

Banking, Insurance, Life Insurance, Health Insurance and Superannuation (prudential standard) determination No. 1 of 2021

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Banking Act 1959, section 11AF

Insurance Act 1973, section 32

Life Insurance Act 1995, section 230A

Private Health Insurance (Prudential Supervision) Act 2015, section 92

Superannuation Industry (Supervision) Act 1993, section 34C

APRA may, in writing, determine a prudential standard that applies to an APRA-regulated entity under:

- (1) subsection 11AF(1) of the *Banking Act 1959* (Banking Act), which applies to all authorised deposit-taking institutions (ADIs), excluding ADIs referred to in paragraph 2 of *Prudential Standard CPS 511 Remuneration* (CPS 511), and authorised banking non-operating holding companies (authorised banking NOHCs);
- (2) subsection 32(1) of the *Insurance Act 1973* (Insurance Act), which applies to all general insurers and authorised non-operating holding companies (authorised NOHCs), and subsidiaries of general insurers and authorised insurance non-operating holding companies (authorised insurance NOHCs);
- (3) subsection 230A(1) of the *Life Insurance Act 1995* (Life Insurance Act), which applies to all life companies, including friendly societies, and registered life non-operating holding companies (registered life NOHCs);
- (4) subsections 92(1) of the *Private Health Insurance (Prudential Supervision) Act 2015* (PHIPS Act), which applies to all private health insurers; and
- (5) subsection 34C(1) of the *Superannuation Industry (Supervision) Act 1993* (SIS Act), which applies to all Registered Superannuation Entity Licensees (RSE licensees).

On 17 November 2021, APRA made Banking, Insurance, Life Insurance, Health Insurance and Superannuation (prudential standard) determination No 1 of 2021 (the instrument), which determines a new cross-industry prudential standard CPS 511.

The instrument commences on 1 January 2023.

1. Background

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system.

APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of entities. The Banking Act, Insurance Act, Life Insurance Act, PHIPS Act and SIS Act allow APRA to issue legally binding prudential standards that set out specific prudential requirements with which APRA-regulated entities must comply.

APRA regularly reviews its regulatory regime and amends its prudential requirements as a result of a number of factors, including:

- international developments;
- changes in financial market conditions or changes in risk management practices, in response to identified weaknesses in the prudential framework; and
- to reduce potential negative impacts of emerging industry issues.

A resilient financial system requires prudent remuneration arrangements – in design, governance and outcomes. CPS 511 sets out requirements to ensure that APRA-regulated entities maintain remuneration arrangements which appropriately incentivise individuals to prudently manage the risks they are responsible for, and that there are appropriate consequences for poor risk outcomes.

Since 2010, changes to market conditions and practices, findings from various APRA reviews and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry¹ have demonstrated the need for stronger remuneration requirements. In particular, the Financial Stability Board has released updated statements and guidance in support of its *Principles of Sound Compensation Practices*.

2. Purpose and operation of the instruments

The purpose of the instrument is to determine a new prudential standard, CPS 511.

CPS 511 is designed to establish and maintain:

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

CPS 511 adopts a proportional approach, meaning that larger and more complex entities (Significant Financial Institutions (SFIs)) are subject to higher requirements than smaller and less complex entities.

¹ The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019) *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Final Report*.

Under CPS 511, the determination of variable remuneration must include consideration of both financial and non-financial risk management. Entities must also ensure that there are appropriate consequences for adverse risk and conduct outcomes.

SFIs are required to assign a material weight to non-financial measures when determining variable remuneration, and have risk adjustment mechanisms to reduce variable remuneration, potentially to zero, where warranted.

Variable remuneration of senior executives at SFIs will also be subject to deferral requirements, combined with provisions for in-period adjustments, malus and clawback.

Smaller and less complex entities (non-SFIs) will be subject to simpler requirements for remuneration design and governance arrangements.

Where CPS 511 refers to an Act, Regulation or prudential standard, this is a reference to the document as it exists from time to time, and which is available on the Federal Register of Legislation at www.legislation.gov.au.

CPS 511 provides for APRA to exercise various discretions. Decisions made by APRA in exercising those discretions are not subject to merits review. This is because these decisions are preliminary decisions that may facilitate or lead to substantive decisions which are subject to merits review.

Under the Banking Act, Insurance Act, Life Insurance Act and PHIPS Act, a breach of a prudential standard is a breach of the enabling legislation, as each enabling Act provides that regulated entities must comply with the standard. Under the SIS Act, it is a condition on all RSE licences that the RSE licensee must comply with the RSE licensee law, which includes prudential standards. However, there are no penalties prescribed for breach of the prudential standards under any of these Acts. Instead an entity's breach of the enabling legislation or RSE licence condition is grounds for APRA to make further, substantive decisions under the relevant enabling legislation in relation to the entity. Those decisions may include the decision:

- (a) to issue a direction to the regulated entity, including: a direction to comply with the whole or part of a prudential standard (section 11CA of the Banking Act, s.104 of the Insurance Act, section 230B of the Life Insurance Act, section 131D of the SIS Act); and a direction to comply with all, or specified obligations, which includes prudential standards (section 96 of the PHIPS Act); or
- (b) to revoke: an authority to carry on banking business (section 9A of the Banking Act); a banking NOHC authorisation (section 11AB of the Banking Act); an authority to carry on insurance business (section 15 of the Insurance Act); an insurance NOHC authorisation (section 21 of the Insurance Act); registration of life insurance business (section 26 of the Life Insurance Act); a life NOHC authorisation (section 28C of the Life Insurance Act); or to revoke an authority to operate an APRA-regulated superannuation fund (section 29G of the SIS Act).

It is only at this stage that an entity is exposed to a penalty, loss of licence or imposition of a penalty if it breaches the direction (50 penalty units each day under section 11CG of the Banking Act, section 108 of the Insurance Act, and section 230F of the Life Insurance Act; 30 penalty units each day under section 104 of the PHIPS Act; and 100 penalty units each day under section 131DD of the SIS Act).² In nearly all cases,³ the decisions are preceded by a full consultation with the regulated entity to raise any concerns they may have in relation to the decision.

The decisions of APRA to impose a direction are subject to merits review (section 11CA of the Banking Act, section 104 of the Insurance Act, section 236 of the Life Insurance Act, section 168 of the PHIPS Act), which is appropriately available at the point where an entity could be exposed to a penalty.

All decisions to revoke authorisations/registrations under the Banking Act, Insurance Act and Life Insurance Act are subject to merits review, unless specifically excluded by the enabling legislation.

Revocation of an authorisation to carry on banking business or a banking NOHC authorisation is subject to merits review unless either:

- (a) APRA has determined that access to natural justice and merits review is contrary to the national interest or contrary to the interests of depositors with the body corporate; or
- (b) (in the case of ADIs only) the authority is an authority that is to cease to have effect on a day specified in the authority (section 9A(8) of the Banking Act).

Revocation of an authorisation to carry on insurance business or an insurance NOHC authorisation is subject to merits review (ss 15 and 21 of the Insurance Act).

Revocation of registration as a life insurance company or a life NOHC authorisation is subject to merits review (section 236 of the Life Insurance Act). The situation in relation to cancellation of registration under the PHIPS Act is different to the other enabling legislation.

3. Consultation

² The exception is section 54B of the SIS Act, which provides that breach of a covenant under sections 52 or 52A is a civil penalty provision. The covenants include a requirement to comply with prudential standards in relation to specified topics (conflicts, capital requirements for operational risk, MySuper and choice products). CPS 511 is not a standard in relation to any of these topics.

³ The Banking Act, Insurance Act and Life Insurance Act specifically provide that APRA does not need to consult where APRA is satisfied that doing so could result in a delay in revocation that would be contrary to the national interest or the interests of depositors with the body corporate (subsection 9A(4) of the Banking Act), contrary to the national interest (subsection 15(4) of the Insurance Act), or contrary to the public interest (subsection 26(5) of the Life Insurance Act), respectively. Consultation is not specifically required under the SIS Act.

APRA undertook two rounds of public consultation in developing CPS 511. This involved engagements with a variety of stakeholders over a period of 24 months, including individual entities, industry associations, consultants and other regulatory agencies.

APRA first consulted on proposed requirements in CPS 511 in July 2019.⁴ APRA had planned to finalise CPS 511 reforms in 2020, but delayed this to allow entities to focus on managing risks associated with COVID-19. APRA received 76 submissions to the 2019 consultation.

In November 2020, APRA released a detailed response to issues raised in the 2019 consultation.⁵ This included a set of revised policy proposals for consultation. The most material revision was a shift to a principles-based approach to the requirement for entities to include non-financial measures in variable remuneration. Minimum deferral periods were also moderately shortened. APRA received 41 submissions to this consultation.

In August 2021, APRA released a response to submissions to the November 2020 consultation. This set out APRA's response to issues raised.⁶

4. Regulation Impact Statement

In developing CPS 511, APRA has followed a similar process to that required for a Regulation Impact Statement, which satisfies the Office of Best Practice Regulation's requirements. The document evidencing APRA's policy development process has been lodged as supporting material.

5. Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at the Attachment to this Explanatory Statement.

⁴ APRA Discussion paper – [Strengthening prudential requirements for remuneration](#), July 2019.

⁵ APRA Response paper – [Strengthening prudential requirements for remuneration](#), November 2020.

⁶ APRA Response paper - [Strengthening prudential requirements for remuneration](#), August 2021.

ATTACHMENT

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

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The legislative instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

Overview of the Legislative Instrument

The purpose of the instrument is to determine a new *Prudential Standard CPS 511 Remuneration* (CPS 511).

CPS 511 sets out requirements to ensure that APRA-regulated entities maintain remuneration arrangements which appropriately incentivise individuals to prudently manage the risks they are responsible for, and that there are appropriate consequences for poor risk outcomes. CPS 511 adopts a proportional approach, meaning larger and more complex entities (Significant Financial Institutions) are subject to higher requirements.

CPS 511 is designed to create:

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

Human rights implications

APRA has assessed the instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instrument is compatible with human rights.

Conclusion

The instrument is compatible with human rights as it does not raise any human rights issues.