5 August 2021

OBPR ID: 25170

Mr Jason Lange

Executive Director

Office of Best Practice Regulation

Department of the Prime Minister and Cabinet

1 National Circuit

BARTON ACT 2600

Email: helpdesk-obpr@pmc.gov.au

Dear Mr Lange,

**CERTIFICATION OF APRA’S NEW PRUDENTIAL STANDARD: CPS 511 REMUNERATION**

I am writing to certify that APRA’s development of its *Prudential Standard: CPS 511 Remuneration* (CPS 511)has followed a similar process to that required under a Regulation Impact Statement (RIS). APRA has addressed all seven RIS questions, as set out in the attachment to this letter.

As set out in the attachment, APRA considered a number of policy options in developing CPS 511 reforms. These options can be broadly summarised as extensive reform across all APRA-regulated entities, targeted reforms at the largest and most complex entities, and no changes to existing requirements. In developing the revised CPS 511, APRA also considered additional alternative options that were put forward by industry during consultation. These are discussed in APRA’s November 2020 Response Paper and APRA’s forthcoming August 2021 Response Paper.

Using the regulatory burden measurement framework, APRA estimates that regulated entities will incur additional compliance costs from the implementation of CPS 511. In aggregate – across banks, insurers and superannuation fund trustees – APRA estimates these costs at around $38 million per year, over the next 10 years (see Table 1 below). In APRA’s view, these costs will be more than offset by the benefits from APRA’s reforms, which seek to strengthen remuneration arrangements and address Royal Commission recommendations, through strengthened incentives, appropriate consequences and greater accountability.

*Table 1 Estimate of regulatory burden*

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

As part of the development of CPS 511, APRA considered three main policy options. APRA’s assessment of these options are summarised in Attachment A of this letter.

Accordingly, I am satisfied that the attached report now meets best practice consistent with the *Australian Government Guide to Regulation*.

Yours sincerely,

**Attachments**

Attachment A: APRA Regulation Impact Analysis

Attachment B: APRA Discussion Paper – Strengthening prudential requirements for remuneration, July 2019

Attachment C: APRA Response Paper – Strengthening prudential requirements for remuneration, November 2020

**ATTACHMENT A: APRA REGULATION IMPACT ANALYSIS**

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.[[1]](#footnote-2)

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 into Misconduct in the Banking, Superannuation and Financial Services Industry*; the Royal Commission recommended that APRA should upgrade its remuneration requirements, in line with international better practice.

The 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.

**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.[[2]](#footnote-3) APRA has considered all relevant compliance and administration costs, including both upfront and ongoing costs, in estimating the regulatory costs of each option.

#### 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 in Table 2).

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| **Table 2: 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 entities subject to heightened remuneration requirements

Under Option 2, all 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 (significant financial institutions or 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 Table 3 below).

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| **Table 3: Annual regulatory costs, averaged over 10 years ($m)[[3]](#footnote-4)** |
| Change in costs ($m) | Business | Community organisations  | Individuals | Total change in costs |
| Total by sector | $66 million | Nil | Nil | Nil |

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 a 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 in Table 3 below). For the average SFI, this would equate to around $454,000 per annum. For the average non-SFI, this would be around $46,000.[[4]](#footnote-5)

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| **Table 4: 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 | Nil |

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 small and large entities. 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 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.[[5]](#footnote-6)
* APRA’s proportional approach to regulatory change will mean that smaller entities are subject to simpler requirements. This supports competition.
* CPS 511 creates stronger incentives for individuals to proactively manage risks they are responsible for. This will promote effective management of financial and non-financial risks, and support the prevention of 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.

**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 (see table 5 below).

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| **Table 5: Comparison of options** |
|  | **Option 1** | **Option 2** | **Option 3** |
| Regulatory costs | Nil | High | Moderate |
| Strengthened board governance | Does not meet this criterion | Meets this criterion | Meets this criterion |
| Limit impact of financial metrics in long-term variable remuneration | Does not meet this criterion | Meets this criterion | Meets this criterion |
| Deferral of variable remuneration | Partly meets this criterion | Meets this criterion | Meets this criterion |
| Consequence management | Partly meets this criterion | Meets this criterion | Meets this criterion |
| Overall | Net cost | Net cost to small entities | Net benefit |

#### Review

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.

1. [Consultation on remuneration requirements for all APRA-regulated entities | APRA](https://www.apra.gov.au/consultation-on-remuneration-requirements-for-all-apra-regulated-entities) [↑](#footnote-ref-2)
2. 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> [↑](#footnote-ref-3)
3. 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. [↑](#footnote-ref-4)
4. 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. [↑](#footnote-ref-5)
5. See [The Australian Financial System | Financial Stability Review – October 2019 | RBA](https://www.rba.gov.au/publications/fsr/2019/oct/australian-financial-system.html) [↑](#footnote-ref-6)