Hayne Royal Commission and Executive Remuneration

February 11, 2019

The *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* published its final report on Monday 4 February 2019. As expected, the report has much to say about executive pay and makes various recommendations. These include recommendations for executive remuneration, board engagement, monitoring non-financial risk, and for the remuneration of non-executive positions.

This article focuses on Commissioner Hayne’s observations and recommendations of the report regarding the effectiveness of executive remuneration “to encourage sound management of non-financial risks”.

The Report acknowledges what every board knows: that there is no agreed ‘ideal’ or ‘optimal’ remuneration system. The responsibility of getting it right rests with the board and there are limits to what can or should be regulated or prescribed.

While many have indicated that the recommendations do not go far enough, on the whole they are pragmatic, realistic, and backed up with sufficient evidence.

Design versus implementation

The report emphasizes the distinction between remuneration design and implementation.

On balance, Commissioner Hayne views past failures as associated mainly with implementation, due to deficiencies in board oversight and APRA supervision.

While this may be true, one can question whether the role of investors was sufficiently taken into account, on both design and outcomes assessment.

Strikes – no home run by Commissioner Hayne

The report did touch on the impact shareholders had on bank executive remuneration. This included critical evidence from APRA. Many regulated entities focused on TSR and RoE as performance hurdles. These are preferred by institutional investors, but do not consider long-term financial performance or risk adjustments.

The dysfunctional aspects of the two strikes law were recognised. Shareholders, particularly institutional investors, were utilising their vote on the remuneration report to register dissatisfaction with other matters. As a result, boards found it difficult to adopt long-term views in designing incentives and including non-financial risk factors into remuneration frameworks. Notwithstanding this, there are notable exceptions on the part of some external stakeholders – see CGI Glass Lewis' response to the Royal Commission HERE.

Despite these observations, the report notes that since the two-strikes rule is mandatory for all listed companies and any question about modifying that rule is beyond the Terms of Reference given to the commission. Any review of the two-strikes rule would be for others to undertake.

Some would argue that the failure to address the 2 strikes law and short term focus of institutional investors puts boards between a rock and a hard place, incurring displeasure from either APRA or their investors if they go one way or the other.

Clawback – management may not like it, but no excuses

The report keeps brief the examination of clawback (the ability to recover pay that has already vested). In short, the report sees no reason why every financial services entity does not have such arrangements. Doing so would be consistent with the Supplementary Guidance of the Financial Stability Board (see HERE) . It would also be consistent with the report of the Prudential Inquiry into CBA (see HERE) .

Risk related pay adjustments – a failure of implementation

All APRA regulated financial services entities allow for board remuneration committees to make risk related pay adjustments to executive pay. However, few make the risk related adjustments to the remuneration of their senior executives. It appears that few that were the subject to the Hayne Royal Commission did it well.

The information provided to the boards was deficient. Management failed to adequately inform the board of the nature and seriousness of risks identified. They did not identify which senior executives were accountable for these issues and there was insufficient documentation and assessment of the quality of their risk management performance.

Boards were considered too trusting in management. They failed to adequately query management or critically review the information provided or request additional data that was not provided.

APRA – amending standards and arming supervisors

APRA introduced remuneration requirements into its prudential standards in 2010. The commissioner observed that action against an APRA regulated institution has never been taken for failing to comply.

Until recently, with the 2017 CBA report and the review of a sample of 12 prudentially regulated institutions' remuneration (see HERE), APRA has not taken, in Commissioner Hayne's view, a sufficiently deep dive into each institution's remuneration management . Hayne referred to the information that could be gathered, but was not, as described in the FSB's *Recommendations for national supervisors: Reporting on the use of compensation tools to address potential misconduct risk* (see HERE) .

APRA has several other actions to undertake as a result of the Royal Commission. The full list and APRA's timetable (released Monday 11 February 2019) can be found HERE.

Disclosure

The interim report and transcripts of proceedings appeared to indicate that the Commissioner was keen on more comprehensive disclosure of the extent and reasons that pay was adjusted for poor risk management. In the interval there was a change in heart, probably in response to APRA concerns that disclosure of poor risk management may have unintended consequences.

In the final report Commissioner Hayne said that remuneration arrangements of an entity show what the entity values. If the board makes an example of the executive board’s variable remuneration in terms of risk, it sends a clear message to the rest of the company on the standards expected. No public disclosure should be required.

Specific recommendations

Recommendation 5.1 states in addition to supervising remuneration systems prudently, APRA should consider implementing sound compensation principles and practices defined within the Financial Stability Board.

Recommendation 5.2 states when APRA undergoes supervision and review of remuneration systems, its aim should also include sound management of financial and non-financial risks such as misconduct and compliance risks.

Recommendation 5.3 states APRA should require remuneration systems to meet a certain set of requirements. These include:

1 . Designing their remuneration systems to boost sound management of non-financial risks and to cut the risk of misconduct;

2 . The board must make regular assessments of the effectiveness of the new designed remuneration system;

3 . Limits on the use of financial metric for LTIs must be set;

4 . APRA regulated institutions must have the ability to claw back remuneration that has vested, in appropriate circumstances; Information regarding risk management performance and remuneration decisions given to boards and committees must be improved.

What to expect in reality of the recommendations

Clawback is the easy one. There is precedent in the USA and UK. We expect APRA amend its prudential standards (CPS 510) and simply make clawback mandatory. No problems with institutional investors either.

Incorporating non-financial measures into LTIs will be difficult for many reasons. There may be an amendment of the prudential standard requiring remuneration to take into accounts financial and non-financial risk factors, and consider longer term outcomes. But this will not be too prescriptive. More likely is a lot of work within APRA to arm supervisors with more specific policies and guides such that they will be compelled to exercise APRA’s power of direction. This may be handy. A board can then go to shareholders and say that they must comply with a specific APRA direction to include non-financial measures in its LTI.

The Commission’s observations and remedies for executive remuneration and appropriate risk management makes a good reading. It is recommended for all listed company board remuneration committees. See for yourself, from page 348 of the Report. (see HERE) .