THE LAW SOCIETY
OF NEW SOUTH WALES

Our ref: BLC:EEsh1749842

22 October 2019

General Manager
Policy Development
Policy Advice Division
Australian Prudential Regulation Authority

By email: ADIpolicy@apra.gov.au

Dear Sir/Madam,

Strengthening prudential requirements for remuneration

The Law Society of NSW appreciates the opportunity to comment on the Discussion Paper "Strengthening prudential requirements for remuneration". The Law Society's Business Law Committee contributed to this submission.

Our observations on the Draft CPS and some of the issues raised in the Discussion Paper are outlined below.

Interaction of the Draft CPS and legislation

The Law Society agrees with the observation in section 4.4 of the Discussion Paper that the interaction of the Draft CPS and the Banking Executive Accountability Regime ("BEAR") under the *Banking Act 1959* (Cth) may cause difficulties. We support the proposal to seek legislative amendments to align any areas of inconsistency.

We note the Draft CPS is intended to apply not only to authorised deposit taking institutions ("ADIs"), but also to other APRA regulated entities including insurers and registrable superannuation entity licensees. Regulated entities that are not ADIs do not currently have legislative requirements equivalent to the BEAR. We consider it is important that APRA carefully consider any legislation that may be introduced to ensure consistency between the Draft CPS and any future legislation with respect to non-ADI sectors.

We agree with paragraph 14 of the Draft CPS that APRA should have the power to either adjust or exclude the final prudential standard.

Minimum deferral period in relation to variable remuneration

We note that the BEAR prescribes, in relation to variable remuneration of an accountable person, a minimum period of deferral of four years or such shorter period approved by APRA.[1] The Draft CPS proposes a minimum deferral period of seven years from the inception of the variable remuneration component for significant financial institutions ("SFI").

[11] *Banking Act 1959* (Cth) s 37EC(1).

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The observation in section 4.4 of the Discussion Paper that "many risks have taken considerably longer to crystallise than the minimum deferral periods under the BEAR" applies not only to ADIs but also to other APRA regulated sectors. For example, the financial and customer outcomes for long tail insurance (such as liability insurance) may take many years (well beyond seven years) to crystallise.

We note APRA's concern that some entities are adopting the minimum deferral period. Given this concern and sector differences, in our view there is no "one size fits all" solution in terms of a minimum deferral period. We recommend APRA consider:

- whether a longer minimum deferral period should apply based on whether an institution is an SFI, or whether there may be other factors (such as the nature of a particular sector) that should determine whether a longer minimum deferral period should apply; and

- whether there should be further guidance that takes into account differences in the different APRA regulated sectors.

Industry participants that are not APRA regulated

The Draft CPS only applies to APRA regulated entities. APRA only regulates banks, insurers and superannuation funds. A significant proportion of the financial services industry is not regulated by APRA. For example, mortgage brokers, insurance brokers, underwriting agencies, payment service providers, non-bank lenders and credit card issuers are not prudentially regulated.

The Draft CPS is a consumer protection measure. However, APRA does not have oversight of the consumer credit regime under the *National Consumer Credit Protection Act 2009* (Cth) except to the extent that those credit providers are also regulated under the *Banking Act 1959* (Cth). There are 93 Australian-owned ADIs, whereas, according to ASIC's Annual Report 2017-2018, there are 5,503 credit licensees.[2] We acknowledge that ADIs may service a substantial proportion of the consumer credit market. However, any reforms targeting remuneration of credit providers should be introduced in concert with ASIC. Otherwise, the Draft CPS will place APRA-regulated institutions at an unfair competitive disadvantage.

The Law Society acknowledges it is beyond APRA's jurisdiction to regulate these industry participants. However, we recommend that APRA, as a member of the Council of Financial Regulators ("CFR"), discuss the issue with other CFR members so that regulation of remuneration issues can be suitably addressed in respect of all industry participants that have an impact on financial system stability and customer outcomes. There may be good reasons for non-APRA regulated entities to have different remuneration arrangements.

Variable remuneration design

At paragraph 38 the Draft CPS proposes a maximum 50% weighting for financial performance measures. We note the Discussion Paper commentary that this figure was decided having regard to APRA's study on the practice of Australian banks and international bank experience. Given the Draft CPS is intended to apply across multiple sectors (and not only ADIs), we recommend APRA consider whether there should be sector-based differences and/or whether there should be a review of this figure in due course after the Draft CPS is implemented across multiple sectors.

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[2] Australian Securities & Investments Commission, *Annual Report 2017-2018*, p 14.

Draft CPS – other items

We raise the following items concerning the draft CPS for APRA's consideration:

a) Paragraph 7 refers to "applicable foreign legislation". We suggest referring to "foreign law" for consistency in language with the BEAR.[3]

b) Paragraph 16(g) defines "misconduct risk" by reference to "expected standards". While "including legal, professional, internal conduct and ethical standards" are mentioned, in our view the expectations of the Board, as the governing body, are similarly important (see paragraphs 20(d) and 21).

c) Paragraph 16(j) defines "risk and financial control personnel"; we assume that despite the reference to compliance, the definition is intended not to include lawyers.

d) Paragraphs 19(b) and (d) are worded sufficiently widely to cover any third party retained under contract by a regulated institution (for example, a professional adviser). We suggest clarification from APRA as to whether this is intended.

e) Paragraph 37(b) refers to "financial and non-financial risks".[4] In our view these should be defined, at least by the Board. We presume the term non-financial risk includes not only misconduct risk but also compliance risk and operational risk, as defined by ASIC's Corporate Governance Taskforce.[5]

f) Paragraph 38 refers to a 50% cap on financial performance measures. In our view, a more appropriate percentage may be 75%. Financial performance measures are more certain and objective than non-financial measures, in that there is less discretion involved in their calculation. In addition, they can indirectly incorporate non-financial risks (for example, via a provision for liabilities). Allowing 25% for non-financial risks may be appropriate given their calculation involves a greater degree of discretion, and as a result, variations in approaches taken by different Boards.

g) Paragraph 43 requires variable remuneration outcomes are "*linked to and are supported by* the entity's performance management system, code of conduct and consequence management processes" (emphasis added). We recommend further APRA guidance as to what is expected of institutions under paragraph 43.

h) Paragraphs 53 to 59 set out deferral and clawback provisions which apply to significant financial institutions. In our view they should apply to all entities. We note that the remuneration objectives in paragraph 20, and the provisions in paragraphs 44 and 45 concerning the application of malus, apply to all entities.

   In our view, the provisions as they stand may also create disincentives to work for significant financial institutions. This could encourage such institutions, in order to avoid loss of talent, to offer higher base pay to compensate for possible deferral and clawback.

   We are also concerned as to how the provisions would operate in practice. An executive's incentive payment may have been spent or channelled away from personal

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[3] *Banking Act 1959* (Cth) s 37BC.
[4] See also paragraphs 41(b), 42(c) and 44(c).
[5] Australian Securities & Investment Commission, *Corporate Governance Taskforce — Director and officer oversight of non-financial risk report* (October 2019), p 9.

liquid assets. The executive may dispute the clawback and have good legal grounds to do so.

i) In paragraphs 53 and 54, we agree that a deferral period of up to seven years is long enough for any concerns to arise, particularly given the availability of six year statutory limitation periods.

Further discussion

Yours faithfully,