26 October 2018

The Commissioner, the Honourable Kenneth Madison Hayne
Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Dear Sir,

Submission on the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Guerdon Associates appreciates the opportunity to provide its submission on the *Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (the Interim Report). As a provider of remuneration and governance advisory services and an expert observer of the impact of executive remuneration internationally, the firm believes it can provide useful insight into:

- the causes and effects of various remuneration frameworks,
- the assumptions underlying these frameworks, and
- the underlying reasons why organisations adopt these frameworks.

Given the limited time available to review the Interim Report and prepare our submission, it is necessarily concise. We would, however, be pleased to respond to any questions you may have or meet with you to explain any aspect in more detail.

The purpose of our submission is to alert you to key factors that our firm believes should be considered as the Commission frames its recommendations.

About Guerdon Associates

Guerdon Associates is an independent[1] executive remuneration and board governance consulting firm. Our clients include a significant proportion of companies in the ASX 300, large private companies and pre-IPO companies. Offices are located in Melbourne and Sydney, with affiliate offices in London, Paris, Zurich, New York, Los Angeles and Beijing. The firm has worked with the boards of many of Australia's listed companies including banks, insurers and other financial services providers, as well as superannuation funds.

The firm's submissions were among the most cited in the Productivity Commission's review of executive remuneration, and over the years it has contributed to Treasury, Australian Taxation Office and CAMAC consultations on numerous Corporations Act and taxation legislation changes, as well as regularly engaging with APRA on remuneration matters.

[1] Independence is defined as a specialist provider of consulting services to boards to minimise conflicts of interest that may result from being a supplier of multiple services to both management and boards.

Is the removal of incentives the answer to misconduct?

The Interim Report concludes that "……. *all of the conduct identified and criticised… was conduct that provided a financial benefit to the individuals and entities concerned* …" (p. 340). The governance and risk management practices of the entities did not prevent the conduct. The report then goes on to state that the culture and conduct of the banks was driven by, and was reflected in their remuneration practices and policies.

Guerdon Associates does not dispute this. However, the report's potential responses to this relationship do not sit comfortably within the context of the industry and the economy in a broader sense, ie: to either:

a. Remove measures of profit from performance management and reward systems, or

b. Remove incentive structures altogether,

It may, first, be instructive to take the broader view, before we address the narrower perspective of specific monetary incentives for sales or profit addressed in the Report.

The context

The foundations for a modern market economy was described in the work of the Scottish economist, Adam Smith. In the *"Wealth of Nations"*, and other later works, Smith expounded upon how rational self-interest and competition can lead to economic prosperity. Since then, there has been continual improvement and refinement in regulating markets so that they work more efficiently (with the occassional regression). But his idea of "rational self-interest" has endured to this day.

Despite many of Smith's ideas being appropriated by various idealogues, his is an amoral position. As such, it can explain why the Commission noted in its summary (p74) that:

> *"No matter whether the motive is called 'greed', 'avarice' or 'pursuit of profit', the [banking] conduct ignores basic standards of honesty."*

Ramifications for incentives

If one accepts the validity of Smith's observations that behaviour is driven by rational self-interest, it follows that, to uphold basic, or higher, standards of honesty, there must be profit consequences for standards that fall below this.

The pursuit of profit can co-exist with high standards of honesty if the consequences of being dishonest will be loss and ignomy.

What has been evident from the Commission's hearings and recent APRA and ASIC reports is that while profit has resulted in gain for industry participants, being dishonest has not resulted in loss. Hence, rational self-interest has, in effect, permitted misconduct as it has not constrained the pursuit of profit – an assymetry in the banking system that has, until recently, rewarded shareholders, management, depositors and other creditors, and bank employees at the expense of some customers.

Therefore, it would be suitably judicious for the Commission to seek better symmetry in risk and reward. That is, provide customers with more weight in the system to influence

profit, risk and reward. This would be a far more realistic, and pragmatic, path than either quarantining profit or its proxies from incentives or abolishing incentives completely as suggested within the Interim Report.

These actions will not remove or lessen the emphasis on profit. Such a reduction in emphasis is impossible. The pursuit of profit is built into the very fabric of our banking system (not to mention, our civilisation):

- Shareholders who provide the equity that enables banks to extend loans require a profitable return
- Banks have to charge in excess of what they borrow from depositors and other creditors to assure them of repayment
- APRA requires banks to be profitable to ensure our banks remain *"unquestionably strong"*
- Customers require access to credit from the banks to realise their aspirations, whether it be establishing or improving a business, or buying a home.

Given the above, denying incentive remuneration or removing profit from incentive determination will not resolve instances of misconduct. Misconduct will still occur because there is profit in it for the company, and enhanced career earnings for employees (via fixed pay increases and promotions, or vice versa if there are no sales and profit from not behaving inappropriately).

Making monetary incentives part of the solution to misconduct rather than its cause

While the report infers that the Commission may be predisposed to regulated entities being prohibited from providing employee incentives, we suggest that incentives may be part of the solution given that:

1. It is acknowledged incentives have directly impacted behaviour; and
2. Employees respond with rational self-interest.

Rather than remove incentives for the pursuit of profit, a more appropriate response would be to ensure the system of incentives has more symmetry. Profit must be impacted by poor behaviour. The reward system must provide for the loss of reward, or potential reward, for misconduct.

Rational self-interest will motivate people to pursue profit, and will ensure they do it without misconduct if to do otherwise will incur a financial cost.

"Negative rewards" as part of the solution

Independent behavioural economics research has shown that the threat of loss is twice as effective as the opportunity for gain[2].

A method that makes use of this principle is malus, a concept that has not been fully considered and addressed in the Interim Report.

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[2] The original research is found in Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. Econometrica, 47, 263-291.See also http://www.guerdonassociates.com/articles/nobel-prize-integrates-economics-with-psychology-a-pity-that-it-has-not-been-yet-applied-to-executive-pay/

Malus is a "negative reward". In practice, it means that *unvested* incentives are cancelled or forfeited. It could also apply to deferred salary, although this is not currently practiced among Australian banks and insurers.

The BEAR legislation requires the remuneration of "accountable persons" to be deferred and subject to malus. Malus is referred to in APRA prudential guidelines[3], and all major and regional banks have malus policies.

A policy must be applied to have effect

Unfortunately, as noted by APRA[4], malus policies are rarely applied at top executive level, and inconsistently applied at other levels.

This is partly because of competition to retain key people, and partly because companies themselves may not have been sufficiently penalised for misconduct by the regulators, but predominantly because most banks apply malus via discretion rather than prescription: i.e., there are no rules where malus is to be applied by default. Rather, the application of malus is considered an exception.

While not removing discretion, malus is more likely to be applied if it is a prescribed action. This will cause a change in what is known as "choice architecture"[5] – a concept recognising that the most likely choice will often be the default choice. There is less likelihood that companies will exercise discretion not to apply malus if its use is otherwise prescribed.

Assuming it is prescribed that every instance of misconduct results in malus, then malus would, initially, be more frequently applied, and more consistently. This more frequent application of a "negative reward" will cause rational self-interest to focus management and employees on reducing misconduct.

Unintended consequences?

There is a prospect that such a system may focus management on the reduction of misconduct reporting, rather than actual misconduct[6].

This can be addressed by facilitating whistleblowing to a government agency. The US SEC, as required by the Dodd-Frank Act, has set up a whistleblower program[7] that offers financial incentives to blow the whistle (rewards of up to 30 percent of amounts recovered) that recognise the risks to the whistleblower's career and livelihood that come from

[3] https://www.apra.gov.au/sites/default/files/PPG511_REM_revised-Dec-09_0.pdf
[4] https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry_Final-Report_30042018.pdf and also https://www.apra.gov.au/sites/default/files/180328-Information-Paper-Remuneration-Practices.pdf
[5] Choice architecture has been used successfully in public policy to "nudge" populations to accept choices beneficial to their health and financial well-being, and still provide them with an alternative to opt out. See behavioural economics research by Nobel Laureate Richard Thaler – see Thaler, R. H., & Sunstein, C. (2008). Nudge: Improving decisions about health, wealth, and happiness. New Haven, CT: Yale University Press
[6] This was noted in the Interim Report in Section 7 on page 69, where it states that "'balanced scorecards' and 'conduct gateways' have too often used doing the 'wrong thing' as a disqualifying criterion. But penalising default is not the same as rewarding the right and proper performance of a task. Penalising default encourages hiding mistakes; it does not encourage doing the 'right thing'" It does not encourage the intermediary or the employee to ask, 'Should I, should the Bank, do this?'"
[7] See https://www.sec.gov/whistleblower

stepping forward. Providing government agencies are adequately empowered and funded[8] to respond to whistleblowers, management may be more inclined to welcome and respond to whistleblowers within their own companies before it gets to government agencies.

Clawback

In response to a Financial Stability Board refinement of its banker compensation guidelines[9], APRA has stepped up its vigilence in regard to the application of clawback[10]. Clawback refers to the recovery of remuneration that has been paid. It is a requirement in the US for incentives that otherwise would not have been paid in instances of financial misstatement, and in the UK for regulated entities up to 10 years after payment.

In practice it is rarely applied, and to our knowledge, only successful as a result of litigation when it has been shown an incentive was paid as a result of fraud.

We conclude that it not a particularly viable mechanism to reduce instances of misconduct.

Culture

Culture would be considered by many industry stakeholders to be the panacea to ensuring employees consider "should I do this". It is not. Most bank and insurance employees, like the rest of society, do have a moral compass that guides their everyday actions. This is to misunderstand what "culture" is.

There is a great deal in the Interim Report, as well as reports from ASIC, APRA and others regarding "culture".

None of these reports have ventured to apply a robust definition. We suggest that culture is defined by the frequency of defined behaviours within an organisation. Organisations that tolerate a broad range of defined behaviours would have a flat bell curve, whereas organisations that do not will have a much taller, narrower curve.

The organisation with the flat curve will have more misconduct. That is, it occurs when there is greater tolerance of employees behaving badly.

To achieve culture change is to change the shape of this curve from one of "tolerance" to "intolerance". Zero tolerance means a rewards system (that encompasses various factors including peer recognition, promotion and remuneration) where penalties are applied for inappropriate behaviour on a more prescriptive and less discretionary basis.

Depending on the frequency and severity, this could be demonstrated in reduced pay (i.e. the application of malus), through to clawback (the recovery of paid monies), termination of employment, and criminal prosecution.

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[8] We note that another US whistle-blower program aimed at uncovering fraud against the US government (see https://www.phillipsandcohen.com/false-claims-act-history/#FCA_Skip)has become in effect self-funded, with $35 billion in fines and civil actions.
[9] See http://www.guerdonassociates.com/articles/global-financial-regulator-makes-clear-the-need-to-adjust-pay-for-fuzzy-non-financial-factors/
[10] See http://www.guerdonassociates.com/articles/apras-review-of-cba-a-checklist-of-what-it-means-for-all-board-remuneration-committees/

If systems that reward and penalise misconduct as described here are implemented and maintained, and are accompanied by complementary systems to detect and report misconduct, rational self interest will do the rest. Cultures will change. Culture is the end result, not the beginning.

Regulators

The Interim Report indicates that regulators could be more effective.

While Guerdon Associates is not in a position to comment on the structural, legal and regulatory impediments for effective regulation, we have observed assymetry in regulatory behaviour that could be addressed, in part, with reward systems.

Regulators have had difficulty attracting and retaining suitably qualifed staff. Those employees who show themselves to be competent and qualified tend to be hired from the regulator into the ranks of the organisations they regulate, or their agents. The earning potential of these employees is considerably higher within regulated employers than it would have been within the regulator.

These employees' rational self-interest will be coloured by the source of their career earnings potential. There is little incentive for ferocious regulation of potential future employers.

This need not be the case.

It is not difficult to envisage effective reward plans for regulatory employees that provide a direct reward to the number of prosecutions, or the recovery of monies for wronged customers, or fines levied.

An effective incentive plan would pay for itself from increases in general revenue from fines and penalties. It is acknowledged that such incentives may change the nature of regulation and supervision from co-operation to more of an adversarial nature. However, there is evidence in the Interim Report that the regulated entities appear to assume this in any case.

The obvious concern with such an incentive framework would be the pursuit of enforcement in a way that is not appropriate or warrant such action. The incentive structure should equally be symmetrical (as described above) so that there is a cost to the employee for poor behaviour or conduct in the way the employee pursues the regulatory objectives.

The changes in remuneration frameworks among regulators will require legislative change, and accommodating budgets.

It would also require a shift from the current perception of the place of incentives in the public service – we acknowledge that this may be a difficult prospect within the service itself and within the community. However, we also note that some agencies, such as ASIC, already receive exemptions in regard to compliance with public sector pay standards.

Responses to specific questions raised by the Interim Report

Q. Should any bank employee dealing with a customer be rewarded (whether by commission or as part of an incentive remuneration scheme) for selling the client a product

of the employer? That is, should any 'customer-facing employee' be paid variable remuneration?

A. Providing the reward framework is structured with symmetry, there is no reason not to permit variable reward.

Reward symmetry means there is provision for reward to go down as well as up, with such adjustments contingent on whether results comply with applicable laws, regulations and standards. This assumes that:

a. laws and regulations are appropriate for customers to receive advice, services and products best suited to their needs
b. There are suitable[11] penalties for the individual, company and/or the company's executives and directors in instances of non-compliance
c. There is a reasonable probability that instances of non-compliance will be discovered, reported and acted on by regulators.

Denying incentive remuneration will not, of itself, resolve instances of misconduct. If a, b and c above are not present, misconduct will still occur because there is profit in it for the company, and enhanced career earnings for employees (via fixed pay increases and promotions, or vice versa if there are no sales and profit from not behaving inappropriately).

There are mechanisms within incentive frameworks that, to some extent, encourage appropriate behaviour. The BEAR requires "accountable persons" to have an element of deferred remuneration that can be forfeited in the event unacceptable risk taking, among other things, is discovered after the fact. So the framework exists for these persons, although, as noted earlier in our submission, the mechanism for malus within banks and insurers is probably deficient.

The malus principle could apply to other employees. However, as they are on lower incomes, there may be some cost to regulated entities to provide, in effect, a once-off "transition" payment, and then defer it. This would enable the symmetrical framework to be adopted without penalising the regular take-home pay of lower-level employees.

Q. If the answer is either 'no' or 'some should not', what follows about incentive remuneration for managers or more senior executives? If more junior employees should not be remunerated in this way, why should their managers and senior executives?

A. As noted earlier in our submission, it would be disingenuous to suggest that profit is not the raison d'etre of senior management employment, and by extension, all employees in private enterprise. The removal of incentive payments will not mean profit will cease to be the underlying motive for continued employment, promotion, annual pay adjustments and career earnings.

Hence, given that the basis of our society is unlikely to be changed by outcomes from the Commission, it is suggested that solutions be accommodated within it. That is, adjust profits for misconduct. Remuneration will self-adjust with profit.

[11] That is, sufficient to ensure "rational self-interest" inspired remedial action

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

A. Remuneration practices at Australian banks can be improved by addressing the following:

- Executive pay is structured to focus on short term[12] measures of profit and relative total shareholder return primarily in response to investor and proxy adviser requirements.
- APRA guidelines on risk adjusted performance measurement are not followed[13].
- Malus is not practised[14].
- Competition prevents structural improvement to remuneration practices[15].

The boards of regulated entities would, we believe, agree that their remuneration frameworks are not ideal. However, the directors of listed banks and insurers serve at the pleasure of institutional investors. These investors mandate that remuneration outcomes reflect short term profit[16].

This suggests either that change will not be voluntary unless it is mandated, or there are impacts on profit from not changing.

There are problems with mandating change. While it can be said that bank and insurer remuneration frameworks at the executive level are poor in terms of design effectiveness, there is no ready answer as to what is effective, other than the application of malus be prescribed in all instances of misconduct.

To assist this, regulated entities would be better placed to have all "long-term incentives" replaced with time vested equity grants that vest over a period that truly reflects the business cycle (which in most cases will be longer than the current three or four-year long term incentive default).

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[12] Even "long-term incentives" are mainly influenced by short term results, and the periods that apply do not reflect a full economic cycle. The investment community that votes on executive pay matters are primarily driven by short term profit results. Research supports this (see http://www.guerdonassociates.com/articles/shareholders-care-about-returns-do-they-care-if-remuneration-is-right/). The bias is also clear from negative investor responses to CBA's 2016 proposed changes to its remuneration structure. This bias is unlikely to change.

[13] See http://www.guerdonassociates.com/articles/apras-frustration-with-company-remuneration-practices-evident-and-patience-tested/

[14] This Royal Commission, and other recent enquiries, have resulted in the application of malus, but formal systems to more rigorously and robust apply malus are lacking.

[15] At executive levels, Australian bank pay is generally below overseas peers, contrary to popular belief. Therefore, in effect, there are just three externally qualified candidates for each vacancy among the big four banks. So there is reluctance among the large banks to be the first to have a "tougher" remuneration policy, such as automatic malus for poor behaviour of employees who may be remote from the executive's direct supervision. A tougher remuneration policy will impact their ability to attract and retain the few resources with the experience to do the job.

[16] Many will deny this, and refer to their guidelines for incentives to also reward "long-term" performance. A thorough analysis of what they mean by this will reveal that their required measures for long term performance are impacted by annual (i.e. short term) results. We also note, with interest, that almost 100% of large superannuation funds who are the investors and also part of the Commission's review, do not have "long-term" incentives and effective malus systems for their own staff.

Most long term incentives are not actually long term, given that they are contingent largely on an end of financial year result. Their replacement with an equity grant that vests over a longer term will permit such a grant to be reduced or eliminated in the event of serious misconduct, even if this conduct comes to light several years after its inception.

Because such an equity grant is otherwise certain, its reduction or elimination via misconduct will also have a more significant impact on behaviour than the less certain long term incentive (see footnote 2 reference).

Otherwise, what is most appropriate in terms of remuneration is likely to vary with the bank or insurer. Therefore, the most effective method is to ensure misbehaviour impacts profit. When profit is impacted, executive remuneration will be impacted.

If a legislative response to pay frameworks is required, the following approach is suggested for regulated entities:

1. Defer a proportion of all employees' pay
2. Apply a malus policy to deferred pay
3. The malus policy prescribes that deferred pay will be reduced in specific and general instances of misconduct, with the amount of reduction determined by the frequency and severity of misconduct
4. Entities have discretion either to increase or reduce the malus adjustment
5. Entities disclose the policy, the extent that malus was applied, and the extent that discretion was applied to override prescribed reductions
6. Replace executive long term incentives with deferred remuneration suitable for enhanced malus application that could be applied up to 5 to 7 years after grant.

This approach would only be feasible if it were to be complemented with measures that encourage the discovery and reporting of misconduct.

Q. Should the BEAR be extended in application?

A: Within existing regulated entities, this could mean extending the incentive deferral and malus requirement to all employees eligible for an incentive. Most of these employees are not highly paid, and an initial reduction in cash will significantly impact their standard of living. To ameliorate this would require all banks to pay more in the initial year of transition so that employees receive the same cash, with an additional amount deferred. This would be costly, as would setting up and maintaining a malus assessment system.

Nevertheless, the Commission has shown that poor behaviour is not isolated and happens right throughout the organisation (as a result of rational self-interest). The suggested legislative response described above could be applied within the BEAR legislative framework.

Concluding remarks

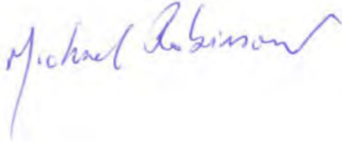
Guerdon Associates has confined our comments to matters of remuneration. However, we trust that our submission demonstrates that remuneration (including incentives) cannot be reviewed in isolation.

Remuneration is part of a complex system that ultimately distributes rewards based on contributions that are valued. The evidence, as pointed out in your Interim Report, is that remuneration is driven by profit and self-interest.

Our qualification to this conclusion is that this self-interest is amoral and rational. While the behaviour it generated and that has been the subject of the Commission's enquiry, is antithetical to a sound moral framework, it does not follow that incentives are antithetical to a sound moral framework. Rather, systems of risk, profit and reward have not been aligned with a sound moral framework when they should be.

Our fundamental assumption is that, in our society, profit will always be valued. Therefore, it follows that behaving badly should affect profit. It has been clear that, in this regard, behaving badly has until recently not affected profit and therefore its subsequent reward.

We would be pleased to respond to any queries you may have in relation to this submission.



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