

New APRA Requirements in Australia Aim to Clarify and Strengthen Industry Remuneration Practices

In response to widespread misconduct in the financial services industry, The Australian Prudential Regulation Authority (APRA) issued a new draft set of standards in July 2019 that aims to clarify and strengthen industry practices in governance, culture, and remuneration. This article discusses the requirement's core goals, key proposals, and what firms can expect for the future.

A resilient financial system is based on alignment between the interests of financial institutions and those of stakeholders, including shareholders, customers and beneficiaries, regulators, and the broader community. Strong remuneration arrangements help better align these interests. Recent evidence, as highlighted by Australia's Royal Commission, has revealed that the current approach to regulation in this area is not delivering satisfactory outcomes. Considering these deficiencies, APRA has looked to regulation in the UK and Europe, U.S., and Canada to form the basis of a new prudential standard on remuneration (CPS 511). The draft standards are subject to a three-month consultation period set to close on 23 October 2019, after which the final standards will be released before the end of the year.

What are the core goals?

The proposed new standard is a key step towards increasing regulation around remuneration to encourage positive behavior and avoid risk. Below are the main goals proposed to shape the foundation of CPS 511:

Strengthen governance of remuneration frameworks and outcomes. This will likely occur through an expanded Board role, where the Board needs to be active and have direct oversight.

Set overarching remuneration objectives that inform the design of all compensation arrangements and influence pay outcomes. The proposed policy is seeking a more holistic industry response to ensuring fair customer outcomes and the long-term prudential standing of financial institutions. If enacted as proposed, coverage will extend beyond executives and material risk takers to the whole organisation.

Further link non-financial risks to remuneration outcomes by promoting the use of non-financial performance criteria. Limits on the use of financial performance metrics (share price and profit-based) have been proposed.

Strengthen consequence management through specific deferral periods for significant financial institutions and the use of malus and clawback mechanisms. These restrictions will provide more 'skin-in-the-game' through better alignment to the time horizon of risk and performance outcomes.

How will this get done?

There are a number of new proposals under this guidance taking a proportional approach that implements additional requirements for only certain entities—namely large, complex firms known as significant financial institutions (SFIs). APRA will also focus on design, implementation, and outcomes of remuneration policies, which will be further supported by new reporting and disclosure requirements. Let's break this down even further with a summary of the key proposals:

Remuneration framework: Instead of only focusing on senior staff, remuneration efforts will be supported by a broad framework that spans all levels of the business. This will require firms to have a more comprehensive assessment of end-to-end remuneration design and outcomes, including the systems and processes supporting the use of risk outcomes for remuneration decision making.

Board oversight: The Board will now have more responsibility and must approve the remuneration policy, actively oversee the remuneration framework, approve the remuneration of senior executives and other roles, and ensure risk outcomes are reflected in remuneration outcomes. This will improve accountability and overall policy guidance to help achieve objectives.

Incentive scorecards: APRA proposes that financial measures be limited to 50% and individually capped at 25%. This requirement concentrates on the use of a balanced scorecard to strengthen the linkage between risk and incentive outcomes to the exclusion of other incentive mechanics. We encourage organisations to assess how effectively existing variable pay design addresses conflict of interest and manages non-financial risk through its scorecard or a combination of other mechanisms.

Consequence management: In regard to remuneration outcomes, the new standard will require Boards to apply malus and clawback as part of their role to exercise stronger review and oversight. For SFIs, minimum deferral periods of up to seven years for senior executives will provide the mechanism for Boards to exercise risk-based adjustments within a timeframe that better aligns to the time horizon of risk. For SFIs, APRA also proposes that clawback mechanisms adjust variable pay outcomes up to four years post-vesting.

Review: In addition to the usual annual compliance reviews, there will now be effectiveness reviews of the remuneration framework across the business every three years. Remuneration committees will need to ensure that the findings of these reviews are addressed and implemented. Conducting supplementary reviews and taking effective action based on results will likely require additional resources.

Transparency: APRA will consult on new measures to increase executive remuneration disclosure requirements that will directly support APRA's ability to supervise CPS 511. The additional requirements include reporting of each entity's remuneration policy along with specific performance metrics used to determine variable remuneration. This requirement reinforces how critical it is to have defensible remuneration outcomes backed by sound remuneration frameworks and variable pay design.

What should firms be doing to prepare?

To reiterate, this consultation period will close in October of 2019, after which a final standard will come into play on July 1st, 2021. While the final standard may be slightly altered from the proposed principles stated above, we recommend that your organisation take stock of its existing incentive schemes and remuneration policies and practices as soon as possible. This will help determine the extent to which they currently align to Australia's regulatory direction and prepare for any change that lies ahead.

Ask yourself these five questions to help unpack the practical implications of the standard for your firm:

1. How well does your organisation's culture and reward philosophy align to the goals of the proposed standard?
2. What support does the Board, executives, people leaders, and staff require to implement the proposed standard effectively?
3. Is the Board prepared for the proposed extended new duties?
4. What existing reward programs will be impacted by the proposed limits on the use of financial measures, as well as the use of malus and clawback?
5. If your organisation meets the proposed criteria for a Significant Financial Institution, do current incentive plan rules and employment contracts allow for the proposed deferral and clawback periods for employees in special role categories? (defined as senior managers, material risk takers, including highly paid material risk takers, and risk and financial control personnel)

Lessons learned from the United Kingdom

As a closing thought, it may be useful to consider some of the outcomes that have been observed from overseas in the UK market. Pay approaches have already undergone significant change following the introduction of the Capital Requirement Directive (CRD) bonus cap (through which variable pay is limited to two times fixed pay) and mandatory three to five-year deferrals. These requirements impacted fixed pay levels, either through salary adjustments or introduction of role-based allowances.

Then following the more recent introduction of the Senior Managers and Certification Regime (SM&CR), senior individuals are now subject to extended deferral periods of seven years and clawback periods of ten years for incentive awards. While the full influence on people and pay is yet to be seen, we have observed the following impacts to date:

- Further upward pressure on fixed pay levels (due to increased deferral and clawback provisions)
- Recruitment and succession planning challenges around senior manager roles covered
- Heightened pressure and additional cost for implementation in medium sized and smaller firms

When taking deliberate action to prepare your organisation, be sure to avoid knee-jerk reactions that could potentially put your firm into a compliance straight jacket. As the financial services sector operates in a shifting governance and competitive landscape, Standard CPS 511 presents an opportunity to ensure that policies, systems, processes, and practices are fit for purpose, as well as aligned to stronger standards of governance.

If you'd like to learn more about the new APRA Prudential Standard and how to ensure your firm's remuneration framework, policies, and practices are ready for evolving regulation, please [contact our team](#).

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