AFMA

25 October 2019

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Australian Prudential Regulation Authority
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Dear Sir/Madam

Re: APRA Discussion Paper: Strengthening prudential requirements for remuneration

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make comment on APRA's proposals in relation to the draft prudential requirements for remuneration.

Banking and other financial services have a central role in the effective operation of the economy, especially by allocating the nation's financial capital and redistributing risk in a manner that best supports economic productivity and growth. The financial system is a complex organic web of relationships and activities. A broad range of ingredients is required for the system to function well, including efficient market processes and access to high quality, talented professionals to lead and manage the financial institutions that sit at heart of the system.

The remuneration practices of financial entities should be designed to reward their employees in accordance with the responsibilities (including risks) attached to their role, subject to the skill, commitment and enterprise that they exercise in applying their capability to meet these responsibilities. Variable remuneration is notably useful in this regard, as incentives can be linked to performance that is in accord with the firm's objectives.

This approach applied by financial entities in a naturally differentiated way will support the effective operation of the financial system and is consistent with APRA's regulatory objectives. However, achieving the right balance in regulation to serve this objective does raise practical challenges. These challenges are discussed in our submission below.

AFMA supports the implementation of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Final Report (the Royal

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Commission) recommendations in relation to remuneration, i.e. Recommendations 5.1 through 5.3., and the implementation of the FSB Principles [1] and Guidance [2] on Compensation. We note the challenge to industry posed by the APRA Chair in a recent speech to the Australian Banking Association and propose draft clauses based on the FSB Principles to achieve the recommendations and change in the industry where appropriate.

We note that majority of the draft standard is a sensible implementation of the FSB requirements and thereby a sound response to the requirements of the Royal Commission.

However, we are concerned that elements of the current draft of the standard, those described as 'more prescriptive' by the APRA Chair [3], may not be aligned with the expectations of the Royal Commission with regard to the need to avoid a 'one size fits all approach', or similar expectations in the FSB Principles and Guidance. Both the Royal Commission Final Report and the FSB recognised the benefits of flexibility for firms to be responsive in setting the parameters of remuneration in response to the relevant risks. The Final Report and the Guidance frame these as matters for firms to decide within the structure of the FSB Principles.

We also note the importance for APRA to retain clarity around its purpose as a prudential regulator. The Royal Commission expressly supported the twin peaks regulatory model with its separation of conduct and prudential regulator. Consistent with this and APRA's legislative mandate, APRA should ensure it manages its engagement with conduct matters to the extent appropriate for a prudential regulator.

Concern about the undifferentiated application of the proposed prudential requirements to Foreign ADIs is discussed, as these entities present a distinctive set of issues compared to other ADIs. From a regulatory perspective, APRA's approach to capital and the governance arrangements for Foreign ADIs reflects, amongst other things, its acceptance of the adequacy of supervision by their home country regulator. Moreover, from a business perspective, Foreign ADIs are operationally different to large scale retail banks, more dependent on tailored management of client relationships and more international in their scope.

We discuss a number of concerns with regard to the 'prescriptive' elements of the draft standard including the proposed threshold of $15 billion, the one-size-fits-all approach to deferrals and clawback, when this should properly be done on a risk basis, the $50,000 threshold for inclusion and concerns associated with the prescriptive 50% maximum for financial metrics rule.

We make the case for maintaining APRA Standards as principles-based to avoid the costs and risks of more prescriptive approaches.

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[1] *FSF Principles for Sound Compensation Practices, Financial Stability Forum of the FSB,* 2009, https://www.fsb.org/wp-content/uploads/r_0904b.pdf

[2] *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices The use of compensation tools to address misconduct risk*, FSB, 2018 https://www.fsb.org/wp-content/uploads/P090318-1.pdf

[3] https://www.apra.gov.au/news-and-publications/apra-chair-wayne-byres-speech-to-australian-banking-association-national

We raise concern about the effects of increased costs and inefficiencies in attracting and retaining staff in a global market place for senior executives, which appears to be incompatible with the Government's interest in Australia achieving its potential as an International Financial Centre.

The risks of the migration of talent and business to the less regulated non-ADI or shadow banking sector is highlighted and the negative risks this creates for prudential regulation more generally. We also raise a number of technical points and respond to the questions in the submission.

Our proposed approach would fundamentally maintain a more flexible principles-based approach to remuneration that is compatible with the FSB Principles and Guidance and the expectations of the Royal Commission. Such an approach is far more likely to maintain the competitiveness of the industry and, ultimately, be of benefit to the economy and the jurisdiction as a whole.

We trust this submission is of assistance. If you would like further information or explication, please do not hesitate to contact me via the Secretariat.

Your sincerely

[redacted]

AFMA Response to the Consultation Paper

Strengthening the prudential framework

AFMA supports strengthening the prudential framework around remuneration through the implementation of the Royal Commission Report recommendations in relation to remuneration (Recommendations 5.1 through 5.3). AFMA also supports the implementation of the FSB (Financial Stability Board) Principles[4] and Supplementary Guidance[5] ("Guidance") which were a focus of the Royal Commission recommendations.

To achieve these outcomes AFMA would support the addition of several principles-based requirements to the current standard (in place of some of the more prescriptive proposals) and their enforcement by APRA as appropriate under its prudential mandate. We will outline some of the key additions in the course of this submission.

The remuneration proposals in the draft standard are APRA's proposed response to the Royal Commission recommendations.

As currently drafted, we would argue that this standard may not contain sufficient flexibility to avoid a 'one size fits all' outcome. Avoiding a singular outcome that is inflexible to risk of different roles[6] is required to be compatible with the Royal Commission recommendations and the FSB Principles and Guidance.

The draft proposals on a number of key metrics are, as acknowledged by the APRA Chair in a recent speech[7], "more prescriptive" in nature including deferral and clawback percentages and periods, and the use of a 50% limit for financial metrics for assessing performance-based variable remuneration.

In the view of AFMA this equates to a 'one size fits all approach', as all ADIs in scope, even those with relatively relatively modest domestic assets, will be required to have the same long periods of deferral and clawback, the same scorecard approach to financial metrics and they will not have the ability to determine how staff are included based on a reasonable analysis of the risks they might create and the timelines for their realisation.

This level of specificity is not aligned with the flexibility which the Royal Commission recommended:

> And it must be recognised and accepted that it may never be possible to identify a single 'ideal' or 'optimal' system. As the FSB said in its Principles, 'financial firms differ in goals, activities and culture, as do jobs within a firm' **One size does not fit all.** This is not necessarily a bad thing. Experience shows that better outcomes – and valuable information – often emerge only through trial and error. **Financial**

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[4] *FSF Principles for Sound Compensation Practices, Financial Stability Forum of the FSB,* 2009, https://www.fsb.org/wp-content/uploads/r_0904b.pdf

[5] *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices The use of compensation tools to address misconduct risk*, FSB, 2018 https://www.fsb.org/wp-content/uploads/P090318-1.pdf

[6] The two-level distinction in the standard between all CEOs for captured ADIs and all senior managers/highly paid material risk takers is *de minimis.*

[7] https://www.apra.gov.au/news-and-publications/apra-chair-wayne-byres-speech-to-australian-banking-association-national

> **services entities must be able (within limits) to try different forms of remuneration and incentive systems**.
>
> The qualification – 'within limits' – is, of course, critical. But **those limits have been identified in the work of the FSB**: **in its Principles and in its Supplementary Guidance.** [Emphasis added][8]

The Royal Commission is clear here that flexibility for firms is appropriate and it is the FSB Principles and the Supplementary Guidance are the appropriate guide as to the limits of firm flexibility that should be applied.

The FSB, in the quote the Royal Commission refers to, was clear that while clear principles requiring alignment of risk time horizons with remuneration are appropriate, mandating the same approach for all firms is not:

> "The Principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. **They are not intended to prescribe particular designs or levels of individual compensation. One size does not fit all – financial firms differ in goals, activities and culture, as do jobs within a firm**. However, any compensation system must work in concert with other management tools in pursuit of prudent risk taking." [9] [Emphasis added]

The FSB Principles and the later issued Supplementary Guidance relevant to the areas in which the CPS 511 draft is prescriptive are generally high level[10]. They keep flexibility in the hands of firms to innovate and determine the most appropriate mix of incentives in the circumstances of the time. They expressly expect adjustments to be made by firms *for individual employees* based on the activity, risk horizon, position and role. The key parts of the relevant Principles and standards relevant for addressing misconduct risk as restated in the Guidance are:

> "Principle 6. Compensation payout schedules must be sensitive to the time horizon of risks. **Profits and losses of different activities of a financial firm are realized over different periods of time. Variable compensation payments should be deferred accordingly**. Payments should not be finalised over short periods where risks are realised over long periods. Management should question payouts for income that cannot be realised or whose likelihood of realisation remains uncertain at the time of payout.
>
> > Standard 6. For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm:
> >
> > a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance;

[8] Final Report, p. 350-1.

[9] https://www.fsb.org/wp-content/uploads/r_0904b.pdf p. 1.

[10] We note the Implementation Standard has one prescriptive element where it suggests deferral periods should be a minimum of three years (including vesting).

Standard 9. The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line"[11] [Emphasis added.]

This is an appropriate risk-based approach. We note it is determined at the individual firm level and the payout timeframes need to be responsive to the risks for which individuals are accountable.

APRA might be of the view that the requirements in the prescriptive parts of the draft standard are 'only minimums' and that firms are free to impose still longer requirements. However, given the competitive pressures that ADIs face, there is in practice little room for further increases. They will through their quantum effectively be the 'one size' that was argued against by the FSB and the Royal Commission.

The principles-based approach promoted by the Financial Stability Board Principles and Supplementary Guidance that is sensitive to risk is preferred over the prescriptive approach in the draft standard.

AFMA would support phrasing from the FSB Principles and Supplementary Guidance being included directly in the APRA standard in place of the draft paragraphs 53 to 55.

In relation to clawback the Royal Commission Report does make one specific recommendation as part of the consideration of retail issues (particularly fees for no service) and the ADIs surveyed by the Royal Commission:

> In its revised prudential standards dealing with remuneration, APRA should require all APRA-regulated institutions to provide for the entity to claw back remuneration that has vested, in appropriate circumstances.

AFMA supports this proposal and the relevant FSB Principle which could be further adjusted to be more specific in response to the Royal Commission Report expectations.

Clawback is, as recognised by the APRA draft standard, not an appropriate outcome for all staff at all times in all ADIs, and the challenge is to draw out what this recommendation should look like when put into a standard.

Rather than a prescriptive and inflexible approach we would support the incorporation of wording in the Prudential Standard that reflects the requirements of the FSB Principles and in that context makes specific mention of clawback. For example, the inclusion in the Prudential Standard of an amended FSB Principle 6 might address the requirement. Proposed amendments are in bold:

> Compensation payout schedules must be sensitive to the time horizon of risks **and where appropriate and warranted by the risk profile should include clawback provisions.**

[11] *Supplementary Guidance.,* p. 16.

This would address the Royal Commission Report recommendation without unnecessary overshoot and the associated risk of unintended consequences.

AFMA is of the view that the inclusion of FSB Principles 5, 6 and 7 in the standard (with appropriate alteration of Principle 6 as discussed and other elaboration if necessary) accompanied by appropriate prudential enforcement will ensure an appropriate uplift in remuneration practices as suggested is required by the APRA Chair in a recent speech[12].

This approach would also align with the Royal Commission Report's comments suggesting responses to the findings of the Commission should avoid "adding a new layer of regulation [which] will not assist"[13]. We are of the view that the prescriptive elements would unavoidably constitute the 'new layer of regulation' that the Royal Commission Final Report opposed.

APRA must retain a clear prudential focus

The Royal Commission was correct to recommend that APRA, as part of its prudential mandate, should look to ensure prudential standards drive good conduct:

> "The use of remuneration systems to reduce the risk of misconduct is a legitimate – and necessary – subject of concern for a prudential regulator. Prudential regulation and supervision of remuneration arrangements must have, as one of its aims, the reduction of misconduct at financial institutions."[14]

Importantly, however, the Royal Commission also set the bounds for this engagement with conduct matters as it expressly supported the retention of the twin peaks model of financial regulation:

> "The 'twin peaks' model of financial regulation should be retained."[15]

Australia's twin peaks model has proven successful over a significant period including through the Financial Crisis. It involves a clear separation between the conduct regulator and the prudential regulator. APRA under the twin peaks model is a defined by legislation as the prudential regulator and is complemented by ASIC as the conduct regulator.

This is the requirement of APRA's enabling legislation:

> (1) The main purposes for which APRA exists are as follows:
>
> > (a) regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards;[16]

Where there is any policy confusion or apparent ambiguity this legislated requirement must of course remain paramount.

[12] https://www.apra.gov.au/news-and-publications/apra-chair-wayne-byres-speech-to-australian-banking-association-national

[13] *Ibid.,* p. 16.

[14] Final Report, p. 346.

[15] Final Report, p. 37.

[16] Australian Prudential Regulation Authority Act 1998, 8 (1)(a).

The aim of twin peaks is to give clarity of purpose to both regulators, with any clash in objectives, or need for cooperation or coordination, to be dealt with through overarching bodies such as Treasury and the Council of Financial Regulators.

At a national level prudential matters are typically more important than any particular conduct matter, given the importance of good prudential outcomes to the economy and the welfare of the country as a whole. From time to time conduct concerns and prudential concerns may create differing pressures. These should be dealt with through the overarching twin peaks structures where they can be more directly balanced and considered by the Government.

Conduct matters should be properly the domain of the conduct regulator beyond the general use of prudential standards to drive good conduct. APRA should also take account of the reforms being undertaken by the Government and ASIC to greatly reduce the risk of misconduct in financial services in calibrating its own policy settings in areas of overlap.

The Royal Commission Report's requirement to seek conduct outcomes as an end in itself is compatible with the twin peaks model and the APRA enabling legislation as it is limited to the proper role of a prudential regulator.

Prudential standards are of course implemented by the prudential regulator. To the extent the standards require management of conduct outcomes APRA must ensure it maintains clarity in its role. For example, APRA may be pressed to decide what the appropriate impact on remuneration should be of various infringements, where possible these matters should be the domain of the conduct regulator. We encourage APRA to ensure it maintains a clarity of prudential focus compatible with the twin peaks model that was supported by the Royal Commission.

Foreign ADIs

The Royal Commission's analysis of conduct issues focussed mostly on retail issues and noted conduct-related prudential risks that occurred internationally.

As Foreign ADI businesses are wholesale-only in nature, the retail issues do not apply. While there can still be risks to wholesale clients from improper conduct, these issues are different in nature given the type of parties involved in wholesale transactions.

This leaves conduct-related prudential risks and the FSB lens and Principles are the most appropriate to apply to them. The FSB Principles were originally designed by the Financial Stability Board's Financial Stability Forum to prevent bank failures through "alignment of compensation with prudent risk taking"[17].

The Financial Stability Forum explains the origins of the Principles:

> Compensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms.[18]

[17] https://www.fsb.org/wp-content/uploads/r_0904b.pdf, p. 2.
[18] *Ibid.*, p. 1.

The prudential risks in relation to Foreign ADIs are small for the jurisdiction and highly unlikely to create solvency issues for the global parent entity given their relative scale and prudential supervision of the parent bank by its home regulator.

In light of the prudential risk profile and international regulatory framework, it is appropriate to recognise when the requirements of the FSB Principles and Guidelines are being already required of Foreign ADIs by their home jurisdiction regulator.

Such recognition would be in line with recent calls from IOSCO[19] and the FSB[20] to reduce market fragmentation through appropriate regulatory deference.

Accordingly, we propose that where Foreign ADIs that are required by their home jurisdiction regulator to abide by the FSB Principles and Guidelines they should have this requirement granted appropriate deference by APRA.

Scope

AFMA agrees with APRA that it is appropriate to restrict the application of the proposed sophisticated remuneration standard to the most significant financial institutions. However, we do not agree with proposed methodology for identifying these institutions and the proposed setting of the threshold at $15 billion.

The $15 billion level is derived, we understand, from the level used to consider which entities might use a simplified capital framework. There is no strong link between the proper level for access to this framework and the risks that the Royal Commission and the FSB seek to address through remuneration.

A level that is more appropriate for these risks would be one that addresses both the retail issues at large banks, as the retail issues were a focus of the Royal Commission, and entities that are significant to the jurisdiction from a systemic prudential viewpoint.

Smaller and regional banks should not be included as the requirements are likely to be disproportionately burdensome. The remuneration proposals in the draft standard are sophisticated and appropriate for significant financial institutions with the type of organisational and remuneration structures that would be scaled appropriately only to larger banks. They risk creating unnecessary burdens for smaller and regional banks.

The *Banking Executive Accountability Regime (Size of an Authorised Deposit-taking Institution) Determination 2018* (ADI Size Determination) provides banded thresholds for BEAR remuneration that might suggest alternate levels for inclusion in the standard. We note that there should be scope to adjust what is included in the domestic asset calculation for activities that are not required to be in the ADI and could be placed in a non-ADI entity. This would assist in minimising the differences in treatment of like for like activities between ADIs and non-ADIs, and thereby maintain a more level playing field.

Wholesale-only banks should only be included if their ADI-specific activities are significant to the jurisdiction. Wholesale exposures in the $10 billion to $100 billion range are not

[19] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf
[20] https://www.fsb.org/2019/06/fsb-report-on-market-fragmentation-2/

likely to be overly significant prudentially to Australia, particularly where the ADIs are branches of foreign banks with solvency matters subject to home regulator prudential supervision.

In respect of medium ADIs which are defined by the BEAR ADI Size Determination to be those with assets between $10 billion and $100 billion, less complex and certainly less prescriptive requirements are appropriate.

We would recommend that the threshold for inclusion in the standard be aligned with the threshold for large ADIs under BEAR at $100 billion. At a minimum, firms in this mid-tier should not be subject to the most prescriptive elements of the standard if these proceed (paragraphs 38, 53-55, 57).

Alternatively, we note that different entities can create different prudential risks for the same level of asset exposure. The APRA levy is adjusted for foreign branch ADIs to be one fifth that applied to domestic ADIs to reflect the costs of supervision of these entities, which is reflective of the prudential risks they create. Using this as a guide it may be appropriate to consider a similar adjustment factor for the threshold, although here again we note it would not be appropriate to capture smaller and regional ADIs.

We note also that $15 billion sits at a level around which many banks are placed with around 9 banks within $3 billion capitalisation. This may result in many banks moving in and out of the threshold. It may be more beneficial to select a threshold where there are few banks located and a natural break in the scale of banks might be present such as the BEAR threshold for large ADIs.

The $15 billion threshold falls amongst a group of similar banks and there would significant competitive pressures to adjust ADI entity balance sheets to fall under the threshold. There are significant scale differences between the largest banks, each at over $500 billion and the smallest banks caught by this threshold. $15 billion is not far off the resident assets of some regional ADIs.

If approaching the $15 billion threshold, banks could face significant disincentives in continuing to increase exposures in ways that fall within the ADI structure.

While systemically not significant individually, banks with resident assets of $15 billion can together as a group make a substantial contribution to foreign investment in Australian economic activity. Setting the threshold at this level could create a disincentive to firms establishing significant onshore presences. This would be a deterrent to growing Australia as a Financial Centre which has been an aim of Governments from time to time.

As per our direct enquiries of APRA we also seek confirmation that it is the resident assets (and for Foreign ADIs resident assets of the branch) that are the metric referred to with total assets.

We note also that the percentage of ADI asset coverage that $15 billion gives is 94% which is high compared to the coverage of insurers and RSE licensees. A $100 billion threshold would bring approximately 77% of ADI resident assets within the standard which while still higher than the level of capture for General and life insurers (68%) and RSE licensees (66%) is more comparable.

Rolling calculation

AFMA is also keen to avoid a situation where firms are unsure for the next financial year (or years) whether or not they will be above or below the threshold. For planning purposes an approach of a three-year rolling average should be adopted so that firms can plan to be in scope or not for the requirements. This would also create more certainty for employees in knowing what to expect.

The formula that should be used might be based on that used in the BEAR regime but with the flexibility to adjust for predictable structural changes, for example if a business is shuttered, there should be a facility for these types of changes with predictable asset impacts to be rolled into calculations.

Need to maintain a principles-based approach to APRA Standards

As noted above, we support the inclusion of the Royal Commission recommendations 5.1-5.3 and the FSB Principles and Supplementary Guidance in the standard. These are the appropriate level of detail for a prudential remuneration standard.

APRA standards have had this approach in the past to standards creation for good reasons.

Standards that are principles-based allow firms the flexibility to innovate in the ways the outcomes are achieved, they are effectively dynamic regulations that move with the times and current practice. There is an inherent lack of efficiency and appropriate flexibility in prescriptive regulation.

As we noted in our submission to the APRA Capability Review "APRA appears to be a well-functioning regulator with a sound track record for appropriate regulatory responses". This conclusion was based in part on APRA's approach to regulation which has been principles-based and avoided unhelpful and unnecessary prescription.

AFMA recommends against changing the nature of APRA standards to have a "more prescriptive tone"[21] and include prescriptive inflexible, rule-based requirements.

This approach to rule making is not new and its effects in jurisdictions where it is prevalent are well known and largely negative. Moving APRA standards away from an approach that preserves much of the ability to innovate and evolve inherent in market-based economies would create significant costs for the efficiency of the economy over the long term.

On a related point we also note that while APRA might hold that its prudential standards are a reference point for a conversation with Prudential Supervisors rather than a strict rule, the industry takes prudential standards seriously and for practical purposes firms will treat these as rules to be followed to the letter. AFMA requests that the discretion available to the supervisor is made clear in the standard or related documents.

Competition Impacts – Loss of staff and business

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[21] See Speech to the ABA by APRA Chair Wayne Byers https://www.apra.gov.au/news-and-publications/apra-chair-wayne-byres-speech-to-australian-banking-association-national

Competitive remuneration practices are an important feature of market economies. Remuneration attracts talent to successful firms and sectors allowing them to build on their success. Less successful firms can also invest in talented leadership and staff to improve their prospects. The result is a significant national good as remuneration practices can assist in attracting talent to where it is most valued within the economy. This contributes to the efficiency of the economy.

If implemented in its current form, the draft standard would likely have negative impacts on the competitiveness of the Australian financial services industry. In particular, the prescriptive elements of the draft standard could harm our competitive positioning within the region. Moreover, Australia does not have the same degree of freedom as the major global financial centres, like the UK, in setting regulatory policy for business that has an international dimension as a presence in the UK for international banks is necessary for global business.

Wholesale markets are also significantly different in nature to retail markets. Firms in these markets compete for business with regional and global firms. International business can just as readily be done from Singapore, Tokyo or Shanghai. There are risks that applying a solution for retail to the wholesale space may have unintended consequences.

As discussed in the *International practice* section below the typical 'requirement'[22] in the FSB survey is three years (including vesting) in 15 jurisdictions.

Affected firms will find attracting senior and trading talent from within the region to Australia more difficult, as the long deferral and clawback periods will be unwelcome by staff as they will decrease the real value of their compensation. Staff will have another strong reason to prefer to work in more competitive jurisdictions that are interested in attracting business such as Singapore.

Decision makers in investment banks establishing new businesses may be less likely than otherwise to choose Australia as the operating base, due to the high relative regulatory burdens on senior executive roles.

Within Australia there will be greater difficulty in attracting staff to the industry. Other industries, such as technology, will not face the same pay lags and risks. This is particularly the case for staff with skills that are highly transferable and valued in many other industries and in other parts of the financial services industry. This will likely increase resourcing costs for the prudentially regulated finance sector.

Level Playing Field

More generally, the draft standard requirements would create incentives for business to move to non-prudentially regulated entities. This would happen in a number of ways.

With the movement of talented staff to boutique firms, business that might have been done within the prudential system is to some extent likely to follow these individuals. Further, new talent to the industry might find the boutique remuneration offerings more

[22] Which may be an expectation in some jurisdictions.

attractive. From this shift of talent away from the prudentially regulated sector the measures could drive a shift in investment business towards boutique firms.

ADIs and corporate groups that conduct certain business in their group ADI already face significant additional costs as a result of being prudentially regulated.

APRA should aim to create, at a minimum, a level playing field between ADI and non-ADI firms by removing the prescriptive elements. Where these firms conduct the same business, ADI firms should not be placed at a substantial disadvantage.

APRA should seek to avoid creating strong commercial pressures for business, people, and structures to move away from prudential regulation.

More fixed remuneration

In line with the experience in the UK, restrictions on variable remuneration and the need for firms to compete for talent with jurisdictions where there are no or fewer such restrictions, results in a shift to greater fixed compensation and less variable remuneration.

This reduces the ability of firms to reward high performers when they perform potentially leading to less efficient remuneration.

A greater proportion of fixed remuneration also lowers the effectiveness of the deferral and clawbacks, by making them less relevant to overall compensation, and thereby reduces the ability of firms to sanction poor behaviour.

It also creates a less dynamic industry that has a reduced ability to shift gears and maximise economic activity and growth when times are supportive.

It would also result in increased prudential risks as businesses would have higher fixed liabilities during more difficult times and would not be able to pass as much of this risk on to staff through lower variable remuneration. In the UK in response to EU imposed rules that limited the size of variable remuneration relative to fixed remuneration, the ratio of fixed to variable remuneration went from a proportion of 1 in 10 in 2010 to 1 in 2 in 2015[23]. The UK argued to the European Court of Justice that this shift to more fixed remuneration made banks "riskier rather than safer"[24].

International practice

APRA has indicated in the consultation paper that it is interested in comparisons to international practice in relation to deferral and clawback arrangements and quotes the FSB Progress Report[25] figures suggesting that "16 out of 20 FSB jurisdictions set

[23] https://www.theguardian.com/business/2017/nov/29/eu-rule-capping-bankers-bonuses-could-be-scrapped-after-brexit-says-bank-boss

[24] https://www.theguardian.com/politics/2013/sep/25/osborne-bankers-bonuses-eu-cap

[25] FSB (2019) *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Sixth Progress Report* (FSB Progress Report)

requirements or expectations for the number of years compensation needs to be deferred for senior executives of banks"[26].

There can be a significant difference between requirements as are present in the UK and Europe and expectations in some of the diverse jurisdictions surveyed.

For senior executives the FSB reports that "three years tends to be the typical requirement with 15 jurisdictions having adopted this requirement"[27]. For Material Risk Takers (MRTs) the FSB reports that "three years tends to be the typical requirement with 15 jurisdictions having adopted this requirement."[28] [29]

The FSB note in footnote 47 that:

> 'The definition of "three year deferral" under the FSB P&S is pro rata and would permit firms to vest up to 1/3 of deferred amounts in each of the three years. In other words, three year deferral would not imply all amounts are cliff vested at the end of three years.'

The APRA proposals in comparison are far more restrictive than this 'typical requirement', requiring four years of no vesting followed by two or three years of vesting. This would be at the far end of international practice comparable with pre-Brexit UK requirements and Canadian practice.

Australia is already quoted in the report as one of only two jurisdictions, the other being the UK, that have recently increased deferral periods, reflecting the implementation of BEAR.

Graph 2 in the FSB progress report reproduced here outlines the "absolute outliers" in terms of market practice (as affected by but distinguished from regulatory compulsion) of the number of years compensation is deferred for senior executives at the significant institutions of interest to FSB.

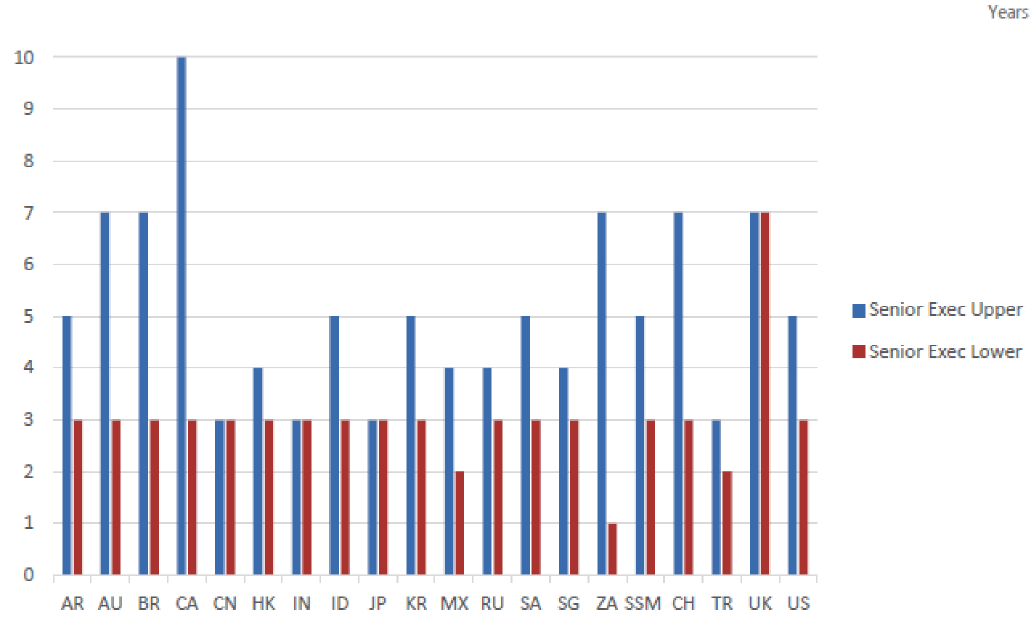
It is apparent that the proposed restrictions, particularly when rolled out as broadly as proposed could leave Australia as a financial centre at a competitive disadvantage particularly in relation to our regional competitors as financial centres such as Singapore, Hong Kong, China, Korea, the US and Japan.

[26] The Consultation, p. 31.
[27] FSB Progress Report, p. 32.
[28] Ibid.

[29] We note that the FSB language is unclear here as to whether 'typical requirement' is being equated with 'requirements or expectations'.

Range of market practice for the number of years compensation is deferred[46] for senior executives

Graph 2



The data in this graph generally reflects the absolute outliers in the number of years in which compensation is deferred therefore data could be affected by a small number of employees. To avoid providing bank specific data, the information listed for Hong Kong is for a larger sample of banks. Note that deferral periods of less than three years sometimes occur as part of arrangements where the majority of deferred pay is subject to a three-year deferral.

Non-financial metrics proposals

APRA is proposing a 50% weighting for financial metrics in determining variable remuneration. Each individual financial performance measure is limited to no more than 25% of total measures.

Implementing these non-financial metric requirements presents the most significant challenge of all the prescriptive requirements.

The Royal Commission required APRA to "set limits on the use of financial metrics in connection with long-term variable remuneration"[30]. We would submit that this need not result in a numerical figure limiting what might be achieved through financial measures, but might look at the calculation system as a whole to ensure that non-financial metrics play an appropriate role.

While some banks for some roles do use a scorecard approach along the lines envisaged this is not standard practice. The concept of a weighting approach to financial and non-financial metrics may not even be the optimal approach to incorporating conduct into variable remuneration management. This is an evolving field and it is too early to know.

[30] https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf p. 357.

Under current practices if an individual fails their non-financial metrics around conduct, they might not be awarded any variable remuneration. Dividing variable remuneration into segments that are rewarded on the basis of different metrics might not accord as easily with such an approach.

The gateway processes used by many firms already effectively mean that conduct matters can be the determinant of 100% of a variable payment in the event they preclude a variable payment. Yet it is not clear that these processes would be recognised as meeting the 50% metric proposal.

Internationally, the FSB reports that only seven jurisdictions require 'mixed scorecards'.[31] We caution against requiring a scorecard approach by all affected firms. This will limit innovation in an evolving field and thereby place additional competitive constraints on firms.

APRA notes there is no clear consensus on the best approach at present and it appears precipitous to suggest a regulator-mandated 50% level is appropriate to be put into the standard when APRA's survey of UK banks that suggested an average of 40% weighting. Figures for banks from other jurisdictions were not provided, and there is no independent data on the effectiveness of different approaches in delivering conduct outcomes.

AFMA is of the view that thresholds for particular metrics while a valid option may not be the superior to other existing practices. Many firms have sophisticated performance management systems that take into account financial and non-financial metrics through multiple step processes including gateways, the use of automated systems, manual panel reviews and other processes. The types of non-financial factors already considered by firms as part of the variable remuneration process include:

- Alignment with firm values
- Leadership demonstrated
- Collaboration and teamwork
- Ethical and Professional behaviour
- Integrity and compliance
- Risk profile
- Progress on strategic initiatives
- Market competitiveness for role
- Client focus
- Risk management
- People and talent development

These processes are not formulaic and do involve an element of careful judgement on the part of Boards and senior management linked the company values and priorities that is hard to quantify. This element of judgement is entirely appropriate and ensures that the outcomes are compatible with the aims of the firm. A formula-based approach regulator-mandated approach might suggest outcomes from time to time that are not aligned with firm priorities in conduct and other areas.

[31] FSB Progress Report, p. 40.

The sophisticated processes used by firms, often based on globally developed systems, are effective and can be readily demonstrated to be as such. As part of APRA's assessment of remuneration practices firms could supply information supporting the effectiveness of their processes if that would be of assistance.

Determining whether non-financial metrics are a certain percentage of existing processes may be impossible and may result in the processes being reengineered to be less sophisticated so that compliance with the cap can be more easily proven. For example, currently a flag around conduct might be raised with a certain level of seriousness to be considered by managers when determining variable remuneration levels. Enough of these flags would result in no variable remuneration, but what is each flag's contribution to the remuneration decision? Does it depend on the potential flags that could have come up for an individual or only those that did?

The most preferable approach would be to include in the standard a clear requirement consistent with the Royal Commission Report and FSB that non-financial metrics need to play a significant role in the determination of remuneration and then allow firms to determine how best, working in with often global systems that this is to occur. FSB Principle 4 is already covered in the draft standard via paragraph 41. We would be open to further amendments of this provision to ensure non-financial metrics form an appropriate part of remuneration considerations.

We note that for ADIs without a local listing there is a reduced scope of financial measures from which to choose. For these firms there will be no share price related, shareholder return, ROE or other listed company financial measures. Profitability is generally the main financial metric that is relevant and used in assessment. In certain circumstances this can make the further limitation of an individual financial measure to no more than 25% additionally challenging for these firms.

Deferral proposals

APRA has quoted the FSB Progress Report and a survey of large banks in the UK, USA, Canada and Europe as sources of "better international banking practice". We note our concerns raised above in relation to the FSB report around the comparisons to other jurisdictional outcomes and statistics that may not sufficiently distinguish market practice in relation to deferral from the requirements around them.

Mandating deferral to the extent proposed is not standard practice internationally. Whether it is even 'better practice' from a regulatory perspective will only be determined over time. There is not sufficient data in relation to wholesale banking to determine whether deferment of executive pay creates better outcomes overall.

In relation to the international banks that adopt long deferral periods, merely because some large banks in some of the largest jurisdictions have voluntarily or otherwise adopted such practices does not mean they will necessarily be an appropriate fit for small banks in a relatively small jurisdiction such as Australia. It certainly does not suggest that these approaches should be mandated by regulatory intervention.

Australian banks, particularly those caught by the low $15 billion threshold are leagues apart from the large banks of the jurisdictions that APRA notes in the Consultation Paper.

The Royal Commission Report recommendations around the FSB Principles and Guidance do not require the APRA standard to have such prescriptive requirements around deferral and clawback periods[32]. Greater alignment with the Principles can be achieved without industry and potentially economically damaging requirements.

As noted above our main recommendation is that APRA reframe the requirements to be principles based as the FSB recommends, and as the Royal Commission Report requires: "Financial services entities *must be able* (within limits) to try different forms of remuneration and incentive systems…those limits have been identified in the work of the FSB: in its Principles and in its Supplementary Guidance." We are firmly of the view that the one-size fits all nature of the current draft in relation to long deferral periods is incompatible with the recommendations of the Royal Commission and the FSB Principles and Guidance.

The industry supports refinements in the standard as discussed above to bring FSB Principles and Guidance directly into the standard.

In the alternate we would argue that the quantum of the deferral is far too long, particularly when compared with the most common period for our regional competitors being 3 years with vesting. Most risks do not take anywhere near the proposed 6 or 7 years to materialise and measures like ASIC's heighted focus on timely breach reporting by financial entities is relevant. ADIs are risk management businesses. Awareness of risks and their management means that it is highly unlikely for firms to be unaware of issues involving yet to materialise risks even a year or so out from the actions of an executive.

Requiring all CEOs to have deferral periods of 7 years and other senior executives 6 years assumes long periods of time might pass before issues are discovered. Requiring another 2 years of clawback and 4 years if an investigation is underway takes the totals to 9 and 11 years for CEOs and 8 and 10 years for other executives.

These are very long periods of time. As a comparison metric the US statute of limitations for federal criminal offences is five years for most crimes.

The working life post-tertiary studies for many executives is around 40 to 45 years. Time spent as a CEO for those fortunate enough to achieve this office is typically no more than 4 to 7 years in publicly owned companies. The average CEO tenure for the ASX 200 companies is 5 years and 8 months[33]. Under the proposals most top executives would not have fully received their pay for their first year in the role by the time they have left the top job.

The fact that this money would continue to be at risk of non-payment due to events not related to any malfeasance on their part (for example the company might experience turbulent market conditions) would be recognised by these employees and the potential future at-risk payments duly and appropriately risk-discounted to being worth a lower

[32] Noting again the three year vesting minimum suggested in the Implementation Standard.

[33] https://www.afr.com/work-and-careers/management/hayne-sparks-20-top-ceo-turnover-20181015-h16nar

amount. This will lower the attractiveness of working within the jurisdiction and increase staffing costs and thereby decrease the efficiency of the jurisdiction.

Deferral and clawback risk would be placed by the draft rules onto key staff, even in the event of no investigations or allegations of impropriety, for up to nearly a quarter of their working lives before they could know that money earnt was theirs to keep. This is a highly unattractive prospect for a globally and regionally mobile workforce. The quantum of the delay changes the nature from prudent pause to punitive measure even where no offence has been committed and innocence is presumed.

We note that there are no other industries in Australia where the Government mandates a restricted period before employees can receive their non-superannuation pay.

Risk-adjusted delay periods will vary significantly from one firm to another and from one role to another, and from one economic period to another but this is a good thing from an economic and prudential perspective.

In the alternate if APRA proceeds to impose a minimum, then it should be just that – a period that is a backstop to prevent no delay taking place rather than a figure which will be highly unlikely to be exceeded.

While noting again our preference for a principles-based standard that allows firms the ability to properly risk-adjust deferral periods, if APRA does proceed with a period we would suggest it should match the FSB definition given in the Progress Report and in line with the Implementation Standard and be a three year deferral period with vesting over this period for all relevant staff:

> The definition of "three year deferral" under the FSB P&S is pro rata and would permit firms to vest up to 1/3 of deferred amounts in each of the three years. In other words, three year deferral would not imply all amounts are cliff vested at the end of three years.[34]

This would also mean that Australia would not be an outlier on the FSB data for current practice.

$50,000 Threshold

The $50,000 threshold for deferred payments to be included in the scheme is far too low. This could bring people into the scheme that were never the intended target of the Royal Commission Report Recommendations 5.1 -5.3 or the FSB Principles.

For employees on this level of variable remuneration, the retention of 40% of their variable component is likely to have disproportionate impacts due to the significance of the payments to their total remuneration and that individuals may be relying on these payments for cost of living expenses.

Particularly for those that leave the industry the retention could create difficulties in certain circumstances. For example an individual may be at the end of their careers in their mid-50s when they work their last year. These individuals may have sufficient

[34] https://www.fsb.org/wp-content/uploads/P170619-1.pdf p. 34.

superannuation to sustain their retirement once they reach the super preservation age which might be 60. In the interim they might be dependent on savings made in the last years of their working lives. Holding 40 or 60 per cent of these variable payments back for 3 years and then delivering these over the 3 years may create planning difficulties until the preservation age is reached.

We note there are only very limited provisions for the advanced payment of monies owed considered in footnote 10. These will, over time, risk unfortunate outcomes in circumstances that do not fall into the categories of 'death, serious incapacity, serious disability or serious illness'. Costly illness in the family might be an example of circumstances are not foreseen in this list. We would suggest that at a minimum provision should be made for applications to be considered by APRA for waivers.

There could a significant number of issues created in relation to financial planning for affected individuals at this level of threshold given the uncertainties created in the payments (again potentially with no relation to the activities of the individual) impacting the ability to gain finance for homes, to plan for retirement and meet family expenses.

We would suggest a minimum variable remuneration cut off of $250,000 indexed.

Consistent with APRA's jurisdictional powers, this should be confined to variable remuneration paid by, or hypothecated to the ADI for individuals with responsibilities that relate to one or more ADI and non-ADI entities.

While this might seem high it should be remembered that the required deferral plus tax take and Medicare levy for these variable payments will mean that CEOs would only see $53,000 of a $250,000 variable component in the first four years after earning it, eventually seeing $132,500 seven years later. Adjusting for the inflation in the interim in Net Present Value (NPV) terms this equates to ~$121,500[35].

This figure should, as noted, be further risk adjusted down to account for the risk of the firm facing financial circumstances over the following seven-year period that prevent it from vesting the payments, result in forfeiture of cash instalments or changes in share prices that render options or shares worth less. Individuals may well have left the firm at this time and may be dependent on the actions of others and general economic conditions to receive payment for services rendered.

Deferred cash and restricted equity payments are typically at risk of forfeiture due to the performance of the firm at the Group, Divisional levels and with reference to Tier 1 Capital Ratio and Liquidity Coverage Ratio Group liquidity ratios. Typically, if any of these are negative or below the set threshold for capital and liquidity ratios the next variable payment is forfeited. The longer period of deferral proposed would increase these risks.

Individuals in lower taxing jurisdictions such as Singapore might see $200,000 after tax and receive this payment over three years. This money is worth more as it is received earlier. Its NPV value would be $194,000[36].

At this level while individuals may have significant family and financial commitments there is more likely to be the potential for deferral to be more accommodated.

[35] Assuming the middle of the RBA target range for inflation of 2.5%.
[36] If we assumed a similar personal tax marginal rate of 20% in Australia for comparison purposes.

Roles that cross the ADI

Individuals within organisations often work across different entities for different functions of their work. For example, an individual might book trades involving futures to the entity within the ADI, while for equity-based trades these trades might be booked to a non-ADI entity. Practices vary across firms as to where particular business is booked.

We note that the draft standard might benefit from greater articulation of how it should be applied to individuals whose role involve part of their work booking to the ADI and part to other entities within the firm.

We would support a proportional approach for these individuals consistent with the approach of APRA in relation to BEAR Section in the Banking Act s37E(3)(a)(ii). A proportional approach would also be consistent with and within APRA's prudential mandate.

There are a range of practices in relation to the apportionment of labour costs to businesses. Some firms will adopt an approach based on an entity that employees' staff internally billing other entities including the ADI group, others will apportion variable remuneration based on the relative profitability of the entity in a particular year, others may use a time estimate based approach. These will reflect different entity structures and the way different roles interact with these structures. The different approaches may have different effects on the amount of deferral of remuneration in a given year.

It is important to recognise that none of these methods could be considered an ultimate source for accurate apportionment. They are all based around approximations and reflect different approaches that are used internally by businesses for a range of reasons.

As long as the method used is consistent the flexibility for firms to use an approach that is best suited to their structures should be maintained. We note again that firms conducting the same activities outside of the ADI structure will not face the same restrictions.

SOOA

For foreign ADIs many do not have a Board structure and rely on a Senior Officer Outside of Australia (SOOA).

AFMA believes that there is a strong case to exclude these governance arrangements from the requirements.

Typically, the SOOA will cover a number of countries in the region. As well as a number of smaller jurisdictions these tend to include a number of larger financial centres such as Hong Kong, Singapore and Tokyo as a result most regional SOOAs have only a limited percentage of their work that is dedicated to the Australian entity, perhaps 5 or 10 per cent.

The SOOAs are already captured by the BEAR requirements and have a proportion of their variable remuneration for the Australian entity deferred for four years.

These percentages of their overall remuneration are already small. If, for example, a SOOA dedicating 10% of their time to the Australian entity who has 50% of their Australian hypothecated remuneration as variable, they are required to retain 40% of this variable component for four years under BEAR equating to perhaps 2% of their total remuneration across all jurisdictions.

	Time spent on Australian Entity (%) of total (A)	Variable Remuneration (%) of total remuneration (B)	Required deferral (%) of variable remuneration (C)	Percentage of individuals' total remuneration across all jurisdictions required to be deferred A x B x C
Current SOOA Requirement under BEAR	10	50	40	2% vests year 4
Proposed SOOA Requirement under CPS 511	10	50	40	0.7 % vests year 4 0.7 % vests year 5 0.7 % vests year 6

If SOOAs are included in the draft standard scheme this would instead require 2% of their total remuneration to be deferred for 6 years with pro-rata payments of 0.7% for each of the last three years (the end of years 4, 5 and 6).

The case has not and is unlikely to be made that there could be any further benefit to the prudential security of the Australian jurisdiction or the entity by having further pernickety deferment of trivial payments of 0.7% of total remuneration. Such restrictions would amount to what the Royal Commission might call "adding a new layer of regulation [which] will not assist".

As we have suggested with the foreign ADIs more generally it would be appropriate to show deference to the SOOA's home jurisdiction for compliance with the FSB requirements.

In summary, the SOOAs are already captured under BEAR and under the FSB principles through their home regulator, as there is likely no benefit to Australia in introducing further minor pay deferrals. They should be excluded from the standard.

Scope of "Special Role Category"

In the current draft CPS 511, the Senior Officer Outside Australia (SOOA) of a Foreign ADI is defined under 16(h) as "*Relevant Oversight Function"* and captured within the scope of "*Special Role Category*" under 16(m) (through the definition of "*senior manager*" under 16(k)) at the same time.

Paragraph 50 requires the "*Relevant Oversight Function*" to approve the variable remuneration outcomes for persons in "*Special Role Categories*". This would suggest a SOOA will be required to approve their own variable remuneration outcome which might not be the intent.

Additionally, all risk and financial control personnel are also included in the scope of "Special Role Category". Depending on the actual position of the SOOA within the Foreign ADI Group, the requirement in paragraph 50 may compromise the independence of the risk, compliance and internal audit functions which might currently have independent reporting lines and approvals.

Access to other Board committees in the context of a foreign ADI

Sub-paragraph 30(a) of CPS 511 requires the relevant oversight function to have free and unfettered access to other Board committees (we assume this refers to the Board Risk Committee (BRC) and Board Audit Committee (BAC) referred in CPS 510 Governance). The existing CPS 510 does not require foreign ADIs to set up the BRC and BAC locally. In addition, the appointed SOOA may not necessarily have access to these Board Committees set up at the head office. Therefore, this requirement may not fit with current structures in some foreign ADIs.

Moving between companies

AFMA seeks greater guidance on the processes that should be associated with individuals moving between firms. The UK has found there can be incentives created by deferral requirements for individuals to change firms if stock is bought out by the new employer.

Highly Paid Material Risk Takers

While some firms have a concept of maximum achievable variable pay, this is not an approach that is common across all firms globally. Therefore, the use of the term 'potential variable remuneration' in relation to the definition of highly-paid material risk taker may not be easily defined in many firms.

Some individuals might be in a position that could overtime lend itself to large remuneration payments but in a particular year might not due to market conditions. Look back is used in some jurisdictions but this creates incentives for staff to change employers after a high paying year.

There may be incentives created to cap benefits to ensure clear compliance with the obligations, this again would not benefit the sector in attracting top talent.

More generally, the use of the FSB principles to allow firms to adjust when individuals should receive remuneration based on the time horizon of the risks they create would negate the need for an artificial distinction such as the $1 million threshold. Boards should be empowered to determine what criteria should be used to determine which individuals are material risk takers in the context of their firm and their risk profile.

Independence of Reviewers

AFMA supports the required level of independence of reviewers as per paragraph 34 to be functional independence within the firm to assist in managing associated costs.

Exclusion of Risk Adjusted and RSE Licensee Investment Return Measures

We recognise that APRA deem risk-adjusted financial measures not to constitute financial performance measures that should count towards the maximum allowed. In this regard the drafting of the standard at paragraph 38 might benefit from rephrasing.

Implementation Timing

AFMA notes that the proposed timing of 1 July 2021 being 15 months from the time firms will be advised whether they will be an SFI for the purposes of the standard is tight in view of the significant changes that would be required to be implemented particularly around the limitations on non-financial risk metrics if these are implemented.

AFMA requests that the changes are implemented in the following financial year, i.e. moving the commencement date from 1 July 2021 to 30 June 2022 with firms free to start earlier if this suits their pay cycle.

Specific consultation questions

Remuneration framework

- Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework?

This is an appropriate period.

- What areas of the proposed requirements most require further guidance?

Please refer to the discussion above.

Board oversight

- Are the proposed duties of the Board appropriate?

The role for the Board described in the draft standard may go beyond the governance role that Boards should be limited to. We would be pleased to work with APRA to revise the wording to ensure that an appropriate delineation between management and governance is maintained in the duties required of the Board.

- Are the proposed duties of the Board Remuneration Committee appropriate?

As per our comment above in relation to the Board some refinements may be appropriate to ensure that the Committee's role as a governance body is clearer in the requirements.

Remuneration design

- APRA is proposing that financial performance measures make up at least 50 per cent of variable remuneration measurement and individual financial performance measures are limited to 25 per cent. Is this an appropriate limit, if not what other options should APRA consider to ensure non-financial outcomes are reflected in remuneration?

Please refer to our discussion above on the difficulties associated with a 50 per cent minimum for non-financial metrics, and 25 per cent maximum for an individual financial metric.

We support as per our discussion above the incorporation of the FSB requirements into the standard. These should will allow sufficient flexibility for the sophisticated assessment schemes currently in use to continue. Limitation of financial metrics should be done through a process that confirms non-financial metrics have an appropriate role.

- What would be the impacts of the proposed deferral and vesting requirements for SFIs? For ADIs, what would be the impact of implementing these requirements in addition to the BEAR requirements?

Please refer to our discussion above.

In summary, the impacts to the sector would be significant. Costs would increase, there is the potential for more business and skilled individuals to move to the less regulated non-ADI sector, the industry would find additional challenges in attracting and retaining the most skilled individuals to the jurisdiction and sector.

AFMA Recommendations in relation to deferral:

- Foreign ADIs should not be included based on their risk profile (wholesale only) and appropriate deferment to their home jurisdiction regulators;
- If Foreign ADIs are included SOOAs should be excluded as they are already captured by BEAR and further minor deferrals of income are unlikely to have any productive effect;
- Smaller and regional banks including those up to $100 billion in assets as per the BEAR threshold should be excluded as the arrangements would be unnecessarily burdensome;
- Total resident assets should be adjustable to exclude activities that could be undertaken by a non-ADI to ensure a more level playing field;
- In the alternate the assets of foreign ADIs should be adjusted as per the APRA levy to adjust for their differing risk profile.

- In the event APRA proceeds with prescriptive limits these should be set in line with the FSB three-year vesting requirement to allow room for firms to adjust upwards as appropriate.

- Would the proposals impact the industry's capacity to attract skilled executives and staff?

Please refer to our discussion above.

In summary, yes, the proposals would have a serious impact on the industry's ability to attract and retain skilled executives and staff who are most highly skilled and operate at the highest level of performance. This would be an undesirable outcome for the sector and the broader economy that relies on it for efficient, innovative, and high-quality services.

Remuneration outcomes

- What practical hurdles are there to the effective use of clawback provisions and how could these be overcome? Would requirements for longer vesting where clawback is not preferred address these hurdles?

Clawback is a challenging contractual arrangement and can face legal challenges in practice.

We note that there may be tax issues associated with clawback. In the UK HM Revenue & Customs (HMRC) published guidance on the relief but the situation is still said to be uncertain and are complex for both employees and employers[37].

We note the requirement at paragraph 56 that variable remuneration must only be awarded if an amount corresponding to it can be recovered from the person if recovery is justified on the basis of the criteria specified in paragraph 58.

Firms have no control on how vested remuneration is spent by employees. It may be difficult or impossible to make an assessment of whether funds paid might be recoverable from employees up to 7 years in advance (from the first year of vesting to the last year of the clawback period. For example, payments that might be made towards a mortgage might not be redeemable due to market conditions at a point in the future. For many employees a significant part of their variable remuneration might be spent on living expenses, this may also make recovery difficult in a way that is difficult to predict.

As firms are required to take reasonable steps to recover, this requirement may be redundant and its presence create impossible to manage risks for firms. We also query what mischief is being targeted.

Our preference is, aligned with the clarity around the responsibilities for the Board elsewhere in the standard, for the Board to have discretion to pursue clawback. Such endeavours can consume significant time and resources and Boards should be

[37] https://www.lexology.com/library/detail.aspx?g=c51630af-b9a3-46d8-97ce-06b83e558441

empowered to consider these costs particularly during periods when the business might be under stress.

- What transitional provisions may be necessary for particular components of the new standard or for particular types of regulated entities?

Transparency

- What disclosures would encourage a market discipline in relation to remuneration practices?

Remuneration remains a confidential matter for firms and their employees. There are competitive issues with remuneration that mean that excessive transparency can be a negative for firms.

AFMA supports transparency in line with the FSB Principle 9:

> Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders. Stakeholders need to be able to evaluate the quality of support for the firm's strategy and risk posture. Appropriate disclosure related to risk management and other control systems will enable a firm's counterparties to make informed decisions about their business relations with the firm. Supervisors should have access to all information they need to evaluate the conformance of practice to the Principles.