remuneration-related policies, practices and procedures.

While our Funds indicated they currently have written remuneration frameworks in place, many of our Funds have raised concerns that there will be an impost on resources and additional costs incurred in complying with the proposed standards.

Few Funds have comprehensive frameworks which include references and links to every policy, practice and procedure so this would require a comprehensive review to identify all components, and a need to update or rewrite current frameworks.

Many remuneration components are explicit in their nature and can be easily identified; others are less so. For example, some Funds offer their additional benefits which contribute to a total remuneration offering to staff but have low individual value, such as fresh fruit. Others offer memberships, store discounts, and such like. Several Funds have ad-hoc rewards, such as movie tickets or low-value vouchers that are used to positively recognise immediate behaviours or outcomes. These components are low risk in relation to misconduct risk, but all are remuneration components that would need to be incorporated into the Frameworks.

Our Funds raised concerns that the incorporation of these low value, ad hoc rewards would create an unnecessarily complex layer of governance as they would need to be

reported to the Board under the proposed standards. This may result in the reduction of their use, or the loss of the ad hoc nature of giving on-the-spot rewards. Our Funds seek greater clarification of the reporting requirements of ad hoc rewards.

2.2 Scope

APRA is also proposing to expand the scope to persons in addition to those employed directly. Of significant concern to our Funds is section 19(d) of CPS511 which covers persons employed, or contracted to, a body that has a service contract. Our Funds acknowledged the desire to minimise the risk of misconduct and request further clarification as to the extent of information required of these external parties.

Many of our Funds use external service providers for risk management, actuarial advice and auditing; some also use aggregators. Currently, none of our Funds have visibility of the remuneration structure and terms for these service providers.

- Our Funds acknowledged that the existence of variable pay does not automatically increase the risk of misconduct. Service provider employees may be offered variable pay components that are not influenced by the delivery advice component of their services. For example, they may be rewarded for winning the contract to deliver the services, but not for the delivery component.
- Our Funds raised concerns about their ability to influence or alter any remuneration arrangements once visibility has been obtained. This may only be possible through the review or renegotiation of contracts, which would introduce an additional cost to our Funds.
- Our Funds also raised concerns about the governance and resourcing impost that would be required to monitor and review remuneration arrangements of external parties, introducing significant additional costs that will impact premiums and further damage affordability of private health cover for consumers.

Our Funds offer the suggestion that section 19(d) be clarified as follows:

- It is suggested that of most interest would be where service providers offer variable pay for an outcome that may negatively impact the community. As such, service providers relating to risk, auditing and actuarial services be excluded from the list.
- Information sought from aggregators or similar service providers should be limited to a confirmation of whether or not variable pay is offered in relation to the services or tasks delivered by that staff, and the details of performance measures used. Entities can then determine a risk assessment of the potential

for a negative impact on the community and can explore alternative arrangements if deemed necessary.

2.3 Internal Review

APRA is expecting a comprehensive annual compliance review to the Remuneration Framework. While many of our Funds review the achievement of remuneration objectives, few conduct as comprehensive a review each year as is suggested in CPS511.

Many of our smaller funds have limited human resource capabilities and will need to engage additional resources or use the services of external advisors in this process. This would increase the costs of compliance for our Funds.

2.4 External Review

APRA is expecting a comprehensive external review of the Remuneration Framework every three years. Few of our Funds currently engage an external party and this would significantly increase costs incurred by our Funds.

Our Funds raised concerns about the proposed frequency of external reviews and suggested the period be longer as few of our funds have changed or altered their remuneration approaches in that time period.

It is suggested that APRA consider longer time frame, such as every five years.

3. Transparency

APRA is proposing the requirement of publication of an entity's remuneration policy. Currently, few of our Funds publish their remuneration policies, and none publish the performance measures used.

Our Funds raised concerns about the level of detail required for publication. Questions were raised in relation to:

- financial measures would be commercially sensitive;
- non-financial measures may be quantifiable, but results may be sensitive in nature where they relate to individual behavioural standards.

It is suggested that APRA consider transparency requirements to be based on the structure and design of remuneration components and measures, rather than individual measures or outcomes.

4. Board Oversight

4.1 Consultation Process

APRA is proposing that Boards establish a formal consultation process between the Remuneration Committee, Risk Committee and Chief Risk Officer (or person in a similar role). Many of our Funds indicated that their Remuneration and Risk Committees already have this process in place.

Our Funds felt that the involvement of the Chief Risk Officer (CRO) in the design, operation and monitoring of the Framework was appropriate but many raised concerns about the inclusion of the CRO being included in the determination of remuneration outcomes for individuals as this gave them greater visibility of remuneration of peers and superiors than currently exists.

It is suggested that the CRO role be limited to the design, operation and monitoring of compliance to the Framework, but be excluded from the determination of remuneration outcomes for individuals.

4.2 Approval

APRA is proposing that the Remuneration Committee has responsibility for approving the remuneration arrangements and variable remuneration outcomes for a broader range of persons. In consultation with our Funds, it is clear that this will extend the scope of responsibilities for this Committee.

To date, few of our Funds' Remuneration Committees review and approve the individual remuneration arrangements beyond the CEO's direct reports. Many felt that governance should be limited to the oversight of compliance to the Remuneration Framework rather than reviewing individuals beyond the CEO's direct reports, particularly for persons with no variable components.

It is suggested that this requirement be applicable only to roles with variable pay components and limited at the CEO and the CEO's direct reports.

5. Remuneration Design Elements

5.1 Financial and Non-Financial Measures

Approximately one third of our funds offer short-term incentive (STI) programs. Only a small number of our Funds offer long-term incentive (LTI) programs. Many of these Funds incorporate both financial and non-financial measures into the design of their STIs, but few would comply with the proposed requirement to have a 50:50 balance between financial and non-financial measures.

Many of our Funds raised concerns about the proposal to cap individual financial measures to a maximum of 25% of total measures. There are considerable costs associated with implementing processes designed to quantify non-financial measures,

such as staff engagement scores, 360 feedback processes and customer engagement surveys. Many of our Funds have limited capacity to incorporate complex quantifiable processes relating to non-financial measures and this has limited their inclusion to date. There are also risks associated with introducing overly simplified measures as results can be unreliable and misleading.

To introduce an effective framework of performance measures, aligned to the strategic objectives and long-term financial success, requires a complex and comprehensive review of all measures and monitoring tools. This is not a small undertaking and would be costly. Our Funds would need to engage external advisors and redesign current measures, introduce new tools, and change remuneration arrangements. This process will take time as it also requires consultation and engagement with those impacted by the proposed changes. There would also be increased ongoing costs associated with the implementation and monitoring of non-financial measures.

It is suggested that APRA increase the cap on an individual financial measure to be 33% of total measures, providing greater flexibility for smaller Funds.

5.2 Deferral Periods and Vesting

Of the Funds which offer LTIs, most offered components valued in excess of \$50,000 however, none of those Funds have programs which would comply with the proposed portions to be held and the deferral periods. Both are significantly higher than current practices among our Funds. Whilst the definition of an SFI will determine if our Funds would be directly impacted, they did express concerns.

Variable remuneration models were introduced to influence individuals to achieve particular outcomes, but a critical element is the timeframe within which an individual receives that reward. The longer the period between action and reward, the less likely it is for there to be an incentive; it simply becomes a delayed remuneration model. Our Funds also raised concerns that the increased deferral period dilutes the value on each year's potential bonus, which in turn dilutes the incentive element.

It is suggested that APRA consider introducing a higher threshold, such as \$100,000 for consideration.

Our Funds raised concerns that the proposed changes increase the likelihood that LTIs will no longer be valued by the individual and this will also negatively impact the perceived value of total remuneration. This in turn has the potential to negatively impact recruitment and retention.

6. Outcomes Management

The Funds which offer STIs and LTIs have the ability to reduce payments based on Board discretion. However, few of our Funds have other adjustment options currently built into their models, such as those proposed by APRA.

While clawback and malus arrangements are most commonly found in larger organisations, they are not common among our Funds.

Our Funds expressed concerns in relation to the clawback proposals. Those Funds which offer STIs feel there would be benefit if APRA introduced a minimum financial threshold to apply to STIs before clawback provisions are required, such as \$50,000.

Should the clawback provisions apply to lower value STIs, some of our Funds suggested a preference for a deferred STI payment approach rather than a clawback approach, such as 80% payment at end of reporting period and 20% deferred for a period of six months. This would enable Funds to adjust components of the second payment rather than have to clawback payments previously made.

With reference to clawbacks for LTIs, concerns were raised about the additional administrative burden to be able to track past employees and recover funds from individuals that no longer have a legal relationship with the organisation. Concerns were also raised about the potential for introducing legal complexities as individuals may challenge the clawback claiming events outside the control of the individual where that individual had not been employed for a large proportion of the deferred period.

Summary

Our Funds believed there is the potential for significant additional costs to be incurred in order to meet the additional compliance requirements. We are concerned that these additional compliance costs will further damage affordability of private health insurance for consumers and runs counter to the Commonwealth Government's stated objective of reducing regulatory red tape and compliance costs. While many of these costs would be incurred in the initial compliance phase, there would also be additional ongoing costs incurred as many of our members would need to engage additional new staff or rely on external service providers.

Given the significant financial impact on our Funds and consumers, we are advocating for no changes to the prudential framework relating to PHI. In the event that APRA chooses to impose new prudential standards, we seek APRA's support to introduce the framework with proportionality applied to minimise the impact and impost on our Funds.

We note that since the machinery of Government reforms to transition from PHIAC to APRA, APRA has introduced a number of significant regulatory changes that have impacted compliance costs for insurers and their customers. As part of the process for introducing new standards, we ask that a detailed and independent regulatory impact assessment be undertaken to quantify the cumulative financial impact that each regulatory change has had, and each new regulatory change is expected to have. This will help provide industry and government policymakers with a holistic understanding of the cost/benefit impact for consumers of each new standard.