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enabling cultural evolution

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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,

We have prepared this submission to share some insights and suggestions on how organisational culture of the Banking, Superannuation and Financial Services Industry may need to evolve in order to address many of the long standing challenges identified in the Interim Report.

These insights and suggestions are based on our work in the Financial Services Industry over the last 30 years, both as finance and risk practitioners and as culture practitioners in shaping and influencing organisational culture.

In this submission, we are responding to two key issues and considerations raised in the interim report and outlined in section 10.

PART 1
What is the role, if any, of short-term incentives in influencing an effective risk culture and ensuring customer reasonable needs and expectations are met?

PART 2
What role can the regulators play to influence effective risk cultures in organisations? How does regulatory practice need to evolve in order to influence better risk cultures across organisations?

Core principles

The reflections and conclusions below are based on some core principles that we believe are essential in enabling effective organisational and financial systems which ethically serve the needs of all stakeholders, including customers and community.

These principles are:

- To evolve organisational culture requires development and evolution in three ways
    1. evolution of individual beliefs and mindsets
    2. evolution of ways of working and shared beliefs about what really gets rewarded or punished and
    3. evolution of policies, systems and processes
- These three ways must have alignment towards enabling an organisational culture that is congruent with the values, purpose and strategy of an organisation
- In addition to internal alignment culture and beliefs of what is okay or not okay are also influenced external factors. These include the subtle messages received, based on behaviours of regulators or auditors or both what is stated AND not stated in corporate governance principles
- Many of the capabilities required of regulators and risk professionals are complex and require sufficient sophistication to be able to hold multiple perspectives or polarities. For example, to be both trusting AND discerning, to be able to be deeply respectful AND completely honest, to both understand the perspective and context of the other party AND hold the other party accountable, to be able to respectfully provide strong feedback AND gracefully receive strong feedback, to identify the problem AND take ownership for what I can do to solve the problem
- To be able to develop this level of sophistication requires a substantial developmental journey. We have found that this is a pre-requisite for genuine cultural transformation
- Organisations go through discrete stages of cultural evolution. A critical aspect of enabling effective risk cultures is to understand an organisations current stage, and what is required to evolve that culture to the next stage. This is an ongoing journey.

PART 1: Remuneration questions raised in section 10 (sub-section 7.2)

The Interim report of the Royal Commission clearly demonstrates that, despite various reviews and historic incidents, the subsequent changes in regulations and practices have not led to the desired effect of better customer outcomes, and short-term incentives have contributed to ineffective outcomes.

Q1: Should any 'customer facing employee' be paid variable remuneration?

The vast array of research on short-term incentives across multiple industries draws very similar conclusions to the findings from the Royal Commission. Short-term incentive schemes have unintended consequences that limit their effectiveness and can erode value. They erode value because they typically decrease intrinsic motivation.[1] When this happens, consequences often include:

- encouraging individual interests over the best interest of the whole. For example, people may allocate resources to themselves, their team or function to achieve their financial bonus, even when this is out of alignment with wider organisational objectives
- encouraging non-creative and overly safe behaviour where people only do what they are incentivised for
- creating unhealthy competition that erodes organisational and customer outcomes. This also negatively impacts culture and the emotional and mental wellbeing of those in the organisation
- reinforcing short-termism and not encouraging broader, more long-term thinking
- distracting focus from organisational purpose, development and the need for evolution of mindsets and behaviours

Conclusion

Focusing on short-term incentives erodes personal agency, creativity and intrinsic motivation. This is to the detriment of consumer interests, long-term organisational performance and human potential.

We believe that 'Customer facing employees' should not be paid variable remuneration in the form of short-term incentives.

Q2: If more junior employees should not be remunerated in this way, why should their managers and senior executives?

Senior managers have significant influence over direct staff through the power and authority that comes with their role (development, promotion, recognition, leave, work allocation etc.). If senior managers continue to receive short-term incentives, it would be reasonably expected that this would continue to perpetuate the current issues. Therefore, the removal of these bonuses for regular staff should also apply to senior leaders.

Conclusion
Any structures or communications must encourage complete alignment to effective customer outcomes right across as well as up and down the organisation.

In order to create complete alignment, managers and senior executives should not be paid variable remuneration in the form of short-term incentives.

Q3: Should other changes be made to the remuneration practices of banks? What would they be, and how could change be required?

A common point of resistance to removing short-term incentives is that an organisation may become non-competitive in its remuneration. Another concern often expressed is that removing shore term incentives will reduce motivation. Any changes need to consider alternative forms of remuneration and motivation.

Alternative forms of remuneration

<u>Option 1: Instead of short-term incentive, increase base salary</u>

Based on the assumption that financial compensation should be a fair exchange and that people generally like to do their best AND research which reveals increased financial incentives have a negative impact on performance, another option is to build into base salaries an assumption that people are doing and developing towards their best.

There are financial implications (increasing base salary also increases overall company liabilities for long service leave, superannuation, redundancy provisions etc.) that need to be considered.

Option 2: Have a proportion of remuneration at risk

Some organisations seek to address these issues by having a component of remuneration 'at risk', sometimes represented as remuneration withdrawn or financial penalty imposed. While this approach may address some of the symptoms, it does not encourage better long-term thinking and may lead to other unintended consequences. An example is non-disclosure of breaches of conduct, for fear of financial loss.

Option 3: Longer-term incentives tied to much broader outcomes that benefit all stakeholders over the longer term.

Longer-term incentives have significant benefits over short-term incentives, as they can assess both the intended short-term consequences and the potential unintended consequences that often appear long after a short-term incentive has been paid.

This encourages people to act in a way that creates sustainable results and therefore consider the consequences of their actions over a much longer period to a much broader group of stakeholders. This is also able to align much more strongly to the purpose of an organisation and is less likely to suppress intrinsic motivation.

This approach is also criticised on the basis that broader incentives are based on other people's performance and things outside of an individual's control such as market disruptions. However, it is also very clear that this reduces unhealthy competition and significantly increases alignment through shared goals and incentives.

Longer-term incentives are less likely to suppress intrinsic motivations in the short term, but can still have longer term effects, albeit much healthier ones. An example is a long-term incentive plan which is highly successful may lead to very high rate of people who choose to stay in the organisation (and hence act as handcuffs). While this has several benefits (reduced turnover improves efficiencies), it may also lead to complacency or less desire to continually grow and evolve, desire to lock in existing performance and play it safe.

Conclusion
Regulators should be fully prepared to drive unacceptable business models out of the market. The short-term incentive model is clearly unacceptable.
We believe replacing short-term incentives with a slightly higher base salary, taking into account cost implications, is a big step forward.

We do not recommend proportion of remuneration at risk, as this may simply suppress the raising of issues that would lead to reducing remuneration.

Alternative forms of motivation

When extrinsic rewards are removed, they need to be replaced with alternatives that have a greater focus on intrinsic motivation – purpose, mastery, growth, relationships and autonomy.

People's motivations are typically linked to aspects of their job that are unrelated to incentive pay, such as developing themselves, enabling positive outcomes and feeling they are contributing to something useful. Studies consistently identify that training and goal-setting programs have a far greater impact on productivity than pay-for-performance plans. Significant investment in developing greater reflection, personal agency, systems awareness and shared purpose would further lift productivity and enable longer term sustainability.

Conclusion
The consequences of focusing on extrinsic rewards are far ranging and include suppression of human development and the capacity of the organisation to adapt and mature over time. We believe that if extrinsic rewards are replaced by investment in intrinsic values and creating a culture of self-awareness, purpose and personal agency, that the financial returns for organisations would likely be higher and longer term than with a focus on short-term financial incentives.

In order to enhance intrinsic motivation, organisations believe organisations need to

- Develop cultures that align intrinsic motivation to desired customer, community and shareholder outcomes
- Invest in learning and ongoing development to build greater personal agency systems awareness and adaptive capacty.[2]

PART 2: Regulator role questions raised in section 10 (sub section 8.1.4)

How regulators respond to the findings from the Royal Commission can have significant flow-on impacts to organisational culture. In the light of the findings, it may be tempting to further tighten regulations across the financial industry.

If this happens, it could impact the whole industry and put added costs and burden back to shareholders and ultimately customers. At the same time, it may mask the deeper cultural problems that have been at the root cause of many of the issues raised in the Interim report.

Q1: Have regulatory entities responded sufficiently to the conduct identified and criticised in this report?

The way a regulator conducts itself and relationships with insurer has a huge impact and influence on organisational culture:

- Relationships based on engagement, without sufficient enforcement, send the message that it's okay not to comply
- Excessive prescription can lead to poor outcomes (focus becomes following a rule rather than achieving the intention of the regulation)
- Excessive enforcement without engagement can lead to non-disclosure and lack of transparency on issues

Conclusion
The commission findings identified insufficient balance between engagement and enforcement. How the regulator can meaningfully balance enforcement and engagement is crucial to effectively influencing organisational culture. This is a complex skill that requires significant development.

Q2: How can recurrence of inappropriate responses be prevented?

If one thing is clear from recent history, it is that regulation alone is insufficient to drive personal ownership and accountability, and insufficient for organisations to act in the best interest of all stakeholders.

A key risk is that the lessons from the Royal Commission will be learned for a short period, change will appear to be positive, and then organisations may slip back into complacency. To enable organisations to drive personal ownership regularly and consistently, whether or not the eyes of the regulator are fixed upon them, requires significant cultural transformation. The type of cultural transformation required goes beyond a temporary change of behaviours to establishing much deeper transformation of individual and collective mindsets and beliefs.

There are several levers that regulators have to more deeply influence genuine cultural outcomes.

1. Direct measures

1. a. Requirements for Board of Directors

Currently under CPS220, Boards are required to form a view of the risk culture in the institution, and the extent to which that culture supports the ability of the institution to operate consistently within its risk appetite, identify any desirable changes to the risk culture and ensures the institution takes steps to address those changes.

An APRA-regulated institution must maintain an RMS that outlines the approach to ensuring all persons within the institution have awareness of the risk management framework and for instilling an appropriate risk culture across the institution.

While these principles are sound, we believe that much greater guidance and reporting on culture is required to enable Boards to more deeply understand the risk culture of the organisation and ensure adequate initiatives are in place to continually evolve this to be more effective.

One way of deepening an organisation’s commitment to effective risk culture is to significantly expand on this current high-level guidance. This could include requiring a risk culture report that outlines how risk culture is assessed, measured and managed. This could include core questions from the Board that the CRO would be required to respond to which assess risk culture and provide insight into the deeper mindsets and beliefs in the organisation. Examples include:

- How has the company demonstrated that it has consistently put ethical standards ahead of shareholder interests?
- What do your customer facing staff do when “no one is watching”?
- How do people across the organisation perceive their responsibility in

relation to risk?
- How do current processes and structures support or inhibit an effective risk culture?
- How is the risk team perceived in the organisation? How well do the risk and audit teams balance engagement and enforcement?
- What are people's perceptions about how safe it is to raise risks in your organisation?
- How well do people consider the consequences of their daily actions and decisions on internal and external stakeholders?

In terms of measuring and assessing culture, cultural evolution frameworks are increasingly being used in risk and safety as they provide a progression from earlier to later stages of maturity. These also can be used to assess an organisation's adaptive capacity, which provides a much richer assessment of organisational resilience and capacity to adapt and respond. These are more forward-looking measures than traditional culture surveys.[3]

The Board can also learn about the organisation's culture through observing it first-hand. Examples include inviting project teams to present at Board meetings, and 1-1 sessions with key experts in culture and risk.

Conclusion

If organisations are to genuinely overcome the reversion to old behaviours that have plagued the industry for decades, the measurements must be able to assess continual progress. They must also assess mindsets, beliefs, and adaptive capacity, not simply current processes and behaviours.

We believe that consideration should be given to expanding:
- CPS220 reporting requirements for risk culture to include risk culture assessments that measure underlying beliefs, mindsets and adaptive capacity (in addition to traditional measures of behaviours and processes)
- Guidance to Boards on frameworks (including guided questions and interviews) to use to develop deeper understanding of culture

1.b. Requirements of risk officers and auditors

Risk and audit staff (internal and external) have both an obligation to appropriately report and advise on risk management AND are remunerated by the organisation they are assessing. This creates a conflict, and the findings from the Royal Commission and previous reviews have identified various instances in which this conflict led to independence being undermined.

The principle of genuine independence is paramount to mitigating conflicts. Examples to mitigate these conflicts include:

- CRO roles reporting directly to chairman or to regulatory authority
- Regulator appoints auditors and CRO
- Regular rotation of auditors
- Regulator-employed auditors and CROS that get charged back to companies via a levy

Conclusion
Each of these examples has varying complexities and there are vested interests that may have concerns with some options. And it is essential that structures be put in place that get the best outcomes for customers, consumers and communities.

This requires a review of existing regulations and guidelines (including CPS 220) related to who risk and audit professionals report to and are remunerated by, in order to create genuine independence and reduce conflicts of interest.

2. Engagement and enforcement

The regulators have capacity to influence organisational culture through engagement and relationships with organisations. Part of that engagement should include understanding and challenging how the Board and senior leaders go about role modeling desirable values and behaviours and advocating for these across the organisation.

Examples include:

- Greater focus by the regulator on senior decision-making. Senior leaders can expect to be asked how they assess whether or not particular behaviours or actions are ethical.
- Where behaviours are uncovered that are not "ethical", what have the senior people done about it?
- Are the actions and tone of the organisation's leaders highly ethical and are these reflected in the actions and tone of employees throughout the organisation?
- How do senior leaders demonstrate commitment to culturally critical processes such as sales and complaints processes?
- How have the senior leaders addressed conflicts of interest and lack of independence, and ensured these have been addressed at all levels?

While it is relatively easy to identify the need to hold both engagement and enforcement, this is a complex skill that requires significant development to be able to master. Consideration should be given to how regulators can develop these capacities across their staff.

Conclusion
It is essential to strike a balance between regulatory engagement and enforcement to effectively influence organisational culture. The Interim Report suggests that this is an area that requires the further development of capacities for some regulatory offices.

From a cultural perspective, this has implications for culture of the regulatory body and the development of individuals within those bodies as much as implications for organisational culture. These cultural implications include regulatory bodies having a deeper level of accountability to continually walk this balance.

3. Relationships with and across regulatory bodies

Some of the findings identified in the Interim Report to the Royal Commission suggest that regulators have acted with varying degrees of effectiveness within and across regulatory bodies.

From an outside perspective, it appears that there may be much greater opportunities for regulators to share information on specific companies and risks between different departments or regulatory bodies.

There may also be opportunities to clearly and consistently articulate across the different regulatory bodies kind of relationships that will influence companies (enforcement and engagement, independence, transparency).

Conclusion
The culture of the regulatory bodies impacts how they perceive their roles in liaising with and learning from each other. This may be a significant opportunity in more effectively influencing organisational cultures.

We believe there is value in reviewing and identifying cultural imperatives of a regulatory body in order to effectively influence the culture of regulated organisations.

4. Indirect measures

At the heart of conduct risk is how customer facing people behave on a day to day basis, and the decisions they make, in terms of how they balance the needs and rights of the customer, the shareholder and other stakeholders. The capacities required to balance the needs of these stakeholders consistently include:

- Self-efficacy, belief in one's capacity to enable change[4,5]
- Mental complexity – capacity to hold many different perspectives and make a decision that balances these.
- Psychological maturity – capacity to balance one's own needs (security, status, certainty) with one's ethical values and contribution to others
- External orientation – capacity to understand current and emerging customer needs and expectations

According to Robert Kegan, Harvard University Professor of Adult Learning and Professional Development, adults have the potential to continue to adapt and evolve over our entire lives[6.] In other words, we have the potential to continually increase our mental and psychological complexity[7] to be able to deal with emerging challenges.

While greater complexity is not a complete solution to self-interest, people at later stages of cognitive and psychological complexity are much more able to hold multiple perspectives simultaneously and see the longer-term consequences of their actions. And, they are more able to put in place solutions that balance stakeholder needs and rights. There are training and development initiatives that have demonstrated significant enhancement in self-efficacy and that support individuals in developing mental complexity, with demonstrated financial and risk benefits.[5]

Regulators can indirectly influence corporate commitment to development through requiring and assessment and measurement. While it may not be practical to assess every individual or key individuals, a culture assessment is both practical and cultural progress is highly influenced by individual progress.[8] This would be part of the Risk Culture Report. Education and awareness. There is also the potential to establish accredited programs that focus on building self-efficacy, and mental and psychological complexity.

Conclusion

Consideration should be given to:

- introducing requirements tor organisations to invest in training and development that focus on building self-efficacy, mental complexity and psychological complexity.
- Include as part of any Risk Culture reporting requirements to assess the adaptive capacity of the organisation.

4.a. Broader consideration – the role of organisations in society

"As it stands, the law generally links the corporate interests to those of the shareholders, and only derivatively with those of the community, consumers, employees and other stakeholders." – Governance Institute of Australia, 2013
Many of the broader issues identified in the Interim report rest at the heart of this question – "who do organisations truly represent and who do they really act for"?

While shareholder primacy is not enshrined in corporate legislation in Australia, there is little doubt that there is a common acceptance in Australia that the shareholder is the primary stakeholder in corporations. This is reinforced by multiple factors including shareholder expectations, often encouraging short-term outcomes at the potential cost of longer-term sustainability. The belief that the shareholder is primary has a strong influence on corporate cultures in Australia and contributes to issues such as balanced scorecards that are balanced towards the shareholder.

According to the Governance Institute of Australia, "Shareholder primacy has been allowed to develop because the law contains neither an explicit statement of what the societal purpose of companies is, nor of what the interests of the corporation are."

Countries such as France have begun to address this with the French Government recommending amendment to the French Civil Code to add, "The company shall be managed in its own interest, considering the social and environmental consequences of its activity," The government also recommends an amendment to the French Commercial Code for the purpose of entrusting the boards of directors to define a company's purpose in order to guide the company's strategy, taking into account its social and environmental consequences.

Conclusion

While many of the above recommendations can influence and shape effective risk cultures, their effectiveness are limited by the current perception that the primary stakeholder is the shareholder. The overarching governance framework must recognise the importance of all stakeholders if changes from the Royal Commission are to move beyond another temporary step forward and become genuine progress.

Adopt additional corporate governance principles that explicitly recognise all stakeholders. Enforce these governance principles through Board responsibilities.

Summary

The Interim Report has clearly identified that many past initiatives to improve consumer outcomes have failed to create genuine, lasting change. A different, deeper approach is required, which enables ongoing development and evolution of all parts and members of the financial system.

Such an approach would support the finance industry to evolve to be more in line with its stated intent – to enable financial health and wellbeing by protecting and growing wealth. We are optimistic that this can have a range of positive benefits for all.

About Adaptive Cultures

Adaptive Cultures supports organisations to become adaptive, agile and sustainable with consideration for all stakeholders. This includes the long-term and complex impacts organisations have on all the people, environments and systems they touch.

Adaptive Cultures exists to enable Cultural Evolution for the good of people and planet. The intention of cultural evolution is to enable individuals, collectives and communities to live their highest potentials, making a positive and deeply humane contribution to their spheres of influence.

https://adaptivecultures.co/

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