10 Minutes on...

Financial Services Royal Commission Final Report: Remuneration Recommendations

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Commissioner Hayne's Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has now been released to the public, together with the Australian Government's response. The Final Report can be found here, and the Government's response found here. With much anticipation and expectation for the Commission to come down hard on bank pay, many financial institutions and their remuneration committees are breathing a sigh of relief. But should they?

The connection between misconduct and pay

Of the four key observations summarised at the start of the Report, the connection between conduct and reward is called out first, setting up an expectation for some drastic changes to pay. The Commissioner states his strong view that *"in almost every case, the conduct in issue was driven not only by the relevant entity's pursuit of profit but also by individuals' pursuit of gain"*.

Along the same line, the Interim Report insinuated a causal link between incentive pay and poor customer outcomes, and came close to calling into question the viability of performance-based remuneration altogether. Therefore, it was somewhat surprising that Hayne's Remuneration Recommendations did not seek to prescribe more change. Rather, Hayne seems to be putting his trust in the principle based approach to remuneration regulation; heightened supervision and expectations for the regulator; the industry being 'on notice' to implement remuneration practices in line with the spirit of regulations; and the clear expectation that he has set regarding a new and deliberate 'test and learn' mindset.

Following what is likely to be an initial feeling of relief, some may be left with a sinking thought - how will we ensure a different outcome from our reward frameworks if no one is dictating the nature of the change? Which is why, in spite of the reasonably sanguine nature of the Remuneration Recommendations, financial institutions should be feeling anything but complacent about pay in a post Royal Commission world.

Remuneration Recommendations

5.1 Supervision of remuneration - principles, standards, guidance: In conducting prudential supervision of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should give effect to the principles, standards and guidance set out in the Financial Stability Board's publications concerning sound compensation principles and practices. Recommendations 5.2 and 5.3 explain and amplify aspects of this Recommendation.

5.2 Supervision of remuneration – aims: In conducting prudential supervision of the design and implementation of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should have, as one of its aims, the sound management by APRA-regulated institutions of not only financial risk but also misconduct, compliance and other non-financial risks.

5.3 Revised prudential standards and guidance: In revising its prudential standards and guidance about the design and implementation of remuneration systems, APRA should:

- require APRA-regulated institutions to design their remuneration systems to encourage sound management of non-financial risks, and to reduce the risk of misconduct;
- require the board of an APRA-regulated institution (whether through its remuneration committee or otherwise) to make regular assessments of the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing the risk of misconduct;
- set limits on the use of financial metrics in connection with long-term variable remuneration;require
- APRA-regulated institutions to provide for the entity, in appropriate circumstances, to claw back remuneration that has vested; and
- encourage APRA-regulated institutions to improve the quality of information being provided to boards and their committees about risk management performance and remuneration decisions.

5.4 Remuneration of front line staff: All financial services entities should review at least once each year the design and implementation of their remuneration systems for front line staff to ensure that the design and implementation of those systems focus on not only what staff do, but also how they do it.

5.5 The Sedgwick Review: Banks should implement fully the recommendations of the Sedgwick Review.

Prescribed changes are substantial for advisers and (in time) mortgage brokers. Whereas, there are few prescriptive changes for executive and front-line incentives

No prescribed solution for Executives or frontline staff

Hayne acknowledges that there is no optimal remuneration solution that will work for all roles, and all institutions. Which in part may explain why he has not prescribed any particular variable pay structure or design elements. The main exceptions being a specific requirement to limit the use of financial metrics in connection with long term variable remuneration (with 'limits' yet to be defined by APRA), and to introduce provisions to claw back paid / vested remuneration.

Other than these two design requirements, the five Remuneration Recommendations are unlikely to lead to an overhaul of variable pay structures (notwithstanding that the content of the revised Standard could eventually include some more specific requirements). This is noteworthy for two reasons. First, because more prescriptive requirements would have been more in-line with the degree to which Hayne has attributed the extent of misconduct to individual financial gain. Second, because such requirements have been put in place in other jurisdictions, to respond to misconduct issues. For example, there are no recommendations to:

- introduce a bonus cap (e.g. 1x salary cap seen in Europe, or 2x with shareholder approval; the Netherlands impose a 20% bonus cap for all employees)[1]
- introduce a limit on the total quantum of pay
- reduce or remove variable pay altogether for some roles, or
- defer more substantial proportions of pay for longer periods of time (e.g. 7 years for Senior Managers in the UK).

Prescribed changes sit mostly outside the Remuneration Recommendations and mean more substantial change for advisors and mortgage brokers:

Prescriptive changes by population	
Financial advisers	Financial Advice Recommendations related to the conflicted remuneration provisions: • Banning grandfathered commissions • Further reducing the cap on life insurance commissions • Removing the exemptions on general insurance and consumer credit commissions
Mortgage brokers	Banking Recommendations: • Gradual ban on lenders paying commissions[2]
Vehicle dealers	Insurance Recommendations: • Cap on commissions for the sale of add-on insurance products

The most immediate responsibility to effect the Remuneration Recommendations lies with APRA, with no accelerated timeline

There is a strong message throughout the Report, that the regulators need to assume greater accountability for supervision. Remuneration is no different with three of the five Remuneration Recommendations relating to enhanced supervision and revised standards (as outlined on the previous page).

The immediate impact for many will be to continue to execute on current programs of work

Whilst the modifications to the Prudential Standard will likely require institutions to make changes to their executive and frontline incentive structures in order to better align pay outcomes with non financial risks, many large financial services institutions are already well down the path of implementing such change following their own self-assessments against the CBA Prudential Inquiry, finalised in November 2018.

The fourth Remuneration Recommendation, relating to full implementation of the recommendations of the Sedgwick Review, is also a detailed program of work that is well underway at most banks. And is work that won't be required by others given it doesn't apply to insurers or wealth managers. Although a number of institutions have voluntarily chosen to apply the Sedwick principles more broadly than their retail banking roles.

However, there is a definite step up in activity required for most institutions to more regularly, and more comprehensively assess the effectiveness of broad-based reward arrangements, and separately of frontline pay.

[1] There are several exceptions to the 20% bonus cap, including for employees not covered by a collective labour agreement (such as many executives). Their variable pay is capped at 100% of fixed remuneration, with the average of the entire group not exceeding 20%.
[2] Although the Government has not committed to address this immediately.

The clear focus on governance and implementation (rather than on prescriptive structures) will require the most behavioural change from institutions

In the spirit of continuing with a principles-based approach, outside of enhanced regulator expectations, the remaining focus of the Remuneration Recommendations is on governance practices such as effectiveness assessments and improving the quality of information provided to the Board about risk management performance and remuneration decisions. Done well, this could still lead institutions to make some further structural changes to pay in order to better align with performance, particularly misconduct and non financial performance. This implementation focus should also provide institutions with more regular and meaningful insight as to how remuneration frameworks are being applied in practice, and to determine whether or not discretion is being used appropriately, in the right circumstances, and with sufficient frequency and materiality.

So even though an overhaul of remuneration structures is not being demanded, the recommendations outlined in the Final Report should lead many financial institutions to challenge the way they reward staff currently, with the confidence that they are being encouraged to do so. And will certainly challenge the rigour with which institutions determine whether or not remuneration arrangements are actually doing their job as intended.

A more detailed report covering insights on the Financial Services Royal Commission Final Report in its entirety, 'Resetting standards - now for the industry to deliver' can be found *here*.

What financial institutions could do now and other institutions could consider…

Revisit the purpose of variable pay. Affirm the purpose of variable pay within your institution. For example, do you expect that most or all of variable pay will be paid unless there are disqualifying reasons, or do you expect to observe extremely varied incentive outcomes for any one individual year-on-year, with payouts occurring only when certain 'stretch' conditions are met.

Develop an 'effectiveness' measurement framework. Define in detail the outcomes, associated measures, and data sources to be monitored that would provide comfort that variable pay arrangements are in fact encouraging the right behaviours, and discouraging the wrong ones.

Be clear on a ***new definition of success, ensure it incorporates non-financial aspects*** of performance over the long-term, and determine if/how it can be measured, in order to encourage better non financial risk management and appropriate conduct through incentives. Ensure this new definition of success informs not only reward, but also other important talent processes (e.g. promotion, recognition, recruitment, development).

Be clear on what non-financial and misconduct risks prevail in your organisation, and develop strategies to ensure incentives promote sound management of these risks, through both rewarding positive examples and penalising negative examples.

Challenge the degree to which accountability for non-financial risk and misconduct has been enforced via remuneration outcomes, including not awarding bonuses, withholding bonuses pending investigation, and clawing back previously awarded pay.

How can PwC help?

To have a deeper discussion about these issues, please contact:

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