



Submission in response to the Royal Commission's Interim Report

Support for Urgent Action to Address the Misconduct Identified

The interim report represents a vital step towards addressing the conduct problems within financial services entities that continue to plague the banking and financial services sector, both in Australia and globally, and for too long have been tolerated, ignored or overlooked.

In terms of offering input and responses to the policy issues and general questions outlined in Chapter 10 of the Interim Report, The Caux Round Table (CRT), is in a relatively unique position. As an international network of business and professional leaders working to promote responsible and moral capitalism, its advice has been widely sought after including by the UN and government bodies.

In March 2009, following the Global Financial Crisis (GFC), the CRT issued a Seven Point Reform Plan to restore trust in the global financial system and to ensure financial system stability— see <http://cauxroundtable.org/newsmaster.cfm?&menuid=99&action=view&retrieveid=11>. The CRT urged the G20 leaders to immediately implement these essential reforms.

While governments and regulators have implemented various reforms in response to the GFC, the reforms have fallen well short of addressing and preventing continued widespread misconduct, largely driven by the pursuit of short-term profit at the expense of basic standards of honesty and trust.

At the time, the then Chairman of the CRT and past Chairman of the Bar of England and Wales, Lord Dan Brennan QC, said “capitalism’s so-called immune system of laissez-faire market discipline has failed the test and the underlying causes of this systematic breakdown - greed and narrow self-interest - must be addressed”. Ten years later, this remains the case and the Commission is in a unique position to put forward policy recommendations to finally address these underlying causes.

At the heart of the problem are dysfunctional and short-sighted systems of misaligned remuneration and conflicted incentives. The compensation of banking and financial services executives, traders and fund managers, and problematic commission structures, too often reward narrow self-interests at the expense of long-term wealth creation and the interests of the customer base. Compounding this, rewards often rise with excessive risk taking and typically are provided in ways that largely shield senior corporate officers from appropriate liability for their decisions.

Added to this are the ongoing shortfalls in proper risk assessment and management. This failure of comprehensive good governance has arisen due to boards of directors not being sufficiently encased in an environment of sound total risk management and transparency and an over reliance on often conflicted risk assessments by management.

And a failure of financial regulation which clearly has been inadequate to prevent the inherent dysfunctionality and misconduct that the Royal Commission has identified.



As the Royal Commission has identified, there have already been responses by regulators and the institutions themselves including: new programs for refunds to and remediation for consumers; abandonment of some products or practices; and new and more intense regulatory focus on particular activities. But these measures have essentially only focused on measures to deal with the misconducts revealed, to penalise the institutions, and to make good the consumers and businesses impacted. While important measures in themselves, they do not adequately deal with the underlying causes of the misconduct.

The need for urgent action to address the underlying causes of the misconduct remains, as identified by the Royal Commission.

Suggested policy recommendations for the Commission's Consideration

While originally proposed in the aftermath of the GFC, much of the CRT's seven step reform plan are equally relevant to addressing the underlying causes of the misconduct identified in the Commission's Interim Report.

In particular, the first four steps of the CRT's 2009 reform plan are directly relevant to the Commission's interim findings. These are set out below, with minor modifications to better reflect the circumstances and the interim findings of the Royal Commission, together with a recommended additional fifth step to address the type of misaligned and conflicted commission and sales incentive structures identified by the Commission.

The CRT respectfully suggests that this five-step reform plan, as set out below, provides a valuable framework against which the Commission can consider and frame many of its policy recommendations in its final report.

1. **Require board directors to consider stakeholder interests beyond shareholders, by codifying the principle of "enlightened shareholder value" in company law.**

Recommended reforms:

- Require board directors of banks and other financial services companies to disclose all material risks and uncertainties to the future reputation, performance and sustainability of the company and its business in the annual report.
- Specifically, require the corporate boards to disclose annually the material risks and impacts to customers and other stakeholders flowing from:
 - conflicts of interest;
 - remuneration and incentive systems;
 - customer, product and service issues;
 - workplace and employee issues;
 - supply chain matters;
 - environmental risks; and
 - social and community issues and concerns.



2. Require minimum standards of corporate governance and ethics knowledge and expertise for banking and financial services company board directors.

Recommended reforms:

- Require directors to have the skills and expertise to:
 - responsibly execute their duties of trust and profit, given business is not without consequence for customers and society;
 - oversee the full spectrum of financial, governance, social and environmental risks to the company; and
 - ensure business practices meet minimal ethical and conduct standards.

3. Require banking and financial services company boards to commission an independent annual risk assurance report.

Recommended reforms

- Require Boards to commission an independent risk assurance report annually, on the effectiveness of their company's risk management processes and to disclose the assurance report findings to regulators.
- Require the Risk Management Framework of financial institutions to comprehensively incorporate the full spectrum of risks - financial, governance, behavioural, social, and environmental

4. Regulate executive remuneration structures to ensure that they are consistent with: prudent risk management; encourage fairness and honesty and ethical behaviour; align executive interests with those of customers, support long-term shareholder wealth creation, and do not incentivise or reward misconduct.

Recommended reforms:

- Require banking and financial services company boards to make annual disclosures (plus at the time of the appointment of any CEO) detailing:
 - potential conflicts of interest and other risks embedded in both short-term and long-term executive performance incentives, including how the Board proposes to manage such risks; and
 - the degree to which remuneration structures align executive interests with those of all stakeholders, including during times of company stress and underperformance.
- Require all equity linked remuneration to be in the form of common equity escrowed for a minimum period of five years, regardless of continued employment.
- Prohibit Board members and key executives from borrowing or hedging against the common equity they hold in the company.
- Cap termination payments at one year's fixed remuneration unless there is shareholder approval of a different amount.

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5. **Regulate commission and sales incentive structures to ensure there are no embedded conflicts of interest, and they are consistent with honest, fair and ethical selling of financial products and services.**

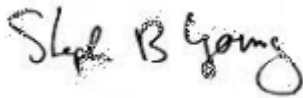
Recommended reforms:

- Ban all commissions structures where there is a clear conflict of interest (particularly against the interest of customers) involved in the selling of a product or service.
- Prohibit the payment of commissions by banks or home lenders to mortgage brokers and require any fee or commission arrangement to be between the broker and home borrowers, just as with stock brokers and their customers.
- Any commissions or sales incentives paid by banks or financial services companies to be fully disclosed in plain English to customers before the sale of the product or service.

The Caux Round Table thanks the Royal Commission for the opportunity to make this submission and for its consideration of the above policy reform recommendations in its important and urgent work.

Sincerely yours,

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