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TO ALL LOCALLY INCORPORATED ADIs AND GENERAL AND LIFE INSURERS

APRA REVIEW OF REMUNERATION

As you will recall, in April 2010 APRA introduced various prudential requirements in relation to remuneration. The purpose of these requirements on APRA-regulated institutions was to ensure remuneration arrangements promoted prudent risk-taking in the management of the business, and that there was effective governance of remuneration matters.

Since then, our supervision teams have monitored progress on implementation as part of their normal ongoing activities. In addition, in the second half of last year we conducted peer comparisons for a number of selected institutions. More recently, APRA had a series of meetings with the Board Remuneration Committees of a group of institutions chosen for more detailed review. The purpose of this round of meetings was to discuss in some detail the progress that had been made in implementing our requirements.

The reason for writing now is to inform you of the outcomes of this work and to highlight matters which APRA considers warrant consideration by all APRA regulated institutions.

Our particular focus in the meetings with the Board Remuneration Committees was on the manner in which they provide oversight of remuneration arrangements for senior executives and how policy is translated into practice.

We have set out below our main observations and findings from the round of meetings. In each section, we have highlighted matters that our findings indicate warrant consideration. We ask that you review each of the matters carefully and consider whether improvements could be made to the current remuneration policies and practices of your institution.

Whilst we are most interested in the way the remuneration arrangements help support the risk management framework and long-term financial soundness of institutions, and our comments reflect this, we recognise that Remuneration Committees have a broader perspective.

1. Governance and operation of Remuneration Committees

We found that all of the Boards we met with had well-established Remuneration Committees, with reasonably clear and robust governance arrangements. In most cases, the Chair of the Board attended meetings (either as a full or ex-officio member). Given our focus on the linkage between risk and reward, it was also pleasing to see a strong linkage between the Remuneration Committee and the Board Risk Committee: the most common model observed was for there to be at least two directors who sat on both committees (and often the Chair of the Risk Committee was a member of the Remuneration Committee).

We were pleased to see considerable evidence that, as appropriate, Remuneration Committees sought advice from external sources, independent of that obtained by management.

The conduct of the Remuneration Committees' work varied considerably. Some committees met only on a quarterly cycle, while others met more frequently. This seemed to reflect differences in the depth of review and analysis being undertaken: for example, some committees focussed on policy setting and the arrangements for only the most senior individuals, whereas others examined the remuneration arrangements for a much larger number of individual staff members.

For consideration:

- *Is the Remuneration Committee well-established, with clear governance arrangements?*

- *Are there strong linkages between remuneration and risk management oversight by the Board or its committees?*

2. Coverage

Across the institutions reviewed, it was clear that there was a strong focus on the remuneration outcomes of the most senior executives. In a limited number of cases, there still seemed to be a degree of tension between the role of the CEO in determining the remuneration arrangements and awards for his/her senior executive team, and the requirement in the Prudential Standard that these arrangements be determined by the Board. While the CEO will rightly be a source of advice and input on these matters, ultimately it is the Board's responsibility to determine both the structure of, and actual outcomes from, the remuneration arrangements of senior executives.

There also appeared to be some inconsistencies across the institutions in the extent of Board approval of the remuneration of material risk-takers below the senior executive level. While it was clear that Remuneration Committees had made efforts to identify material risk-takers and review their remuneration outcomes, it was not always clear whether this was truly a case of the Board considering and approving individual outcomes in advance of finalisation, or in practice simply an after-the-fact review.

Amongst the institutions reviewed, a number of subsidiary Boards have elected to adopt the remuneration policies and guidelines of their parent/group, as allowed for in the Prudential Standard. However, it was not clear that in all cases the remuneration arrangements for senior executives of the subsidiary entities were receiving scrutiny at Board level. It is possible that some subsidiary Boards have interpreted the ability to use group policies as absolving them of the need to review the individual remuneration arrangements of their senior executives. This is not the case: the remuneration of senior executives of an APRA-regulated institution must be determined at Board level, either of the institution itself, or by subsidiary Board delegation to its parent.

Further, the remuneration arrangements of relevant staff of a related body corporate which provides material services to the regulated institution may also be subject to the requirements of the Prudential Standards. An example of this could be an asset management business providing services to a life insurer. In a number of cases, it is not clear that this has been recognised in remuneration policies and/or practices.

For consideration:

- *Is the primacy of the Board in setting remuneration arrangements for relevant staff* well understood and recognised in practice?*

- *Is the Remuneration Committee giving adequate attention to the remuneration arrangements of <u>all</u> material risk takers, including approval of those arrangements in advance?*

- *Are the remuneration arrangements for the relevant staff* involved in the management of an APRA-regulated subsidiary appropriately overseen by the*

Remuneration Committee, or by an equivalent committee of the Board of the subsidiary?

- *Are relevant staff* of key related (non-APRA regulated) companies considered in the same way as relevant staff of the regulated company?*

* that is, staff in one of the three categories identified in the Prudential Standard – responsible persons, risk management and control personnel, or others who may affect financial soundness.

3. Factoring risk into remuneration

A key principle within the Prudential Standard is that the performance-based components of remuneration must be designed to align remuneration with prudent risk-taking.

Most of the Remuneration Committees we met with have established performance assessment arrangements based on a scorecard approach, in which various quantifiable objectives and benchmarks are used to assess performance. However, the application of these scorecard-based approaches varied widely. Some scorecards contained fairly high level metrics only, with a high degree of judgement applied by the Remuneration Committee to convert key performance indicators (KPIs) into actual rewards. At the other end of the spectrum, we saw extremely detailed scorecards with extensive metrics designed to explicitly limit the need for judgement. APRA does not advocate either of these approaches in their entirety, believing instead that good performance assessment requires both clarity of objectives to provide a sound basis for performance measurement, and the application of experienced judgement to reflect those aspects of performance which cannot be measured using readily quantifiable KPIs.

Indeed, this balanced approach is used in most institutions we met with. If implemented well, such an approach provides appropriate performance metrics, covering financial, risk and operational aspects of an individual's performance, which are derived from institutional business objectives and are clear and understood by all parties in advance. These metrics establish explicit incentives and provide a basis on which overall performance can initially be assessed. But recognising the imperfection of any set of KPIs, there remains an important role for judgement in assessing whether the metrics provide a true measure of performance. Examples we encountered where such judgement was sensibly applied included cases where unrealised profits had been generated for which the Remuneration Committee felt it wise to withhold recognition until such time as the profits were actually realised (or at least more certain). Another example where such judgement was exercised involved good performance which was largely the result of fortuitous outside influences over which executives had no control.

We are wary of totally 'mechanical' or formulaic approaches to performance-based remuneration, which rely completely on the use of quantitative risk measures as a means of meeting the requirements within the Prudential Standard; while measures of risk-based capital are a commonly used component of assessing risk-adjusted performance, capital models are unable to fully take account of the complexities of an individual's risk-taking activities (i.e. while they may capture risks of a transactional nature, rarely do they adequately encompass broader perspectives of the adequacy or quality of institutional risk management). Additionally, most institutions allocate capital to business units at the start of the financial year, and do not reassess the capital actually used during the year to generate a given level of profitability (and so do not explicitly consider whether any apparent outperformance was in fact the result of underestimating the amount of capital needed to support the business conducted). Equally, we are wary of highly subjective approaches – they lack a sound basis on which to establish performance expectations or measure the adequacy of results, and rely too heavily on the judgement of the Remuneration Committee to ensure remuneration outcomes are appropriate.

In APRA's view, practices across the industry need further development in four particular areas:

a) While it is recognised that senior executives, in particular, are expected to apply themselves towards institution-wide objectives and goals, we found a number of instances in which KPIs were largely uniform across the senior executive team and lacked any material recognition of each individual's performance and risk-taking. This may be mitigated, in those institutions which utilise such an approach, by the exercise of judgemental overlays by the Remuneration Committee in determining final outcomes. However, without a demonstrated history of the operation of such overlays, it is difficult to determine good practice in the application of such overlays at this stage.

For consideration:

- *Do KPIs adequately reflect potential risk-taking by an individual as opposed to the wider management team?*
- *If not, does the Remuneration Committee have a robust process for exercising judgement to amend bonus outcomes to properly reflect risk-taking by the individual?*
- *Has the Remuneration Committee considered how KPIs based on group total shareholder return, or indeed incentive payments in group shares, meets the prudential requirements for subsidiaries which are not a significant part of the total group?*

b) Furthermore, specific risk-related measures received, in our view, a relatively low weighting within overall considerations in many cases (particularly given the tendency for such measures to be institution-wide, rather than individually targeted). Critically, given our focus on the alignment of prudent risk-taking and reward, it was difficult to see how this would offer material incentives for individuals to actively manage risk. Some institutions have developed specific 'gates' which provide for an employee to be ineligible for the variable component of his/her remuneration if there was, for example, a material breach of the institution's or business unit's risk appetite statement. These gates provide a clear penalty for serious instances of excessive risk-taking, but given their binary nature do not lessen the need for more refined measures of risk-adjustment to the overall performance assessment.

For consideration:

- *Is the Remuneration Committee satisfied that appropriate weight (such that there are material incentives for the individual to prudently manage risk) is being given to risk-related KPIs?*
- *Is there over-reliance on the concept of "gates" to try to capture imprudent risk-taking?*

c) In some cases it was not apparent that the quality of risk management was explicitly taken into account in the performance assessment process (other than after the event, when outcomes had been adversely impacted). Where the Remuneration Committee had the power to exercise judgement or apply a qualitative overlay in setting final bonuses, it was usually argued that quality of risk management would be taken into account in so doing, based on input from the Risk Committee members. We consider it important that the *quality* of risk management is taken account of rather than the outcomes from the risk management process (i.e. the identification of failures as a result of poor risk management). In some cases, the process has been strengthened by having the Chief Risk Officer (or equivalent) also provide advice and input into the Remuneration Committee's deliberation on the quality of risk management and control within an institution. On the whole, we would prefer greater formality in these arrangements than was evident from our discussions.

For consideration:

- *Is the quality of risk management explicitly taken into account in the KPIs?*

- *If not, is there a robust process for taking* quality *of risk management into account in any qualitative overlay used by the Remuneration Committee in determining final bonuses?*

- *In making such assessments, does the Remuneration Committee have explicit input from the board risk committee and/or the chief risk officer?*

d) Across the institutions reviewed, the most common refinement to the remuneration arrangements for risk *and fi*nancial control personnel to ensure their incentives were appropriately aligned with their important risk management functions was to simply impose a policy that they received a higher proportion of their remuneration as fixed salary. More thinking is needed about whether this simple step is an adequate means of dealing with the issue, or whether more refined risk-based performance measures might need to be developed.

For consideration:

- *Is the only adjustment to the remuneration arrangements for risk and financial control personnel an increased proportion of remuneration as fixed salary?*

- *If so, has the Remuneration Committee actively considered other ways to ensure incentives for such personnel are appropriate, given their particular responsibilities?*

4. Deferral, Vesting and Clawback

Almost all institutions we met with make use of a combination of short-term and long-term incentives for senior executives.

In the case of short-term incentives (STIs), there has been a tendency to:

- lengthen the extent to which STIs are deferred (increasing from two to three years), and

- increase the proportion of STIs which are deferred into shares.

APRA supports both of these initiatives as consistent with the intent of the Prudential Standard to align performance-based remuneration with both risk (albeit institutional risk rather than any individual contribution), and the time needed to reliably measure performance.

As with STIs, the trend was for long term incentives (LTIs) to be extended in term, with a number of institutions now utilising vesting periods out to five years. Again, the extended period for vesting helps align remuneration with institutional outcomes of risk-taking.

For consideration:

- *Are the deferral periods for STI (and LTI where relevant) sufficient for adverse outcomes (as a result of imprudent risk-taking) to emerge?*

- *Are the amounts deferred (in dollars) sufficient to provide a material incentive?*

All the institutions reviewed had some ability to withhold unvested STI and, to a lesser extent, LTI payments. Two issues were identified in the course of our discussions:

a) The circumstances in which unvested payments can be reconsidered vary to quite a degree. Some institutions have a very clear and broad capacity to adjust or withhold unvested payments, including for example financial misconduct, writing poor quality business, material breach of policies, or where risk frameworks were subsequently found to be weak/inadequate.

Others have far less capacity, restricting themselves to instances of material financial misconduct, etc. Clearly, the narrower the capacity to withhold or adjust unvested payments, the more important it is that the initial performance assessment process is robust and fully considers the inherent risk within a given period's financial and operational outcomes.

For consideration:

- *Are the conditions for withholding payments broad enough to adequately influence behaviour?*

b) A number of institutions do not have a capacity to withhold unvested LTIs, even if it was subsequently determined that the initial reward was based on an inaccurate assessment of performance. It was argued that, since LTIs were exposed to share price movements, this provided an element of risk adjustment to the value of the reward received by the employee. However, since this reflects only institutional outcomes, rather than individual outcomes, we are not convinced that relying solely on share price adjustments provides genuine alignment with the outcome of risk-taking by any given individual. We would like to see alternatives actively considered.

For consideration:

- *Has the Remuneration Committee actively considered having the power to withhold unvested LTIs (if applicable)?*

Further action

At this stage APRA is not seeking a formal response from you or your institution.

However, as part of our ongoing supervision process, we will be considering, as appropriate, the issues raised – we may discuss these with a combination of management, Boards or Board Remuneration Committees.

In the meantime, please do not hesitate to contact me should you have any questions regarding the issues raised above, or if you would like us to meet with your Committee.