



# RESPONSE PAPER

## Strengthening prudential requirements for remuneration

27 AUGUST 2021

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# Executive summary

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The finalisation of *Prudential Standard CPS 511 Remuneration* (CPS 511) represents a key milestone in APRA's objective to transform industry practices in governance, risk culture, remuneration and accountability. CPS 511 will raise the bar for remuneration practices across all APRA-regulated industries.

A resilient financial system requires prudent remuneration arrangements – in design, governance and outcomes. As highlighted by the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Royal Commission) and recent APRA supervisory reviews, remuneration incentives which overemphasise short-term financial performance can drive poor customer and beneficiary outcomes and jeopardise financial soundness. Under APRA's reforms, entities will no longer be able to reward strong financial performance without regard to the impact on customers or risk management outcomes.

This Response Paper outlines feedback from industry and other stakeholders during the recent consultation on CPS 511, received in early 2021. It sets out APRA's response and finalised requirements, expectations for implementation, and regulatory impact analysis.

## Policy development and consultation

In November 2020, APRA consulted with industry and other stakeholders on a revised CPS 511. Responses were received in February 2021, with no material concerns raised on the main proposed requirements.

Following the consultation, APRA has made three revisions to specific elements of CPS 511. These revisions are to requirements related to third-party service providers, risk and conduct adjustments, and the determination of Significant Financial Institutions (SFIs). In each of these areas, APRA has sought to address the concerns raised and provide clarifications to the requirements.

The finalisation of APRA's remuneration reforms addresses recommendations 5.1 to 5.3 of the Royal Commission. CPS 511 also aligns with international better practice, incorporating standards and guidance produced by the Financial Stability Board (FSB).

## Overview of the new standard

The new CPS 511 will require entities to establish and maintain:

- stronger incentives for individuals to manage the risks they are responsible for;
- appropriate consequences for poor risk outcomes; and
- increased oversight, transparency and accountability on remuneration.

### Stronger incentives

Under the new requirements, a sole focus on financial metrics in determining variable remuneration will be unacceptable. A prudent assessment of performance must include consideration of both financial and non-financial measures. SFIs will be required to assign a

material weight to non-financial measures when determining variable remuneration, and have risk adjustment mechanisms that can reduce variable remuneration, potentially to zero, where warranted.

### Appropriate consequences

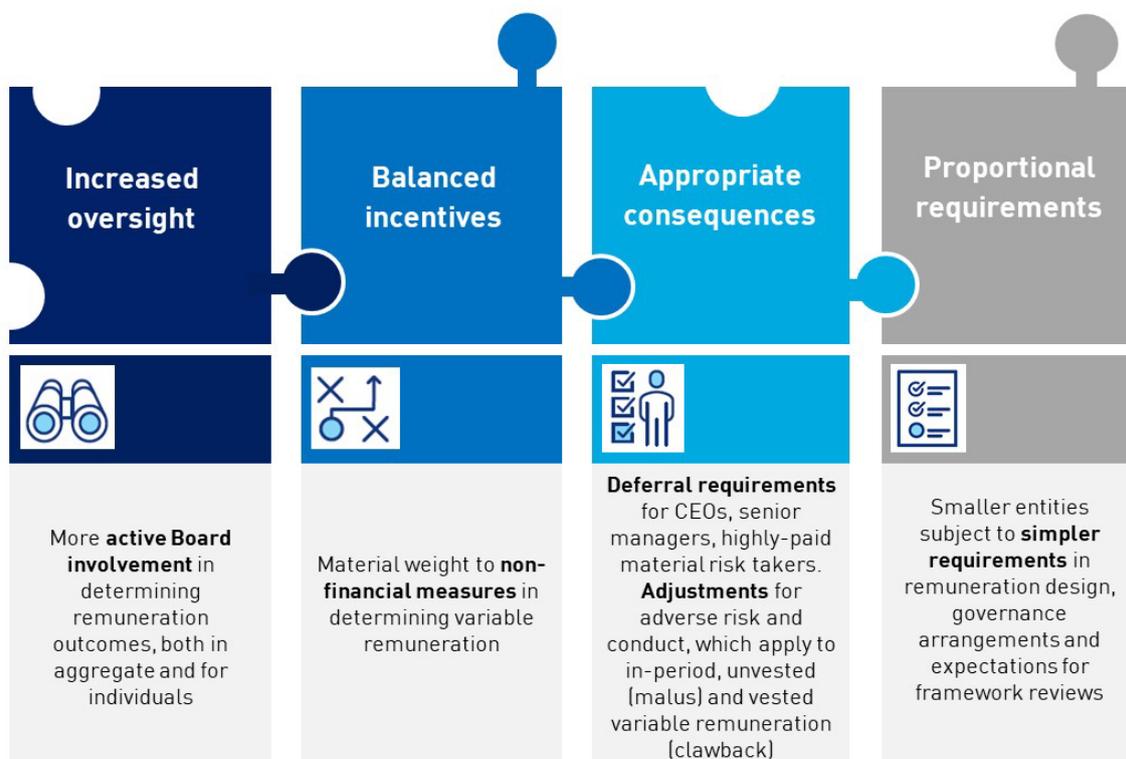
Variable remuneration of senior executives at SFIs will also be subject to longer deferral, combined with provisions for in-year, malus and clawback adjustments. Senior executives will now have more 'skin in the game' for a longer period of time. This will ensure that short-term rewards cannot be enjoyed without regard to longer-term outcomes.

### Increased oversight, transparency and accountability

Meeting these new standards will require more active Board involvement in determining remuneration outcomes, both in aggregate and for individuals in key roles. Boards of SFIs will need to be satisfied that non-financial measures included in variable remuneration are appropriate and that the weighting applied to them is material.

Non-SFIs must also factor non-financial measures into the determination of variable remuneration, and ensure that there are appropriate consequences for adverse risk and conduct outcomes. However, these entities will be subject to simpler requirements for remuneration design, governance arrangements and framework reviews. This proportional approach will materially reduce the regulatory impact of the reforms for smaller and less complex entities.

Figure 1. CPS 511: Key elements



## Implementation: next steps

APRA is providing all entities with an extended timeline to transition to the new requirements, so that Boards can oversee effective implementation. CPS 511 will be implemented under a phased approach, beginning on 1 January 2023 with the largest and most complex ADIs. APRA expects that all entities will assess their readiness to meet the new requirements and develop implementation plans to close any gaps identified.

**Figure 2. Remuneration reform - timeline**



To support entities in transitioning to the new CPS 511 requirements, APRA is currently finalising *Prudential Practice Guide CPG 511 Remuneration* (CPG 511). The PPG outlines examples of better practice to assist entities in meeting the requirements in the standard. The consultation on the draft PPG closed on 23 July 2021, and the final PPG will be released in October 2021.

APRA will ensure there is appropriate alignment between the design and implementation of CPS 511 and the Government's proposed Financial Accountability Regime (FAR). The proposed FAR will set minimum requirements for the deferral of variable remuneration by all APRA-regulated entities. APRA is working closely with Treasury, and may make additional minor amendments to CPS 511 where appropriate, once the proposed FAR is finalised.

To reinforce accountability for effective implementation, APRA will also be consulting on new disclosure requirements for remuneration early next year. It is important that entities publicly demonstrate how they have strengthened their remuneration arrangements in line with CPS 511 requirements. APRA's disclosure requirements will better enable stakeholders to hold entities to account for prudently managing remuneration.

# Glossary

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<b>ADI</b>	Authorised deposit-taking institution.
<b>BEAR</b>	Banking Executive Accountability Regime set out in Part IIAA of the Banking Act 1959.
<b>Board</b>	The board of directors or relevant oversight function, and for an RSE licensee, either the board of directors or a group of individual trustees.
<b>Clawback</b>	The recovery of an amount corresponding to some or all variable remuneration subject to recovery that has been paid or vested to a person.
<b>Financial measures</b>	Measures that are based on revenue, sales, profit, the entity's share price, or other measures that directly affect these.
<b>In-period adjustment</b>	An adjustment made to variable remuneration during the period set for measuring the performance under a variable remuneration arrangement.
<b>Malus</b>	An adjustment to reduce the value of all or part of deferred variable remuneration before it has vested.
<b>Non-financial measures</b>	Measures that are not financial measures.
<b>Non-significant financial institution</b>	An APRA-regulated entity that is not a significant financial institution.
<b>Relevant oversight function</b>	For foreign ADIs and Category C insurers, the senior officer outside Australia, and for EFLICs, the Compliance Committee.
<b>RSE</b>	Registrable superannuation entity.
<b>Remuneration arrangement</b>	An arrangement that includes measures of performance, the mix of forms of remuneration (such as fixed and variable components, and cash and equity-related benefits) and the timing of eligibility to receive payments. All forms of remuneration are captured by CPS 511, regardless of where, or from whom, the remuneration is sourced.
<b>Remuneration framework</b>	The totality of systems, structures, policies, processes and people within an entity that identify, measure, evaluate, monitor, report and control or mitigate all internal and external sources of risks relating to remuneration.
<b>Significant financial institution</b>	Where an APRA-regulated entity is of a certain total asset size as specified in CPS 511, has complexity in operations or remuneration practices, or is a member of a group.
<b>Variable remuneration</b>	The amount of a person's total remuneration that is conditional on objectives which include performance criteria, service requirements or the passage of time.
<b>Vesting</b>	The process by which the person becomes the legal owner of the variable remuneration.

# Chapter 1 - Introduction

This chapter summarises APRA’s approach to developing the new CPS 511. It outlines the key revisions made to APRA’s proposals, in response to issues raised by stakeholders during the July 2019 and November 2020 consultations, and the final position as set out in August 2021.

**Figure 3. Prudential standard – CPS 511**



## First consultation – July 2019

In July 2019, APRA released a discussion paper setting out proposals for new prudential requirements for remuneration across all APRA-regulated industries. These new requirements were part of APRA’s response to the Royal Commission.

APRA received significant feedback from a range of stakeholders on the proposed remuneration requirements. APRA’s proposal for a 50 per cent limit on the use of financial measures to determine variable remuneration outcomes was a key area of focus, as was the proposed approach to minimum deferral periods. In total, APRA received more than 70 written submissions from regulated entities, shareholder groups, proxy advisors, consultants and consumer groups.

## Second consultation – November 2019

APRA conducted a second consultation on CPS 511 in November 2020, introducing a revised set of proposals in response to earlier stakeholder feedback. The revised proposals represented a more principles-based and proportionate approach. APRA maintained its focus on the use of non-financial measures in variable remuneration incentives, but shifted from a prescriptive 50 per cent limit to the principle that entities must give material weight to these measures and adjust variable remuneration, potentially to nil, for adverse risk and conduct outcomes. Minimum deferral periods were also moderately shortened.

In total, APRA received 41 submissions on the revised proposals. Stakeholders broadly supported APRA’s revised policy proposals, noting that the approach provided Boards with more flexibility to strengthen remuneration practices in a way that was appropriate to their business model and particular risks. Industry also supported greater proportionality; under CPS 511, the majority of reforms are aimed at larger and more complex entities (SFIs). Many of the issues raised in the second consultation were focused on areas of clarification, and have been incorporated into the development of guidance (see Chapter 2).

## Finalisation – August 2021

APRA is finalising the November 2020 CPS 511 proposals without material revision. APRA has made minor amendments to clarify certain requirements, consistent with industry feedback. These amendments are outlined in the table below.

Issue	Amendment
Remuneration arrangements of service providers	The final CPS 511 clarifies that an APRA-regulated entity must identify and mitigate material conflicts to the objectives of its remuneration framework that may result from third-party service provider compensation arrangements. APRA will also include additional examples of better practice in the final accompanying guidance, CPG 511.
Downward-adjustments to variable remuneration	The final CPS 511 clarifies that downward-adjustments to variable remuneration must be proportionate to the severity of adverse risk and conduct outcomes. The draft guidance, CPG 511, provides better practice examples to assist entities in assessing severity.
Proportionality: SFI thresholds	For the purposes of determining ADI SFIs, APRA has increased the quantitative asset threshold to \$20 billion from \$15 billion. This aligns with proportionality thresholds used in other parts of the ADI prudential framework. For the purposes of determining superannuation SFIs, APRA has clarified that the \$30 billion asset threshold applies to all RSEs of RSE licensees. APRA has also clarified that foreign ADI and insurer branches will not be SFIs, unless otherwise determined by APRA.

## Phased implementation – from 2023

Industry will be required to comply with the new CPS 511 requirements from 1 January 2023, under a staged implementation approach. This is consistent with the timeline outlined in APRA's November 2020 consultation. Further detail on implementation timelines are provided in Chapter 4.

Over the next 18 months, APRA will have a strong supervisory focus on industry's implementation of the new CPS 511 requirements. As set out in Chapter 4, it is important that entities self-assess their readiness to meet CPS 511 requirements and develop plans to address any gaps identified in a timely manner. For a subset of entities, APRA will undertake a more detailed review of implementation progress, including benchmarking against peers. The thematic findings from this review will be publicly communicated to assist all entities with implementation.

# Chapter 2 - Revisions after consultation

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This chapter sets out APRA's response in more detail to issues raised in the recent November 2020 consultation on CPS 511. It covers the three key areas where revisions have been made to CPS 511. The revisions include changes to requirements around service providers, risk and conduct adjustments, and the determination of SFIs.

## 2.1 Service providers

In its November 2020 consultation, APRA proposed that regulated entities must identify and address inconsistencies with the objectives of their remuneration framework that may result from the remuneration arrangements of third-party service providers. In introducing this requirement, APRA's goal was to ensure that the use of third parties did not undermine the overall intent of the remuneration reforms. For example, an entity heavily reliant on brokers may find that its own carefully designed remuneration incentives are undermined if brokers' remuneration is solely driven by volume or financial targets.

### Comments received

Submissions sought greater clarity on APRA's expectations for addressing inconsistencies between the remuneration arrangements of their own employees and those of third-party service providers. Entities noted that, at times, they can have limited influence over how a service provider chooses to remunerate their employees. Some submissions also requested greater consideration of materiality, suggesting that APRA should take a more risk-based approach to this requirement.

### APRA's response

APRA has amended the Prudential Standard to clarify its expectation that regulated entities must focus on material conflicts to the objectives of the remuneration framework that may result from their compensation arrangements with third-party service providers. Where material conflicts are identified, CPS 511 requires an entity to mitigate these.

There are a range of possible mitigants available to APRA-regulated entities, depending on the conflict. APRA would not expect changes to a third-party service contract or termination of an arrangement where a regulated entity has put effective mitigants in place.

For example, to mitigate material conflicts associated with third-party compensation, such as volume-based commissions, an APRA-regulated entity might heighten its focus on non-financial risks and conduct risks. Business written by third-parties could be subject to additional oversight or controls to more actively incentivise the management of non-financial risks and the prevention and mitigation of conduct risk. This could include tighter approval criteria, increased reviews or more frequent and detailed monitoring. An entity might consider changes to the design of variable remuneration for an accountable person that oversees the third-party business. Entities might also seek assurances from third-party service providers. It is important that APRA-regulated entities have appropriate mechanisms in place to address instances of adverse risk and conduct outcomes, even where these arise from the activities of third-party service providers.

Some third-parties will be subject to legislation covering compensation structures or remuneration arrangements. CPS 511 does not require third-parties to make changes to these arrangements.

## 2.2 Risk and conduct adjustments

In its November 2020 consultation, APRA proposed specific requirements for the application of risk and conduct adjustments to variable remuneration, including in-period adjustments, malus and clawback. The proposed requirements linked the application of malus to 'significant' adverse risk and conduct outcomes, and clawback to 'material' adverse risk and conduct outcomes. APRA's objective was to ensure that regulated entities implement consequences that are commensurate to the severity of a risk or conduct incident.

### Comments received

Submissions requested further clarity on the difference between significant and material incidents. Some respondents also suggested that APRA's focus should be on the overall adjustment to variable remuneration, rather than prescribing the specific tools that entities must use in particular circumstances.

### APRA's response

APRA has revised its approach of linking the severity of risks to particular adjustment tools. The final CPS 511 requires APRA-regulated entities to ensure that adjustments to variable remuneration are proportionate to the severity of the risk or conduct incident, but provides flexibility regarding the type of adjustment tool to be used. An entity can use in-period adjustments, such as a modifier, malus and clawback to ensure that the adjustment to variable remuneration appropriately reflects severity.

As noted in the draft guidance, CPG 511, in gauging the severity of a case, an entity would consider a range of factors. This includes the expected or actual impact on the entity's reputation, customers or beneficiaries and prudential standing, as well as any financial loss.

In some adverse risk and conduct events, the use of an in-period adjustment alone may provide for an appropriate consequence. For more significant events, an entity would also consider malus. Where in-period adjustments and malus do not provide a sufficient consequence, clawback would be considered.

## 2.3 Determination of Significant Financial Institutions

A key element of CPS 511 is proportionality. Under this approach, SFIs are subject to heightened prudential requirements, compared to smaller and less complex entities. This includes establishing a Board Remuneration Committee, applying a material weight to non-financial measures, applying minimum deferral periods and clawback arrangements, and periodically reviewing the remuneration framework. In its November 2020 proposals, APRA set out its proposed approach to determining SFIs, which was based on both quantitative and qualitative assessment criteria.

## Comments received

Several respondents requested greater clarity on the SFI determination process. Some submissions highlighted differences in APRA's approach to setting quantitative thresholds compared to the BEAR requirements; under the BEAR, asset thresholds allow for indexation and the use of rolling averages.

## APRA's response

APRA is amending the quantitative asset threshold for ADIs, from \$15 billion to \$20 billion. This will maintain consistency with proportionality requirements in other parts of the ADI prudential framework, including simplified ADI capital requirements. APRA is also clarifying that, for superannuation funds, the \$30 billion asset threshold will apply at the RSE licensee level and therefore to the aggregate asset value of all RSEs of an RSE licensee. The final asset thresholds for each industry are presented below.

Industry	Total asset threshold for SFIs <sup>1</sup>
Authorised deposit-taking institutions	> \$20 billion
General and life insurers	> \$10 billion
Private health insurers	> \$3 billion
RSE licensees	> \$30 billion

APRA does not consider it appropriate to add complexity to asset thresholds through indexation or averaging. APRA will revisit the appropriateness of quantitative thresholds periodically, including when the standard is reviewed (see Chapter 3).

APRA-regulated entities with assets in excess of the quantitative thresholds, excluding foreign ADI and insurance branches, will be designated as SFIs. APRA will advise these entities, and any other additional entities which are determined to be SFIs based on other qualitative criteria, by no later than 30 October 2021.

Under the final revisions to CPS 511, foreign branches will be classified as non-SFIs, unless they are determined as SFIs based on factors other than asset thresholds. Foreign branches with assets above the SFI threshold will be required to defer the variable remuneration of highly-paid material risk-takers, in line with the requirements of SFIs. This targeted approach ensures that individuals which can have a material impact on an entity's risk profile take into account the long-term risks of their decision making. Importantly, foreign branches

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<sup>1</sup> Total assets is derived from *Reporting Standards ARS 322.0 Statement of Financial Position, ARS 323.0 Statement of Financial Position, GRS 300.0 Statement of Financial Position, LRS 300.0 Statement of Financial Position, HRS 602.0 Financial and Capital Data and SRS 320.0 Statement of Financial Position.*

will also continue to be subject to home country regulations for remuneration. All APRA-regulated entities will be subject to minimum deferral requirements for accountable persons under the proposed FAR.

# Chapter 3 - Other issues raised

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This chapter sets out APRA's response to other issues raised in the consultation on CPS 511 in November 2020, where the proposed requirements will be maintained. It covers minimum deferral periods, limits on financial performance measures, alignment to the Financial Accountability Regime (FAR) and disclosure.

## 3.1 Minimum deferral periods

In its November 2020 proposals, APRA shortened its minimum deferral requirements for SFIs, compared to the original July 2019 proposals. In making this revision, APRA sought to balance its objective of incentivising employees to take into account the long-term effects of their decision making, against the risk of any unintended consequences for an entity's ability to attract and retain high quality employees. The revised minimum deferral requirements placed APRA in line with international better practice.

### Comments received

Submissions questioned the need for APRA to establish minimum deferral periods that were longer than those implemented under the BEAR and proposed under the Government's FAR. Some respondents also questioned the need for a common approach across all APRA-regulated industries. In particular, some insurers and RSE licensees have argued that they should not be held to the same standard as banks, since international reforms have typically focused on banks.

### APRA's response

APRA is implementing its November 2020 proposals for minimum deferral periods, without revision. APRA's objective is to sustainably strengthen remuneration practices across all APRA-regulated industries, and this requires consistent minimum standards. The Royal Commission and recent APRA supervisory reviews have identified weaknesses across all industries that need to be addressed.

For the largest and most complex APRA-regulated entities, APRA is also maintaining longer minimum deferral periods than proposed under the FAR. This risk-based approach reflects that failings in risk management at large and complex entities can have significant adverse consequences for the financial system. APRA has aligned its requirements for SFIs to international better practice.

## 3.2 Limit on financial measures

In its November 2020 consultation, APRA proposed a more principles-based approach to limiting the use of non-financial measures in variable remuneration. Under this approach, SFIs would be required to give material weight to non-financial measures in the determination of each component of a person's variable remuneration. They would also be required to have risk adjustment mechanisms that could reduce variable remuneration, potentially to zero, for adverse risk and conduct outcomes. APRA's objective was to promote

a balanced approach to incentives, encourage the prudent management of risk, and limit financial performance measures so that they are not the sole or predominate driver of remuneration outcomes.

### **Comments received**

Submissions broadly supported the more principles-based approach. The majority of feedback focused on clarification, including for key issues such as defining non-financial measures of performance and applying a material weight to these measures. Some submissions continued to suggest that measures such as Total Shareholder Return (TSR) and Return on Equity (ROE) already provided a balanced approach to incentives. Others noted that the use of non-financial measures in remuneration incentives remained immature, and required a longer transition period.

### **APRA's response**

APRA is implementing its November 2020 proposal for non-financial measures without revision. Under CPS 511, SFIs will be required to give material weight to non-financial measures in determining each component of a person's variable remuneration. They will also be required to adjust variable remuneration for adverse risk and conduct outcomes.

As APRA has previously noted, experience has shown that TSR and ROE are not adequate measures to capture all financial and non-financial risks. In particular, these measures typically do not effectively promote accountability for sound risk management. While these metrics might be appropriate as part of a suite of measures to determine variable remuneration, on their own they are inadequate to deliver the objectives of a prudent remuneration framework.

For industry, meeting the requirement to give material weight to non-financial measures will represent a significant shift in practices. SFIs that have adopted non-financial measures in short-term incentive plans will also need to incorporate these in long-term incentives. In the draft guidance, CPG 511, APRA has provided examples of better practice and set out principles to support entities in meeting this new requirement. Ultimately, it is for the Board to determine how to apply the principles in CPG 511 in a way that is appropriate to their entity's business model and particular risk profile.

## **3.3 Alignment to the Financial Accountability Regime**

In finalising CPS 511, APRA has engaged with the Treasury and the Australian Securities and Investments Commission (ASIC) to ensure that there is appropriate alignment with the Government's proposed FAR, which is also aimed at strengthening remuneration practices. FAR proposes minimum deferral requirements and adjustments to variable remuneration of all accountable persons of APRA-regulated entities.

### **Comments received**

Submissions requested that there be appropriate alignment between underlying definitions in CPS 511 and the proposed FAR to reduce unnecessary complexity for industry in implementing the two reforms. As discussed in section 3.1 above, some respondents also

questioned the need for longer minimum deferral periods under CPS 511, compared to the proposed FAR.

### **APRA's response**

APRA's objective is that CPS 511 complements and reinforces requirements under the FAR. APRA and Treasury are working together to ensure there are no inconsistencies in definitions and terminology across CPS 511 and the FAR, particularly relating to deferral and variable remuneration. APRA has made a small amendment to align CPS 511 with the FAR drafting for deferral periods.

APRA is also aware that entities have raised questions through the FAR consultation, regarding the use of consistent terminology in APRA's draft CPG 511 and the draft FAR Explanatory Memorandum. An area of focus has been the use of 'maximum opportunity' and 'award' for determining amounts subject to deferral. APRA is working with Treasury to address this and will include, in CPG 511, aligned wording to the final FAR. APRA will release the final CPG 511 in October 2021.

APRA may also make additional consequential amendments to CPS 511 or CPG 511 in due course, should this be considered necessary to achieve appropriate alignment with the FAR.

## **3.4 Disclosure**

In its November 2020 consultation, APRA invited feedback on potential approaches to improving transparency of remuneration arrangements. APRA's objective is to reinforce accountability, by requiring APRA-regulated entities to demonstrate publicly how they are meeting key CPS 511 requirements.

### **Comments received**

While submissions generally supported APRA's objective to strengthen transparency, industry highlighted a number of sensitivities that would need to be considered in developing specific policy proposals. This included the potential for duplication with existing requirements under the *Corporations Act 2001* and *Superannuation Industry (Supervision) Act 1993*, as well as potential reputation, privacy and legal risks. Industry also sought clarity regarding APRA's expectations for proportionality, and the balance between quantitative and qualitative disclosures.

### **APRA's response**

APRA recognises that the design of disclosure requirements will need to balance carefully the benefits of transparency on remuneration decisions with commercial-in-confidence information and the privacy of individuals. APRA is currently conducting a data study with a sample of regulated entities across all industries, to inform the design of potential reporting and disclosure requirements. APRA is also reviewing international practices and consultation feedback, and will be engaging with ASIC on the disclosure requirements.

APRA's proposed disclosure requirements will be released for consultation in early 2022. In the lead up to CPS 511 coming into effect in 2023, APRA expects that entities will proactively seek to improve and maintain transparency on their remuneration arrangements through

publicly demonstrating that they meet CPS 511 requirements with clear, comprehensive and timely disclosures.

# Chapter 4 - Implementation

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## 4.1 Phased implementation approach

APRA-regulated entities will be required to comply with the new CPS 511 requirements from 1 January 2023, under a staged implementation approach. This is consistent with the proposed approach set out in APRA's November 2020 consultation.

SFIs will be required to meet the new requirements first, beginning with:

- ADI SFIs from 1 January 2023;
- Insurance and RSE licensee SFIs from 1 July 2023; and
- Non-SFIs (across all APRA-regulated industries) from 1 January 2024.

Under the approach to implementation, CPS 511 requirements would not apply to a person's variable remuneration if the opportunity to earn the variable remuneration arose before the relevant commencement dates of the Prudential Standard. In practice, this would mean that an ADI SFI with a 30 June financial year-end must have incorporated CPS 511 requirements into variable remuneration arrangements from 1 July 2023. APRA generally expects that all variable remuneration arrangements would comply with CPS 511 requirements within the first 12 months of the implementation date.

For SFIs, the transition to the new CPS 511 requirements will require continued focus and ongoing Board engagement. It would be prudent for entities to begin transitioning to the new requirements as soon as possible, allowing time for learnings and refinement ahead of CPS 511 coming into force.

APRA's *Prudential Standards CPS 510 Governance* (CPS 510) and *SPS 510 Governance* (SPS 510) include certain minimum requirements of APRA-regulated entities in managing their remuneration arrangements. In the period ahead, APRA intends to repeal the remuneration components of CPS 510 and SPS 510 to ensure there is no unnecessary duplication with the new CPS 511. Further detail will be provided to industry ahead of CPS 511 coming into force.

## 4.2 Pre-implementation review

The implementation of CPS 511 will be a key area of APRA's supervisory focus over the coming 18 months, particularly for SFIs. It would be prudent for all entities to undertake a self-assessment against the new CPS 511 requirements and develop an implementation plan to close any gaps. APRA will regularly engage with SFIs to assess progress.

APRA will also undertake a more detailed review, focused on implementation at a subset of entities.<sup>2</sup> APRA plans to publish thematic findings from its review in early 2023, highlighting examples of better practice and drawing attention to any areas that require further focus. This is intended to assist industry in transitioning to the new requirements. APRA will begin engaging with entities that will be included in this review in late 2021.

### **4.3 Post-implementation review**

To ensure that the remuneration reforms are achieving their intended objectives, APRA will review CPS 511 in 2027, four years after its implementation. This post-implementation review will also provide an opportunity to update guidance on better practice, to reflect improvements that are made by industry over the period ahead.

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<sup>2</sup> Refer to APRA's Information Paper *Transforming governance, culture, remuneration and accountability: APRA's approach* released in November 2019.

# Chapter 5 - Regulatory Impact Analysis

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Consistent with the Australian Government Guide to Regulation, APRA has followed a similar process to that required for a Regulation Impact Statement (RIS). APRA's evaluation of the impact of CPS 511 policy changes is provided below.

APRA has undertaken two rounds of public consultation in revising CPS 511 and has engaged with a variety of stakeholders over a period of 24 months, including APRA-regulated entities, industry bodies, remuneration consultants, proxy advisors and other regulators. As detailed in APRA's November 2020 and this August 2021 response to submissions, APRA has clarified or amended its proposals in certain areas, following consideration of issues raised by stakeholders.<sup>3</sup>

In its July 2019 Discussion Paper, APRA set out the problem and why regulatory action was needed. APRA's 2018 review of remuneration practices had revealed that remuneration practices among the largest APRA-regulated entities did not consistently and effectively encourage behaviour that would support prudent risk management and long-term soundness. The impact from these weak practices was reinforced through the findings of the Royal Commission, which recommended that APRA should strengthen its remuneration requirements, in line with international better practice.

The July 2019 Discussion Paper also outlined APRA's preliminary analysis of policy options for CPS 511, including the potential impact for industry. The sections below expand on APRA's initial analysis, taking into account feedback received during the consultation period.

## 5.1 Assessment of regulatory costs

As part of the consultation process, APRA invited submissions on additional regulatory costs incurred as a result of the three policy options under consideration. Respondents were invited to use the Australian Government's Burden Measurement Tool to assess regulatory costs.<sup>4</sup> APRA has considered all relevant compliance and administration costs, including both upfront and ongoing costs, in estimating the regulatory costs of each option.

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<sup>3</sup> [Consultation on remuneration requirements for all APRA-regulated entities | APRA](#)

<sup>4</sup> This tool calculates the compliance costs of regulatory proposals on business, individuals and community organisations using an activity-based costing methodology. The tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at: <https://rbm.obpr.gov.au/home.aspx>

## Option 1: No change to the prudential framework for remuneration

Under the first option, there would be no change to APRA's existing remuneration requirements. There would be no new regulatory costs, as shown below.

Annual regulatory costs, averaged over 10 years (\$m)				
Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total by sector	Nil	Nil	Nil	Nil

However, prudential risks would remain heightened. Without changes to APRA's existing remuneration requirements, senior executives could continue to be rewarded where there are failings in risk management, and this behaviour can undermine an entity's long-term soundness and create broader social costs to the community. An entity's long-term soundness requires sound incentive structures and clear accountabilities for outcomes. Recommendations from the Royal Commission would also not be addressed, which could impede efforts to restore confidence in the Australian financial sector.

On balance, APRA considers there to be a long-term net cost associated with Option 1. While there are no additional regulatory costs from this option, there are long-term costs associated with the risks to financial soundness and poor community outcomes.

## Option 2: All APRA-regulated entities subject to heightened remuneration requirements

Under Option 2, all APRA-regulated entities would be subject to the same remuneration requirements. This would, in effect, mean that small entities would be held to the same standard as the largest and most complex entities (SFIs).

Under this option, APRA-regulated entities would incur significant additional regulatory costs. APRA estimates the cost to industry, at an annual average of around \$66 million over the next 10 years, as shown in the following table.

Annual regulatory costs, averaged over 10 years (\$m) <sup>5</sup>				
Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total by sector	\$66 million	Nil	Nil	\$66 million

APRA's estimate is based on information provided by a sample of large entities (SFIs). These entities estimated both the upfront and ongoing costs associated with the implementation of CPS 511. This included the costs associated with reviewing the new Prudential Standard, revising policies and frameworks, creating new remuneration plans, modifying governance and reporting, and legal costs.

APRA has estimated the average cost for a small entity (non-SFI) at 30 per cent of an SFI. This reflects that non-SFIs have significantly fewer employees than SFIs (as an indication, the average balance sheet of an SFI is 50 times the size of a non-SFI) and many non-SFIs do not offer variable remuneration incentives. However, under this option, not all regulatory costs would be appropriately scaled to reflect these entity's simpler business models. For example, small entities would be required to conduct regular independent reviews of their remuneration arrangements, despite having simple practices. They would also be required to maintain governance arrangements that are more appropriate for larger and more complex entities.

Under Option 2, APRA considers it unlikely that additional regulatory costs to small entities could be absorbed by business, without adverse impacts for competition. On balance, APRA considers there would be a net cost to smaller entities associated with Option 2.

### Option 3: SFIs subject to heightened remuneration requirements

Under Option 3, non-SFIs would be subject to simpler requirements compared to Option 2.

Under this option, smaller entities would incur significantly lower regulatory costs, compared to Option 2. APRA estimates the total cost to industry, at an annual average of around \$38 million over the next 10 years (as shown below). For the average SFI, this would equate to

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<sup>5</sup> Under Options 2 and 3, estimates do not include additional costs associated with new regulatory reporting and disclosure requirements. These costs will be estimated separately, as proposals are developed.

around \$454,000 per annum. For the average non-SFI, this would be around \$46,000 per annum.<sup>6</sup>

Annual regulatory costs, averaged over 10 years (\$m)				
Change in costs (\$m)	Business	Community organisations	Individuals	Total change in costs
Total by sector	\$38 million	Nil	Nil	\$38 million

Under Option 3, non-SFIs will need to make significantly fewer changes to remuneration arrangements to meet new CPS 511 requirements, compared to Option 2. They will be subject to simpler governance arrangements, no requirements for regular reviews and less complex remuneration design requirements; for example, these entities would not be required to establish clawback provisions. There would also be some regulatory savings; in certain areas, the new CPS 511 will remove existing regulatory requirements of smaller entities.

The additional regulatory costs to smaller entities would be significantly lower than estimated under Option 2. APRA considers it likely that these costs could be absorbed by business. On balance, Option 3 would provide a net benefit from regulatory change.

### Assessment of net benefits

As outlined in APRA’s July 2019 Discussion Paper, there are strong net benefits of APRA’s approach to revising CPS 511 (Option 3):

- The majority of APRA’s reforms are targeted at large and complex entities. The costs to these entities from failings in risk management and poor conduct have been significant in recent years. In October 2019, the Reserve Bank of Australia estimated that remediation costs to large entities associated with poor customer outcomes and regulatory non-compliance had amounted to \$7.5 billion over the prior two years.<sup>7</sup>
- APRA’s proportional approach to regulatory change will mean that smaller entities are subject to simpler requirements. This supports competition.

<sup>6</sup> Under Option 3, the costs for SFIs are the same as those assumed for Option 2. For non-SFIs, APRA has excluded costs that would no longer be relevant to these entities and applied a lower (20 per cent) scaling factor to SFI costs. This reflects that there are regulatory savings under Option 3.

<sup>7</sup> See [The Australian Financial System | Financial Stability Review – October 2019 | RBA](#)

- CPS 511 creates stronger incentives for individuals to proactively manage risks that they are responsible for. This will promote effective management of financial and non-financial risks, and support the prevention and mitigation of conduct risk.
- CPS 511 also ensures there are appropriate consequences for poor outcomes. Senior executives will not be financially rewarded where there are failings in risk management.
- CPS 511 addresses recommendations 5.1 to 5.3 of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*. This will help to maintain trust in financial institutions.

## 5.2 Conclusion: comparison of policy options

When developing policy, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, while promoting financial system stability in Australia. APRA considers that, on balance, Option 3 will enhance prudential outcomes and improve financial system safety and stability in Australia. APRA's proportional approach to regulatory reform under Option 3 will also significantly reduce burden for smaller entities, supporting competition. This approach ensures that CPS 511 reforms will result in a net benefit, as shown below.

### Comparison of options

	Option 1	Option 2	Option 3
<b>Regulatory costs</b>	Nil	High	Moderate
<b>Strengthened Board governance</b>	Does not meet this criterion	Meets this criterion	Meets this criterion
<b>Limit impact of financial metrics in long-term variable remuneration</b>	Does not meet this criterion	Meets this criterion	Meets this criterion
<b>Deferral of variable remuneration</b>	Partly meets this criterion	Meets this criterion	Meets this criterion
<b>Consequence management</b>	Partly meets this criterion	Meets this criterion	Meets this criterion
<b>Overall</b>	Net cost	Net cost to small entities	Net benefit

## Review

As outlined in Chapter 4, review of these new measures is scheduled for four years from implementation. This review will consider whether the requirements and guidance have met the objectives of establishing prudent remuneration practices, remain consistent with international better practice, and are relevant and effective in facilitating sound risk management.

As delegated legislation, prudential standards impose enforceable obligations on APRA-regulated entities. APRA monitors ongoing compliance with its prudential framework as part of its supervisory activities. APRA has a range of remedial powers available for non-compliance with a prudential standard, including issuing a direction requiring compliance, the breach of which is a criminal offence. Other actions include imposing a condition on an APRA-regulated entity's authority to carry on its business or increasing regulatory capital requirements.



APRA