10 minutes on...

Remuneration, risk, and conduct following the APRA review

April 2018

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The financial services sector continues to feel the impact of increasing external pressure

Regulators are exerting influence on companies' remuneration frameworks to promote stronger risk-alignment and increased accountability, while organisations themselves are also examining the role of remuneration in driving excessive risk taking and short-term decision-making.

There has been, and continues to be, a significant number of regulatory reviews into incentives within the financial services sector. These include:

- Hayne Royal Commission into Financial Services, with a significant focus on remuneration
- the Banking Executive Accountability Regime (BEAR), which includes restrictions on executive remuneration
- the Sedgwick review into sales incentives in retail banking, and the subsequent industry-led reform of front line incentives
- ASIC review of mortgage broker commissions

Most recently, APRA has published its findings and initial recommendations on remuneration practices in financial services companies based on the CPS/SPS 510 review.

APRA's review of remuneration practices

- APRA announced a review of remuneration practices in the FS industry in 2016 with a 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.
- The findings from the review were published in April 2018 - see next page.

Hayne Royal Commission into Financial Services

The first round of hearings on consumer lending practices concluded in March 2018, with the second round of hearing focusing on financial advice starting this week.

The remuneration themes coming out of the hearings and where the Senior Counsel Assisting identified either misconduct or conduct below community standards or expectations of remuneration practices include:

- Remuneration structures (incl commissions arrangement) for front line staff, specifically how they incentivise individual behaviour and the remuneration consequence in case of misconduct / inappropriate behaviour, i.e. risk adjustment mechanism and its application
- Non-disclosure of commissions payments
- Correlation of volume based commissions to poor customer outcomes
- Use of upfront/trailing commissions
- Use of flex commissions and existence of conflict of interests
- Low financial penalty to brokers who engage in misconduct.

BEAR

- Subject to the Governor-General's royal assent, the remuneration requirements (focusing on deferral policy of variable award) will largely take effect from 1 July 2018, impacting awards made on or after 1 January 2019.
- The Big 4 banks are progressing toward their 1 July 2018 deadline, with a focus on compliance (ie identification of Accountable Persons, completing Accountability Statements and determine reasonable steps).

Sedgwick review

- The latest ABA's governance review report* includes the progress of each participating bank's self-assessed status in implementation of the Sedgwick Review recommendations relating to variable reward and performance management of retail bank executives and staff.
- Collectively the banks have reported progress against the Sedgwick Review recommendations are either complete, or substantial alignment of policies and practices has been achieved.

ASIC's review of mortgage broker commission

- ASIC published their findings report in March 2017 which included a number of proposals for industry aimed at improving consumer outcomes.
- Since then, representatives of Australia's mortgage broking industry (known as the Combined Industry Forum, 'CIF') have agreed on six principles that will be implemented to ensure better consumer outcomes and improved standards of conduct and culture, while preserving competition in mortgage broking. The CIF will report on its ongoing progress to ASIC, Treasury and the Government on a regular basis.

* Independent governance - expert report, Australian banking industry: Package of initiatives, Report 7, January 2018 (link)

APRA's review found companies focused primarily on meeting minimum standards

In early April 2018, APRA published findings from their review that sought to understand how effectively companies had implemented the *Prudential Standards** that looked to ensure that companies' performance-based components of remuneration encouraged behaviour that support sound risk management and long-term financial stability of the organisation (link). The review analysed the remuneration processes and outcomes of approximately 280 senior roles (800 data points) over a 3 year period from a sample of 12 large financial institutions.

Key findings

Overall

- Most institutions' remuneration policies and frameworks met minimum requirements of the standards, but in APRA's view often fell short of sound/strong governance

Design of risk management performance measures

- Risk measures have diminished effectiveness when included as one of a large number of metrics (up to 20), and on average only had a 14% weighting
- There is an absence of links to measures of long-term financial soundness or risk-adjusted measures in LTI plans
- Not differentiating incentive frameworks to individuals in risk management functions can reduce their ability to act independently

Remuneration outcomes

- Adjustments in the event of poor risk outcomes is extremely rare (including use of malus / clawback, or bonus pools)
- Sign-on / buyout packages are not aligned to risk adjustment principles (e.g. guaranteed bonus extending beyond 1 year)
- Material Risk Takers are not identified where collective impact could affect risk / financial soundness

Board Remuneration Committee oversight

- Overall lack of collaboration between board remuneration and risk committees

APRA recommendations

*"Well targeted incentive schemes and firmly enforced accountability systems should be viewed not simply as a matter of regulatory compliance, but essential for sustained commercial success" - **APRA***

Design of risk management performance measures

- Risk outcomes should act as a modifier to performance across all measures, not just a component of the scorecard
- Performance measures (including risk) should be more closely tied to individual performance
- Risk function roles should not be subject to the same incentive framework as other roles, and at a minimum should have a reduced weighting on financial performance
- The deferral policy should be reviewed to better align outcomes to business and investment cycles

Remuneration outcomes

- The remuneration policy should include specific processes to adjust individual incentives or pool calculations on the basis of risk outcomes

Board Remuneration Committee oversight

- Boards should seek to hold joint meetings between the remuneration and risk committees, specifically to determine the best way to promote prudent risk management behaviours

APRA's next steps

- Review the prudential framework to support a more robust and credible implementation of the requirements and guidance
- Consider expansion and strengthening of prudential requirements in light of international regulatory development
- Consider alignment with the implementation of BEAR legislative requirements
- Proposed changes to consider include (but are not limited) to:
  - improve design of framework
  - enhance implementation and outcomes
  - strengthen remuneration committee oversight, and
  - enhance reporting and disclosure

*"Institutions should not wait for regulatory changes to address the scope ... nor regard the task as one of simply meeting minimum regulatory requirements." - **APRA***

* CPS510 Governance and Prudential Standard and SPS510 Governance (for superannuation entities)

What might organisations consider doing now?

	Activities to undertake…
1 **Articulate the governance and collaboration framework between remuneration and risk committees**	❑ Consider if the **risk committee** can have **a more explicit role** in determining bonus outcomes, e.g. having joint meetings between the remuneration and risk committees to discuss how remuneration outcomes reflect risk ❑ Ensure that the remuneration committee receives all **relevant information / documentation to assess the appropriateness of risk ratings** and how this should impact individual and incentive pool outcome
2 **Develop a remuneration consequence policy/framework that defines the approach to determining appropriate level of risk adjustments**	❑ Draft a policy that specifically sets out: • **processes for pool level adjustments** <u>and</u> **individual payment adjustments** (e.g. identifying risk events and quantifying adjustment sizes) • the **roles and responsibilities** at each stage of the adjustment process • the **associated documentation** to the board **to enable effective decision making** regarding the need and the size of the required adjustment ❑ Regarding **adjustments to group pools**, consider setting a **reasonable expectation** within the policy and then allow for discretion in extreme circumstances. e.g. the board could determine the financial impact of a specific fine or risk event and use that to adjust the pool proportionally. ❑ Consider whether **individual risk adjustments** can be **directly linked to the severity of the event,** the outcome of a disciplinary process, non-bonus related consequences and prior conduct. ❑ Consider potential **impact of both crystallised risks** ('ex-post adjustment') and as yet **uncrystallised risks** ('ex-ante adjustment') in assessing risk outcomes / adjustments
3 **Consider aligning deferral requirements to that of BEAR**	❑ Review current deferral policy against **BEAR requirement** which mandates that a certain portion of variable remuneration must be **deferred for at least four years** ❑ Articulate how the deferral period reflects **the business and investment cycles** and is therefore considered appropriate in aligning remuneration and risk outcomes
4 **Review the role and impact of risk / risk-adjusted measures in determining pay outcomes**	❑ Explore if **risk / risk-adjusted measures are appropriately integrated** into the bonus calculation at both the group, business unit and individual level. ❑ Review the weighting of risks measure in the scorecard and **consider using risk as a modifier** to performance of other measures ❑ Ensure there is a **transparent explanation** of the reasons for risk adjustments and the value related to each risk.
5 **Review arrangements for risk and control personnel**	❑ Consider how the **incentive framework for risk management personnel** should vary from the rest of the organisation, e.g. through a higher weighting on individual performance and lower variable pay.
6 **Consider merits of some/all of the Sedgwick recommendations for frontline incentives**	❑ Review the **Sedgwick recommendations** (even if your organisation is not a big bank) and conduct **gap analysis against current frontline arrangements** ❑ Consider **implications for non-frontline incentives** (e.g. manager arrangements) which may be inconsistent with the Sedgwick recommendations

How can PwC help?

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

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