Financial institutions
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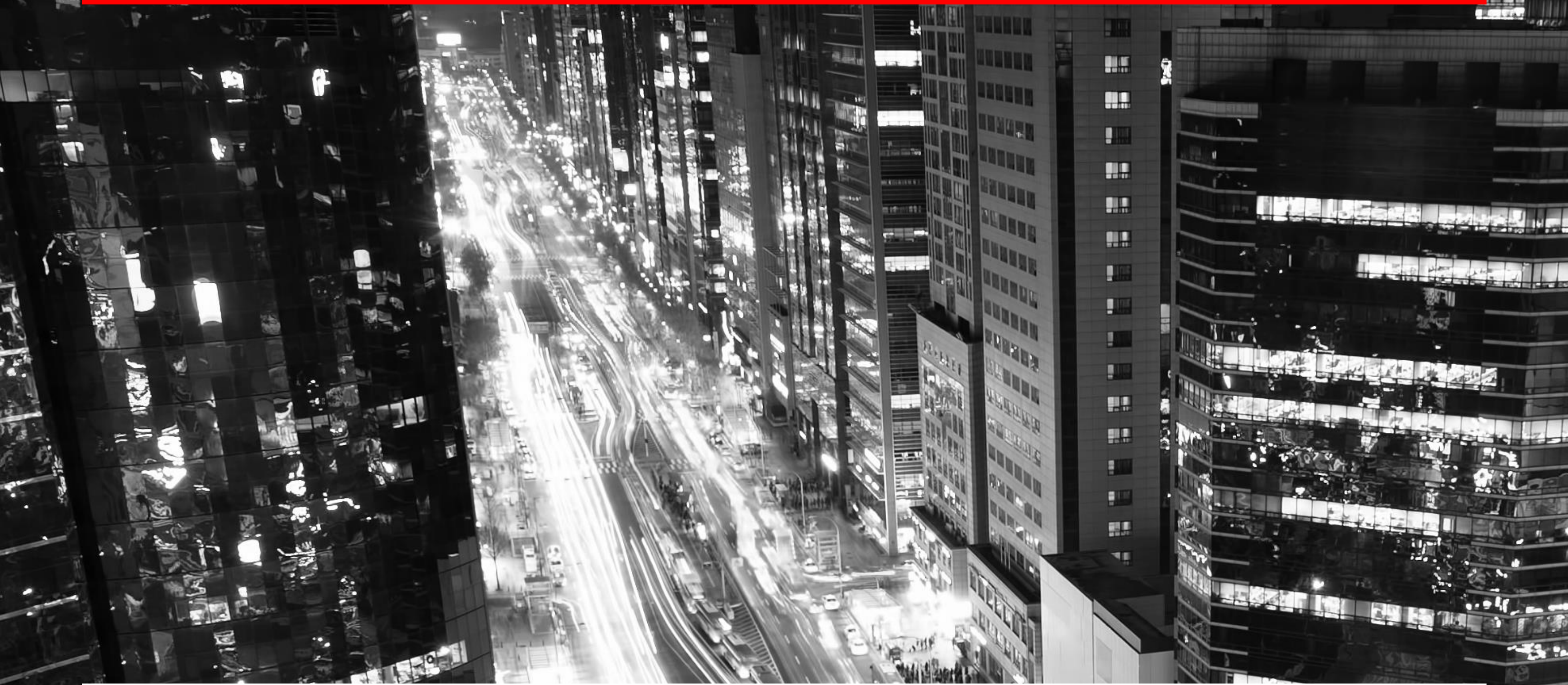

Hayne's final report

Remuneration: Hayne and the concrete path of compensation

In his Final Report, Commissioner Hayne emphasises the important connections between culture, governance and remuneration on the one hand and regulatory, compliance and conduct risks on the other.

In particular, Hayne sees an entity's remuneration arrangements as matters of design and implementation that "tell staff what the entity rewards and what the entity values".

Hayne says that "no-one has identified an "ideal"…system of executive remuneration for financial service entities". However, it is clear from the evidence put before the Commission that good design can be undermined by bad implementation and vice versa.

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Design

Given one size of remuneration arrangement does not fit all, Hayne recognises there will be some experimentation in finding a compensation structure that is right for a particular financial services entity. However, any type of remuneration system will only be effective if:

- the systems are genuinely directed to encouraging good risk management and reducing the risk of misconduct; and
- the results of applying the system are reliably identified and, if possible, measured.

With regard to executive performance, and in particular to its link with his "six simple ideas" (obey the law etc), Hayne asserts: "In the end, what is being assessed is not just what people do but how they do it. "What" can be measured; "how" cannot."

One of the additional challenges in designing a remuneration policy is fixing the proportion of fixed and variable remuneration. Of course, there is no single right answer. Hayne says that the purposes of allowing variable remuneration must be clearly understood both by employer and employee. There is a clear link between this and the effective management of risk in an organisation: "effective management of risk will depend upon the criteria that will be applied in determining variable remuneration".

If variable remuneration is to be a component of executive compensation, the criteria for assessing the variable award must include a strong link to the adequacy of the executive's attitude to, and performance in, managing non-financial risk. The package must avoid what APRA observed as too much focus on total shareholder return measures as the basis for payment.

Implementation

Much of what the Commission considered on remuneration focused on poor implementation of remuneration arrangements. Remuneration arrangements can be designed very well, with, for example, a well-balanced set of criteria around financial performance (very measurable) and risk management (not so measurable). But if they are not applied properly by the board or senior management, then culture and governance suffer, and ultimately poor outcomes are inevitable.

Hayne says that boards must get the right information about the risk position of their institution and whether serious conduct or other non-financial risk issues are emerging. Without adequate information, boards cannot correctly apply policy and make judgments on variable remuneration.

Quite often it was only when serious risk issues found their way into the public domain that there was any impact on decisions on variable remuneration (judged in part on risk management criteria) – that is, accountability of an executive for compliance and misconduct issues was not reflected in downward adjustment of that executive's pay.

Organisations need to understand that financial metrics should not solely determine remuneration. Both financial and non-financial risks must be taken into account in both the design and the implementation of a remuneration system.

Regulators

Hayne sees a role for external supervision by regulators in the way that boards implement remuneration arrangements. Recommendation 5.3 states that APRA should require a board to make regular assessments of the effectiveness of its remuneration system to encourage sound management of non-financial risk. Boards are on notice that APRA will concentrate on design and implementation and so they need to ensure their remuneration practices, and the frequency they consider them, must stand up to scrutiny.

Interestingly, APRA had indicated that in the recent past it may not have had the expertise to be able to confidently challenge a bank on its determination of variable remuneration. The regulator (and by extension boards) will need to get used to this because Hayne is adamant APRA must develop that confidence and expertise as quickly as possible.

In addition, the advent of the BEAR regime on ADIs (and, in the future, most likely on other financial service entities) will not only provide entities and regulators with a clearer understanding of responsibilities within banks but also subject entities to deferral requirements in variable remuneration. This will provide APRA with another avenue for supervision and monitoring in the area of executive compensation.

And finally…

We do need to appreciate that remuneration is not the only way to encourage good behaviour or discourage bad behaviour. Hayne makes the "unsurprising" observation that good management of staff produces good outcomes for the business and for the customer – and in making this observation he points to a skill that he clearly believes was lacking at critical moments within the Australian financial sector.