INFORMATION PAPER

Remuneration practices at large financial institutions

April 2018

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Executive summary

As in many other industries, performance-based remuneration has increasingly become the norm in the financial sector, with monetary incentives and accountability mechanisms used to motivate and influence employees' behaviour. Remuneration frameworks and the outcomes they produce are important barometers and influencers of an organisation's risk culture, providing insights into the extent that risk-taking is likely to be conducted within reasonable bounds. The global financial crisis in 2008 laid bare the potentially disastrous consequences of getting the balance of incentives and accountability wrong, by encouraging practices by individuals that were detrimental to the long-term interests of the financial institutions that employed them. A combination of misaligned incentives and ineffective accountability created poor risk cultures and undermined risk management, leading to unbalanced and ill-considered decision-making.

Though Australia was largely spared the worst impacts of the global financial crisis, APRA nevertheless sought to encourage improved remuneration practices. The foundation for this are the requirements within *Prudential Standard CPS 510 Governance* and *Prudential Standard SPS 510 Governance* (for superannuation licensees), and accompanying prudential practice guides. The core objective of APRA's requirements is that performance-based components of remuneration should encourage behaviour that supports the effective risk management and long-term financial soundness of the institution.

To better determine whether this objective was being met, APRA undertook a review of remuneration policies and practices across a sample of large APRA-regulated entities. The review, which was primarily undertaken in 2017, examined in particular how the stated remuneration frameworks and policies were translating into outcomes for senior executives.

The review found that remuneration frameworks and practices across the sample did not consistently and effectively meet APRA's objective of sufficiently encouraging behaviour that supports risk management frameworks and institutions' long-term financial soundness. Though all institutions had remuneration structures that satisfied the minimum requirements of APRA's prudential standards, the frameworks and practices often fell short of the sound practices set out in the relevant prudential guidance, and were therefore some way from better practice.

The review focused on three main themes:

- design of risk management performance measures;
- remuneration outcomes; and
- Board Remuneration Committee oversight.

Amongst other things, the review found room for improvement in:

- ensuring practices were adopted that were appropriate to the institution's size, complexity and risk profile;

- the extent to which risk outcomes were assessed, and weighted, within performance scorecards;
- enforcement of accountability mechanisms in response to poor risk outcomes; and
- evidence of the rationale for remuneration decisions.

Based on these findings, there is considerable room for improvement in both the design and implementation of executive remuneration structures within the Australian financial system. Just as institutions are expected to operate with a prudent buffer over their minimum financial requirements, APRA does not believe institutions should be satisfied with simply meeting the minimum requirements on remuneration. Well targeted incentive schemes and firmly enforced accountability systems should be viewed not simply as a matter of regulatory compliance, but as essential for sustained commercial success.

APRA's preference is that boards and senior executives consider the findings of this review and take action to better align their remuneration arrangements with good risk management and the long-term soundness of their institutions. Indeed, some institutions have already informed APRA that they have made or are making changes to the remuneration framework to address identified areas for improvement. However, APRA also intends to strengthen its prudential requirements on remuneration to better support this outcome. This will take account of the forthcoming introduction of the Banking Executive Accountability Regime (BEAR) for ADIs, as well as insights from international practice.

Any revisions to the prudential framework will be subject to APRA's usual practices of stakeholder consultation and engagement. Until proposals are made, APRA encourages all regulated institutions to review their remuneration frameworks and address any areas where APRA's findings indicate room for improvement.

Chapter 1 - Introduction

Context for APRA's remuneration review

The global financial crisis highlighted the pivotal role that remuneration practice plays in driving risk management behaviours and outcomes. Importantly, remuneration practices were identified as one of the key contributing factors to unsound risk-taking behaviour in the lead-up to the crisis.

The way in which an organisation implements its remuneration framework provides an insight into its risk culture and has the potential to contribute to, or detract from, the overall effectiveness of its risk management. The manner in which executives and staff are rewarded, and the extent to which risk-taking is explicitly considered in remuneration decisions, plays an important role in shaping the risk culture of an organisation.

The financial crisis raised awareness of this risk and prompted international standard-setters to publish principles and standards via the Financial Stability Board (FSB).[1] These international principles and standards on sound remuneration practices were principally aimed at addressing the lack of alignment of remuneration with risk management in many financial institutions. Through amendments to its prudential standards and guidance (see 'APRA's supervisory approach' below), APRA has adopted these principles in Australia.

APRA's focus on remuneration is aimed at ensuring that remuneration practices, including the governance of remuneration outcomes, support prudent risk management and the long-term financial soundness of APRA-regulated institutions. In other words, the prudential framework seeks to ensure that remuneration practices are supportive of a strong risk culture.

A number of recent reviews conducted by other financial regulators and industry bodies have also focused on remuneration, largely from the perspective of limiting the potential for misconduct.[2] The link between remuneration and misconduct is also of interest to APRA as a prudential supervisor because conduct issues can provide additional insights into an organisation's attitudes towards risk more generally. While these reviews had different objectives, there is a common theme of ensuring that incentive arrangements do not result in adverse outcomes for relevant stakeholders over both the short and long term.

Since the initial FSB principles were developed, FSB member jurisdictions, including Australia, have continued to review the following areas with a view to further strengthening the links between remuneration design and risk alignment, including:

[1] See the following FSB publications:
Principles for Sound Compensation Practices (April 2009)
Implementations Standards for the FSB Principles for Sound Compensation Practices (September 2009)
Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices (March 2018)

[2] See for example:
ASIC Review of mortgage broker remuneration (March 2017)
Retail Banking Remuneration Review - Sedgwick Report (April 2017)

- remuneration governance, focusing on robust controls and regular reviews of outcomes against intent;
- risk alignment, with a focus on ensuring risk and remuneration outcomes are symmetric and cover the full range and time horizon of risks which need to be addressed; and
- external stakeholder engagement, focusing on transparency and clarity in linking remuneration to stakeholder outcomes.

APRA will continue to contribute to this work internationally, and will also draw on information shared by other jurisdictions to ensure its prudential framework aligns with best international practice.

Domestically, APRA has continued to develop its understanding of risk culture within APRA-regulated institutions. This work supports the obligations imposed on the boards of regulated institutions by APRA's cross-industry risk management standard, CPS 220, and included, in 2016, publishing a stocktake of industry practices in relation to understanding risk culture within individual institutions. APRA subsequently committed to undertake a stocktake of current industry remuneration practices. This report sets out the key findings and observations from that work.

More recently, the Banking Executive Accountability Regime (BEAR) passed by the Parliament introduces a heightened focus on remuneration for senior executives and directors ('accountable persons') within authorised deposit-taking institutions (ADIs).[3] In particular, BEAR requires the mandatory deferral of a proportion of variable remuneration for at least four years, and changes to remuneration policies to require reduction of variable remuneration for accountable persons who do not meet their accountability obligations. APRA is currently working with the four major Australian banks to meet their obligations under BEAR, which the Government has announced will come into effect on 1 July 2018. Other ADIs will be subject to BEAR from 1 July 2019.

APRA's supervisory approach

APRA's mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by regulated institutions are met within a stable, efficient and competitive financial system. To fulfil this mission, APRA has developed a comprehensive framework of prudential standards and prudential practice guides (PPGs) for all regulated institutions to promote sound financial and risk management, and good governance. Notwithstanding these standards and guides, APRA's supervisory approach recognises that the management and boards of supervised institutions are primarily responsible for the sound operation of their businesses.

APRA's prudential standards set out minimum capital, risk management and governance requirements, which are legally binding. PPGs provide guidance on how regulated institutions might best satisfy the prudential standards, and on APRA's view of sound practice in particular areas. Where possible, APRA takes a principles-based approach and recognises that the practices identified will not necessarily be directly relevant for every regulated institution, and that there may be alternative practices that achieve the desired prudential

3 Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018

outcomes. The relevance of the guidance in PPGs to institutions will vary depending upon the size, complexity and risk profile of the institution.

The remuneration requirements contained in *Prudential Standard CPS 510 Governance*[4] were introduced in 2010 for ADIs, general insurers and life insurers. Requirements for RSE Licensees (superannuation) were introduced in *Prudential Standard SPS 510 Governance*[5] in 2012. These prudential standards are supported by PPGs, *Prudential Practice Guide PPG 511 Remuneration*[6] and *SPG 511 Remuneration.*[7] The fundamental principle underlying the remuneration requirements is that performance-based components of remuneration must be designed to encourage behaviour that supports:

- the regulated institution's long-term financial soundness; and
- the risk management framework of the institution.

Remuneration frameworks, and the outcomes they produce, are important barometers and influencers of risk culture. A sound risk culture is integral to ensuring that risk-taking in financial institutions is conducted within reasonable bounds and that risks are clearly identified and well managed. As noted in its 2016 *Information Paper on Risk Culture*[8], APRA's core objective is for a regulated institution to establish and maintain a sound risk culture that is aligned with its organisational objectives, values and risk appetite. This serves to reduce the potential for undesirable behaviours to jeopardise an institution's financial well-being. Well-designed and implemented remuneration frameworks can positively influence risk culture, and provide incentives to act responsibly, with integrity, and in a manner consistent with the risk management framework.[9] As part of its broader work plan on risk culture, APRA will continue to assess how remuneration practices are interacting with the risk cultures of regulated institutions.

APRA's review of remuneration practices

APRA's review of current industry remuneration practices set out to gauge how its requirements and guidance are understood and implemented by regulated institutions. In June 2017, APRA requested detailed information on remuneration practices from a sample of 12 regulated institutions to support its analysis. The sample included the largest institutions across the ADI, life insurance, general insurance and superannuation industries, which collectively account for a material proportion of the total assets of the Australian financial system.

The primary focus of the review was to gauge whether regulated institutions were meeting APRA's expectations established in the current prudential framework and to assist APRA's

4 APRA 2016, *Prudential Standard CPS 510 Governance*

5 APRA 2016, *Prudential Standard SPS 510 Governance*

6 APRA 2009, *Prudential Practice Guide PPG 511 Remuneration*

7 APRA 2013, *Prudential Practice Guide SPG 511 Remuneration*

8 APRA 2016, *Information Paper – Risk Culture*

9 Paragraph 26, APRA 2015, *Prudential Practice Guide CPG 220 Risk Management*

consideration of whether changes to the framework are required to better achieve prudential objectives.

The data request was extensive, with APRA requesting that institutions submit all Board Remuneration Committee (BRC) papers and minutes, individual employment contracts, performance scorecards, annual performance assessments, remuneration outcomes for senior executives, risk and control staff, and material risk-takers (MRTs) for the three most recent performance years (generally up to the 2016 financial year). The review analysed the remuneration process and outcomes of approximately 280 senior roles (800 data points) across the sample over the three year period. The data requested covered the following areas in the context of the current standards and guidance given by APRA:

Information Type	Objective
Remuneration Policy	To assess whether the remuneration policy adequately captured the requirements of the prudential standards and accompanying prudential practice guides
Performance Pay Design	To assess the effectiveness of performance pay design in incentivising prudent risk-taking and supporting long-term financial soundness of the institution
Individual Remuneration Outcomes	To assess whether individual remuneration outcomes in the roles sampled adequately reflected achievement of performance measures
Annual Bonus Pool Determinants	To assess whether the methodology and process to determine the annual bonus pool supports the long term financial soundness and risk management framework of the institution
Valuation Methodologies (used when allocating equity components of remuneration)	To assess the use of the equity valuation methodologies in relation to variable remuneration and how they encourage behaviour that supports long term financial soundness and the risk management framework of the institution
Material Risk Takers (MRT's) (i.e. persons or groups whose significant portion of remuneration is performance based and who may materially affect financial soundness of the institution)	To assess the effectiveness of how MRT's or groups are identified, captured, and overseen by the BRC
Consequence Management	To assess the extent of remuneration consequences for underperformance against objectives and behavioural expectations

The review work was undertaken between July and December 2017. As the review progressed, APRA liaised with the institutions in the sample to clarify specific aspects of the information provided. Early in 2018, feedback sessions were held bilaterally with the institutions assessed to present the observations from the review and to provide insights into the assessment of each individual institution relative to others in the sample. In many cases the institutions indicated that work was already underway or that they planned to strengthen remuneration practices in the areas where weaknesses had been identified.

Chapter 2 – Remuneration structures and general practices observed

While the basic building blocks of remuneration are relatively simple, the way in which they are brought together to form a remuneration package can be complex.

Remuneration structures

Remuneration for senior executives usually contains both a fixed and variable component and is typically delivered in the form of cash, benefits, equity or other capital instruments (such as, options or performance rights). The inclusion of a variable remuneration component within remuneration plans is intended to facilitate the alignment of the organisation's interests with the performance and behaviours of its employees. It also potentially allows the entity to attract, motivate and retain key employees by providing competitive remuneration packages. Incentives may be short-term in nature, typically assessed based on performance and outcomes over 12 months or less, or longer term where the outcomes are assessed over a number of years.

Remuneration structures for senior executives typically consist of the following components:

- fixed remuneration (FR) – including salary and superannuation
- short term incentives (STIs) – including annual bonuses and commissions
- long term incentives (LTIs) – including equity in the form of performance rights, share options and shares
- benefits and other allowances – including those subject to fringe benefits tax

Although practices may vary, STIs are generally delivered in a combination of cash and equity and LTIs in equity.

The manner in which these elements are brought together to form a remuneration package can vary based on a wide range of factors relating to each institution's context and circumstances. This might include:

- the business environment – encompassing the institution's size, context, cultural values, and industry trends and norms;
- market and public expectations including financial or strategic expectations and corporate social responsibility;
- regulatory, legal and governance environment; and
- executive leadership attributes encompassing role complexity, available talent, motivation and leadership culture.

The structure of incentives within a remuneration package is designed to drive and influence employee behaviours and outcomes. Given that adverse risk and performance outcomes may take years to surface, it is appropriate that remuneration structures take this longer term horizon into account. This is achieved in practice by deferring the payment or award of a proportion of an employee's variable remuneration (both STI and LTI) until a defined date in the future. The period over which the remuneration is deferred is referred to as the 'vesting period'. Where the deferred component of remuneration is in a form other than cash, such as share options, the value of the award may also change over the vesting period in line with changes in the market price of the shares.

In any one year the amount that an employee will receive in remuneration will consist of fixed remuneration, benefits, allowances and any prior period variable incentive that has vested. As such, when deferred remuneration is taken into account, the amount awarded may not necessarily equal the amount received in any one year.

The table below provides a summary, at a senior executive level, of the incentive award terms available across banking and insurance institutions in the sample.[10] The practices observed within RSE licensees in the sample are described later in this chapter.

Feature	Average	Range
Total incentive award[11] (STIs and LTIs) as a % of total remuneration for CEOs	70%	64%-75%
Total incentive award as a % of total remuneration for CROs	65%	58%-67%
STI target[12] award as a % of FR for CEOs	108%	100%-133%
STI maximum deferral period (years)	2	1-4
% of STI awards deferred	43%	25%-50%
LTI target award as a % of FR for CEOs	117%	65% -150%
LTI performance period (years) for vesting	3.3	3-4

10 The table below covers those institutions in the sample who have conventional STI and LTI plans. The deferral and performance periods outlined relate to the plan terms applicable to senior executives.

11 The award is the potential annual incentive opportunity set for STIs and LTIs, which is then assessed and tested against the criteria and timeframes set to deliver on STI/LTI objectives.

12 Incentives are expressed in relation to a target level of performance, which are intended to correspond to appropriately challenging but achievable outcomes. If the target level is reached the employee is awarded 100 per cent of the expressed target. If outcomes and behaviours exceed the expressed target level of performance then an amount exceeding the target level may be awarded. Equally if performance is assessed as above a threshold but below the target level a proportion less than 100 per cent of the expressed incentive may be awarded.

Factors impacting the variability of STI and LTI awards

Incentive payments should be variable in nature, and adjusted to reflect the extent to which the desired outcomes or behaviours have been met. Whether or to what extent the outcomes have been achieved should be assessed based on a pre-determined set of criteria, measures, and metrics, typically subject to further adjustment at the discretion of the BRC/Board.

Factors which can impact the variability of STI and LTI outcomes are:

- For STI, a 'balanced scorecard' approach is often used, where the incentive awarded is based on a number of differently-weighted criteria. These could include for example financial, strategic, risk-based, staff or customer-focused objectives. Measures may incorporate both quantitative (the 'what') and qualitative (the 'how') criteria. An 'all or nothing' gateway approach may also be used, where a satisfactory risk management score is a prerequisite to an individual receiving an STI payment. Part of the STI award is typically deferred to ensure that the results on which the STI award is made are validated over an appropriate time frame. STI deferrals may also be used as part of an institution's employee retention strategy.

- For LTI, a range of performance criteria may also be used including performance measures such as shareholder returns, financial returns, or other strategic measures. LTIs are typically delivered in the form of performance rights which vest when specified performance outcomes have been achieved. An emerging trend, noted in the sample, is the replacement of separate STI and LTI structures that have different metrics and assessment periods, with one single structure where the award is assessed over a one-year period but vests over a number of years.

The size of the bonus pool also influences the variability of the STI and LTI awards and one of two designs is typically observed:

- top-down – where the amount of the bonus pool is set based on organisational or divisional criteria which then cascades down to eligible STI participants; and

- bottom-up – in which the sum of individual target incentive opportunities is adjusted by a measure representing the overall organisational outcome.

The majority of the institutions in the sample adopted a top-down approach taking into account individual target payout rates (expressed as a percentage of fixed remuneration).

There are also a number of structural elements that affect the variability of STI and LTI award outcomes:

- the performance ranges and payout levels built into the plan design – typically a threshold, target and maximum performance range – are set, with a specified payout at each level. Typically a minimum payment is applied if the minimum performance threshold is met. The amount paid out above the minimum is increased if the target is met and is increased again if the maximum performance range is achieved;

- the form of the award – equity-based instruments are also subject to share price fluctuations over the holding period and may have access to dividends or dividend equivalents as part of the incentive arrangements;
- the valuation methodology adopted for deferred equity portions of variable remuneration – for example, using face value or fair value accounting treatments can result in significantly different vesting outcomes; and
- consideration of other remuneration objectives including retention.

Basis of adjustments to performance based/variable remuneration

Where incentive payments have previously been awarded, but are subsequently deemed to be inappropriate given outcomes or behaviours, the remuneration policies should allow for the adjustment downwards of those performance-based components. The mechanisms available for downward adjustments, are:

- in-year adjustments – where bonuses are reduced (or not awarded) for the performance year due to an adverse outcome or underperformance during the year;
- malus – where deferred bonuses awarded from previous performance years are prevented from vesting as a result of an adverse outcome; and
- clawback – where vested remuneration is required to be repaid by the employee because of an adverse outcome that has since become known.

APRA's review found that in-year adjustments are the most common form of adjustment to variable incentives, followed by malus. These two approaches tended to be favoured over the application of clawback, in part because they are applied before the award vests. In some jurisdictions, the application of clawback has given rise to legal impediments or enforcement issues which has also impacted the frequency with which it is considered. Internationally, the FSB has noted, in recently published supplementary guidance to their Principles and Standards, that institutions should have access to the full range of tools available (including clawback) to address long tail risks such as misconduct.[13]

Variation of practice for RSE Licensees (superannuation)

While this information paper sets out the overall findings across the industries in the sample, there were some noticeable differences for RSE Licensees (although there was only a small number of RSE Licensees in the sample, so some caution is needed in drawing definitive conclusions).

As a general observation, the remuneration structures within RSE Licensees in the sample were simpler in structure. STIs were in the form of cash rather than shares, with a

[13] Page 11, *Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices* (March 2018)

maximum deferral period of two years. No RSE Licensee in the sample incorporated an LTI component into its remuneration structure.

Where STI arrangements were in place for RSE Licensees, the ratio of performance-based remuneration to fixed remuneration (for senior executives other than the Chief Investment Officer (CIO)) was significantly lower - at 10 per cent to 30 per cent - than seen at institutions from the other industries in the sample. However, staff working within investment teams, including CIOs, tended to have remuneration structures that included larger proportions of performance-based remuneration.

Finally the application of malus at superannuation entities was observed to be less prevalent than in the other industries. Similarly, buy-outs, sign-on payments and guaranteed bonuses in the superannuation industry were also less frequently observed.

Chapter 3 – Key findings

In assessing the remuneration practices of the institutions in the sample, APRA's focus was on gauging how well the existing requirements and expectations set out in its prudential standards and guidance were being implemented. The findings of the review have been set out below under a number of key themes:

- Design of risk management performance measures
- Remuneration outcomes
    - Assessment process
    - Adjustments to variable pay
    - Sign-on payments and guaranteed bonuses
    - Identification and treatment of MRTs
- Board Remuneration Committee (BRC) oversight

In presenting the findings, each theme is prefaced by excerpts from the prudential framework that formed the basis of the assessment.

Overall, the review found that remuneration frameworks and practices across the sample did not consistently and effectively meet APRA's objective of sufficiently encouraging behaviour that supports risk management frameworks and institutions' long-term financial soundness. Though all institutions had remuneration structures that satisfied the minimum requirements of APRA's prudential standards, the frameworks and practices often fell short of the sound practices set out in the relevant prudential guidance, and were therefore some way from better practice.

Design of risk management performance measures

Prudential standard or guidance	Paragraph	Excerpt
CPS 510	54	The Remuneration Policy's performance-based components of remuneration must be designed to encourage behaviour that supports: (a) the institution's long-term financial soundness; and (b) the risk management framework of the institution.
SPS 510	27	In addition to any other objectives, the Remuneration Policy's performance-based components of remuneration must be designed to encourage behaviour that supports: (a) protecting the interests, and meeting the reasonable expectations, of beneficiaries;

Prudential standard or guidance	Paragraph	Excerpt
		(b) the long-term financial soundness of the RSE licensee, any of its RSEs or connected entities; and (c) the risk management framework of the RSE licensee.
PPG 511	46	Sound remuneration practice will adjust for risk when setting performance targets and measuring actual performance against targets for remuneration purposes.
PPG 511 **SPG 511**	53 40	...It is important for an institution/RSE licensee to recognise and adjust remuneration for non-financial measures, such as compliance with risk management and internal audit frameworks, management of staff, adherence to corporate values and displaying acceptable corporate citizenship.
PPG 511	39	...that risk and financial control personnel be remunerated in a manner that does not compromise their independence in carrying out their risk or financial control functions.

APRA's review considered the extent to which remuneration frameworks have been designed to encourage behaviour that supports long-term financial soundness and effective risk management.

Findings

All of the institutions reviewed had established risk management-related performance measures. Two main methods were observed for STI assessments:

(i) a 'balanced scorecard' approach where the incentive awarded is based on a number of differently weighted criteria; and

(ii) a 'gateway' approach where a satisfactory risk management score is a prerequisite to an individual receiving a STI payment (3 out of the 12 institutions sampled utilised gateways).

However, there was a wide range of practices observed in the implementation of these measures.

Scorecard design could be more effective – the review identified institution scorecards with a large number of core drivers (up to 20 metrics in some cases). A high number of measures can reduce the impact of any one metric, which is of particular concern if risk management is one of the metrics with diminished impact.

Within the sample, institutions applied over eight metrics (on average) in calculating STI outcomes with an overall range of between 2 to 20 measures. For the majority of the sample, risk management was given an average weighting of 14 per cent of the total performance scorecard, with an overall range between 5 and 25 per cent. As a result of the low weighting, the review did identify instances of individuals with very poor risk management scores still receiving over 90 per cent of their STI target. This clearly indicates misalignment between effective risk management and remuneration outcomes.

An example of better practice in the sample was the application of a performance framework with measures across four areas of performance: risk; financials; customer focus; and people and reputation. These measures were explicitly tied to annual priorities and long-term strategies. The assessment in the risk category was used to apply a modifier across the other measures, ensuring incentives were adjusted to reflect risk management outcomes.

Individual performance measures and variability of outcomes minimised – for the majority of entities in the sample (7 out of the 12), the weighting of assessment metrics was more closely tied to the overall financial performance of the institution rather than to individual performance. This resulted in a 'herding' effect for executives where, for a given institution, STI outcomes rarely differed significantly between senior executives. Allowing poor risk outcomes in a particular business line to be 'averaged out' across the business as a whole reduces the impact on the executive(s) most accountable and potentially undermines effective risk management.

Excess focus on return measures – *PPG 511 Remuneration* paragraph 71 states:

An astute Board will recognise that:

- *profits are most usefully measured relative to a reference return on the amount of capital supporting the product, portfolio or business; and*
- *the amount of capital should reflect the risk associated with the product, portfolio or business.*

Unfortunately, the review observed that for the majority of cases, the conditions which allow LTIs to vest focussed wholly on annual investor return measures such as total shareholder return (TSR) and return on equity (RoE). No apparent links to measures of long-term financial soundness or risk adjusted performance measures (such as metrics relating to risk-adjusted return on capital) were observed.

Limited differentiation of Chief Risk Officer (CRO) adjustment metrics – For half the sample, the financial performance metrics by which CROs were assessed were the same as those of the wider executive team. In APRA's view, this is not consistent with the CRO's responsibility to provide effective challenge to the activities and decisions of the institution and potentially inhibits the ability of the CRO to act independently. Better practice observed was for financial objectives to have a materially lower weighting within CRO scorecards than for other executives.

Remuneration outcomes

Assessment process

Prudential standard or guidance	Paragraph	Excerpt
CPS 510 **SPS 510**	55 28	Performance-based components of an APRA-regulated institution's remuneration arrangements must be designed to align remuneration with prudent risk-taking and must incorporate adjustments to reflect: (a) the outcomes of business activities / RSE licensee's business operations; (b) the risks related to the business activities / the RSE licensee's business operations) taking account, where relevant, of the cost of the associated capital; and (c) the time necessary for the outcomes of those business activities / operations to be reliably measured.
PPG 511 Attachment 2	6	For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm: • a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance; • a substantial portion of variable compensation, such as 40 to 60 per cent, should be payable under deferral arrangements over a period of years; and • these proportions should increase significantly along with the level of seniority and/or responsibility. For the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, for instance above 60 percent.
PPG 511 Attachment 2	7	The deferral period described above should not be less than three years, provided that the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis.

To assess the correlation between remuneration outcomes and performance, APRA requested entities in the sample to provide detailed information from executives' remuneration and performance assessments against scorecard measures for the last three years.

Findings

The data submitted highlighted that processes to determine individual remuneration outcomes varied greatly depending on the structure, governance framework and intended remuneration drivers of the institution.

Objectivity of assessments – in most cases a subjective rather than an objective, evidenced-based approach was observed in the assessment of performance against risk management measures. For example, in several cases the 'risk assessment' that determines an individual executive's risk rating simply comprised of a high level statement from the CRO to the BRC indicating that no significant risk issues affecting performance measures had been noted (for executives as a collective).

Instances of better practice included where the risk management function was formally engaged to provide input into the assessment of the risk measures within each individual executive's scorecard. However, there was no evidence within the sample period of any institution compiling a comprehensive assessment of risk management effectiveness in the executive's area of responsibility (although several entities within the sample are currently taking steps to address this).

Deferral periods for variable remuneration relatively short – deferral periods for variable remuneration were typically[14] between one and two years for STI (where typically 25 per cent to 50 per cent of total STI is deferred) and three years for LTI (with one institution in the sample recently increasing the deferral period applicable from three to four years). In APRA's view, the principle of aligning variable remuneration with long-term financial soundness suggests that longer periods of deferral should be considered to reflect the institution's risk profile and the time horizon of risks.

The appropriateness of deferral periods of variable remuneration for ADIs will also now need to be considered in line with the requirements of the BEAR, which mandates that a certain portion of variable remuneration must be deferred for at least four years. It will be important that the minimum deferral period in BEAR does not automatically become the default arrangement, and that institutions consider more broadly how to optimise their deferral periods to better align remuneration and risk-based performance outcomes over the business and investment cycles rather than performance reporting cycles.

Documentation shortcomings – the review observed a range of practices in relation to documentation. In some cases, there was clear documentation of performance scorecard assessments against each scorecard metric; a clear and demonstrable flow of scorecard scores through to remuneration calculations and outcomes; and documented performance assessments to support the remuneration decisions made. However, in a number of cases, performance assessments against individual scorecards for executives were not documented, or only partially completed. This resulted in a lack of clarity and auditability about the rationale and transparency of the remuneration decisions.

[14] For those institutions with conventional STI and LTI plans.

Adjustments to variable pay

Prudential standard or guidance	Paragraph	Excerpt
CPS 510 SPS 510	56 29	The Remuneration Policy must provide for the Board, the senior officer outside Australia or the Compliance Committee, as relevant, to adjust performance-based components of remuneration downwards, to zero if appropriate, in relation to relevant persons or classes of persons, if such adjustments are necessary to: (a) protect the financial soundness of the APRA-regulated institution/RSE licensee…; or (b) respond to significant unexpected or unintended consequences that were not foreseen by the Board Remuneration Committee (CPS510: the senior officer outside Australia or the Compliance Committee, as relevant).
PPG 511 Attachment 2	5	Subdued or negative financial performance of the entity should generally lead to a considerable contraction of the entity's total variable remuneration, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus and clawback arrangements.
PPG 511 SPG 511	51 34	A prudent policy will require will require that performance-based remuneration is low, perhaps zero, where the individual has been found to have exposed the institution to risk beyond its risk appetite or control.
PPG 511 SPG 511	12 12	The Board Remuneration Committee is also required under the governance standards to make annual decisions on the remuneration of all of the categories of persons required to be covered by the Remuneration Policy (other than those persons for whom individual recommendations are required). This will usually require, inter alia, the Board Remuneration Committee …, to make decisions on the annual distribution of an institution's/RSE Licensee's bonus pool.

Findings

APRA found that all entities in the sample had made provision for the application of in-year adjustments and the majority for malus either in remuneration policy or by the application of board discretion. Entities were also asked to provide information on downward adjustments to variable pay for issues of underperformance or misconduct over the last three years.

Absence of significant downward adjustments at executive level – the review observed that downward adjustments to individual executives' remuneration were rare. While there were multiple examples where employees at lower levels received downward adjustments (either in the form of in-year adjustments or malus), these were not always matched by corresponding adjustments at an executive level to recognise overall line or functional accountability. Limiting responsibility for poor risk outcomes to below the executive level suggests an inappropriate assignment of accountability.

Some institutions in the sample used 'risk gates', which provide for an executive to be ineligible for the variable component of their remuneration in the instance of a significant risk incident or a material breach of the institutions risk management framework. While these risk gates provide a clear penalty for serious failures of risk management, they are rarely used. They also do not replace the need for more refined measures of risk-adjustment to the overall performance assessment.

Preference for using in-year adjustments over the use of malus or clawback – while rare, the review observed several instances of in-year adjustments at the executive level due to underperformance or a specific adverse outcome over the performance period. There were also a few examples across the sample of malus being applied for poor behaviour. However, there was limited evidence in the documentation provided that consideration had been given to risk events or issues from prior years which might reasonably give rise to the application of malus.

The review did observe that a small proportion of the sample had made provision for clawback, although in some cases these provisions were only applicable to employees in regulatory jurisdictions which specifically mandate clawback provisions. Except in one case, there was no evidence observed that consideration had been given to events or issues which might reasonably give rise to consideration of the application of clawback. Although clawback is often considered to be difficult to execute, both from a legal and operational perspective, an institution will be better positioned to enforce clawback by having the appropriate provisions within remuneration policies, incentive plan terms, and individual employment contracts.

Risk adjustments to the bonus pool – the majority of institutions stated in relevant policies that current and potential risks are considered when determining bonus pools amounts. However, the review found that bonus pool amounts are still largely based on short-term performance measures, with little evidence of explicit consideration of longer-term risk measures. Furthermore, the majority of the sample had not developed mechanisms or processes for the adjustment of the bonus pool to respond to significant risk events. Three institutions in the sample did, however, explicitly consider and utilise a risk-adjusted overlay to the bonus pool (with the weighting independently determined by the risk committee) in response to unexpected or unintended risk outcomes.

Sign-on payments and guaranteed bonuses

Prudential standard or guidance	Paragraph	Excerpt
PPG 511 **SPG 511**	83 48	Guaranteed or upfront cash payments beyond normal remuneration for incoming executives or other staff ('golden handshakes') are generally inconsistent with prudent remuneration practice as they generally do not align with the principles of risk adjustment and deferral until performance is validated. Also, such payments restrict the ability of a regulated institution / RSE licensee to reduce at risk remuneration upon material adverse outcomes eventuating. APRA expects any remuneration paid to incoming staff as compensation for deferred remuneration forfeited at a previous employer to be subject to performance validation or risk adjustment and deferral.
PPG 511 Attachment 2	11	Guaranteed bonuses are not consistent with sound risk management or the pay-for-performance principle and should not be part of prospective compensation plans. Exceptional minimum bonuses should only occur in the context of hiring new staff and be limited to the first year.

APRA's review addressed the practice of employers compensating new executives for variable incentives foregone from a previous employer, having regard to the guidance given by APRA on sign-on payments. The review also addressed the application of guaranteed bonuses having regard to the guidance given.

Findings

Sign-on and guaranteed bonuses – the review found evidence of sign-on payments made to employees as an incentive that were not related to variable remuneration arrangements with their former employer, and therefore not aligned with the principles of risk adjustment and validation of outcomes. Furthermore, there was also evidence of guaranteed bonus payments being made and extending beyond one year. As outlined in APRA guidance, this practice is not consistent with sound risk management or the principle of pay for performance.

Identification and treatment of Material Risk-Takers

Prudential standard or guidance	Paragraph	Excerpt
CPS 510 **SPS 510**	57 30	The Remuneration Policy must set out who is covered by the Policy. The Remuneration Policy must cover, as a minimum: …….. (c) All other persons for whom a significant portion of total remuneration is based on performance and whose activities, individually or collectively, may affect the financial soundness of the institution. (SPS 510: may affect the interests of beneficiaries, the financial position of the RSE licensee, any of its RSEs or connected entities, or any other relevant prudential matter).
PPG 511 **SPG 511**	27(c) 24(c)	The third group are those persons who receive a significant proportion of performance-based remuneration such as through bonuses or commissions. These persons may not individually pose a risk to the institution / to the RSE licensee and / or its business operations) but may collectively affect the soundness of the institution (SPG 511: but may collectively do so, or affect the ability of the RSE licensee to meet the reasonable expectations of beneficiaries). Therefore, remuneration arrangements for this class are important. APRA envisages that such persons would typically include, but not be limited to, financial market traders, other transaction oriented staff, commissioned sales personnel, (SPG 511: financial planners) and intermediaries such as agents and brokers. *Also see CPS 510 (paragraph 68, (b) and (c))/SPS 510 (paragraph 42(b) and (c)) under Board Remuneration Committee Oversight below.*

The concept of the 'material risk-taker' refers to an individual or category of individuals for whom a significant portion of total remuneration is based on performance and whose activities, individually or collectively, may affect the financial soundness of the institution or group. APRA gave specific consideration in its review to the approaches in remuneration frameworks to MRTs.

Findings

Inconsistent approaches to identifying MRTs – a variety of approaches to identifying MRTs was observed even amongst entities with similar profiles (size and characteristics). For example, different definitions have been applied to 'significant portion of total remuneration based on performance' including metrics related to the dollar value of variable remuneration and percentages of variable remuneration or of fixed pay. In some cases individuals with very significant remuneration packages were not considered MRTs and there was no analysis provided as to whether their roles could affect the financial soundness of the institution. Given the differences in definitions, the review also found a significant difference in the number of MRTs being identified across the entities (between 6 and 70). This suggests that the MRT identification practice needs to be reviewed for all entities. APRA considered that most institutions in the sample underestimated the extent of MRTs within their organisations that needed to be covered by the remuneration policy.

MRTs not identified collectively – while the remuneration policies of entities tend to include the language used in the prudential standards of 'individually or collectively' to identify individuals that may affect the financial soundness of the institution, the majority of entities did not identify any MRTs based on identification of a group that may collectively affect financial soundness, e.g. financial market traders, or intermediaries such as agents and brokers.

Board Remuneration Committee oversight

Prudential standard or guidance	Paragraph	Excerpt
CPS 510 **SPS 510**	68 42	The responsibilities of the Board Remuneration Committee must include: (a) conducting regular reviews of, and making recommendations to the Board on, the Remuneration Policy. This must include an assessment of the Remuneration Policy's effectiveness and compliance with the requirements of this Prudential Standard; (b) making annual recommendations to the Board on the remuneration of the CEO, direct reports of the CEO, other persons whose activities may, in the Board Remuneration Committee's opinion, affect the financial soundness of the APRA-regulated institution / RSE licensee's business operations or group and any other person specified by APRA; and (c) making annual recommendations to the Board on the remuneration of the categories of persons covered by the Remuneration Policy (other than those persons for whom such recommendations are already required under paragraph 68(b) (CPS 510) and (42(b) (SPS – 510)).
PPG 511 **SPG 511**	16 16	Effective coordination between the Board Risk Committee and the Board Remuneration Committee (or equivalent group that performs this role) will assist in producing a properly integrated approach to remuneration.
PPG 511	50	… Where the institution makes adjustments to the statutory accounts … and these adjustments affect remuneration

Prudential standard or guidance	Paragraph	Excerpt
		arrangements the adjustments would be expected to be properly documented and substantiated.

Findings

All of the entities in the sample were observed to have appropriately structured BRCs with charters and terms of reference. However the review did find evidence of inconsistencies in the level of oversight by BRCs of remuneration outcomes.

Inadequate documentation – APRA's review noted instances of poor quality, incomplete or inadequate documentation provided to the BRC. For example, in several cases, formal documented performance assessments of individual senior executives against balanced scorecard metrics were not provided to the BRC. The review also noted several examples where BRCs did not take the opportunity to seek additional information from other committees, such as the risk or audit committee, to support its assessments – often relying solely on cross-membership between committees as a means to provide adequate input. Inadequate documentation and a lack of collaboration undermines the BRC's ability to perform its role in reviewing and independently assessing the remuneration outcomes of individuals. Better practice observed made use of joint meetings between the BRC and the risk committee, primarily to focus on the appropriateness of risk ratings and remuneration outcomes of senior executives, risk and financial control personnel and MRTs.

BRC willing to act in the absence of adequate documentation – a compounding issue was the apparent lack of BRC challenge to receiving inadequate documentation. The review also noted in almost half the sample, the BRC assessed and approved remuneration outcomes of senior executives largely based on a verbal discussion and generalised attestations (applying to all the executives) from the CEO (for balanced scorecard metrics) or the CRO (for risk-specific metrics). A lack of adequate documentation results in limited transparency of decision-making and impacts the ability to review decisions, potentially limiting effective governance over the decisions and the oversight required by the prudential framework.

Better practice observed was where the BRC actively challenged remuneration recommendations based on an assessment of risk management considerations, with the committee closely analysing the metrics on which remuneration recommendations were made for better assurance they were prudentially appropriate.

BRC oversight of adjustments to financial measures used as the basis for variable remuneration – as performance-related remuneration metrics are often linked to cash earnings, any adjustments made to statutory profit to calculate cash earnings may directly affect remuneration outcomes. There was limited evidence of BRCs expressly reviewing adjustments to statutory profit which could directly affect whether targets and hurdles for variable remuneration are met.

Remuneration policy reviews – all of the entities in the sample performed periodic reviews of the remuneration policy to assure its ongoing compliance with the minimum prudential requirements. However, all but one of these reviews were observed to be a routine process rather than a substantive review of whether the remuneration policy was working as intended.

One institution in the sample, however, recently adopted better practice by seeking an independent review of its remuneration policy and framework. As a result, it made changes to its remuneration structure to improve effectiveness of the operation of the remuneration policy by incentivising appropriate behaviours and outcomes.

Chapter 4 - Conclusions and next steps

When APRA first consulted on its prudential requirements on remuneration for ADIs, general and life insurers in 2009, the related discussion paper[15] noted:

> *APRA's principles-based approach …. will be aimed at ensuring compliance with both the intent and the substance of these requirements.*

APRA's review found that overall, remuneration frameworks and practices across the sample did not consistently and effectively meet APRA's objective of sufficiently encouraging behaviour that supports risk management frameworks and institutions' long-term financial soundness. Though all institutions had remuneration structures that satisfied the minimum requirements of APRA's prudential standards, the frameworks and practices often did not meet fully meet sound practices set out in the relevant prudential guidance, and were therefore some way from better practice.

Remuneration governance requirements should not be implemented with the primary focus on ensuring a minimum level of compliance with the prudential standards. Instead, a more thoughtful and considered approach should be taken to ensure that the spirit as well as the letter of APRA's requirements are embedded into risk management and remuneration frameworks. Remuneration practices should align to the culture, values, risk profile, risk appetite and risk management framework of an institution, as well as its financial objectives.

The effective implementation and embedding of an institution's remuneration framework is as important as its design and structure. It is expected that these findings will be relevant to all regulated institutions, not just those sampled, and APRA's approach to addressing the findings will take this into consideration when taking next steps.

The requirement for ADIs to defer a proportion of an accountable person's variable remuneration for a minimum of four years introduced under the BEAR legislation is consistent with the review finding that the average time horizon of risk being incorporated into senior executives' remuneration arrangements is currently too short to effectively reflect each institution's risk profile. Implementation of the BEAR requirements will require ADIs to change their practices, and APRA sees this as an opportunity for practices to be reviewed more holistically not just to comply with new minimum statutory requirements but to ensure a much stronger alignment between risk and performance outcomes for the long-term benefit of institutions and their stakeholders.

Next steps

In the next phase of its work, APRA intends to review the prudential framework to support a more robust and credible implementation of the objectives of the prudential requirements and guidance on remuneration supported by ongoing supervision. APRA will also consider the expansion and strengthening of prudential requirements to reflect evolving international

[15] *Remuneration: Proposed extensions to governance requirements for APRA-regulated institutions* (May 2009)

standards and regulatory expectations related to remuneration, including the application of the most recent FSB Supplementary Guidance on Sound Compensation Practices.

APRA will continue to focus on its core principle that remuneration must be designed to encourage behaviour that actively supports the risk management framework and long-term financial soundness of the institution. Proposed changes will focus on better alignment of remuneration and its outcomes with prudent risk management and long-term financial soundness.

APRA intends that any proposals to address the areas identified in this review will be considered in conjunction with the implementation of other initiatives such as BEAR.

The proposed changes to be considered include (although may not be limited to):

- improved design of remuneration frameworks;
- enhanced implementation and outcomes;
- strengthened Board Remuneration Committee oversight; and
- enhanced reporting and disclosure.[16]

Ultimately, it remains the responsibility of boards and senior executives to ensure that the remuneration arrangements within their organisations are aligned with good risk management and long-term financial soundness. More needs to be done to achieve this outcome. While improvements to the regulatory framework will help provide a foundation for better remuneration structures that support and reinforce a strong risk culture within financial institutions, institutions should not wait for regulatory changes to address the scope for improvement that currently exist, nor regard the task as one of simply meeting minimum regulatory requirements.

[16] ADIs have existing reporting and disclosure requirements under *APS 330 Public Disclosure* which give effect to the Basel Committee on Banking Supervision (BCBS) Pillar 3 disclosure requirements. Other considerations for enhancing reporting and disclosure requirements include consideration of the proposals on consistent national reporting and data collection by national supervisors on the use of compensation tools which the FSB is working on. Disclosure and reporting requirements in Australia, also need to be put in the context of existing requirements under s.300/300A of the Corporations Act and under the ASX Listing Rules, as well as the application of reporting requirements under the BEAR.

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