KPMG

Mutuals Newsletter

October 2019

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Introduction

Draft CPS 511 Remuneration

APRA has released its proposed draft remuneration standard for consultation, the CPS 511.

CPS 511 introduces a number of new, notable requirements and will shift the remuneration requirements set out in the CPS 510 and SPS 510 into a stand-alone prudential standard that covers ADIs, general insurers, life insurers, private health insurers and RSE licensees.

APRA has created a standard that builds on the findings of the Royal Commission and with a view to increasing the organisational oversight over remuneration arrangements so as to ensure these support a prudent risk management environment. In many cases, particularly for large financial institutions, CPS 511 is more prescriptive and creates additional requirements that will impact reward design and governance.

The Draft Prudential Standard also builds on the provisions of the Banking Executive Accountability Regime (BEAR) which deals with remuneration. The BEAR was introduced in 2018, and whilst it currently only applies to "authorised deposit-taking institutions" (ADIs), the Government intends, pursuant to recommendations of the Royal Commission, to extend the BEAR to other entities in the financial services sector.

It is important to determine whether you wish to make a submission as well as the implementation of the changes. Given CPS 511 will not come into effect until 1 July 2021, the immediate priority should be determining if you wish to make a submission. If you would like to make a submission, you should consider the following as part of your submission:

- Creating an inventory of your existing variable remuneration;
- A gap analysis of plans against the standard;
- Consider who the material risk takers /senior managers are; and
- Does the Board have the information required to have oversight.

Written submissions on these proposals ***must be submitted by 23 October 2019.*** This will be the only opportunity to make a submission, with the final standard to be released in late 2019 or early 2020. It is therefore imperative to begin discussions on any considerations / objections to CPS 511, so that they can be raised in a submission before this date.

Capitalising on the Current Commercial Context

In February 2020, KPMG will be helping Australian Mutuals to develop their innovation capability and capitalise on the current commercial context by running the next installment of our corporate innovation accelerator – mLabs 2020. We will be taking the best from design thinking, lean startup methodologies and corporate innovation and compressing it into an intensive 8-week program covering ideation, concept testing, prototyping, an in-market pilot, business case development, pitch coaching and more.

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Overview

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It is important for mutual banks to consider the proposals of the Draft Prudential Standard against CPS 510 and the BEAR and their impact on your organisation, particularly as follows:

- **Remuneration framework:** The remuneration policy is being extended from senior executives and limited additional staff under the current framework to all remuneration arrangements which are to be supported by remuneration objectives and a broad framework under CPS 511.
- **Board Oversight:** Board oversight will still be required to approve the remuneration policy and have the responsibility for reviewing and approving remuneration recommendations for senior executives and limited other staff. The Board must also actively oversee the remuneration framework and ensure risk outcomes are reflected in remuneration outcomes for senior executives and other roles.
- **Variable remuneration design:** The variable remuneration design now includes minimum design requirements for all employees, which seek to promote more prudent risk management processes and support remuneration objectives. Financial measures are now limited to 50 per cent in total and individually capped at 25 per cent.
- **Outcomes management:** Entities are required to ensure that adjustments to variable remuneration to reflect performance and risk outcomes are being made; and set minimum criteria for adjusting any deferred variable remuneration through application of malice, (cancellation of unvested awards) including in response to risk management failures, misconduct or significant adverse outcomes for beneficiaries, among other things
- **Review:** The review of the remuneration policy requirement has changed from a 'regular basis' to annual compliance reviews and triennial effectiveness reviews of the remuneration framework.

Heightened oversight of executive remuneration

The Board will have an increased workload as it will have oversight for the remuneration policies that apply to all employees. The Board will also now be involved in remuneration arrangements for persons in special role categories (ie the new standard will require Boards to approve the remuneration outcomes of all persons in special role categories on an individual and collective basis).

Additionally, Boards will be required to establish a clear link between remuneration arrangements and prudent risk management of the entity to ensure risk outcomes are reflected in the remuneration outcomes for persons in special role categories.

APRA also considers that by requiring the Board to approve key remuneration decisions, they will need to be more actively involved in dealing with misconduct or compliance issues when variable remuneration outcomes are being determined.

Limiting use of financial performance measures

For all variable remuneration arrangements, the Standard limits financial performance measures to no more than 50 percent of total measures used to allocate variable remuneration. Further, a single measure must not have a weighting of more than 25 percent of total measures.

APRA is seeking consultation on whether this is an appropriate limit, and what other options APRA should consider to ensure non-financial outcomes are reflected in remuneration.

There is also an opportunity to request that APRA provides further guidance as to what it considers to be a 'non-financial' measure, and whether these non-financial measures can operate in tandem with financial measures (i.e. as a gateway or multiplier).

Outcomes Management

Under the draft CPS 511, entities will be required to ensure that adjustments to variable remuneration to reflect performance and risk outcomes are being made, and to also set the minimum criteria for adjusting any deferred variable remuneration as a result of, for instance malice, risk management failures, misconduct or significant adverse outcomes for beneficiaries, amongst other things.

Significant Financial Institutions (SFIs)

APRA is also proposing to define a new category of APRA-regulated entities termed significant financial institutions (SFIs). The proposed approach for determining if an entity is an SFI is set out below.

Industry	Asset size	Number of entities	% of industry assets
ADIs	>$15 billion	21	94
General and life insurers	>$10 billion	8	68
RSE licensees	>$30 billion	17	66
Private health insurers	N/A	N/A	N/A

Although currently no mutual banks are classified as a significant financial institution (SFI), the developments regarding SFI's should be considered as they will potentially reframe the remuneration space in the financial sector. For instance, SFIs are required to comply with the additional deferral and clawback obligations set out below.

Deferral (SFIs only)

The deferral period for the CEO of an SFI has been increased. As a result, 60 percent of variable pay would be deferred for 7 years (with pro rata release from year 4) and for other senior managers, 40 percent of variable pay would be deferred for 6 years (with pro rata release from year 4). This is an increase beyond the requirements recently announced under the Banking Executive Accountability Regime (BEAR).

APRA is seeking submissions on the impact of the proposed vesting and deferral requirements in addition to BEAR, as well as the impact on attracting key talent.

Clawback (SFIs only)

SFIs will need to have the ability to clawback all incentives for a further period of at least 2 years post release, and at least 4 years in circumstances involving a person under investigation (i.e. up to a maximum of 11 years after award for the CEO).

APRA is requesting feedback on the hurdles of the use of clawback, whether longer deferral instead of clawback would better address this, and what transitional arrangements may be necessary.

The Next Steps

Due to the potential difficulties in the interaction between the Draft Prudential Standard and BEAR, APRA is seeking feedback on this issue and intends to work with the Government to seek legislative amendments to BEAR in implementing the proposed deferral requirements, as necessary.

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Capitalising on the Current Commercial Context

The Mutuals continue to face challenging markets with respect to innovation as the Big Four banks continue to spend on digital offerings, while the introduction of neo, and new digital, banks to the Australian financial services marketplace provides new competition.

In a post-royal commission world however, the tide seems to be turning in favour of Mutuals due to the combination of three critical factors:

- The reduction in trust in the big banks
- The growing macro consumer trend back toward community-led brands
- Many Mutuals having commenced their journey towards implementing more agile technology platforms

Now appears to be the perfect time for Mutuals to establish and refine their innovation program. However, in order to capitalise on the current and future opportunities, Mutuals will need to master three key attributes of a modern, innovative business:

- Hiring and training for future skills
- Creating and enhancing a culture of experimentation
- Delivering tangible outcomes at pace

KPMG's innovation accelerator – mLabs 2020

In February 2020, KPMG will be assisting Australian Mutuals to develop their innovation capability and capitalise on the current commercial context by running the next instalment of our corporate innovation accelerator – mLabs 2020. We will be taking the best from design thinking, lean startup methodologies and corporate innovation and compressing it into an intensive 8-week program covering ideation, concept testing, prototyping, an in-market pilot, business case development, pitch coaching and much more.

At the end of the accelerator program, your organisation will have:

- A validated concept with a clear value proposition that is ready to scale
- Tangible assets (eg: branding and marketing collateral)
- Data from in-market testing with real customers to inform further investment

mLabs 2020 is currently taking applications and will be capping participation at eight Mutuals. To find out more and reserve your place, please contact Tyson Rose (trose1@kpmg.com.au) from KPMG Upstarts to arrange a meeting.

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