

26 October 2018

Royal Commission into Misconduct in the  
Banking, Superannuation and  
Financial Services Industry

To the Royal Commission

## **Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry**

Governance Institute of Australia (Governance Institute) makes this voluntary submission on issues raised by the Interim Report (Report) of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Commission).

Governance Institute is the only independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance professionals and risk managers are unrivalled.

Our members have primary responsibility for developing and implementing governance and risk frameworks in public listed, unlisted and private companies. They are frequently those with the primary responsibility for dealing and communicating with regulators such as the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA). In listed companies, they have primary responsibility for dealing with the Australian Securities Exchange (ASX) and interpreting and implementing the Listing Rules. Our members have a thorough working knowledge of the *Corporations Act 2001* (the Corporations Act). We have drawn on their expertise in our submission.

Governance Institute is vitally interested in the outcome of the Commission and will remain at the forefront of efforts to enhance good governance practices, and by extension, the culture, of Australian business through its advocacy and education and support of its members.

Governance Institute welcomes the opportunity to make a submission to the Commission.

### **Summary**

- The Report and the results of the most recent Governance Institute annual [Ethics Index](#) demonstrate that the banking, finance and insurance sectors have lost the trust of the community and that the community expects that financial services companies should behave ethically. Our members consider that it is critical for companies in these sectors to look closely at the ethical frameworks<sup>1</sup> underpinning their future governance models.
- An ethical framework should sit at the heart of a company's governance to enable delegation of authority to responsible decision-makers while maintaining organisational integrity.<sup>2</sup> The framework should serve as a common and authoritative point of reference and give shape to culture. Once established and adopted by the board, all aspects of the company (current and prospective) should be assessed and, if required, aligned with the framework, purpose or values.

<sup>1</sup> Also referred to by some companies as their purpose or values.

<sup>2</sup> See *Managing Culture: A good practice guide*, 1<sup>st</sup> edition 2017, Institute of Internal Auditors Australia, The Ethics Centre, Governance Institute of Australia and Chartered Accountants Australia and New Zealand at page 11.

- Companies and their officers must, at a minimum, comply with the law – it is not optional. Legal compliance must be taken as a given rather than a choice made on the basis of 'cultural', business or financial factors. More than this, there is a need for companies operating in the banking, finance and insurance sectors to give greater focus to their ethical foundations and their culture. This would help employees at all levels to make fair and honest decisions. Boards play a critical role in setting the 'tone from the top' and modelling that tone as well as monitoring culture.
- Given that conduct is the manifestation of culture, a prudent board must consider how to avoid setting policies, building systems or establishing practices that might drive conduct that is at odds with their organisation's declared ethical framework, particularly in the area of remuneration and incentives.
- Our members endorse the view in the Report that more disclosure around remuneration is unlikely to assist in addressing poor conduct. Governance Institute has advocated for some time that there is a pressing need for an approach to legislative reporting requirements that simplifies reporting, rather than adding further layers of complexity.
- Our members consider that now is the time for a wide-ranging conversation on the clarity of the role of the board versus management. Addressing the matters raised by the Report will require boards and management to work together differently in the future. Our members are already actively considering the implications of these matters.
- Governance Institute advocates for better enforcement of the existing laws and that no new legislation is proposed before the impact of some of the reforms currently in progress are assessed. Any new individual element of the regulatory landscape needs to be evaluated for its impact on the regulatory 'whole' or 'sum of the parts'. The greatly increased amount of corporate law and governance legislation introduced in recent years has led to significant complexity as well as unintended consequences.
- Our members believe the Australian Securities and Investments Commission (ASIC) can play a key role in restoring and maintaining trust and confidence in the market, which funds the broader Australian economy. If ASIC is to better enforce the existing laws, it must be well funded and appropriately resourced. There must also be proper accountability and transparency in relation to any funding it receives and in relation to any enforcement action it takes.

### **Australians' perceptions of ethics in banking, finance and insurance sectors**

The loss of trust in the banking, finance and insurance sectors is highlighted by the most recent results of Governance Institute's third annual Ethics Index that surveys Australians' attitudes and perceptions of ethics.

The August 2018 results indicate that:

- the Index overall has fallen six points since 2017, from 41 to 35, in large part, dragged down by the poor perception of ethics in the banking sector
- the corporate and finance sectors saw significant falls of 6 and 12 points respectively, demonstrating the poor regard for these sectors
- For the third year in a row, Banking, Finance and Insurance was the lowest category in the Index. Its net score has dropped dramatically from -3 last year to a score of -15; 55% of respondents consider the sector unethical and only 28% view it as ethical
- the Education (80) and Health (70) sectors continue to hold the highest perceived level of ethical behaviour

- those at the most senior level in organisations continue to be perceived to have the most influence on overall ethical practices and outcomes, with CEOs and boards of directors seen as the most influential (80%+ 'Strong influence').

Australians expect the highest standards of their financial institutions; good corporate and governance practices (84% importance score) and good corporate culture (78% importance score) are perceived to be important to ensuring ethical behaviour in the sector. These perceptions have increased since 2017. Compared to last year, more Australians nominated issues surrounding poor corporate culture (38%) and poor corporate governance (37%) as being important to them. The majority (76%) think that there should be board action when a senior executive's behaviour is poor.

### **Ethics, culture and governance**

Ethics, culture and governance are inextricably linked. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (Principles and Recommendations) observe that acting ethically and responsibly is key to strong governance frameworks, and involves more than abiding by the law.<sup>3</sup> It includes being, and being perceived to be, a 'good corporate citizen'. Culture, risk management and risk appetite are also closely linked, as boards need to consider the risks that the culture may create and the effect of this on the organisation's long-term sustainability.

The culture of a company will affect whether there are appropriate boundaries on decision-making in place, whether they are monitored and whether consequences apply when boundaries are breached. 'Boundaries' are not limited to formal regulatory delegations. They also include ethical limitations – the difference between what 'could' and 'should' be done - the 'Can we? Should we?' questions identified in the APRA *Prudential Inquiry into the Commonwealth Bank of Australia (CBA) Final Report*.

There is no 'one-size-fits-all' approach to culture, just as there is no 'one-size-fits-all' approach to governance or risk management.<sup>4</sup> In addition, companies will have subcultures. Culture will always need to be appropriate for the context in which the company is operating. While cultural variation can be an important driver of innovation, there needs to be internal alignment around a core organisational purpose, values and principles to ensure an overall cultural coherence.

How do employees know what makes a decision 'good' or 'bad'? The ethical framework of the company should guide them. The Report demonstrates the need to give increased attention to the ethical foundations of companies operating in the banking, finance and insurance sectors, to help employees at all levels know how to make good decisions, thereby shaping their culture.

An ethical framework sitting at the heart of the governance structures of a company enables the delegation of authority to a distributed network of responsible decision-makers while maintaining organisational integrity.<sup>5</sup> The ethical framework should serve as a common and authoritative point of reference for all decision-makers, and give shape to culture. Once a company's board establishes and formally adopts the framework, all aspects of the company (current and prospective) should be assessed and, if required, aligned with the framework.

An ethical framework is different to a code of ethics or conduct. Codes articulate decisions to be made in specific circumstances. An ethical framework, however, provides guidance on any decision, regardless of its unique circumstances. Typically, a code of ethics or conduct will take

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<sup>3</sup> *Corporate Governance Principles and Recommendations*, 3<sup>rd</sup> edition 2014, ASX Corporate Governance Council at page 19.

<sup>4</sup> See *Managing Culture: A good practice guide*, 1<sup>st</sup> edition 2017, Institute of Internal Auditors Australia, The Ethics Centre, Governance Institute of Australia and Chartered Accountants Australia and New Zealand, Chapter 2.

<sup>5</sup> Op cit at page 11.

the values and principles espoused in an ethical framework and apply them to specific circumstances, but will never cover every possible decision an employee might face. The principles referred to in Chapter 3.1 of the Report could well form the basis of an ethical framework – obey the law, do not mislead or deceive, be fair, provide services that are fit for purpose, deliver services with reasonable care and skill and when acting for another, act in the best interests of that other.

The Report and the results of the Ethics Index both demonstrate that the community expects that financial services companies will behave ethically. The concept of ethics underpins the basis of community outrage – the conduct was wrong. There was a gap between the way these companies talked about their services and how they actually behaved towards customers, particularly vulnerable customers. In many cases, companies asked themselves the wrong question – they asked whether they could, when the question was whether they should.

Our members consider that it is critical in the future, that companies in these sectors look closely at the ethical frameworks underpinning their current governance models. Attaining coherence and consistency in decision-making is a foundational aspect of setting culture and one of the principal tasks of those responsible for companies' governance, those perceived to have the most influence on overall ethical practices and outcomes. Failure to undertake and complete this task limits the capacity of an organisation to act consistently and with integrity – to act ethically.

One key aspect of much of the misconduct identified in the Report is the attitude of many organisations to their compliance with legal obligations. Companies and their officers must comply with the law – it is not optional. The Law Council of Australia makes this point well in a recent submission:

*'... listed entities and their officers must comply with the law. This is not a question of culture or risk management...legal compliance must be treated separately from other "compliance" obligations...'*

*In orthodox risk management methodology, a decision must be taken about the acceptable level of risk. But there is no "acceptable" level of non-compliance with the law. If an enterprise decides, based on purely financial factors, that it will not comply with the law, or is reckless as to whether it complies, by ignoring risks because the enterprise is willing to accept the financial penalty, the community should be deeply concerned, and the behaviour would be unacceptable to a court. It is a mistake to treat non-financial risks in the same way as financial risks, or indeed treat legal compliance in the same way as other business risks – legal compliance must be taken as a given rather than a choice made on the basis of business or financial factors.<sup>6</sup>*

The issues identified in the Report were, in many cases, associated with non-compliance with the law (and community expectations). So, in relation to the question 'whether they could?', the answer is 'they could not' if they had complied with the law, apart from those actions that were in fact lawful but were not in accordance with community expectations. As the Law Council observes, it is important not to conflate compliance with the law on the one hand and ethics (community expectations) on the other.

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<sup>6</sup> Law Council of Australia, Business Law Section, Submission on Draft Fourth Edition of the Corporate Governance Principles and Recommendations, 30 July 2018, paragraphs 58 – 61 at <https://www.lawcouncil.asn.au/resources/submissions/draft-fourth-edition-of-the-corporate-governance-principles-and-recommendations>.

## Culture, remuneration and conduct

If culture is the set of shared mental assumptions that guide interpretation and action in organisations by defining appropriate behaviour for various situations, how people behave is the manifestation of culture.

Employees take their cues about behaviour from those above and around them in the organisational structure. Staff will treat as important what a company 'really' values and rewards. Hence the critical importance of tone at the top of an organisation. The board of directors is responsible for overseeing implementation of tone .... 'The board cannot "set and forget" culture. It has a critical responsibility to monitor how management is implementing the "tone from the top".<sup>7</sup> A prudent board must consider how a company avoids setting policies, building systems or establishing practices that might reasonably be expected to drive behaviour that is at odds with the declared ethical framework, purpose or values.'<sup>8</sup>

Senior executive remuneration, particularly the level of CEO remuneration, is the focus of much public commentary. The results of this year's Ethics Index indicate that for Australians, the more the CEO is paid, the more unethical they think it is, 77% of Australians think it is unethical if a CEO is paid \$3 million per annum (i.e., 50x the average Australian's yearly income). However, as the Report makes clear, remuneration and reward practices below executive level can lead to misconduct.

Incentives and rewards play a powerful role in influencing the values and conduct of individuals, and hence culture, and may have unintended consequences. Research indicates that individuals will seek to do those things that are rewarded, often to the exclusion of activities that are not rewarded.<sup>9</sup> This can create cases of folly where the types of behaviour rewarded are those which the organisation is trying to discourage, while the desired behaviour is not rewarded at all. The Report demonstrates that in most cases the misconduct was implicitly or explicitly encouraged by the remuneration and reward practices in place in various companies or offered to intermediaries.

Writing about mis-selling and market manipulation scandals in the UK, Professor Roger Steare notes the scandals:

*... 'have not only occurred within the context of an increasingly rules-based regulatory regime, they have been perpetrated by people working within cultures driven by a coercive focus on short-term profit maximisation, demanded by analysts, investors, Boards and senior management (Wheatley, 2014). When faced with even a subtle threat to their jobs or their careers, good people can do bad things when faced with the need to comply not only with regulation, but also with what we might call 'Rule #1: You will make the numbers... or else.'<sup>10</sup>*

In a complex multi-level cultural system, middle managers, under implicit or explicit pressure to perform, play an essential role in generating unethical and ethical behaviour. If the system is only set up to capture easily measurable performance outcomes, employees and their managers quickly understand that only those outcomes matter and everything else leaders might have said about ethics recedes into the background. This is because it is not being

<sup>7</sup> For a useful discussion of how boards can set and monitor culture see the UK Financial Reporting Council Report, *Corporate Culture and the role of boards: report on observations*, July 2016 at <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/July/Corporate-culture-key-to-sustainable-growth.aspx>.

<sup>8</sup> *Managing Culture: A good practice guide*, at page 17.

<sup>9</sup> Kerr, S, 'On the folly of rewarding A, while hoping for B', *Academy of Management Journal*, 1975; vol. 18, no. 4, p 769 quoted in *Managing Culture: A good practice guide* at page 18.

<sup>10</sup> 'Character, culture and conduct: why good people do bad things in a fear-driven culture', Professor Roger Steare, *Transforming Culture in Financial Services*, DP 18/2, March 2018, Financial Conduct Authority at page 66.

measured or rewarded. If middle managers' remuneration is tied to the performance of their subordinates (as it often is), middle managers are being incentivised to 'do what it takes' to get employees to 'perform', write Treviño, Den Nieuwenboer, and Vieira da Cunha.<sup>11</sup> They conclude:

*'... middle managers can play an essential role in driving unethical behaviour in organisations...to reach goals, and especially if incentives tie their compensation to their subordinates' performance, middle managers get creative. They use their organisational knowledge to find ways that their employees can make it at least look like they are achieving the goals imposed from above. Their employees may resist but, under pressure, they ultimately go along, making it look as if they are the source of the unethical conduct that can actually be traced to their managers.'*<sup>12</sup>

What is clear from this research is that eliminating incentive-based payments for front-line staff will not necessarily affect the ways in which they are managed, if their managers are rewarded by reference to sales or revenue and profit.

A further complexity in relation to remuneration, particularly in larger listed companies, is the role that proxy advisers and institutional investors play in driving financial metrics for remuneration. While there is some acknowledgement that non-financial objectives have a place if they have clear metrics, there is certainly a strong focus in their guidelines on achieving financial targets. For example, ISS Australia's 2018 Proxy Voting Guidelines provide: 'Where non-financial objectives are used as part of the performance conditions, ISS expects the majority of the payout to be triggered by the financial performance conditions'.<sup>13</sup>

Remuneration in Australia operates within a patchwork of law, guidance and the accounting standards. Since the requirement to put the remuneration report before shareholders was introduced (s 250R), there have been a substantial number of new requirements added to the Corporations Act in relation to this disclosure requirement. Each new requirement supplements rather than replaces existing remuneration disclosure requirements. With the stated policy objective of simplification, the addition of more layers of regulation rather than adopting the approach of taking a holistic view, has resulted in complexity and confusion for investors, particularly retail investors. Governance Institute has advocated for some time that there is a pressing need for an approach to legislative reporting requirements that aims to simplify reporting, rather than adding further layers of complexity.<sup>14</sup>

Our members endorse the view in the Report that more disclosure around remuneration is unlikely to assist in addressing poor conduct. They consider there needs to be greater simplicity and clarity around the rules dealing with conflicted remuneration in financial services and those companies need to give greater thought to the sorts of conduct their remuneration policies incentivise or punish.

### **The role of the board**

There has been a great deal of contemporary commentary about what boards should be doing to restore trust and to right the wrongs uncovered by the Commission. In our members' view,

<sup>11</sup> 'The invisible role of middle management – unethical behaviour and unrealistic expectations', Niki A. den Nieuwenboer, João Vieira da Cunha and Professor Linda Treviño, *Transforming Culture in Financial Services*, DP 18/2, March 2018, Financial Conduct Authority Op cit from page 68.

<sup>12</sup> Op cit page 70.

<sup>13</sup> See *Proxy Voting Guidelines, Benchmark Policy Recommendations*, Effective for Meetings on or after October 1, 2018 page 18, ISS Australia at <https://www.issgovernance.com/file/policy/active/asiapacific/Australia-Voting-Guidelines.pdf>.

<sup>14</sup> See Submission to Treasury 2016-2017 Budget Submission, 5 February 2016.

this raises some fundamental questions about the role of company boards and the role of management and how they will work together in this new environment.

In most Australian companies, directors have delegated day-to-day management of the business to the CEO and the senior management team. There is a separation between the board and management. The types of matters a board reserves to itself and those it delegates to management will be a function of a company's size, complexity, ownership structure, history, culture and the skills of the board and the management team. These will not necessarily remain static but will change as a company changes and evolves.

It is good governance for listed company boards to have a majority of independent directors.<sup>15</sup> Independent non-executive directors are a key governance mechanism for avoiding situations where an individual or group of individuals dominate board decision-making and for maximising the likelihood that board decisions will reflect the best interests of the company as a whole, rather than individual security holders or interest groups. Independent directors also play an important role in challenging management and holding them to account.

For example, the Report clearly identifies a need for many financial services companies to focus on the strengthening of systems, processes, and associated controls. They will need to look much more closely at the quality of their wider management systems and the related risk control framework. Boards cannot know everything, which is why in the past there has been such a strong reliance on the CEO and the senior management team. Boards need to find a better way to oversee how management implements these systems and frameworks and to monitor that a company has an appropriate culture in place. Arguably, this calls for directors to act more like management. This raises a number of important questions:

1. Is our current corporate structure the right structure? Does the way boards currently operate deliver what is needed? Does there need to be a change to the way boards operate?
2. Does the need for boards to become more involved in management systems and risk control frameworks call into question independent directors' role as a safeguard in our system of governance?
3. The board cannot know everything, which is why it must rely on the CEO. Do we change the model or how it is applied? How should boards approach delegation and accountability in the future?
4. How does management provide useful information to the board? How do you curate and edit information that supports boards in meeting their oversight obligations?

While it is not the Commission's role to answer these questions, dealing with the issues raised in the Report will require boards and executives to work together differently in the future and to consider the answers to these questions.

## **Law and regulation**

The Commissioner has found that there is no need for new laws to add to the complexity of the existing regulatory landscape. Governance Institute has long supported modernisation and simplification of the current complex regulatory landscape, particularly the Corporations Act given its importance as national infrastructure. However, Governance Institute members advocate for better enforcement of the existing laws and that no new regulation is proposed before the impact of the reforms currently in progress is assessed.

If the Commissioner ultimately recommends that law reform is required, any new individual element of the regulatory landscape needs to be evaluated for its impact on the regulatory 'whole' or 'sum of the parts'. The greatly increased amount of corporate law and governance legislation introduced in recent years has led to significant complexity as well as unintended

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<sup>15</sup> Recommendation 2.4, Principles and Recommendations.

consequences. The practice of adding to the law by means of regulatory guidance has also created a complex landscape, which is difficult to navigate even for those with access to legal and other advice.

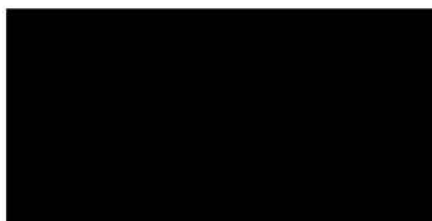
The approach to any new regulation should be measured, so that it can be appropriately bedded down and reviewed for efficacy in achieving the desired policy objectives and required policy outcomes. This is as opposed to the all too frequent approach in recent years of almost non-stop regulatory reform in the corporate law and governance arena, where layer upon layer of legislation or regulation is added to the existing framework, often with truncated consultation periods.

Governance Institute has also advocated for some time for the establishment of an independent body, similar to the former Corporations and Markets Advisory Committee. An independent research-based reform body able to provide advice through a transparent process of arriving at that advice, structured with appropriate expertise and supported by a Legal Committee, could play a valuable role in any regulatory reform that emerges from the Commission's deliberations. Such a body would be in a position to provide advice without the constraints of the political and electoral cycle.

While we appreciate the role that Treasury plays in coordinating advice, more often than not it provides advice to governments in response to particular policies that a government wishes to introduce and expresses how such policies can be implemented. An independent external body would be able to provide advice on matters on which the government has not yet formed a policy position, in order to assist the government to formulate policy. It is difficult for Treasury to secure access to a similar calibre of expertise which is required for many regulatory matters in an ongoing and timely fashion or at an appropriate cost.

Our members consider ASIC can play a key role in restoring and maintaining trust and confidence in the market, which funds the broader Australian economy. If ASIC is to better enforce the existing laws, it is vital that it is well funded and appropriately resourced. There must also be proper accountability and transparency in relation to any funding it receives and in relation to any enforcement action it takes.

Yours sincerely



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