The Secretariat

Royal Commission into Financial Services Interim Report

VIA ONLINE SUBMISSION SYSTEM

22 October 2018

Dear Commissioner Hayne,

Submission on interim report

In response to the Interim Report released on 28 September 2018, please accept this submission for your consideration on the causes of misconduct, item 7.2 (remuneration) and the BEAR regime, item 7.3.

I am willing to support this submission with further evidence, including oral evidence, or a supplementary submission.

I thank you for this opportunity to comment on the remuneration aspects of the Interim Report.

Yours sincerely

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[1] This submission focuses on the following questions raised in chapter 10 of the Interim Report, under **section 7 Entities: Causes of misconduct, item 7.2** (remuneration), and **item 7.3** (The BEAR).

[2] My research interests and expertise are in the regulation of executive remuneration in listed companies. The Regulated Remuneration Cycle[1] indicates that the practice of executive remuneration is largely regulated via a set of principles and guidance outside legislation. Discipline within this model is enforced by shareholders, but the incentives for this group to undertake this role come from a series of principles and guidance encouraging engagement with company boards, such as the Australian Asset Owner Stewardship Code.[2]

[3] Shareholder voting on remuneration, whether the annual advisory vote on the remuneration report, resolutions to approve termination benefits, or resolutions to approve grants of share-based remuneration under ASX Listing Rule 10.14, is but one feature in this system. How shareholders set rules around remuneration practices and how they enforce those practices via their engagement activities are also important mechanisms for achieving 'good' remuneration outcomes.

[4] This system depends upon shareholders being able to correctly identify which policies are more likely to deliver 'good remuneration outcomes', monitoring remuneration reports to check on policies and outcomes, then deploying their voting rights to sanction poor remuneration outcomes.

CEO REMUNERATION IN THE BIG FOUR BANKS: THE SCORECARD AND WHY IT MATTERS

[5] My research into the remuneration schemes operated by financial institutions in the ASX 100 examines executive remuneration, including how these entities measure performance. For the 'Big 4' banks, a scorecard approach has traditionally been used. The data in **Table 1** below is taken from the 2017 Annual Reports: three of the big 4 have 30 September financial year ends and have not disclosed for FY2018 at the time of this submission.

[6] *Profit* features in all four scorecards, but with different weights (25% NAB; 40% CBA; 50% ANZ; 60% WBC). The Sedgwick Review recommended bonus eligibility for retail banking staff should be broadly based,[3] yet this can be undermined if senior executive team scorecards have high weights attributed to profit as this will drive management actions.

[7] It will be difficult to reduce the weighting given to profit within scorecards because of shareholders' interests in ensuring that profitability plays a part in determining STI outcomes. Take, for example, ACSI's Governance Guidelines on assessing remuneration arrangements:

> *'ACSI will consider whether remuneration practices are designed to reward sustainable long-term performance and shareholder value creation…where appropriate, financial measures should be supplemented by other quantitative ESG measures – some examples include safety performance, customer satisfaction, employee turnover and achievement of ESG performance targets.'*[4]

[8] Banks also have different approaches to including *risk* within the scorecard. It could be a 'gateway measure' (CBA), a factor that results in an adjustment to the score otherwise achieved (ANZ), a separate factor within the scorecard (NAB) or else incorporated as a factor within financial performance (WBC, weighted 10%). How risk is measured also differs, with

only ANZ and NAB clearly identifying regulatory investigations/ breaches as impacting on the risk measure score. This does not mean the other two banks don't do so: it is just it is an express factor within these two schemes.

[9] *Customer measures* do not appear to factor into the 'score' of that item adverse customer outcomes. ANZ includes customer complaints to external dispute resolution within the overall risk adjustment. Westpac includes customer complaints (a reduction in customer complaints) within the scorecard measure 'Driving Strategic Change' where it is part of the metric 'Service Revolution'. Neither CBA nor NAB included any such negative customer service measure in their scorecards for 2017.

[10] ASIC's Fees for No Service report released in October 2016 (so within the 2017 financial year) documented that each of these four banks were identified as having fee-for-service failures, with remediation then estimated to fall within the range of $1.2 million (Westpac), $16.9 million plus interest (NAB), $49.7 million (ANZ) and $105.7 million plus interest (CBA).[5] These outcomes do not appear to have explicitly been taken into consideration within a scorecard measure to determine remuneration decisions made in FY2017.

[11] The Sedgwick Review recommended that banks refine existing measures or invent new measures to capture the customer dimension to give credibility to reduce the emphasis on sales performance for retail banking staff.[6] Evidence of the measures in these four bank scorecards suggest attention needs to be focused not only on the selected measures within the customer dimension of the scorecard, but also to the weighting given within the scorecard to this dimension.

[12] All four banks appear to reward *achievement of strategic activities*, which rewards 'doing things' without waiting to see how or indeed if, the 'things' deliver by way of improved performance. Such performance need not be explicitly financial: it could be a reduction in customer complaints or negative customer experiences. However, the risk is that such a measure could now reward executives for taking initiatives to fix up the mistakes of the past without also acknowledging the executive failures that led to these mistakes.

[13] How the banks recognise income from sales in their STI schemes is also important because it can create a risk-reward horizon problem if reward time frame doesn't reflect risk time frame (some risks may take time to materialise). At the retail banking level, this could be rewarding bonuses based on monthly or quarterly performance, paying bonuses monthly, quarterly or six monthly.

[14] Having the right measures isn't sufficient to ensure good behaviour if the way the performance calculus is undertaken does not sufficiently sanction non-performance or poor performance on targets.

[15] **Table 2** below outlines the remuneration outcomes for FY2017 for the four CEOs of the big four banks. Only Ian Narev, then CEO at CBA, received no STI award for FY2017, with damage to that banking '*group's trust and reputation as a result of risk matters, most notably the recent civil penalty proceedings initiated by AUSTRAC*',[7] being cited as the reason for this outcome. At two of the Banks (NAB and Westpac) performance on the risk measures that include regulatory compliance ranged from below target to at target. Customer measures were on target at ANZ, CBA, partially achieved at NAB and above target at Westpac.

[16] **Table 3** below indicates that all four banks incorporate behaviours as part of their remuneration principles. This indicates there is potential for the scorecards to encourage good behaviour, although as the discussion above and Table 1 demonstrates, these factors can all too easily be lost in the 'noise' of the various measures chosen.

[17] Two further mechanisms for sanctioning poor conduct can be found in the definitions of misconduct within employment service agreements and within clawback schemes. **Table 4** below demonstrates that how these four banks define 'misconduct'. Each bank could be clearer in spelling out what constitutes 'misconduct' or 'serious misconduct', as well as delineating between an exercise of board discretion to malus adjust remuneration about to vest and an exercise of board discretion to clawback remuneration already received by the executive.

BEAR REGIME: EXTENSION OF CONDUCT OBLIGATIONS?

[18] The BEAR Regime, imposes a series of *accountability obligations on the authorised deposit-taking institution*[8] and separately imposes *accountability obligations*[9] on *accountable persons.*[10]

[19] One question asked in the Interim Report is whether this regime should be extended to other persons. This could be achieved in one of two ways: replicating these provisions within the *Corporations Act 2001* (Cth), chapter 2D.1 where the general duties are found, or else via amendments to Chapter 7 of that Act, probably sitting close to where the general obligations are imposed on AFS licensees in part 7.6, division 3.

[20] Already Part 2D.1 of the Act covers employees in relation to the misuse of their position[11] and the misuse of information.[12] Bringing the BEAR accountability obligations into this part of the Act would impose those obligations on all corporations, especially if the 'person definitions' used in that part (director, secretary, other officer or employee) are adopted.

[21] Any decision to introduce the accountability obligations within part 7.6, division 3 of the Act would need to consider how best to amend the definition of 'accountable persons' to ensure that it can reach the right persons within AFS licensees and any of their authorised representatives.

BEAR REGIME: REMUNERATION OBLIGATIONS

[22] The BEAR Regime also imposes limited rules on remuneration practices by imposing *deferred remuneration obligations*[13] in relation to the *variable remuneration*[14] of an accountable person.

[23] The amount of deferral is linked with the size of the ADI, but ranges from 10% for an accountable person of a small ADI or one of its subsidiaries, through to 60% for the CEO of a large ADI. The minimum deferral period is 4 years.

[24] These provisions also require the ADI's remuneration policy that allows for a reduction in the remuneration of an accountable person if that person has failed to comply with his or her accountability obligations.[15] The amount of reduction is to be proportionate to the failure, and the legislation contemplates that a proportionate reduction could be a reduction to zero.[16] The legislation further contemplates that the reduction need not be achieved via clawback of remuneration (that is variable remuneration relating to a period in which the failure occurred).[17] It contemplates that remuneration sanctions can apply to a current year's performance award. This means that banking remuneration policies and principles,

together with their remuneration scorecards, are required to examine legacy issues and their ongoing impact. Yet as Table 4 below indicates, currently it is Board discretion alone that can ensure this outcome.

[25] Banks are currently releasing their responses to BEAR requirements for deferral and ideally this isn't just about the remuneration schemes, but also the key terms of employment agreements (such as clawback, payments on employment ceasing, approach to sign-on awards)

a. ANZ is reviewing its remuneration in light of the BEAR requirements during FY2018.

b. CBA has released its 2018 remuneration report: no change to STI payment schedule re deferral but scorecard has introduced two modifiers, values and risk & reputation, while Financial/shareholder weighting has increased to 60% for CEO and group executives, with 40% split between three scorecard measures of customer, people and strategy; LTI now 4 years.

c. NAB has adopted a single variable remuneration scheme, with group profit deciding the size of the bonus pool, then reward based on a mix of customer, risk and financial metrics, with an adjustment for regulatory compliance, customer outcomes and reputation impacts. 40% paid in cash at end of financial year, 60% deferred into shares for at least 4 years, with dividends payable to executive during the deferral period. All reward subject to clawback. Forfeiture of deferred component on ceasing employment for resignation or dismissal for cause, but also remaining employed by failing to meet threshold conduct requirements or if board exercises its discretion. The effect of this scheme is to reduce the performance horizon to 12 months.

d. Westpac is reviewing its practices in light of both BEAR and Sedgwick but as not as yet released the outcomes of these deliberations.

[26] Non-compliance with the obligations in Part IIAA exposes the ADI to a pecuniary penalty.[18] The remuneration obligations commence progressively based not only on the size of the ADI, but more particularly on the date of the accountable person's contract that provides for variable remuneration (if prior to 20 February 2018, the commencement date is 1 January 2020; otherwise the 1 January 2019 date applies to large ADIs such as the Big 4 banks discussed in this submission).

[27] It will therefore take some time to see what effect these provisions have on remuneration practices. From the discussion above at [2]-[17], it is clear the BEAR remuneration measures do not address what are the appropriate measures of performance to include within a variable remuneration scheme, how much remuneration is 'appropriate', or what an 'appropriate' adjustment to variable remuneration should be. Shareholders will therefore continue to play the key role in defining, monitoring and disciplining remuneration practices in each of the Big 4 banks.

REMUNERATION, STRATEGY AND CULTURE

[28] Remuneration ultimately reflects corporate strategy and choices made by senior management and endorsed by the Board on what performance for the coming year as part of the strategy cycle, and how it is to be achieved.

[29] What is yet to be revealed by the banks is how (or indeed if) their strategy has changed in response to the Royal Commission and to the evidence of failing in their internal

management arrangements (including remuneration). Getting the banks to focus their strategy on the right outcomes and activities is a precondition to achieving 'better' remuneration.

[30] At the date of this submission, only CBA has disclosed its FY2018 strategy (in its annual report). With a headline of 'becoming a simpler, better bank for our customers'[19] might suggest a different focus to its FY2017 headline of a focus on 'creating long-term value for our customer, shareholders and people',[20] its scorecard of measures for the short-term incentive scheme, summarised in **Table 5** below, suggests otherwise. Note, in particular, the increased weighting given to financial/shareholder measures of performance (40% in FY2017 scorecard; 60% in FY2018 scorecard).

[31] What stood out for me from reviewing the closing submissions across the six rounds of hearings (so not just the four rounds discussed within the Interim Report) is just how many times poor systems contributed to the problem. A problem emerges but it isn't examined to see how widespread the problem is. This is rather telling about the cultures within these institutions in terms of sharing information about problems and a culture of getting to the root of problems and sorting it out.

[32] Remuneration also reflects corporate culture. As the discussion above and Table 1 below indicate, performance is geared towards momentum, and less on proactively managing problems that arise.

[33] I don't subscribe to the view that there is one culture within these large banks, but rather a series of micro-cultures reflecting the tasks and activities and customer group of a particular business unit (which could be at the branch level within the retail business unit). This means that saying the tone is set at the top by the board focus board efforts on big picture statements of corporate purpose or corporate values. These can be easily undermined by micro-cultures and how individuals are managed within that micro-culture. The tone in these large organisations is going to be set by the combined efforts of the various micro-cultures.

[34] If remuneration drives corporate strategy and reflects corporate culture, the current practices of executive remuneration in each of the Big 4 banks will need to change significantly. Addressing remuneration practices at the level of retail banking staff won't be sufficient to drive the change to behaviours necessary to ensure these banks take responsibility for identifying and fixing problems within their internal management arrangements.

Short term incentive scorecards from 2017 annual reports

ANZ	CBA	NAB	WBC
RISK (overall adjustment) • Material breaches of relevant regulations • Adverse audit trend • Mandatory learning completed by employees • Customer complaints referred to EDR	**SOUND RISK MANAGEMENT** (gate opener/ adjustment) – so not a scorecard item	**RISK (25%)** • Regulatory investigations • Control environment • Risk management framework (credit management; prudential compliance; conduct obligations) • Performance against risk appetite (credit risk; market risk; balance sheet and liquidity risk management) • Compliance risk management	(included in performance discipline)
FINANCIAL AND DISCIPLINE (50%) • Strategy execution • Profitability • Returns • Funding and liquidity	**SHAREHOLDER (40%)** • Group cash NPAT • Group underlying PACC • Productivity	**FINANCIAL (25%)** • Cash earnings • Revenue • Expenses • Cash ROE	**PERFORMANCE DISCIPLINE (60%)** • Economic profit (30%) • Core earnings growth (10%) • Capital management (10%) • Adherence to group risk appetite statement (10%)
CUSTOMER (30%) • Customers as advocates (NPS/ customer satisfaction/ relationship strength) • Diversification of sales channels (increase brand strength; launch customer innovations; increase profit contribution and diversity to less capital intensive revenue streams in institutional; increase proportion of digital sales) • Market share	**CUSTOMER (15%)** • Roy Morgan survey position (6 month rolling average; four major banks) • DBM institutional (+$300m or +$500m) • DBM whole of market	**CUSTOMER (25%)** • NPS ranking relative to other banks in priority segments • NAB LABS and innovative partnerships • 10 minute digital onboarding for business customers with simple needs • Application process for everyday accounts (7 minutes application time) • Simplified digital superannuation portal	(included in driving strategic change)
PEOPLE AND REPUTATION (20%) • Diversifying our workforce • Engagement • Retention and performance management (50% reduction in # of employees with consecutive years of poor performance outcomes; reduce staff attrition from 'key talent') • Sustainability (ANZ employer of choice ratings; DJSI performance)	**PEOPLE AND COMMUNITY (30%)** • Reputation • Culture • Engagement • Safety	(included in strategy & leadership)	**PEOPLE AND SUSTAINABILITY (10%)** • DJSI • % women in leadership roles • Employee engagement (79%) • Incident management and whistleblowing processes (feel safe to speak up – 80% in survey) • Health, safety and wellbeing metrics (LTIFR and same day incident reporting)
(included in financial and discipline)	**STRATEGY (15%)** Strategy development & execution	(included in strategy and leadership)	**DRIVING STRATEGIC CHANGE (30%)** • Service revolution (NPS ranking against major banks; Complaints (reduced by 18%); • Technology innovations to customers; external awards)

ANZ	CBA	NAB	WBC
			• Building growth highways (deposits; SME lending; market share in wealth) • Digital transformation (productivity savings; major investments eg customer service hub, big data platform, oracle banking platform, customer management; programs on track re milestones and outcomes; using technology to drive transformation; cybersecurity coordination centre; new call centre infrastructure)
		STRATEGY & LEADERSHIP (25%) • Productivity savings • TSR ranking against other major banks • Development, articulation and implementation of Group's purpose • Reshaping incentives in light of Sedgwick review • Gender diversity metrics (5 in total) • Employee engagement score (59% - objective was to achieve 67%) • Continued enhancements to products and services	

Table 1: Comparison of STI scorecard approaches

ANZ	CBA	NAB	WBC
RISK – TARGET	Risk gateway not opened due to risk and reputation matters	RISK – partially achieved to achieved	
FINANCIAL & DISCIPLINE – ABOVE TARGET	SHAREHOLDER – above target	FINANCIAL – achieved to highly achieved	PERFORMANCE DISCIPLINE – range from below target (group risk appetite statement adherence; core earnings) to above target (economic profit and capital management)
CUSTOMER – TARGET	CUSTOMER - target	CUSTOMER – partially achieved	
PEOPLE & REPUTATION – BELOW TARGET	PEOPLE & COMMUNITY – below target (threshold?)	STRATEGY AND LEADERSHIP – achieved to highly achieved	PEOPLE AND SUSTAINABILITY – above target
	STRATEGY - target		DRIVING STRATEGIC CHANGE – all measures above target
CEO'S BONUS AS % OF MAX: 63%	NIL	49%	74%
CEO'S ANNUAL BONUS $2.0 MILLION	0, due to gateway	$1.955 m	$2,981,460
50% immediate cash 50% deferred into shares, released 25% each year over 4 years	50% immediate cash 50% deferred cash over one year	50% immediate cash 50% deferred into performance rights vesting in two equal tranches after 1 year and 2 years	50% immediate cash 50% restricted ordinary shares, vesting in two equal tranches after 1 year and 2 years
LTI = 3 years	LTI = 4 years	LTI = 4 years	LTI = 3 years plus 1 year holding

Table 2: STI scorecard outcomes FY2017

ANZ	CBA	NAB	WBC
Reward for performance and behaviours aligned with ANZ Values: performance assessments and remuneration outcomes take into consideration performance assessed against individual objectives, ANZ's Values and our risk and compliance standards.[21]	Recognises the role of non-financial drivers in longer-term value creation STVR (short term incentive) has a 'risk and values assessment' as part of its balanced scorecard comprising financial and non-financial measures.[22]	Remuneration policy is designed to support NAB's strategy through building a strong culture that encourages the right behaviours to deliver sustainable customer, shareholder and business outcomes. This is reinforced through appropriate consequences being applied where there is inappropriate risk taking or poor behaviours demonstrated.[23]	Remuneration framework is designed to • align remuneration with customer and shareholder interests; • support appropriate risk culture and employee conduct …[24]

Table 3: Remuneration principles that speak to behaviour and values

Factor	ANZ	CBA	NAB	WBC
Immediate termination	Serious misconduct[25]	Misconduct[26]	Not disclosed[27]	Misconduct[28]
Malus adjustment LTI	Information now known indicates remuneration was either not justified at the time or should not vest because of employee behaviour or conduct before, on, or after the date of grant Adjusts to zero.[29]	Risk and compliance review Also a discretion to adjust amount and form of any vesting award to prevent any unintended outcomes.[30]	Group's financial performance, management of business risks, shareholder expectations and the quality of the financial results. Can adjust down to zero.[31]	Board discretion to adjust downwards or to zero (when circumstances of executive's departure warrant) or to respond to misconduct resulting in significant financial and/or reputational impact to Westpac[32]
Clawback	Not separately disclosed	Not separately disclosed	Not separately disclosed	Not separately disclosed

Table 4: Defining the circumstances for immediate termination of employment, malus adjustment of deferred remuneration, clawback of receiver remuneration

CBA 2017 SCORECARD	CBA 2018 SCORECARD[33]
SOUND RISK MANAGEMENT (gate opener/ adjustment) – so not a scorecard item	VALUES (MODIFIER, not a scorecard item) RISK AND REPUTATION (MODIFIER, not a scorecard item)
SHAREHOLDER (40%) • Group cash NPAT • Group underlying PACC • Productivity	**FINANCIAL/SHAREHOLDER (60%)** • Group cash NPAT • Group underlying PACC • Productivity
CUSTOMER (15%) • Roy Morgan survey position (6 month rolling average; four major banks) • DBM institutional (+$300m or +$500m) • DBM whole of market	**CUSTOMER (15%)** Blended average of net promoter score outcomes for retail and business customers (six-month rolling)
PEOPLE AND COMMUNITY (30%) • Reputation • Culture • Engagement • Safety	**PEOPLE (15%)** • Culture • Talent • Diversity • Safety and wellbeing
STRATEGY (15%) Strategy development & execution	**STRATEGY (10%)** Delivery of key strategic initiatives

Table 5 Comparison of CBA scorecard, FY2017/FY2018

[1] Kym Sheehan, 'The Regulatory Framework for Executive Remuneration in Australia' (2009) 31 *Sydney Law Review* 273, 278.

[2] Australian Council of Superannuation Investors (ACSI), *Australian Asset Owner Stewardship Code* (May 2018), principle 2 on voting and principle 3 on engagement, 9-11.

[3] Stephen Sedgwick AO, *Retail Banking Remuneration Review*, (19 April 2017) (*Sedgwick Review*), 14.

[4] Australian Council of Superannuation Investors (ACSI), *ACSI Governance Guidelines: A Guide to Investor Expectations of Listed Companies* (November 2017), 18.

[5] Australian Securities & Investments Commission, *Financial Advice: Fees for No Service*, Report 499 (October 2016), 20-1.

[6] *Sedgwick Review*, 17-18.

[7] Commonwealth Bank of Australia, Annual Report 2017, 67.

[8] *Banking Act 1959* (Cth), s 37C.

[9] *Banking Act 1959* (Cth), s 37CA (conduct the responsibilities of his or her position as an accountable person by acting with honesty and integrity and with due skill, care and diligence; by dealing with APRA in an open, constructive and cooperative way; to take reasonable steps to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the ADI.

[10] *Banking Act 1959* (Cth), s 37BA.

[11] *Corporations Act 2001* (Cth), s 182(1): A director, secretary, other officer or employee of a corporation must not improperly use their position to (a) gain an advantage for themselves or someone else; or (b) cause detriment to the corporation. This is a

civil penalty provision. A criminal version of this conduct is found in s 184(2) and requires that the use of position is dishonesty with the intention of directly or indirectly, or else reckless as to whether the use may result in gaining (either directly or indirectly) an advantage to themselves or someone else, or causing detriment to the corporation.

[12] *Corporations Act 2001* (Cth), s 183(1): A person who obtains information because they are, or have been, a director or other officer or employee of a corporation must not improperly use the information to (a) gain an advantage for themselves or someone else; or (b) cause detriment to the corporation. This is a civil penalty provision. A criminal version of this conduct is found in s 184(3) and has the same mental elements as noted above for misuse of information: dishonest use of information with the intention (directly or indirectly) or else reckless as to whether the use may result in gaining (either directly or indirectly) an advantage to themselves or someone else, or causing detriment to the corporation.

[13] *Banking Act 1959* (Cth), s 37E(1).

[14] *Banking Act 1959* (Cth), s 37EA(1).

[15] *Banking Act 1959* (Cth), s 37E(1).

[16] *Banking Act 1959* (Cth), s 37E(2).

[17] *Banking Act 1959* (Cth), s 37E(2).

[18] *Banking Act 1959* (Cth), s 37G.

[19] Commonwealth Bank of Australia, Annual Report 2018, 13.

[20] Commonwealth Bank of Australia, Annual Report 2017, 13.

[21] ANZ Banking Group, Annual Report 2017, 44.

[22] Commonwealth Bank of Australia, Annual Report 2017, 69.

[23] National Australia Bank, Annual Financial Report 2017, 36.

[24] Westpac Group, Annual Report 2017, 45.

[25] ANZ Banking Group, Annual Report 2017, 54

[26] Commonwealth Bank of Australia, Annual Report 2017, 78.

[27] National Australia Bank, Annual Financial Report 2017, 50 is the table of senior executive contract terms.

[28] Westpac Group, Annual Report 2017, 55.

[29] ANZ Banking Group, Annual Report 2017, 44.

[30] Commonwealth Bank of Australia, Annual Report 2017, 75.

[31] National Australia Bank, Annual Financial Report 2017, 37.

[32] Westpac Group, Annual Report 2017, 54.

[33] Commonwealth Bank of Australia, Annual Report 2018, 106.