

Royal Commission Series | Culture

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The Commissioner sees remuneration as being a key part to changing the misconduct and poor behaviour revealed throughout the Royal Commission. He recognises the importance of design and implementation of remuneration arrangements and that poorly designed frameworks can increase the risk of misconduct.¹ The Commissioner considers remuneration structures must take into account effective management of risk. It is therefore not surprising that many of the recommendations falling under this theme relate to remuneration structure reform.

As expected, APRA is viewed as having a very important part to play in ensuring remuneration drives the right outcomes. In addition to the Recommendations, APRA has been told it must revise its prudential standards and guidance about remuneration.² It must also increase the intensity of supervision in this area.³

Commissioner Hayne observed that Boards too have a role to play in remuneration structures. When adjustments are made to variable remuneration of executives for poor management of non-financial risks, staff should be told as it sends a clear message of behaviour that will not be tolerated.

According to the Commissioner, there is an important role for regulators to play in reviewing risk culture, it should be part of mainstream supervisory processes.⁴ However, each entity is responsible for its own culture. While the principle recommendation relating to culture (Recommendation 5.6) is broad in nature, Commissioner Hayne expressly warns “to ignore the recommendation would be foolish and ignorant”. Enhancement in this area needs to be much more than “box-ticking” and demands “intellectual drive, honesty and rigour”.

Summary of Recommendations for Culture

Category	Recommendations	Impact
Remuneration	<p>Recommendation 5.1 – Supervision of remuneration – principles, standards and guidance</p> <p>Supervision of remuneration principles, standards and guidance – APRA should give effect to the principles, standards and guidance set out in the Financial Stability Board’s publications concerning sound compensation principles and practices</p> <p>Recommendation 5.2 – Supervision of remuneration - aims</p> <p>In conducting supervision, APRA should have as one of its aims the sound management by APRA-regulated entities of not only financial</p>	<ul style="list-style-type: none"> Remuneration structures will need to be reviewed and amended to ensure they sufficiently address performance for management of non-financial risks and in particular misconduct and compliance. Review and amendment of remuneration frameworks in line with revised prudential standards and guidance in particular impacts on the metrics surrounding long-term incentives and the ability to clawback remuneration that has vested. Board reporting on risk management performance and remuneration will need to be reviewed and enhanced.

¹ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, Page 346

² Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, Page 345

³ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, Page 364

⁴ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, Pages 386 - 387

risk but misconduct, compliance and other non-financial risk.

Recommendation 5.3 – Revised prudential standards and guidance

Revised prudential standards and guidance which:

- Require design of remuneration systems to include sound management of non-financial risks;
- Require the Board to make regular assessments of the effectiveness of remuneration systems;
- Set limits on the use of financial metrics in connection with long-term variable remuneration;
- Require claw back remuneration that has vested in appropriate circumstances;
- Improve the quality of information being provided to boards about risk management performance and remuneration decisions.

Recommendation 5.4 – Remuneration of front line staff

All entities should perform at least an annual review of remuneration systems for all staff.

Recommendation 5.5 – The Sedgwick Review

Banks should fully implement the recommendations of the Sedgwick review.

Culture

Recommendation 5.6 – Changing culture and governance

All entities should, as often as reasonably possible:

- Assess culture and governance;
- Identify any problems with that culture and governance;
- Deal with the problems; and
- Determine whether the changes it has made are effective.

Recommendation 5.7 – APRA should:

- Build a supervisory program focused on building culture that will mitigate the risk of misconduct;
- Use a risk-based approach to its reviews;
- Assess the cultural drivers of misconduct in entities; and
- Encourage entities to give proper attention to sound management of conduct risk and improving entity governance.

- The implementation of a regulatory requirement to periodically review culture and governance.
- Increased supervision of culture by APRA.
- Regulated entities which breach more frequently or more severely are likely to be subject to closer supervision.

What can you do now to prepare?

The Commissioner provides specific guidance in the Final Report on the steps he considers should be taken by all entities to ask themselves:

- Your organisational culture is the sum of the individual mental models of work of your staff as evidenced by the dominant cultures of practice (the way thinking is frequently evidenced in work practices). You want to measure these dominant cultures of practice and then ensure they align with policy (i.e. match, mismatch or missing).
- Is there adequate oversight and challenge by the board and its gatekeeper committees of emerging and non-financial risks?
- Is it clear who is accountable for risks and how they are to be held accountable?
- Are issues, incidents and risks identified quickly, referred up to the management chain, and then managed and resolved urgently? Or is bureaucracy getting in the way?
- Is enough attention being given to compliance? It is working in practice? Or is it just “box-ticking”?
- Do compensation, incentive or remuneration practices recognise and penalise poor conduct? How does the remuneration framework apply when there are poor risk outcomes or there are poor customer outcomes? Do senior managers and above feel the sting?

In addition to these questions, Ash St. recommend entities also ask themselves:

- What are our dominant cultures of practice? What do we want it to be and how will we get there?
- Have we got the right structure and assignment of accountabilities?
- Do the senior managers overseeing non-financial risk have the necessary capabilities?

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We view the Royal Commission recommendations as an opportunity for industries to strengthen their compliance frameworks and apply independent practices to their respective businesses.

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