10 minutes on…

Perspectives on the new Banking Executive Accountability Regime

May 2017

As part of the 2017 Federal Budget, the Government announced a raft of measures designed to drive a more accountable and competitive banking system. This follows the recently released Sedgwick review of retail banking remuneration, which mandated significant changes in banking remuneration and culture.

What is driving the change?

- The call for increased government intervention in the banking sector has been coming from a wide range of voices across the community. A key area of concern is the perception that banking executives have not been held to account for the various scandals regarding the mistreatment of customers
- The Government is looking to address many of these concerns through the introduction of the Banking Executive Accountability Regime ('BEAR' or the 'Regime') - which is part of a number of budget measures that impact Authorised Deposit-taking Institutions (ADIs), including banks. The Regime appears to echo the Senior Manager and Certification Regime (SM&CR) in the UK, which came into force last year
- In addition, the recently released Sedgwick Retail Banking Remuneration Review Report, initiated by the Australian Bankers' Association, made 21 remuneration and governance related recommendations designed to improve the culture of the banks through ensuring an increased focus on customer and a reduced focus on sales outcomes
- The announcements also come at a time while APRA is reviewing the implementation of the existing remuneration requirements contained in CPS510 [1]

Banking Executive Accountability Regime

Remuneration is just one element of the Regime, all of which are designed to make it easier to "hold executives to account".

Focus area	Highlights
1. Registration of senior executives	• Requirement to advise APRA of all senior appointments prior to them being made • Requirement to complete accountability maps for senior executives
2. Enhanced powers to remove and disqualify	• APRA will have powers to deregister and disqualify senior executives and directors that have been found not to have met the new expectations
3. Increased expectations and penalties	• Conduct standards for executives and directors - covering matters such as conducting business with integrity, due skill, care and diligence and acting in a prudent manner • Introduction of civil penalties for ADIs who fail to meet the new expectations (e.g. hiding misconduct), or do not appropriately monitor suitability of executives to hold senior positions
4. Deferral, vesting and malus	• A minimum of 40% of an executive's variable remuneration to be deferred for a minimum period of four years, increasing to 60% deferral for certain executives such as the CEO • APRA will also be given stronger powers to require ADIs to review and adjust their remuneration policies when APRA believes such policies are not appropriate

PwC's perspectives

We believe that trust needs to be rebuilt, and pay design and quantum plays an important role in this. There is little doubt that BEAR, in conjunction with the Sedgwick recommendations, will result in significant changes in remuneration approaches at ADIs but it remains to be seen whether this will lead to a material increase in trust.

The current Government proposal is light on detail, and we can expect further information when the Government puts forward a bill containing the Banking Executive Accountability Regime.

There are significant implications from a remuneration perspective. We consider these issues on the following pages.

[1] PwC's *10 minutes on.. APRA's review of remuneration* http://www.pwc.com.au/consulting/assets/publications/ten-minutes-apra-remuneration-oct16.pdf

Potential implications for remuneration

At first glance, the proposed changes may not necessarily appear that onerous. However, their implementation, in combination with the Sedgwick recommendations, are likely to result in significant changes to structures, potentially more so for small to medium banks and other ADIs.

Considerations and issues		Potential implications
Deferral of a minimum of 40% of variable remuneration for 4 years	• There are a number of key details that will need to be confirmed to determine the impact of the deferral requirements: - What is included in the definition of 'variable' pay, with a critical issue being if long term incentive (LTI) awards are included, whether they are captured at grant date or vesting, and how they are valued - What are the restraints on the vesting schedule, and if it can occur on a pro-rata basis over the minimum period of four years - If there will be a requirement for deferral to be in equity instruments, cash or a combination of both - If there will be a de minimis rule where variable pay below a certain threshold could be excluded from the deferral rules. This could be appropriate, for example, in years where bonus payments are low, or LTIs do not vest - The interaction with leaver provisions, and whether deferral is expected to remain in place after an individual has left an organisation	• For senior executives in the large Australian banks the impact may be minimal, with deferral rates typically being 50% of annual incentives, and higher if LTIs are included. However, deferral periods will, in most cases, need to be extended to four years • It is potentially a greater concern for smaller Australian and foreign owned ADIs, who may have lower levels of deferred incentives and smaller LTI grants • Competitiveness for talent where individuals can easily move between FS or other industries, or other jurisdictions • Potential barriers to entry and competitiveness issues for smaller banks, branches of foreign banks, building societies, and credit unions. Other jurisdictions have allowed a proportionate approach to be taken, considering the size and complexity of the institution, with respect of deferral requirements • Greater levels of deferral into equity will aid executives in achieving minimum shareholding guidelines
Malus and the vesting of deferred equity	• The objective of the deferral is to stop executives being paid for bad decisions which take a long time to materialise • However, it is not clear if the intention is to extend the current regulatory requirements to adjust performance-based components of pay downwards (where appropriate)	• The requirements for malus is not new for the industry, however the government may expect 'malus' to be used more frequently. This is in contrast to the current approach taken by many institutions, that any action that warrants the application of malus warrants dismissal, but does not often also lead to the use of malus
Governance of remuneration arrangements	• APRA will also be given stronger powers to require ADIs to review and adjust their remuneration policies when APRA believes such policies are not appropriate • It is not yet clear how APRA's new powers will interact with the existing responsibilities and rights of Boards and shareholders. For example, will APRA's powers override shareholders rights with respect of approving equity grants to executive directors? The BEAR Bill will need to provide clarity about how these powers interact • Coupled with the the Sedgwick recommendations this places significant restrictions on remuneration design	• Added complexity and confusion to the already blurred sharing of responsibility for executive remuneration between policy makers, regulators, shareholders and boards • Regulation has the potential to drive homogeneity in reward design, and this will force organisations to consider how they emphasis other elements of the employee experience when they look to develop a unique and compelling employee value proposition

Potential implications for remuneration (cont'd)

Considerations and issues		Potential implications
Pay quantum	• The Government has not made any references to the quantum of remuneration. However, ARPA's review of the implementation of CPS510 may well consider how the quantum of variable pay relates to prudential risk taking, and how effective bonus caps have been in other jurisdictions • While not specifically aimed at executives, the Sedgwick review did call for a reduction in variable pay	• Increased deferral requirements will reduce the perceived value of incentives - and if anything place upward pressure on incentive • The increased regulatory and community scrutiny is going to make any increase is variable pay difficult, which would, in a competitive market, put pressure on fixed pay
Performance measures, target setting and assessment	• The introduction of the bank levy follows a number of other regulatory interventions that have impacted the banks' profitability • This is coupled with Sedgwick's recommendations that performance has to be more holistic, and take into account a wide range of measures	• Banks may review the use of profitability measures, and consider what is included or excluded in the definition • It will be increasingly difficult to set financial performance targets (especially over the long term) • Boards, remuneration committees and employees are going to need to become more comfortable using their judgement when making performance assessment and determining bonus outcomes. Boards and remuneration committees will need to stand behind their decisions when applying discretion, and can expect even more scrutiny by shareholders and shareholder advisory bodies

PwC's perspectives

The intent of the remuneration restraints are to ensure ADIs can adjust bonuses down when the consequences of decisions materialise, even if this is a number of years after the decision was made and the associated bonus awarded. Although a simple concept, a significant amount of detail needs to be finalised before the measures can be implemented. The current remuneration models adopted by the major banks already align with the intention, and will likely satisfy many aspects of the proposed requirements. It is likely to be a greater concern for smaller Australian and foreign ADIs.

The Government's proposal to give APRA additional powers to require ADIs to review and adjust their remuneration policies when APRA believes such policies are not appropriate is very significant. APRA's new powers will have the potential to add more confusion to the already blurred sharing of responsibility for executive remuneration between policy makers, regulators shareholders and boards. Pressure will also continue to build on aligning remuneration, performance and the shareholder experience.

Identifying the most appropriate performance measures and the setting of targets will remain a key focus area, as will implementing these changes in light of the Sedgwick recommendations and its focus on conduct and culture.

Notwithstanding the proposed remuneration requirements, we believe that there is an opportunity to review remuneration strategies from a first principles standing, to ensure that they are best-fit and tailored to the specific needs and circumstances of each organisation. Measures to rebuild trust are also vital. This may include improving oversight of pay fairness throughout the organisation (not just a focus on the top), more meaningful disclosures of pay and its link to performance, prudential risk and good customer outcomes, and a greater need for judgement and discretion when making remuneration decisions.

Increased accountability and conduct expectations

The introduction of a senior executive and director accountability regime is significant and appears to echo the Senior Manager and Certification Regime (SM&CR) in the UK, which came into force last year. Our experience with SM&CR has shown that it is highly personal, and has a significant cultural dimension. For this reason, it offers many opportunities to empower people to do the right thing.

Considerations and issues		Potential implications
Application to entities and groups	• It is not yet clear how the Regime will apply to Groups that contain an ADI and have other operations and permissions, or international banking groups with subsidiaries or branches operating in Australia	• Competitiveness for talent where individuals could more easily move between FS or other industries • Political implications within diversified groups with a ADI
Individuals covered by the Regime	• We expect some flexibility for ADIs to undertake an accountability mapping exercise. It is not clear which accountabilities should be included in this mapping, and therefore which senior executives and/or directors are likely to be in-scope of BEAR • For example, APRA's current definition of Responsible Persons, and possibly the broader set of individuals covered by the Remuneration Policy (i.e. select Responsible Persons, risk and financial control staff, and material risk takers)[1] could be a starting point.	• Identifying the right individuals will be highly personal, political and impactful. Individuals identified will have very personal accountabilities, be subject to remuneration requirements, and specific conduct expectations • Review of organisational structures to understand where authority and accountabilities fall. Where matrix structures are used, consider how the necessary clarity and alignment be achieved
Additional expectations on individuals	• We expect that conduct expectations (such as conducting business with integrity, due skill, care and diligence and acting in a prudent manner) will apply to senior executive and directors in addition to the accountabilities	• Requires embedding these conduct expectations in internal processes, systems and governance to reinforce • Potential extension to cover staff broadly across the ADI
Reporting and assurance	• It is not yet known what regulatory reporting or independent review/assurance may be required, although we expect this will form part of APRA's requirements for BEAR	• Internal processes will needed to be designed and documented in a way that enables obligations to be properly carried out, embedded and remain fit for purpose in a way that can be reported on and subject to independent review

PwC's perspectives

The introduction of a senior executive and director accountability regime is significant and recognises that leadership is key to driving cultural change. We believe that by placing clear accountability on leaders, individuals will respond, taking steps to carry out their remit and, where necessary, improve the quality of governance and systems that support them in decision making.

However, at face value the proposed Regime appears to be less reaching than SM&CR in the UK. For example, the proposed Regime allows for firms to advise the regulatory of senior appointments, whereas the SM&CR requires regulatory pre-approval of certain senior managers and directors, as well as certification of employees in 'material' risk-taking positions. Furthermore, while the threat of civil penalties provides a significant stick, the proposed Regime does not threaten the possibility of criminal proceedings.

UK regulation introduced to strengthen accountability

The SM&CR and Senior Insurance Managers Regime (SIMR) came into force on 7 March 2016, replacing the Approved Persons Regime, with the primary objective of strengthening accountability to support a change in culture at all levels in banks, building societies, credit unions and PRA-designated investment firms. SM&CR and SIMR require firms to assess the fitness and propriety of certain employees who could pose a risk of significant harm to the firm or any of its customers; require firms to allocate Prescribed Responsibilities across their Senior Managers, forming part of a governance map; and meet the Conduct Rules with notification requirements in certain circumstances.

The Certified Regime (CR), applying to banking institutions, captures 'material risk-takers'. Firms are required to identify individuals, assess and re-assess the fitness and propriety of certified staff on an annual basis, and meet the Conduct Rules.

[1] We note that APRA's review of CPS 510, includes the coverage of individuals in each of the segments prescribed.

How can PwC help?

To have a deeper discussion about these issues, please contact:

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