



FINANCIAL SERVICES ROYAL COMMISSION FINAL REPORT

Part 4: Remuneration

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CONTENTS

| | | |
|-----|--|---|
| 1 | APRA REMUNERATION GUIDANCE TO BE AMENDED | 2 |
| 1.1 | Specific recommendations to improve APRA prudential guidance | 2 |
| 1.2 | Financial Stability Board's approach endorsed | 2 |
| 2 | APRA'S SUPERVISION OF REMUNERATION TO INCREASE | 3 |
| 2.1 | Greater scrutiny by APRA | 3 |
| 2.2 | FSB's approach endorsed | 3 |
| 2.3 | Recommendations regarding APRA cultural reviews | 3 |
| 3 | FRONTLINE STAFF GET PARTICULAR ATTENTION | 3 |
| 3.1 | Retail banking | 3 |
| 4 | CLAWBACK MECHANISMS | 3 |
| 5 | DISCLOSING CONSEQUENCES | 4 |
| 6 | REGULAR INTERNAL REVIEWS | 4 |
| 7 | DETERIORATION OF VARIABLE REMUNERATION? | 4 |
| 8 | WHAT NEXT? | 5 |

In the Final Report of the Financial Services Royal Commission, Commissioner Hayne found the conduct criticised by him was "driven by the pursuit of profit – the entity's revenue and profit, and the individual actor's profit." Remuneration, and particularly variable remuneration, was a focus of the Commission. For individual profit, Commissioner Hayne identified instances where variable remuneration encouraged employees to engage in misconduct, and instances where variable remuneration was provided to employees, including executives, despite their failure to adequately address risks and misconduct.

Commissioner Hayne's recommendations on remuneration largely refer to implementing the recommendations of other reviews, as well as some new ideas. We unpack what they mean below, and address what financial institutions should do next. This may also provide food for thought to other sectors.

1 APRA REMUNERATION GUIDANCE TO BE AMENDED

The Australian Prudential Regulatory Authority (**APRA**) has issued Prudential Practice Guides addressing remuneration structures, directed at all institutions regulated by it (this includes institutions across banking, insurance and superannuation). These guides provide APRA's view on sound practice. APRA is in the process of updating its guidance on remuneration.

1.1 Specific recommendations to improve APRA prudential guidance

Much of the Final Report's discussion on remuneration is directed at improving APRA guidance. Commissioner Hayne recommended APRA guidance:

- have, at one of its aims, the sound management of **not only financial risk, but also misconduct, compliance and other non-financial risks**. He considered the current guidance was narrowly focused on financial risks to institutions, rather than risks of misconduct in its own right;
- require the **board of institutions to regularly assess** the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing risks of misconduct;
- set **limits on use of financial metrics** in connections with long-term variable remuneration;
- encourage APRA-regulated institutions to **improve the quality of information provided to boards** and their committees about risk management performance and remuneration decisions; and
- require institutions to provide for **malus** (forfeiture of deferred remuneration that has not vested) and, in appropriate circumstances, **claw back** remuneration that has vested.

We unpack each of these below.

1.2 Financial Stability Board's approach endorsed

Commissioner Hayne recommended, in revising its prudential standard and guidance about remuneration, APRA should give effect to the principles, standards and guidance set out in the Financial Stability Board's (**FSB**) publications. The FSB is an international body that monitors and makes recommendations about the global financial system, and which published guidance on remuneration structures following the Global Financial Crises and incidents of serious misconduct between 2012 and 2015. Commissioner Hayne was complimentary of the way FSB's guidance was focused on discouraging misconduct, rather than just reducing financial risks for institutions.

We will await how APRA responds to this recommendation, but APRA-regulated institutions may consider implementing the types of systems envisaged by Commissioner Hayne now.

2 APRA'S SUPERVISION OF REMUNERATION TO INCREASE

2.1 Greater scrutiny by APRA

APRA-regulated institutions should expect greater scrutiny of their remuneration structures. Commissioner Hayne recommended that APRA should "increase the intensity of its supervision of the way APRA-regulated institutions implement their remuneration frameworks." He found APRA should do "more to gather information about the way that remuneration systems are being applied in practice, and about whether those systems are actually encouraging sound management of non-financial risks, and reducing the risk of misconduct."

2.2 FSB's approach endorsed

Commissioner Hayne recommended APRA, in supervising the design and implementation of remuneration systems, give effect to the principles, standards and guidance set out in the FSB's publications.

2.3 Recommendations regarding APRA cultural reviews

The recommendation for greater scrutiny on remuneration structures complements other comments by the Commissioner regarding APRA having a role in changing the culture of institutions. After describing a review APRA undertook of a bank's "frameworks and practices in relation to governance culture and accountability", Commissioner Hayne found APRA planned to retreat from this type of work, and such a retreat was "not desirable". Indeed, he endorsed comments by the FSB on ensuring regulators treat culture "as a root cause analysis and intervene when they see demonstrably serious problems as opposed to making culture a generalised supervisory add-on".

3 FRONTLINE STAFF GET PARTICULAR ATTENTION

Commissioner Hayne made the point that inappropriate remuneration systems for non-frontline staff (for example, managers and executives) may have a knock-on effect on frontline staff, indirectly encouraging them to engage in misconduct. Nonetheless, frontline staff and retail staff were still selected for particular attention, recommending that all financial services entities perform annual reviews of "the design and implementation of their remuneration systems for frontline staff to ensure that the design and implementation of those systems focus... not only what staff do, but also how they do it".

3.1 Retail banking

In 2016, the Australian Bankers' Association engaged Stephen Sedgwick AC to conduct an independent review into remuneration practices in retail banking. The Sedgwick Review made 21 recommendations, including that incentives no longer be paid to any retail staff directly or solely on sales performance; and eligibility to receive any personal incentive payments will instead be based on an assessment of that individual's contribution across a range of measures. Commissioner Hayne received evidence that some of the smaller banks had not implemented the Sedgwick Review's recommendations. He recommended that banks fully implement the recommendation of the Sedgwick Review.

4 CLAWBACK MECHANISMS

Commissioner Hayne's recommendation in relation to introducing clawback mechanisms, if implemented, will require changes to current practices of most financial services entities. Commissioner Hayne stated that while the remuneration arrangements examined by the Commission generally allowed for the forfeiture of "part or all of the unvested portion of deferred remuneration, they very rarely provided for remuneration that had vested to be clawed back." He recommended that APRA guidance provide for

APRA-regulated institutions to claw back remuneration that has vested, in appropriate circumstances. Those circumstances could possibly include where it is discovered, after the variable remuneration is vested, that the employee engaged in misconduct.

To be implement such guidance, APRA-regulated institutions will need to implement contractual entitlements to claw back vested variable remuneration in specified circumstances (for example, when misconduct is proved). In drafting such clauses, care should be taken to ensure that mechanisms by which employees may repay variable remuneration (for example, through deductions in pay) comply with Fair Work Act 2009 (Cth).

5 DISCLOSING CONSEQUENCES

Commissioner Hayne made comments on the value of informing employees when executives' variable remuneration is reduced in some circumstances, stating:

"if the board reduces the variable remuneration of executives for their poor management of non-financial risks, and tells other staff that the variable remuneration of those who are accountable for particular events or forms of conduct has been reduced, it sends a clear message to all staff about both accountability and what kinds of conduct the board regards as unacceptable."

If institutions plan to disclose consequences, including reductions in remuneration, they should take care to ensure that they comply with confidentiality and privacy requirements, and consider any other risks arising in the circumstances. It would be prudent for institutions to plan the manner in which disclosures of consequences may be made, in light of its legal duties and risks.

6 REGULAR INTERNAL REVIEWS

At several points, Commissioner Hayne emphasised the importance of regularly reviewing the remuneration of employees, including:

- ▶ recommending APRA Prudential Guidance required boards of APRA-regulated institutions regularly assess the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing risks of misconduct (see above);
- ▶ recommending annual reviews of remuneration systems for frontline staff of all financial institutions (see above); and
- ▶ stating that "banks must continue to give frequent and considered thought to how their variable remuneration systems are structured: to whether they are geared not only to *what* employees do but *how* they do it". [emphasis in original]

Commissioner Hayne's emphasis on constant revision in this area is manifest. Further, we can expect APRA to adopt this emphasis in its Prudential Guides and supervisory activities.

7 DETERIORATION OF VARIABLE REMUNERATION?

While stopping short of prohibiting variable remuneration, Commissioner Hayne cast doubt over its value. He stated:

"The ends that entities are seeking to achieve through variable remuneration can be achieved through other means. Those other means are to be preferred, if they carry fewer intrinsic risks with them."

Commissioner Hayne also referred to a pilot program of one bank that removed individual incentives for bank branch staff, and stated:

"there are evident advantages, and no obvious disadvantages, in moving to this type of model. And there may be advantages, and no disadvantages, in moving to other models, such as models that increase the amounts of fixed remuneration paid to staff and decrease variable remuneration, or that remove variable remuneration altogether. **The point is that this work should continue.**" [emphasis added]

Indeed, he was at pains to emphasise this is not the end of reform in this area, and that regulators and financial institutions should continue to look at ways to address problems that can arise as a result of variable remuneration.

8 WHAT NEXT?

Next steps for financial institutions include:

- ▶ establishing processes for annual reviews of the design and implementation of remuneration systems for frontline staff to ensure that the design and implementation of those systems focus not only what staff do, but also how they do it;
- ▶ for banks, reviewing whether they have fully implemented the recommendation of the Sedgwick Review;
- ▶ for APRA-regulated institutions, assessing how remuneration systems compare against the FSB's publications, because Commissioner Hayne has recommended APRA's standards and guidance should give effect to the principles, standards and guidance set out in these publications. This includes consideration of the practices outlined above;
- ▶ for APRA-regulations institutions, considering whether they have contractual mechanisms to claw back variable remuneration in appropriate circumstances and, if not, how to implement such contractual arrangements;
- ▶ planning the manner in which disclosures of reductions in remuneration may be made, in light of legal duties and risks; and
- ▶ considering what other regular reviews of remuneration systems are appropriate for your particular institution or business, in order to address misconduct and risky behaviour.

Commissioner Hayne's findings in relation to remuneration may hold true beyond the financial services industry. Other sectors should consider how the design and implementation of remuneration systems may encourage misconduct, and ways to amend those systems and improve the culture surrounding them.

GET IN TOUCH

We welcome conversations on Commissioner Hayne's report. If you wish to have your own conversation with us on the report and how it may affect you and your business, please contact us:

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You can also keep up with our rolling coverage at our dedicated Financial Services Royal Commission hub <https://www.claytonutz.com/financial-services-royal-commission/hub>.

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