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26 October 2018

Mr Kenneth Hayne
Commissioner

via online submission facility

Submission

in response to the Interim Report of the

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

Dear Mr Hayne

I write to offer some ideas on better understanding, and how to address, the failures on conduct as set out in your Interim Report. These ideas are based on insights from my research with colleague Andrew Brown into Risk Culture over the past several years as published by the Actuaries Institute (see endnote references [i],[ii],[iii]) and my experience as an actuary and advisor in risk management and financial services.

Section 8.2 Causes

High level response

You ask (Vol 1, Chap 10 #8.2 Causes), and I've added my response:

What were the causes of the conduct identified and criticised in this report?

- *Conflict of interest and duty?*

  Yes, directly – encourages dilution or elimination of best interest of consumer

- *Remuneration structures?*

  Yes, directly – where they incentivise organisation or personal profit as opposed to consumer best outcome

- *Culture and governance?*

  Yes, indirectly. Both culture (the way people do things around here) and governance, influence people's behaviour / conduct. To improve the culture of an organisation it is necessary to positively change individuals' behaviour, which in turn leads to improved organisational and risk culture.

- *Regulatory response?*

  Yes, contributory. Not a sufficient deterrent and discouragement to bad conduct.

Three ideas to address areas causing this poor conduct

1 Eliminate conflicts of interest

Observation

The single most identified source of conduct risk is conflicted compensation / remuneration. We need to seriously rethink our current corporate model in financial services to avoid this conflict. Current media discussions declare the vertical integrated model as dead because of the depth of conflict it creates between those selling financial products and those manufacturing, despite the regulatory requirements of putting the consumer's best interests first.

Research has consistently demonstrated that "short term incentives" don't work for more complex tasks because:

- They incentivise individual interests over the best interest of the whole (allocate resources to me and my team to get our bonus)
- They encourage non creative / overly safe behaviour (only do what you get incentivised for) so opportunities are not always taken or are diluted
- They create competition and potential resentment between people
- They encourage short-termism

There is a need to reflect on long term incentives also, as they have different consequences; for example, more likely to improve retention of staff but they may not be the best people for the business.

What can be done?

As Dan Pink[iv] has said "When the profit motive becomes unmoored from the purpose motive, bad things happen". Consider how to align incentives and policies so that people can better engage with their sense of purpose, mastery, autonomy and relatedness.

Consider how to strengthen enforcement mechanisms to reduce any conflicts.

Examples include:

- Intentionally eliminate conflicts of interest; where there are representatives on industry bodies with conflicts, the body needs to be chaired / overseen by person from independent body who has final say

- Strengthen conflicted remuneration regulations (revisit FOFA) in light of Royal Commission insights and recent market developments

- Strengthen regulatory enforcement against organisations that don't enforce appropriate measures against misconduct (for example, not enforcing clawback provisions)

- Strengthen the powers of independent bodies to assess complaints against advisers/ organisations - (for example give the Australian Financial Complaints Authority (AFCA) stronger enforcement powers)

- Consider restricting ownership and / or regulate to break up of entities to force independence and lack of conflicts (ban vertical integration)

2 Individuals ethics are both an input to and outcome of effective culture

Observation

While a large proportion of people are likely to behave ethically for a large proportion of the time, things get much murkier when people are facing either extreme gains or losses of any size. Daniel Kahneman's research has concluded that we are loss averse rather than risk averse. Our observation is that people may take significant risks with other people's money (shareholders or customers) to avoid personal loss.

To enable people to make consistently ethical decisions requires a culture that supports and encourages ethical decision making, and has a zero tolerance for unethical behaviour. This requires strong ethical role models and mentors. It also requires much deeper personal insight and awareness and a deep sense of personal responsibility. And it requires strict enforcement of consequences when ethical breaches occur.

So, what do you want an individual to do?

1. Take responsibility for all that emerges from current behaviour, and hence take action.
2. Ethical weigh up of different strategies.
3. Be transparent, thus facilitating the right actions.
4. Observe and call out wrong behaviour.
5. Seek help

What can be done?

Behaviour change is a significant undertaking. While behaviours may be changed in the short term through incentives and or punishment, longer term change is less likely without understanding and evolving the underlying beliefs and mindsets. For example, a shift in belief from "it's only wrong once you get caught" to "it's not okay to act inappropriately" is a significant shift that will lead to much broader change than large penalties for getting caught.

Developing a strong ethical mindset rarely occurs in a single event or program, but requires ongoing diligence to practice and reflect on personal behaviours and their consequences to others, in real life scenarios.

It also requires an understanding of our default behaviours and what underlying beliefs drive these. Robert Kegan, Harvard Professor in Adult Learning and Professional Development, has researched what stops adults from changing for over 30 years. They have developed methods to overturn our deeper beliefs that can cause us to revert to default behaviours (our "psychological immunity system").

3 Structures, processes and systems intended to drive good outcomes can actually do the opposite

Observation

Our organisations, especially our larger organisations are centres of complexity. Complexity created over time. Ultimately this was created by human beings who through the lens they were viewing, established processes, structures, policies and practices intended to create effective operations.

However, the unintended consequences of many of these systems has been severe. The following are some key examples:

<u>Organisational structure</u>

Large organisations typically have multiple levels of formal and informal hierarchies. Matrix management adds extra dimensions. Yet, these traditional corporate structures have inherent flaws – their hierarchies stifle autonomy, limit openness, and prevent the democracy of debate.

These can all have disastrous consequences from a risk perspective.

<u>Risk and compliance practices</u>

Compliance regimes focus attention on risks on the compliance list rather than taking holistic approach or encouraging responsibility for wider risk management. As the APRA Prudential Review into CBA observed, these have often created compliance to a process rather than compliance to an outcome.

The three lines of defence model increases oversight. For the first line, this may increase complacency or reduce responsibility (someone else is looking at the risk and that's their job). For example, we sometimes hear from risk officers how the first line may respond to lack of traction on a risk issue as a lower priority for them than the risk team.

<u>Incentive systems</u>

Incentive systems have often created conflicting goals and led to poor consumer outcomes. Unless incentives create an alignment between customers, providers and advisors, bad things will happen.

Conflicted remuneration incentivises the wrong behaviour. As human beings facing into these conflicts we haven't proved to be ethically mature enough to adequately address this paradox.

What can be done?

Each of these challenges requires a deeper understanding of the systems we are part of. We must ensure any structural solutions we put in place (risk policies, organisational structures, incentive schemes) are fully aligned to desired outcomes, and potential consequences are carefully considered.

Structures and systems can influence and shape people's sense of what is possible (their self efficacy) and their ways of working (can make collaboration easier or harder). Systems, structures and policies must carefully consider how these impact on people's experiences and beliefs.

For effective risk outcomes, this will include systems and structures that

- build confidence that people can safely speak up
- encourage and reward effective outcomes
- reinforce the importance of risk ownership and personal accountability.

I would be pleased to discuss any of the above, if that helps.

Yours sincerely

[redacted]

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Managing Director

About McGing Advisory & Actuarial

McGing Advisory & Actuarial is a Melbourne based boutique consultancy led by Sean McGing providing a personalised consulting service to directors, senior leaders and executives, and their support teams to deliver quality, valued advice in superannuation, life insurance, wealth management, risk management, actuarial and investment consulting.

[i], McGing S. and Brown, A., 2018, Actuaries Institute, *Establishing a Culture of Risk Ownership – Responsibility, Accountability and Outcomes in a post Hayne Royal Commission World*

[ii], McGing S. & Brown, A., 2014, Actuaries Institute, *Risk Culture Leadership, Measurement & Management – A Comparison across Industries*

[iii], McGing S. & Brown, A., 2013, Actuaries Institute, *Board leadership in a complex world – optimising value from risk and opportunity*

[iv] Daniel Pink , 2009, *Drive: The Surprising Truth About What Motivates Us*