APRA draft prudential standard: CPS 511 Remuneration

1. Overview

- On 23 July 2019, APRA released its new draft prudential standard aimed at clarifying and strengthening remuneration requirements in APRA-regulated entities, and an associated discussion paper. The documents can be accessed here.
- The proposed standard is far-reaching, with a strong focus on risk management. A number of new requirements are proposed in relation to structure of remuneration frameworks (and ongoing review of those frameworks); board oversight; variable remuneration design; and outcomes management.
- Several of the proposed requirements are materially more prescriptive than APRA's current remuneration requirements, although APRA emphasises that it has endeavoured to take a predominantly principles-based approach with more detailed prescription limited to the largest and most complex entities.
- Key proposals involve:
    - an **expanded role for the board**, including in approving and actively overseeing an organisation's remuneration policy and approving remuneration outcomes for an expanded number of roles;
    - **prescription in terms of design**, including:
        - a requirement that **financial performance measures must not comprise more than 50 per cent of performance criteria for variable remuneration outcomes**;
        - **minimum deferral periods** for variable remuneration of **up to seven years** for CEOs in larger, more complex entities;
        - **scope to clawback remuneration for up to four years after vesting**; and
    - **annual compliance reviews and triennial effectiveness reviews** of the remuneration framework.
- APRA confirms that it will be intensifying its supervision of remuneration practices under the new standard, with a focus on design, implementation and outcomes.
- The standard will be finalised in late 2019 or early 2020 and it is expected that it will come into effect on 1 July 2021 (although APRA will determine the effective

date based on feedback from the consultation). New reporting and disclosure standards will be consulted on following finalisation of the new standard.

2. Key proposals in draft standard

- As set out in the discussion paper, key proposals in the draft standard (including the shift from the current standard) are outline below:

Key area	Current standard	Key proposed change
Remuneration framework	Remuneration policy for senior executives and limited additional staff only.	Remuneration policy for all arrangements, supported by remuneration objectives and a broad framework.
Board oversight	The Board must approve the remuneration policy. The Board has responsibility for reviewing and approving remuneration recommendations for senior executives and limited other staff.	The Board 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.
Variable remuneration design	Variable remuneration for special categories of employees must be designed to allow adjustments to reflect business outcomes, risks inherent in business activities and incorporate appropriate time for performance to be realised	Minimum design requirements for all employees, which promote prudent risk management and support remuneration objectives. Financial measures limited to 50 per cent and individually capped at 25 per cent. Constraints on deferral and vesting set for significant financial institutions (SFIs).
Outcomes management	Remuneration policy must allow the Board to adjust variable remuneration downwards to zero if appropriate for employees in special categories.	Require adjustments to remuneration outcomes so as to align with risk outcomes; stronger review and oversight. Clawback to apply to senior roles in SFIs.
Review	Remuneration policy must be reviewed on a regular basis.	Annual compliance reviews and triennial effectiveness reviews of the remuneration framework.
Transparency	No requirements other than for ADIs, who are subject to remuneration disclosure requirements as part of APRA's implementation of "Pillar 3" of the Basel capital framework.	APRA to consult on measures in 2020.

3. Overall approach to new standard, and implementation

- APRA proposes to shift the remuneration requirements from the governance standards in CPS 510 and SPS 510 into a stand-alone prudential standard covering ADIs, general insurers, life insurers, private insurers and RSE licensees with a view to reinforcing the need for industry to improve current remuneration practices.

- A proportionate implementation of the new requirements is proposed, with certain new expectations applied only to large, complex entities and to certain senior executives and other special roles. Accordingly, APRA is proposing to develop a new category of ARPA-regulated entities termed significant financial institutions (SFIs).

- Criteria for inclusion in the SFI category could be based on measurable indicators such as asset size, presence in certain markets, membership of a conglomerate group or the provision of critical services (see page 23 of the discussion paper for further detail). At this stage, SFIs would include ADIs with assets over $15 billion, general and life insurers with assets over $10 billion and RSE licensees with assets over $30 billion. Private health insurers are excluded.

4. Role of the board

- APRA underscores the need to address key conclusions of the recent governance self-assessments and the Financial Services Royal Commission, including that there is a need to strengthen board oversight and governance of remuneration, access to information, coordination in making remuneration decisions and senior management accountability.

- The draft standard would require the board to have an expanded role in oversight of organisation-wide remuneration. In particular, it mandates:

    - board responsibility for the overall remuneration framework (including consideration of factors such as how it promotes effective risk management);

    - board involvement in remuneration arrangements for persons in "special roles" categories[1] (with the draft standard requiring boards to approve the remuneration outcomes of all persons in special role categories on either an individual or collective basis depending on the role); and

    - that the board establish a clear link between remuneration arrangements and prudent risk management of the entity to ensure risk outcomes are reflected in remuneration outcomes for persons in special role categories.

[1] A "special role category" means "a person in the category of senior manager, material risk-taker (including highly paid material risk takers) and risk and financial control personnel.

5. Design considerations

- As foreshadowed by APRA Chair Wayne Byres, the new standard aims to limit the use of financial performance metrics (share-based and profit-based) and promote the use of non-financial performance criteria in designing incentives.

- APRA has proposed that entities must ensure that financial performance measures make up no more than 50% of the weighting of the total performance criteria used to determine variable remuneration, with any individual financial measure to comprise not more than 25% of the total measures used. This requirement would apply across the entire organisation and across the total amount of variable remuneration.

- The standard also significantly extends minimum deferral periods for senior executives where variable remuneration is $50,000 or more. For a CEO of an SFI, 60% of total variable remuneration is to be held for 7 years with pro-rata vesting after 4 years. For other "special roles" (being senior managers and highly paid material risk takers), 40% is to be held for 6 years with pro-rata vesting after 4 years. APRA's view is that this provides an appropriate time horizon for negative performance and risk outcomes to emerge.

- While APRA acknowledges the trade-offs and risks (eg that it may make it more difficult to hire executives and staff with relevant skills and could affect the use of variable remuneration as a performance management tool), it strongly defends the need for strengthened requirements.

- The new standard also requires entities to take steps to assess and mitigate conflicts of interest that may appear or be created in remuneration design. This requirement is intended among other things to avoid remuneration structures which focus primarily on volumes and sales, and their effect in creating conflicts of interest among staff.

- Notably, APRA is not proposing to constrain the overall amount of remuneration, either in absolute terms or in relation to fixed salary, and specifically notes that there is not sufficient evidence that these approaches materially improve remuneration practices.

6. Outcome management

- APRA has highlighted that it intends to ensure that remuneration outcomes remain sensitive to risk outcomes into the future.

- The draft standard would require entities to ensure that variable remuneration outcomes are:

    - commensurate with performance and risk outcomes; and

  - adjusted downwards, to zero if appropriate, through tools that are triggered when remuneration objectives are not met, or in response to significant unexpected or unintended consequences which impact the effective management of both financial and non-financial risks, sustainable performance, long-term soundness of the entity and for an RSE licensee have an impact on promoting the financial interest, and reasonable expectations, of beneficiaries. Tools include but are not limited to in-period adjustments, malus, clawback and overriding discretion and judgment..

- Entities would also be required to set minimum criteria for adjusting any deferred variable remuneration through application of malus, including in relation to risk management failures, misconduct or significant adverse outcomes for customers, beneficiaries or counterparties.

7. Regular review of the remuneration framework

- It is proposed that entities be required to conduct a triennial, operationally independent effectiveness review of remuneration frameworks. Amongst other things, the effectiveness review must:

  - assess the alignment between the entity's remuneration objectives and remuneration framework;

  - assess the alignment of remuneration outcomes with the performance and risk outcomes achieved including, where relevant, back testing of remuneration outcomes against remuneration design and performance and risk outcomes; and

  - assess whether the remuneration framework and arrangements could create circumstances which increase misconduct risk.

- The Board Remuneration Committee must then take action to ensure review findings are adequately addressed and implemented in a timely manner.

8. Consultation questions

Remuneration framework	• Is triennially an appropriate frequency for conducting independent reviews of the remuneration framework? • What areas of the proposed requirements most require further guidance?
Board oversight	• Are the proposed duties of the Board appropriate? • Are the proposed duties of the Board Remuneration Committee appropriate?
Remuneration design	• APRA is proposing that financial performance measures make up at least 50 per cent of variable remuneration measurement and individual financial performance measures are limited to 25 per

	cent. Is this an appropriate limit, if not what other options should APRA consider to ensure non-financial outcomes are reflected in remuneration? • What would be the impacts of the proposed deferral and vesting requirements for SFIs? For ADIs, what would be the impact of implementing these requirements in addition to the BEAR requirements? • Would the proposals impact the industry's capacity to attract skilled executives and staff?
Remuneration outcomes	• What practical hurdles are there to the effective use of clawback provisions and how could these be overcome? Would requirements for longer vesting where clawback is not preferred address these hurdles? • What transitional provisions may be necessary for particular component of the new standard or for particular types of regulated entities?
Transparency	• What disclosures would encourage a market discipline in relation to remuneration practices?