10 minutes on...

APRA's review of remuneration: How remuneration interacts with risk culture

Following a review of risk culture in financial institutions [1], APRA has announced the commencement of a formal review of APRA regulated institutions' remuneration policies and practices[2] to understand how effectively the requirements of CPS 510 have been implemented.

How does APRA's increased focus on risk culture impact remuneration?

- On 18 October 2016, APRA released their information paper on risk culture, and announced a review of industry remuneration as a key pillar of supervisory activity.

- APRA has highlighted specific areas for companies to consider, following recent meetings with Board Remuneration Committees of selected institutions.

- The review will commence in 2016 and focus on how well requirements of CPS/SPS 510 are being implemented, how they interact with the risk culture and cover both remuneration **arrangements** and **outcomes** of senior executives, risk and control staff, and material risk takers.

- Concurrently, APRA will compare its remuneration requirements with international regulatory developments, and supervisory practices.

PwC's perspectives

- We agree with APRA's perspectives that there is a balance to be struck in determining the approach to managing risk through remuneration, and that this may vary by organisation.

- This continues to place greater onus on companies - particularly Boards and Remuneration Committees - to be aware of the specific nuances of and within their organisations - eg subsidiaries.

- We believe there are implications not only for APRA regulated institutions but also cross industry given a number of these themes are at the forefront of proxy advisor and investor group concerns in relation to remuneration more broadly.

Focus area	Highlights of specific considerations identified by APRA
1. Governance and operation of Remuneration Committees	• Effectiveness of the link between remuneration and risk management oversight, eg the link between the Remuneration Committee and Risk Committee.
2. Coverage	• Robustness of the process used to determine coverage and governance arrangements of each of the segments covered by the Standards • Consistency of coverage across all relevant segments, eg addressing ambiguity on the Board's primary role (rather than the CEO) in relation to senior executive remuneration, and any deficiencies in the level of focus for material risk-takers below senior executive level. • Importance of appropriate governance of remuneration of APRA-regulated subsidiaries - eg simple adoption of group policies may not be sufficient to meet the Board or subsidiary Board's obligations.
3. Factoring risk into remuneration	• Differentiated results based on an individual's (or a subsidiary's) performance, as opposed to team (or Group) performance • Sufficiency of weight on risk-related KPIs, and a challenge to whether there is an overreliance on 'gates' which can result in binary rather than nuanced outcomes • Greater formality in capturing input on the quality of risk management (eg from the Chief Risk Officer or Risk Committee) and articulating how quality of risk management (as a lead indicator to potentially poor risk outcomes or failures) would impact performance assessment • Adequacy of arrangements for risk and financial control personnel - specifically whether refined performance metrics are required outside of an increased proportion of remuneration as fixed salary.
4. Deferral, vesting and clawback	• Appropriate balance between scope of clawback (eg breadth of scope) length / quantum of deferral, quality of performance assessment, eg the narrower the scope of clawback, the greater need for application of initial performance assessment robustness • Potential for Remuneration Committees to consider whether the ability to withhold unvested LTIs is appropriate.

1. APRA Information Paper: Risk culture http://www.apra.gov.au/MediaReleases/Pages/16_40.aspx; http://www.apra.gov.au/CrossIndustry/Documents/161018-Information-Paper-Risk-Culture.pdf
2. Letter to industry: APRA review of remuneration: http://www.apra.gov.au/CrossIndustry/Pages/Letter-to-industry-APRA-remuneration-review.aspx

What the review means for you

While APRA has not asked for a formal response, the review signals a more detailed examination of remuneration structures than previously considered. APRA-regulated companies should identify those areas where there is most likely to be ambiguity or queries. For non-regulated companies, the review covers a number of themes commonly considered by external stakeholders.

Theme	APRA-regulated institutions	All institutions	What you should do now
Building trust in how judgement is applied	Use of judgment to assess performance at an organisational **and** individual level is viewed well. But how it is used will continue to be under significant scrutiny - by APRA, internal and external stakeholders alike. There needs to be a willingness to apply judgement and develop a 'demonstrated history' of the effective use of discretion, otherwise trust in how judgment is applied can be quickly eroded.		**(All co's) Communication & transparency:** Consider how clearly the process for exercising judgement and the scope of its application is defined and communicated. Are there any areas of ambiguity? Test how well key stakeholders understand their responsibilities (eg input / challenge) in the application of judgement to remuneration outcomes. **Differentiation:** Consider if there is an appropriate focus of metrics / discretion at the individual vs team level.
Prevention or cure?	Organisations should include a qualitative overlay to address quality of risk management - not just assess risk outcomes. There is scope for organisations to consider whether an end of year assessment is sufficient to address risk management throughout the year, and determine the right parties to be involved.	Include a combination of outcome and quality metrics, and consider timeliness of performance assessment (eg safety & customer management and outcomes).	**(APRA co's)**: **Early signals:** Consider whether building earlier signposts (eg interim assessments by the Remuneration Committee and Risk Committee) can provide guidance to management earlier in the year. **(All co's) Leadership**: How is leadership showing up in remuneration governance? Do behaviours align to expectations? Are you tapping into the knowledge /experience of different groups (eg Remuneration, Risk, Safety) as part of the process, to improve execution.
Appropriate focus on all relevant groups	Confirm that all relevant segments covered by the regulations have been given the right level of consideration in remuneration design and governance. Attention needs to be applied separately to different segments (eg subsidiaries) and in a timely way (not an 'after the fact' review once outcomes have been determined).	A tailored approach to different employment segments recognises the various impact of organisational performance that each segment may have.	**(APRA co's)**: **Focus:** Are there any areas where your organisation hasn't actively considered each of the areas identified by APRA? **(All co's): Segmentation:** Are some segments prioritised over others appropriately?
Beyond borders?	With trust in executive pay at lower levels in overseas markets (eg the US and UK), there is greater likelihood of international regulatory changes (eg remuneration guidelines) being adopted by APRA or more broadly in the market[3].		**(All co's): Monitor international developments** and proactively address changes, instead of playing catch-up. At the heart of changes, is an emphasis on increasing trust by all stakeholders in institutions, and associated remuneration structures.

3.   For further detail on UK developments, see: 2 minutes on.... Rebuilding trust in executive pay: The UK Executive Remuneration Working Group's recommendations

How can PwC help?

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

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