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TRANSCRIPT OF PROCEEDINGS

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THE HONOURABLE K. HAYNE AC QC, Commissioner

IN THE MATTER OF A ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

MELBOURNE

10.00 AM, THURSDAY, 29 NOVEMBER 2018

Continued from 28.11.18

DAY 68

MS R. ORR QC and MR M. HODGE QC appear with MR M. COSTELLO, MS E. DIAS, MR A. DINELLI, MR T. FARHALL, MR M. HOSKING and MS S. ZELEZNIKOW as Counsel Assisting
DR M. COLLINS QC appears with MS K. WILLIAMS SC, MR M. RUSH and MR T. CLARKE for ANZ
MR D. BATT QC appears with MR C. PARKINSON for Bendigo and Adelaide Bank
MR R. DICK SC appears with MR J. WATSON and MS E. BEECHEY for APRA

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<SHAYNE CARY ELLIOTT, ON FORMER AFFIRMATION [10.00 am]

<CROSS-EXAMINATION BY MS ORR

THE COMMISSIONER: Yes, Ms Orr.

MS ORR: Mr Elliott, could I turn to asking you some questions about some aspects of ANZs consumer lending practices?---Yes.

The first thing I want to ask you about is ANZs use of the HEM benchmark. Now, in October 2016 APRA asked a number of banks, including ANZ, to get an independent targeted review done assessing the risks associated with potential misrepresentation of mortgage borrower financial information?---Yes.

And KPMG did the targeted review for ANZ?---That's right.

And they delivered a report in April last year?---I believe so, yes.

And KPMG found that 73 per cent of the files that they tested at ANZ defaulted to the household expenditure measure or HEM?---Yes.

And after that report was provided, ANZ wrote to APRA and told APRA that it was taking steps to reduce its reliance on the HEM benchmark for the purposes of inquiring into and verifying a consumer's financial information?---Yes, that's right.

And since that letter, which was sent in September last year, ANZ has been engaging with APRA about its use of HEM?---Yes.

Now, in March this year you discussed, among other topics, ANZs use of HEM with APRA during a prudential consultation. Do you recall that?---I don't recall the specifics, but I believe that to be the case, yes.

Could I show you a file note, an APRA file note, of that prudential consultation meeting, which is APRA.0050.0001.0164. So this is a note from APRA of a prudential consultation on 7 March this year. And you were one of the attendees?---Yes, I recall. Yes.

Now, if we turn to 0168 in the document. We see that the note records, about halfway down – there's a reference to SE – a reference to you?---Yes.

Continuing:

> *At high level, ANZ doesn't disagree about weaknesses in HEM. ANZs issue is that it is easy to talk theoretically on this, but from a practical perspective it is*

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difficult. For example, there is difficulty in verifying people's positions when they are not your customer. Don't disagree with the need to address these issues and they are doing more work. Working on the tools.

?---Yes.

Now, is that a broadly accurate description of comments by you at this prudential consultation meeting?---Yes, I think they're a fair representation.

And what weaknesses in HEM were you referring to here?---So my recollection is less about – it's less a comment on weaknesses in the index. Rather, it's a comment on the weaknesses in the application of it and the usage of it. So we accept that it's conservative, in terms of it's a relatively low level of expenditure. And, again, what we were referring to further in this comment was the difficulty and the reason we use HEM. In particular, it's when we are dealing with applicants who are not our customers and, therefore, we have difficulty in seeing their financial position.

What about applicants who are your customers? Do you make use of the full set of information that you have about those customers?---No. And I think that is an agreed area for improvement. So in – historically, we had not. And when we talked about the work we are doing and working on the tools, I believe that's a reference to the fact that we have an investment program at present. It's a name we – it's a piece of software called Triex which we're developing which would allow us to analyse an ANZs customer's actual expenditure. And what that – that sounds easy, but what it does, it can identify which expenditure out of your account is rent, which may be utility bills, which might be discretionary expenditure, etcetera. So it's a tool that will enable us to do a better job of looking at an individual's actual historical expenditure through an ANZ account. And that's – that's limited, because we know – and I can give you the statistics, if you prefer – but many of our customers do not only bank with – even if they have an account with ANZ, it's not necessarily their only account. And so we don't know which other accounts they have. And – and most applicants for a home loan with us are not ANZ customers.

So is it the case, though, moving forward, that you plan to try and use the information that you do have - - -?---Yes.

- - - from the accounts that they do hold with you to get a better sense of their living expenses, in order to assess their financial position and comply with your responsible lending obligations?---Yes. And – that is the – that is the plan. And that work is underway. And just for a point of clarification, it is for all expenditure, rather than just living expenses. So - - -

I understand?---Yes.

And what about the customers who don't have accounts with you? And, can I ask, before we move to them, do you expect there to be any role for the use of HEM for customers who do bank with you and for whom you can assess expenses?---Yes. I do expect that. And there are some – the term HEM is used in broad terms as if it is an index. It's not an index; it is a series of indices. They have various timescales. They – we use an income-adjusted HEM. We also adjust it for the number of dependants you use, etcetera. So there is some finesse in the use of HEM. I believe that even when we use – even if our system operates at the level we expect, Triex, there will still be cases that will default to HEM. We expect that to be – or our plan, if you will, is, if we are successful in the roll-out of our system, our usage of HEM should fall to around a third of our applications in total, not necessarily ANZ customers.

And what about the ANZ customers?---I – yes. That's a very good question. I'm not sure that I have it on the top of my mind what that would be, but I would imagine that that would be – so lower than a third, because we, obviously, have greater information about ANZ customers.

And when you speak of defaulting to HEM – I just want to make sure I understand the particular use that HEM is having – is HEM to be used to verify the customer's financial position, or is it to be used as a serviceability measure?---So there's an issue here around definitions of those terms – or not an issue, but perhaps a lack of clarity and perhaps we use those terms loosely. It's my understanding that we – well, my understanding and also from reading commentary made from our regulators which support that, that HEM is part of the verification process. So we use HEM in order to meet our obligations under our responsible lending regulations.

In what way? As a floor, as a - - -?---As a test. We know that people have difficulty recalling their expenditure, despite asking more and more detailed questions, which I – we – we have certainly done. And there has been no measurable change in the total. And I – it's not that people – I'm not sure that I buy the argument that people are deliberately misleading. People know roughly what their household expenditures are. And if I give an example. Most people know what they earn pretty accurately. Most people know what's left in the bank at the end of the month, whether they're a surplus. And so they intuitively know what their expenses are. Where they struggle is to determine the categories of expense, where it actually went. And particularly when you're asking somebody to recall that over a year; not all expenditure happens in equal monthly amounts, for example. So we ask questions. I think it's fair to say in the past we haven't asked enough questions and we haven't done enough work using our own data. And that's what we are fixing. But then, ultimately, we use it as a benchmark to – just as a test, a rule of thumb, to say does this sound right for this – for a person in this family situation, with this income, does it feel right? Now, another observation about HEM which is a weakness, HEM – my understanding, anyway, it is an index that is created from – essentially, it's representing all families or all – yes, all families in Australia. People who are borrowing for a mortgage are not necessarily typical of all families. Only a third of Australian households actually do have a mortgage. Two-thirds do not. I'm not sure it's reasonable to assume that that – that the people who are applying for mortgages have the same spending habits as average Australians, given that in preparation for a mortgage it's likely you've

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been saving to create a deposit. So there are some limitations in it. But it's a useful test to say does it seem reasonable.

You said that your hope is that, with the investment in technology and the further questions that you're now asking, the use of HEM overall will come down to about a third of your home loan applications?---Yes.

Do you know what it is roughly now?---Yes. So at the time of the prudential review, we were in the mid-70s. I think it was 73 per cent, the number you quoted. There's a slight difference between applicants that come through our own branch channels and applicants who come through a broker. The most recent data we have had is that the – in total, the average is now in the mid-50s and continues to trend down. And the most recent data – that is, across the whole portfolio. I – I had some data from my team literally last week in terms of our branch channel. I don't have the broker channel. The branch channel is now in the mid-40s. So we are seeing quite a significant change happening in real time.

And what do you attribute that to, Mr Elliott?---I attribute that to a few things. One is just greater care, to be perfectly honest. We are – we are more diligent, we are – we have made it important. We've talked to our frontline. We've reinforced the need for people to ask more questions. I think that's the most – so there's behavioural elements to it. And then, as I mentioned, we have implemented new processes. We have a home loan guide which we've updated, which our home loan managers have to work through. And we're being much more insistent about following the guide and we've improved the guide, giving it greater depth and – and greater scrutiny to questions.

And you said there was a difference between the use of HEM through loans that come through brokers - - -?---Yes.

- - - and loans that come directly to you. What sort of numbers do you see in the broker channel?---So, perhaps surprisingly, when we did the review, when we were talking about the mid-70s, the branch channel was actually slightly – had slightly higher usage or dependency on HEM, as opposed to the broker. That with – that actually is counterintuitive. I think it would be reasonable to expect, well, if we know these customers, one might expect to use HEM less. So, when discussing that with the team and looking at it, I think there is a rational answer for that – yet to be proven totally with data, but there's a rational answer. And the rational answer is actually applicants that come to us through a branch typically look different than applicants that come through a broker. And that is that there is a skew within those applicants towards what we would call a top-up mortgage. So I already have a mortgage with ANZ and my application is to increase it. Given – and those are mostly for renovation purposes – not always, but mostly. In that case, given the strength of relationship that – that applicant has with the bank, the bank manager, the home loan manager, is more – has historically been more likely to, if you will, shortcut the process, understand the position, hasn't documented it, necessarily, very well. And so there's a slightly higher dependency on him. That's changing as we

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speak. As of – in the latest data I saw, the branch network is now lower in terms of its usage or reliance on HEM versus the broker channel. And that's because we are in, if you will, greater control of that process in terms of our ability to coach and send signals to our branch network.

Yes. I wanted to ask you about that, because the first thing that you attributed the decline to was greater care, more diligence, behavioural changes. How will you seek to drive those sorts of changes to people who are not your employees in the broker channel?---So we will do exactly the same. It just is a little bit more difficult, because of numbers and we have less direct influence. But we have a lot of influence. So we have updated the home lenders guide that the brokers – we require the brokers to use. We have been very direct with our aggregators and brokers of our expectations, and we've improved our hindsight monitoring and of broker applications. And we – at the end of the day, when – when the broker submits an application, we still assess it. So we still have controls. So we're much more likely to send it back if we see discrepancies than we have been in the past. And their – their numbers are coming down rapidly, as well.

Yes?---So I don't want to forget that point.

Yes?---It's just that the branch has come down slightly faster.

And you would expect to see no more than around a third across both channels?---Yes.

And how long do you think it might take you to get to that point?---We have made a commitment to our regulator that, from recollection, it is by the end of our next financial year. So later in calendar 2019. That's my recollection.

All right. Could I tender the note of that prudential consultation, Commissioner.

THE COMMISSIONER: Prudential consultation file note of meeting 7 March '18, APRA.0050.0001.0164, exhibit 7.134.

EXHIBIT #7.134 PRUDENTIAL CONSULTATION FILE NOTE OF MEETING DATED 07/03/2018 (APRA.0050.0001.0164)

MS ORR: Now, I want to stick with the topic of mortgage brokers, Mr Elliott. In your statement you said that change is needed in the mortgage broking industry to better protect the interests of home loan customers who use a broker?---Yes.

And am I right in thinking there are at least two parts to that change that you think is needed, change in relation to clarification of the duty owed by brokers, and changes in relation to the remuneration of brokers?---Yes.

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Now, I want to ask you about both of those matters, but, firstly, are there any other ways in which you think change needs to be brought to the mortgage broking industry?---No. I think that other changes would be reinforcing of those. So, for example, if we talked about some sort of professionalisation of the industry or – or training requirements, that – licensing, that would be more about the - - -

Duty?---The duty.

Yes?---So it would be in support of that. Yes.

So let's talk about that duty. In your statement you say that you believe that many, if not most, customers would believe that their brokers already owe them a duty to protect their interests?---Yes, I do believe that.

And, on that topic, can I take you to the evidence that you gave earlier this year in the Productivity Commission as part of their inquiry into competition in the Australian financial system. Can I take you to RCD.0014.0069.0001. This is evidence that you gave on 6 March this year, Mr Elliott. And I would like to direct your attention to a passage at 0025?---Yes.

Now, there had been a discussion prior to the statement you make about halfway down the page about whether a broker should be under a duty of care to act in a customer's best interests. Do you recall that?---I remember the – the broad conversation, yes.

And you said:

> *So I think it's important to go and ask consumers. Let's find out. But my guess, and I've done a bunch of focus groups when I first took on the job and listened to people and issues, I imagine that a lot of people think that the broker does have a duty of care to them. I imagine that when mums and dads walk into a broker, they assume that that is the case. You may even go as far to say they have a best interest duty, as well. I don't know, but I think there is an expectation. And I think FOFA and others have probably raised that expectation. People would say, "Well, if that's the rule for a financial planner, I assume it is for a broker. But I think it is important to go and ask consumers and their representatives to see what they would expect."*

Now, that was the evidence that you gave to the Productivity Commission. What I want to ask you, Mr Elliott, is whether you think it's time for that belief on the part of consumers that you referred to in this evidence to be reflected in the law?---Yes, I do. I'm not – I'm not a lawyer. I can't give you – I can't suggest how that might manifest itself or what terms it uses, but I believe it should be reinforced in the law, yes.

Yes. So are there any views that you would like to advance, bearing in mind that you're not a lawyer, about the form of duty?---I – I've – you know, doing the

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research, obviously, for this conversation with the Productivity Commission and afterwards, I've had a bit of a learning around the difference between customer first and the best interests duty. I don't know. I – I'm not really equipped to comment on the difference. I understand there is potentially a difference in terms of the obligations that come with those terms. I just think it's – and from a simple perspective – and that's what I was trying to say here – as a customer when I walk into a broker, I believe they're acting for me. That's what our customers tell me, that they're acting in their best interests. And I think that should be codified in a way, and there should be obligations that come with that that include what happens when things go wrong, when – when brokers do not meet that obligation, how are those disputes resolved. I think there would be value in having a framework for that. And just to add, my conversations, which are limited, with aggregators, in particular, is they broadly agree. That's my understanding. They want their – they see it as a profession, they want to raise standards. And this is one way of doing it.

You referred in your evidence to the FOFA changes and the duty - - -?---Yes.

- - - imposed on financial advisers or planners as a result of those changes, and the potential link between those changes and expectations that consumers might have?---Yes.

You do see that link? You think it's more likely now that people would think a broker is acting in their best interests?---I do. It's not based on data or any particular survey. I think – it's a personal opinion. I think that those reforms have had sufficient coverage. I think most people understand – maybe not in legal terms and formal terms, but I think they understand the responsibilities that a planner has. Certainly, I see that in terms of – it manifests itself in terms of the way that people come to us and complain and say something went wrong. They understand the duty is there. And I don't think it's unreasonable that you would extend that. For most people, the activities of a broker seem awfully similar. They are different. There is a difference, but they feel similar. I am going to a person, essentially, for advice. Now, again, there's a legal definition around advice, but that's the relationship that person has. And that has been reinforced to me time and time again in these focus groups of speaking to customers. They believe – they put it simply, that the broker is on their side. And that's – I think that would benefit from reinforcement.

Can I ask you then about remuneration for brokers. You say in your statement that you think there's merit in considering alternative models for broker remuneration to ensure that the current model remains appropriate and better than any alternative. Now, is that because you accept that there's an inherent risk that incentives might cause brokers to behave in ways that lead to poor customer outcomes?---There is always that risk, as we discussed yesterday. The term incentive is to incent behaviour. Therefore, it can be misused or it can – it can cause, you know, unintended outcomes if – if the broker is, you know, apt to be led by their own financial reward. Yes.

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And an example that you gave in your statement of an alternative remuneration model that could be considered is a model involving a flat fee paid by the lender to the broker. What do you see as the benefits of that sort of model?---So my statements here in our witness statement, but also just publicly on this is really referring to the fact it deserves thought, and there are – there would be value in doing detailed research. No system is perfect. A fixed fee is also capable of being misused and also leading to unintended outcomes. It is just my observation that there have been – there is at least some data on this from other markets, most notably in northern Europe. It seems a model that's worth looking at. I'm not suggesting it's necessarily an improvement; it just feels like a credible alternative. And the benefit there is – a little bit like financial planning – you pay a fee for a service. The service is the work you are paying for, and perhaps the fee should not necessarily be tied to the outcome. I think that's not an unreasonable proposition.

That's a very important matter, isn't it, because moving to a fixed fee model would remove the link between the loan size and - - -?---Yes.

- - - the money that's paid to the broker. And do you see that as an advantage, as an improvement?---I – well, for some, I – I do. The difficulty with the fixed fee, if I may, is it, essentially, is of major advantage to people who can afford and have the financial position to undertake large mortgages. It potentially is a burden to those who have small. So a subsidy would be being paid by those least able to afford it, and it runs the risk of making broking a privilege for the wealthy.

Are you talking there about a fee paid by the lender?---Well, at the end of the day the fee is paid – at the end of the day it's paid by the customer.

Yes?---How it manifests itself is slightly different. But that is – you're right. It's more of an issue if it's paid by the borrower.

Yes?---If it's paid by the lender, that may mitigate some of that risk. That's a fair point.

And I just want to ask you some questions about that model of moving away from the fee being paid by the lender and a fee being paid directly by the borrower?---Yes.

That, of course, could be capitalised into the loan?---Yes, it could.

Do you agree with that?---Yes.

And would that address some of the concerns that you have?---Not really. I – again, you're paying for it. We can – we can move it further away, so it's not immediately obvious to you, but somebody is paying for that customer. So, again, if it's paid by the borrower, the incentive there will be that people seeking smaller loans, it would be uneconomic to go to a broker. So a broker becomes a service for the wealthy, much like financial planning has become.

What about moving to the Netherlands model, which requires a fee to be paid not just to the broker, but also to the bank for the origination of the loan?---Again, there's – there's merit in looking at that. It still is an imposition of cost that would otherwise not have been there. So today – and ..... you know - - -

THE COMMISSIONER: Well, that wouldn't have been there or wouldn't have been - - -

MS ORR: Wouldn't have been transparent.

THE COMMISSIONER: - - - transparently there?---Well, the volume that came through the broker would have been there. But, again, a reasonable amount of volume comes straight to my branch. A lot of that is just top-ups. People don't pay for that one way or the other. There's no hidden fee, they're not paying brokerage and now they would be compelled to pay me a fee. So I think there is some – there would be some cost. There would be new costs – in my example before, I'm coming for a top-up. I've already got a $500,000 loan, I want a $50,000 top-up for a renovation. And now, I as a bank – you go to your bank and I am compelled to charge you a flat fee. Why?

MS ORR: Well, the argument is to create channel neutrality between brokers and banks?---And in the pursuit of that, create a distribution, if you will, a subsidy from small borrowers to large. The beneficiaries in that system are people who have large debt.

But it's the case, is it not, that even under the present system, the commission-based system, it is the borrower who is paying? The borrower is not seeing a fee for that service that they are getting, but the reality is that somewhere, filtered back down to them, will be the cost of that service from the bank?---In general terms, yes. Not necessarily in direct terms like that fee I charge you as a borrower – and just in terms of that, at ANZ, actually, we – I would have to go back and look, but we have, for some time, disclosed that. So when you do get a mortgage through a broker, we do advise the customer what we have paid that broker. So it is disclosed to them. But I take your point. I – all I'm – all I'm pointing to is any system has issues with it. The problems with the – the lender paying is, as I said, the discrimination against people who otherwise wouldn't have paid anything, who are small borrowers. It actually does two things. In a flat fee that I pay as a customer, it actually incents me to get the biggest loan possible. So in my example, I would think I should get as much value out of my fee as possible. I will get the biggest possible loan, so I don't have to go back for a top-up, because then I have to pay the fee twice. So people will be incented to borrow more. If it's paid by the lender to the broker, the broker, if they are apt to add – act badly and be incented in a poor way, their incentive will be to encourage people to borrow less and come back for more top-ups, so that they get more fees. So there is – there are consequences.

How common are these top-up situations, Mr Elliott?---So in any year – I can only give you the volume, the value, rather than the number. At ANZ, we would book

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new loans of around $50 billion a year. That's new to the bank. Our top-ups – and, above that, we would do about $17 billion in top-ups. So it's material. It's 30-odd per cent of our volume.

In your evidence to the Productivity Commission you said you understood there were already brokers in Australia who were charging customers directly, but you weren't sure how prevalent that was or how big a part of the market it was?---That's what I've been told. And I've been told they're quite – it's a niche offering and it has not been hugely successful, but I believe it is available.

You also said in your evidence to the Productivity Commission that a move to a fixed fee model was not something that you thought could evolve naturally. You said that you thought it would require intervention as an industry or regulation. Do you still hold that view?---Yes, I do.

All right. Could I tender Mr Elliott's evidence in the Productivity Commission.

THE COMMISSIONER: Transcript of evidence of Mr Elliott Productivity Commission Inquiry into Competition in the Australian Financial System, 6 March '18, RCD.0014.0069.0001, exhibit 7.135.

EXHIBIT #7.135 TRANSCRIPT OF EVIDENCE OF MR ELLIOTT PRODUCTIVITY COMMISSION INQUIRY INTO COMPETITION IN THE AUSTRALIAN FINANCIAL SYSTEM DATED 06/03/2018 (RCD.0014.0069.0001)

MS ORR: I want to turn to another topic, Mr Elliott, which is ANZs culture and the steps that you are taking to change ANZs culture and to evaluate the changes that you're making to culture. Now, we've touched on that a little already?---Yes.

But in the submissions that ANZ provided to the Commission following the interim report, ANZ said that, as a generalisation, over a number of years and due to various events, the financial services industry has developed a culture that is overly focused on revenue and sales. This is a topic that I asked you about yesterday?---Yes.

And can I ask you just to reflect on what those events were that you think have led to the development of that culture across the industry?---And, again, without repeating myself too much, I think yesterday we talked about Australia has been blessed with a growing economy for 30 years. In that environment, in an operation like ours, which at a superficial level, but has some weight to it, we run a largely fixed cost operation. There's a – there's a large fixed cost in running a bank: the technology, the branch network, etcetera. You have a high returning business, ROEs, return on equity, approaching 20 per cent in the early part of that period, and fast growing. The logical strategy to pursue, and that is to grow, is to do more. And so the way you do more is to focus on growing revenue. And so it becomes a derivative of that strategy

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to continue to do more. And, at some level, it becomes so confined that people become totally fixated on just the revenue achievement. That's what I'm referring to.

So it wasn't a matter of external events?---No.

It was the development within the industry of this pursuit of growth in an economically stable and profitable environment?---Yes. And – and, again, this is – this is grossly simplistic, but if we go back a few years, I think it's widely accepted that if we take home loans, for example, is probably the easiest example, the return on equity at the origination of a home loan, so at the time, was somewhere in the 30 per cent area. That has taken into account the level of capital you had to hold, the margins, and, importantly, credit losses, which in Australia have been close to zero over that period of time. Well, if something – if something has a 30 per cent ROE – and, remember, the market is growing every year – you know, a commercial enterprise will want as much of that as they can get. And so you grow. And you don't spend too much time discerning which part of the market you want. It is largely all good. And so that has kind of fed this culture over a period of time. That has changed dramatically, by the way. The returns now are half that. And growth is, you know, close to zero. So that is necessitating a complete rethink of strategy and how to succeed.

Could I ask you then to reflect not on culture within the industry, but culture within ANZ. And you've been at ANZ for some time. How would you describe the culture at ANZ back when you were chief financial officer of ANZ?---So the culture at ANZ can be described in a number of ways. At its heart our bank has always been outward looking, internationally focused, adventurous, compared to some of our peer groups. We've always had aspirational networks. And you can see it in the place in terms of the nature of people, what we talk about, what we care about. We would be described still and then as a nice culture. It was a culture that valued collaboration, collegiality, did not value challenge, robust, necessarily. It was a culture that, as I mentioned yesterday in terms of our values, was comfortable around integrity, and collaboration was less comfortable about excellence, in terms of performance on – on that. It was a good news culture, so a culture that liked to hear good news, that valued that. And it was a culture largely individualistic. So it valued individuals, it valued stars, it rewarded individuals. And, therefore, it led to this model of confederation. You know, we are a confederation of business units, teams, individuals, doing their own things. So those are some of the descriptions I would give.

So do I understand you to be saying that it was, at the same time collaborative and collegial, but also with this focus on rewarding individuals?---Yes, that's a good observation. So – it's a very good point. So it was collaborative or collegial in the sense that people were nice to each other, not necessarily they were truly collaborative in the sense that you or I might understand in terms we work together to achieve an outcome. That is – that is a very perhaps subtle, but important, difference.

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So the outcomes were individual-focused?---Yes.

And the reward for the outcomes was individual-focused?---Yes. And you saw that in the way our incentive structures really – it talked about individual contribution. And there was high – higher leverage or multiples given for what was deemed to be outperforming individuals.

Now, I think this came through in a number of answers that you gave yesterday, Mr Elliott, but could I ask you to summarise what the culture is that you are now trying to create at ANZ?---Sure. Sure. So we have a sense of purpose. And underlying that is a culture of, really, three aspects. One is customer centricity. It's an easy thing to say, quite difficult to do. We can talk about why. But customer centricity. Two – and they're all related – learning. A culture of learning: a culture that learns from its mistakes, a culture that is curious that asks questions, asks questions of what we do today, but also looks at other industries and other practices to try and learn and continually innovate and try new things, a culture that rewards people who try new things, etcetera, but does it well. And, again ..... excellence. And the last part of the culture that's very important to us is a culture of simplicity, a culture that believes in the value of doing a few things and doing them well. Let's not create complexity for the sake of it. So those are the three parts of our aspirational culture. We've got work to do on all three.

A number of the documents that have been produced by ANZ to the Commission refer to a speak-up culture?---Yes.

Can you explain what that is?---Yes. So that's part of the – in order to be well governed, be well managed from a risk perspective, to uncover where we make mistakes, to be able to learn from them and remediate them, we need people to say what – when they see things. And we need a culture that people feel empowered, encouraged to speak up and say there's something wrong here. I was reminded, in putting together our first submission to this Royal Commission, when I looked through the 50 pages and you look for what were the common causes here. Many of those individual cases I was familiar with. But if you looked at them as a group and said what was common here – and, again, this is a generalisation – virtually none of them came through formal governance – came to our attention through formal governance processes, external audit, internal audit, reviews, etcetera. Nearly all of them came through somebody in the bank speaking up, a new manager who was questioning a process, why is this happening, or a customer putting their – or a customer actually speaking up and saying there's something wrong here. So I think having a speak-up culture is incredibly important in a bank, as an ingredient of being well-governed and being aware of what is happening in your company and your people.

And in the time that you've been CEO it appears ANZ has done a significant amount of work in assessing its culture. Is that right?---Well, we've tried.

Yes. Well, can I talk to you about your attempts to do that?---Sure.

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Your internal audit team has designed a cultural assessment tool. Is that right?---Yes.

And when was that tool designed?---From memory, two years ago, something around that time.

And that tool appears to focus on organisational culture, rather than solely on risk culture. Is that right?---Yes.

And the methodology used by the cultural assessment tool has been validated through engagement with APRA?---Validated may be a strong term, but certainly we've discussed it with APRA, yes.

Yes. I took that term from one of your documents?---Okay. All right.

But how would you put it?---No. I think, you know, we were encouraged – so it may sound hokey, but, you know, we know that the ultimate differentiator or driver of competitive advantage is your culture. And so we were thinking about that anyway. At the same time, we were being, quite rightly, asked by APRA to consider culture when they were talking about prudential supervision, etcetera, in terms of being unquestionably strong, if we go back to the financial services inquiry, it was referred to. Those conversations are going on, our own interest, APRAs interest, and we kind of coalesced that into this work. And, to your point, we tried to move away from a narrow definition of culture and risk culture, which was primarily what APRA were, quite rightly, interested in, to a broader view. What we wanted to do was engage APRA in that conversation to get their thoughts about was what we're doing of value, and, you know, was it valid in that sense. And I don't know that we were necessarily seeking their approval, or endorsement, but, really, seeking their expertise to say this – was this helpful from their perspective.

And what was their feedback?---From memory, we engaged a lot about definitions, what exactly we were trying to achieve. I think it was constructive. I couldn't tell you that it was necessarily formal. I'm not sure, to be honest, whether there were any formal feedback documents, but I know in conversations it was a constructive conversation.

Could I show you a document that describes this approach to assessing culture, which is ANZ.800.076.4416. This appears, Mr Elliott, to be a document for the board - - -?---Yes.

- - - for a meeting on 4 October last year - - -?---Yes.

- - - presented by the people whose names we see on the front page. Is that right?---Yes, that's right.

Relating to these culture assessments?---Yes.

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And could I take you to 4421 within this document. This diagram appears to show that what ANZ measures as part of this cultural assessment is four key levers that it considers impact on ANZs culture and the way people within ANZ work?---Yes.

And those four levers are leadership and tone from the top, middle management and tone from the middle, risk environment, and a transparency and speak-up culture?---Yes.

Then, if we turn to 4422, we see that ANZ appears to use four different mechanisms in the assessment. It engages with business leadership to, amongst other things, seek input on the relevant questions to be asked?---Yes.

It sends an online survey to all employees?---Yes.

And this slide indicates that ANZ set a target response rate of 60 per cent, but the response rate for the pilot cultural audits for the survey was around 73 per cent?---Yes.

So more people participated than you expected?---Well, more people participated than we – we had set a benchmark at 60, thinking that would be representative and we could take comfort - - -

Yes?--- - - - from the scale of that, if it reached 60 per cent, yes.

And the internal audit team, as part of that part of the process, then undertakes the statistical analysis of that data from the online survey?---Yes.

And then ANZ conducts focus groups and one on one interviews?---Yes.

And the slide shows us that at this time, in October last year, about six focus groups were to be conducted and there were an additional six one on one interviews?---That's right, yes.

And we see that the purpose of this stage is to clarify cultural strengths, challenges and associated root cause analysis?---Yes.

And the final mechanism is engagement with the leadership team. And the leadership team then creates an action plan over a three-month period with oversight from internal audit?---Yes.

And then there appears to be ongoing engagement with management to discuss the effectiveness of the agreed actions, with more formal reassessments undertaken as needed?---Yes.

Now, does this remain ANZs approach to cultural assessment?---In broad terms, yes. I couldn't comment on every single bullet point but, yes, this is exactly what we do across the group today. Yes.

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So you have continued with this approach?---Yes, we have.

And the documents that we have suggests that as of 30 June this year the internal audit team had conducted more than 30 cultural assessment reviews covering more than 21,000 of your employees?---Yes.

And 16 of those, covering 10,000 employees, were completed in your 2018 financial year?---Yes, that's my understanding. Yes.

And they included reviews into a number of units within your Australia division, including business and regional banking, your – also included your direct life insurance business?---Yes.

And that's within the Wealth part of your business?---Yes, it is.

Is that right?---Yes. Yes.

Now, the documents indicated to us that you anticipate a further six cultural assessment reviews being completed – or you did anticipate them being completed by the end of September this year. Did that occur?---I couldn't tell you if we – if we – we have an audit plan that's monitored by our audit committee, so I would be surprised if they didn't happen.

And have you also now commenced reassessments to assist in your understanding of shifts in culture over time?---I – yes, with only – I can't be certain it's in terms of following this process, but as – as a broad assessments we have. Through our talent and culture team, we've undertaken some studies to see shifts in behaviours, particularly around our leaders, which is related to this.

So having discussed the approach with you, I now want to move to some of the results of that work, but could I tender this document, Commissioner.

THE COMMISSIONER: Internal audit culture assessment board presentation, 4 October '17, ANZ.800.076.4416, exhibit 7.136.

EXHIBIT #7.136 INTERNAL AUDIT CULTURE ASSESSMENT BOARD PRESENTATION DATED 04/10/2018 (ANZ.800.076.4416)

MS ORR: Could we now bring up ANZ.801.252.0399. This is a presentation that - - -?---Yes.

- - - explains the results of a cultural assessment of the finance workforce within ANZ - - -?---Yes, that's right.

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- - - from January this year. And am I right in understanding the finance workforce to be comprised of people with a direct link to your chief financial officer?---Yes, that's right. Yes.

And so who are those sorts of people, Mr Elliott?---So they fall into various categories. The vast bulk of these people are our accounting and financial control functions. They either work in groups, so they're responsible for our regulatory reporting, our financial accounts. There's also a significant group which we would determine to be finance business partners. So they sit with the businesses and provide management information, rather than – rather than formal accounts, but driver analysis, etcetera, and advice for the businesses. There are also some small teams in the group, for example, tax specialists, including – and, also, our mergers and acquisitions teams. So there's some specialist teams in there, as well.

Could I ask you to look at 4101 which sets out what were observed – after the process that we've just discussed was completed – what were observed to be the cultural strengths of the team. I'm sorry. 0401:

> *And the observed cultural strengths for this team within ANZ included a strong sense of personal accountability, resilience and risk management responsibility.*

?---Yes.

And could we turn then to 0402 – I'm not sure if it's possible to bring 0402 and 0403 on to the screen at the same time – because these two pages set out what were observed to be the cultural challenges for the finance team. Thank you. And on the first page we see, under the heading – I'm sorry – I will go to 0403 on the right-hand side. Under the heading Decisions Are Perceived to be Short-term and Not Aligned to Values, we see:

> *Employees are seeking more value alignment in decision-making – particularly respect and collaboration. Only 39 per cent of finance employees believe systems are designed to support decision-making. Leadership decisions are seen to be aligned to short-term cost KPIs, rather than long-term strategic KPIs.*

?---Yes.

And we see below that, under the heading Speaking Up is a Challenge, that:

> *72 per cent of employees in this team only sometimes or do not share bad news, due to fear of repercussions.*

?---Yes.

And, in the second dot point there:

Finance managers are perceived to be less likely to escalate issues compared with other areas of the bank, and 69 per cent of employees feel that action is taken action to resolve issues raised.

I am not quite sure what that last - - -?---What that means is that when people – basically, if you raise an issue, how confident are you it will actually lead to action.

Yes?---And finance are saying, well, 69 per cent of them feel that, as opposed to 75 per - - -

75 per cent across the bank?--- - - - cent of the average population. Yes. So they're less likely to believe something will be done.

So how are these sorts of findings received by the relevant unit within the bank?---So that's a good question. I – just to give you a bit of context, when – when this first idea came up, I have to admit I was a little sceptical about doing a cultural audit, how exactly would that work, what exactly would they ask, how reliable would the data be, because we already do a lot of surveys. So we piloted it. I recall we – I think we piloted it in Singapore, actually. And the feedback from the team, the recipients, a very senior person at the bank, had been at the bank a period of time, was that this was enormously valuable information, and it gave them the ability to not only get this feedback, but do something about it. So the good news here is that we're getting this feedback. The team – so this report actually was to the finance leadership team. They were aware – audit present this and said this is what we found. And then it is their responsibility to go and craft an action plan, what are they going to do. Now, I can't tell you what the action plan here on this particular one. But I know they are held to account for that. And then summaries of this – and I'm not sure of this particular one – but summary reports go to the HR committee of the board.

So we know from the process that what should happen is that the leadership team develops an action plan over a three-month period?---Yes.

That is – that has oversight from internal audit, and that there's ongoing engagement with management about that. So that would have been what happened in this case?---I – I presume so. And the – and the challenge there will be we're talking about culture, and, you know, it's not going to fix it in three months. But the question is is the action plan reasonable and can the team show that they are actually doing what they say? And the ultimate test will be when we go back and revisit at some point to see whether that change has been effective.

So is that the plan, that these people then participate – or the people who are in the business at that time then participate in this process again?---Yes.

So that you compare the results at that point in time with the previous results?---Yes. So, much like we would do any audit – and we haven't built this muscle perfectly yet – that is to say there would be a schedule of repeat analysis, not comprehensive, that every single team gets audited on this every time, but there would be a sampling

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done on a regular basis so that you can see change. Otherwise, we have no – I mean, it's all very interesting, but if we don't see any actual outcome, it's largely pointless.

And what sort of oversight do you have of the actions that are designed and the implementation of those actions?---So I don't see the actions at a business unit level like this. This would be the CFO, who reports to me. She will have oversight of the outcomes here. The head of audit who oversees this program reports to me. And we meet at least once a month, if not more. And this will get as much attention, this summary, the overall outcomes as any other audit item. So, for example, if it is his determination that finance, in this case, has not – did not create a sufficiently robust plan, is not acting according to their commitments, he would inform me, and we would then discuss what to do about it.

What do you think – it's relatively early days - - -?---Yes.

- - - obviously. You've had this as a pilot program for a couple of years, and - - -?---Yes.

- - - you've extended it and you will be extending it further. But have you seen any effect on culture in the business so far from this piece of work?---I think I would be misleading if I said yes, I can give you absolute assurance I've seen a change in the culture. What I have seen is there's a change across the group. What I have seen is in the change of the culture and the conversation at the most senior level of the bank. So at my team, we pay attention and talk about this now. That, in and of itself, is not going to solve it either, but it tells you it is something we care about and we discuss and give it attention. And I think that's equivalent at the board. The board and the HR committee has shown an intense interest in this. And we do give them summary reports. It might be worth just giving one actual example.

Yes?---And I – and, again, these things seem simple. Speak up culture has been a challenge. And one of the – at the end, to put that into context, we're also in an environment of restructuring our industry for the lower growth, therefore people worry about job security, etcetera. And so there are some other elements of why people feel they are not – they don't want to speak up. One of the great insights that came through one of these audits was – and it came through a focus group – was that the reason that people did not want to put up their hand and say I've seen a broken process is that the culture – the response at ANZ was, well, that's terrific. We empower you to go and fix it. And so people, basically, were voting for more work. And so people felt reluctant to do that. So that was quite insightful. It's not – at one level, it's easy to fix: we don't have that response, that we take those observations and move them out to other teams who can go and fix things. But I certainly know at the HR committee and at the executive committee, that was incredibly useful insight and it has changed the way we communicate to our people.

Could I tender this document, Commissioner.

THE COMMISSIONER: Finance culture review, 18 January '18, ANZ.801.252.0399, exhibit 7.137.

EXHIBIT #7.137 FINANCE CULTURE REVIEW DATED 18/01/2018 (ANZ.801.252.0399)

MS ORR: Mr Elliott, in addition to these area-based cultural reviews overseen by your audit people, ANZ also undertakes much larger scale cultural reviews within the organisation. Is that right?---Yes. If you're referring to surveys.

Yes?---Yes, we do. Yes.

So in January this year you sent a survey out to 10,000 of your employees asking them to share their perceptions of their leaders?---Yes.

And, as a result of that piece of work, you produced a leadership dial in the middle of this year which assesses significant leadership shifts and strengths and opportunities?---Yes.

And you also have entity-wide My Voice surveys every two or three years. Is that right?---It's – yes. A My Voice survey is mostly every year. There was one year where we skipped it, but yes.

And you did one of those surveys in May and June of this year?---Correct.

And you appear to have received more than 15,000 responses to that survey?---That sounds about right, yes.

Can I take you to a presentation about those survey results that was provided to the human resources committee, ANZ.800.011.0065. I'm sorry, I may have said the number incorrectly. ANZ.700.011.0065?---Yes.

So this is a presentation from July this year about this year's My Voice survey. And if I take you to 0068. We see from the headline that the results of the survey this year were mostly down versus previous year surveys?---Yes, that's right.

And we see from the detail on this page that the results in all categories declined from the 2016 survey results, other than overall satisfaction. Do you see that?---Yes, I do.

And three items that were listed in the highest scoring items category, where the scores were equal - - -?---Yes.

- - - to the 2016 results?---Yes.

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And could I take you to 0071, which is appendix A to this document. And that contains an analysis of matched samples, which I understand to be a direct comparison of results between people who responded to the 2016 survey and the same people who responded to the 2018 survey?---Yes, and this is just an attempt to remove the statistical noise and recognising the fact that the organisation and the composition of our employees has changed materially in those two years. So it was just trying to see - - -

The filter?--- - - - through that, yes.

And, for this population, the 2018 survey results were consistently lower - - -?---Yes.

- - - than the 2016 survey results. And, frequently, they were quite substantially lower?---Correct.

And what was your reaction to these annual survey results this year, Mr Elliott?---Well, the first reaction it's always disappointing. We always hope for better. But the reality is it is what it is. And it's a – it's an incredibly valuable piece of data. It tells us what our people really think. And it has the benefit – it's an anonymous survey. I have no ability to find individuals. And what you don't see here is they come with thousands of comments, as well, which we work through. So my reaction is it's disappointing, but it's a great source of data. It's a rich source of data. And it gives us the ability to see opportunity to do better.

If we turn to 0069, we see some of the more specific findings from this year's results?---Yes.

We see, about halfway down the page with the paragraph starting "comments", that a significant number of respondents, almost 2000, made comments to the effect that:

> *The purpose and direction is clear from the top, but gets lost in middle management layers.*

?---Yes.

What's your reaction to that, Mr Elliott?---I'm not surprised. And we – we run a large organisation. We have 40,000, roughly, employees across the place. Of those 40,000, 8000 of those people lead a team. So it would be – describe themselves as a leader. You can imagine, in a traditional hierarchical sense, there are multiple layers. So I as the chief executive at the top, there are – in most parts it's seven or eight layers, in some cases nine or 10, through to our workforce. And this is describing exactly the challenge of any trickle down methodology of messaging, and the difficulty of communicating direct messages to all of our people. It requires repeat and it requires translation and local context to be given by those – the – well, middle management. And that has not been as successful as it – as it should be.

So that's, obviously, a very important - - -?---Yes.

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- - - and significant challenge for a number of organisations. But for ANZ, in this setting, what are you doing to try and ensure that your middle management convey those messages that you have articulated at the top and that they are filtering down and changing behaviour through middle management to the people at the frontline?---So we're doing a number of things. So the first thing is actually identify who those 8000 are. We didn't know that in the past. We had looked at seniority and other ways of considering impact of people. So, historically, when ANZ would have – get together the – you know, the top 100 people, or whatever it might be, they weren't actually necessarily the people leading the organisation. They had very important roles. A lot of them were invisible to our people, who were doing important work, but in head office. So we've now identified who these people are. To use the Commissioner's description yesterday, the sergeant majors, if you will, or whatever the term is, from a military - - -

THE COMMISSIONER: I'm going to regret that analogy, aren't I, Mr Elliott?---No. No. So we've identified who they are and now we reach out to them directly. So we have big calls ..... big call, where we actually invite all of them and they hear directly from me and my team. And we engage with them and we answer questions. We use some technology that allows those questions to be anonymous, if they choose, so that we can actually try and engage direct and not rely on – well, not rely solely on the trickle down methodology. We use multiple types of communication: video, which is very effective way, where people can on our intranet watch things that we talk about. So we're using multiple channels of communication, whether it's video, whether it's letters, whether it's email, whether it's voicemail, and – and, importantly, these big calls to try and engage these people in that conversation. We've also changed when we do get the – our leaders together – the top 200 that I call together now are actually – the way we describe those 200 and select them is the most visible leaders in the company. So they're not necessarily the most senior people, but these are the most visible people. And we get them together twice a year for at least a day, a day and a half, and we talk through culture. The recent one, for example, we talked through and we listened to customer complaint calls, so that people understand and can personalise, humanise, what can go wrong and what are we doing about it and the importance of remediation, for example.

MS ORR: Can I ask you about another specific finding - - -?---Sure.

- - - of this survey at 0066. We see, again, about halfway down the sentence that starts:

> *The risk culture index –*

Do you see that?---Yes, I do.

That only – I just want to make sure I've got the right part, sorry:

The risk culture index at 73 per cent has decreased by three per cent since 2016.

And this was the bit I was looking for:

Our main concern relates to the item regarding "speak up", which has a 67 per cent favourable response to the item "I can raise issues and concerns at ANZ without fear of reprisal or negative consequences", which is a three per cent decrease since 2016.

Now, we've spoken about this speak up culture. And this decrease of three per cent since 2016 in the response to this question was described by the authors of this paper as their single main concern - - -?---Yes.

- - - of the results from this survey. Do you agree with that?---Yes, I do.

And why is it the biggest concern of all of the results to you?---Because if we don't have a culture where people feel free they – to speak, we will fail. We will fail in terms of our responsibilities of being well managed and ultimately we will fail our customers. I would just say to – to understand the point of data, the people who said that they did fear repercussions was 14 per cent. And – and that's too high. And the difference being people who sit in the middle. And the people who sit in the middle are generally people who would say I don't have any experience to influence my view. So it's still not good enough, but it is of serious concern.

So that is a particular finding that you are undertaking work to improve?---Absolutely. And this has actually got serious attention from our board, as you would imagine.

And can you summarise the key pieces of work that you propose to undertake to change this?---There seems to be – so when we looked at – we take this data, then we look at the culture audits that we've just referred to previously. What they tend to indicate that people feel comfortable speaking up when they see something that is wrong from a risk perspective, somebody doing something patently bad. They – you know, something like 90 per cent in those surveys would say they do speak up in that case. This is referring more to a sense that if you're not on the bus – if you're not with us, you – you don't feel empowered to speak up and say I don't agree with the strategy or I don't agree with new ways of working or I have concerns about things. So what we're doing – this is difficult. We are – yesterday we talked to – as well, it does come – unfortunately, it's easy to say it comes down to leadership. There's an adage in HR that people join companies and leave managers, and it's true. It's about the roles of our leaders encouraging their teams to speak up. So we've been working on simple programs of making sure that managers set time and meetings to ask for feedback, and to be more proactive. Now, that won't resolve everything. We do – we are fortunate that our head of talent and a number of people in the team are actually psychologists and have training and understanding of human behaviour and that's what we're seeking to change. We've also done some surveys. And that

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leadership dial that you talk about is actually to try and measure are leaders changing their habits in terms of seeking feedback, creating greater clarity of what's expected, etcetera. So this will take time.

What sort of period of time do you think it might take, Mr Elliott?---It's always going to be too long. And – I – I think – I believe you can see shifts in culture in reasonable periods in the medium term, you know, in the kind of two to three year period. I think you can. I think it takes obsessive – literally obsessive focus by management to say that this is really important, to lead by example, and to make – and I give an example. You know, our purpose, while it's slightly different, we never actually had a stated – we had it, it was there, it was inherent in the place, but actually written down – didn't exist three years ago. Today, 92 per cent of our people say in that same survey they consider our purpose when making decisions. You know, today people can articulate what it means. So we've been able to achieve that in three years. Is it embedded and perfect? No. But that's a big step forward. So I – I think these sorts of things can be achieved and closed within that kind of timeframe.

I tender this document, Commissioner.

THE COMMISSIONER: 2018 My Voice survey, 24 July '18, ANZ.700.011.0065, exhibit 7.138.

EXHIBIT #7.138 2018 MY VOICE SURVEY DATED 24/07/2018 (ANZ.700.011.0065)

MS ORR: Could we now bring up ANZ.801.247.0702. This is a document, Mr Elliott, that appears to be a note of questions and answers that were put to three of your non-executive directors as part of some sort of interview process. Is that right?---So – so this was a information gathering as part of the response to the APRA requirement related to the CBA review. We were all doing a self-assessment. That self-assessment is due maybe today or tomorrow. It's due as we speak. This was part of a data collection, if you will, of - - -

I see?--- - - - our – of some of our non-executive directors.

For your self-assessment to be provided - - -?---For our self-assessment. This then informed the self-assessment document which we're finalising today.

And who were the non-executive directors that this document deals with?---I actually don't know. I – the three initials that are there are actually the people who did the interview.

Yes?---So those are two advisers or consultants from PwC. And SP relates to our company secretary, Simon Portidge, who was there. I don't know - - -

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So we can't tell from the document - - -?---I don't know who this is.

- - - who they were?---No.

Can I ask that you look at 0703. We see that these three non-executive directors were asked question 8:

How would you describe culture at ANZ?

And part of the response was:

We are in transition. Challenged by change in organisation (huge) and the external environment (negative).

Now, I think you would agree, Mr Elliott, that the culture at ANZ is in transition?---Yes.

And what is it transitioning from and to?---Well, it, as we discussed before, from an individual-driven confederation good news culture. I'm summarising. To a culture of customer centricity, learning and simplicity.

The directors also referred here to the numbers. I will just find the part of the page that refers to My Voice, net promoter score, etcetera. It's the dot point underneath the – sorry – it's - - -

THE COMMISSIONER: It's the pop-up we had.

MS ORR: It's dot point 3 within the pop-up that we had, question 8?---Yes.

Continuing:

In terms of outcomes, the numbers (My Voice, NPS, etcetera) show we are standing still

What do you understand that to mean?---I understand to be, in reading the whole answer, that there's a belief that we are on the right track. However, the data does not support that we've been successful at this stage. And the two quite important points, our employee data.

Yes?---And our customer data.

The NPS being the customer data?---The NPS, yes.

And the My Voice the internal?---Yes.

All right. Could I tender this document, Commissioner.

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THE COMMISSIONER: Non-executive directors interview for the purposes of self-assessment, ANZ.801.247.0702, exhibit 7.139.

EXHIBIT #7.139 NON-EXECUTIVE DIRECTORS INTERVIEW FOR THE PURPOSES OF SELF-ASSESSMENT (ANZ.801.247.0702)

MS ORR: I want to ask you, Mr Elliott, about whether it would be useful to have information about how your culture compares to the culture of other banks. And I want to do that by reference to the work undertaken by the Banking Standards Board, an industry body in the United Kingdom. Are you aware of the work that the Banking Standards Board does?---Not in any level of specificity, no.

What it appears to do is it conducts annual firm-specific culture assessments which assess the extent to which the firms demonstrate set characteristics?---Okay.

Nine particular characteristics. And the Bank Standards Board then provides individual feedback to the boards of those firms about how the firm fared against those characteristics. And that feedback is provided in a way that allows the board to assess their firm's position against the aggregated and anonymised position of other firms. And the purpose of that, articulated by the Banking Standards Board, is to provide firms with an independent, external and evidence-based perspective of their firm's culture. Do you think that there would be utility in ANZ receiving that type of benchmarking information in relation to culture?---I think there's always value in getting external data. I think there's a danger – and, again, only hearing this, essentially, for the first time – I think there's a danger in some benchmark reviews, in that they imply there is the right answer, that – that somehow there is – we've defined perfection and we measure you. Culture is situational. It depends on your business and your strategy and what you are trying to achieve. Now, there will be some fundamental elements that we would all agree to around integrity and others. So I think it would need to be thought through and to ensure that we were not all delegating responsibility as a board to define what culture we want, as opposed to some external well-meaning body who has defined it for us.

What do you see as the role of regulators in assisting you with the culture of your entity?---This is a difficult question. We've actually had conversations, particularly with APRA, on this, that relate back to the unquestionably strong discussions where they, quite rightly, articulated that unquestionably strong was more than just balance sheet strength and that it did involve culture and management quality. I don't have a terrific answer. I think they have a role in giving us guidance and a – a perspective. I don't know that they – again, given that culture is situational, it does depend on what you are trying to achieve. I think their role should be more advisory and perhaps giving guide rails, rather than being prescriptive, like they might well be with capital, for example.

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Do you think they have a role in calling out poor culture?---Yes. And they have a – almost unique – perhaps unique perspective. Because of their relationship and their interaction with our people, they will have a perspective that is probably different than almost anybody else. And I think getting feedback from that in a formal sense would be of enormous value.

THE COMMISSIONER: At what level of the organisation does the feedback go in, do you think, Mr Elliott? Does it go in at your level or at board level or at both or - - -?---It should go in at the board level and at the executive committee level. Today, I would suggest that that feedback is more typically at a board level, today. I don't know that we've paid sufficient attention to actually being very specific around feedback on culture. I think it leaks its way into broader conversations. So it's not a specific topic. But it could be. But, at the end of the day, the executives are the ones who have to operationalise that, and so that feedback should also be direct to them.

MS ORR: I have no further questions, Commissioner.

THE COMMISSIONER: Thank you, Ms Orr. Yes, Dr Collins.

DR COLLINS: There's no re-examination.

THE COMMISSIONER: Yes. Thank you very much, Mr Elliott. You may step down?---Thank you.

<THE WITNESS WITHDREW [11.20 am]

THE COMMISSIONER: Now, Ms Orr.

MS ORR: Commissioner, the next witness is Mr Robert Johanson. Perhaps if we could have a brief adjournment to allow his representatives to come to the bar table.

THE COMMISSIONER: Come back at, say, 25 past 11 - - -

MS ORR: Thank you, Commissioner.

THE COMMISSIONER: - - - Ms Orr.

ADJOURNED [11.20 am]

RESUMED [11.26 am]

THE COMMISSIONER: Yes, Ms Orr.

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MS ORR: Our next witness is Mr Robert Johanson, Commissioner.

<ROBERT NIVEN JOHANSON, SWORN [11.26 am]

<EXAMINATION-IN-CHIEF BY MR BATT

THE COMMISSIONER: Thank you very much. Do sit down. Yes, Mr Batt.

MR BATT: Thank you, Commissioner.

Mr Johanson, your full name is Robert Niven Johanson?---It is.

And your business address is the Bendigo Centre, 22 to 42, Bath Lane, Bendigo, Victoria?---Yes.

And you are the chairman of the board of directors of Bendigo and Adelaide Bank Limited?---I am.

Do you intend to give evidence pursuant to a summons by the Commissioner dated 8 October this year?---Yes.

Do you have the original of the summons with you, Mr Johanson?---Yes.

I tender that, Commissioner.

THE COMMISSIONER: Exhibit 7.140, the summons to Mr Johanson.

EXHIBIT #7.140 THE SUMMONS TO MR JOHANSON DATED 8/10/2018

MR BATT: Now, Mr Johanson, you have prepared, have you, a witness statement, dated 7 November 2018, in response to questions directed to the bank under Rubric 7-05 issued by the Commission?---Yes.

And do you have the signed original witness statement and its exhibits with you?---I do.

Could you just briefly, please, turn on page 9 of your statement to paragraph 40. And if you have that before you, is it right that you wish to delete the words at the start of that paragraph which read:

> *As set out in section 7.1 of the remuneration policy.*

on the basis that that cross-reference is not entirely applicable?---I do.

If you have a pen, could you then, please, take it out and strike out the words I read and initial that deletion. With that change having been made, Mr Johanson, are the contents of your witness statement true and correct?---They are.

Thank you. Commissioner, I tender the statement with its exhibits.

THE COMMISSIONER: The statement of Mr Johanson and exhibits in relation to Rubric 7-05 becomes exhibit 7.141.

EXHIBIT #7.141 THE STATEMENT OF MR JOHANSON AND EXHIBITS IN RELATION TO RUBRIC 7-05 DATED 7/11/2018

MR BATT: Nothing further, if the Commissioner please.

THE COMMISSIONER: Thank you, Mr Batt. Yes, Ms Orr.

<CROSS-EXAMINATION BY MS ORR [11.28 am]

MS ORR: Mr Johanson, you've been a non-executive director of Bendigo and Adelaide Bank for 30 years?---I have.

And you've been the chairman of the board for the last 12 years?---Yes.

And you plan to retire from the board when your term ends next year?---I do.

And in your 30 years as a director, what are the major changes that you've seen in the financial services industry?

THE COMMISSIONER: I hope there's a limit to the time we're going to sit here?---Yes. Well, an enormous amount has changed. When I started, the organisation was a very small country building society with – with a distribution presence, really, only in central Victoria. Soon after came the pyramid crisis, which some people in the room may remember. But, out of that, Bendigo Building Society which, effectively, took over a lot of other building societies which were in great difficulty. And in the 90s there – there came a process of – of rationalisation, of expansion, and following, in a sense, the freeing up of the financial system that was unleashed by the Hawke government in the early 80s. And in a way the pyramid crisis was part a consequence of that. So we've seen that cycle. Our organisation then expanded through acquisition and merger and through growth. And we expanded, in substantial part, because we then started to partner with local communities to provide banking services to places that felt that they were missing out on them as things were tending to centralise. The next big event was, I suppose, the global financial crisis. And what happened – so we, by that stage, were a bank. Bendigo was a very retail-focused, retail-driven, deposit funded organisation. And we were missing out on a whole part of the business, which was the wholesale end of the business. And so we merged with Adelaide Bank, which was a much – stronger in those parts of the business. Now, the consequences of the collapse in credit and funding through the global financial crisis meant that a lot of those – a lot of those parts of the business, in fact, became quite challenged. And, indeed, the whole – the whole finance system became quite challenged. And, as a result of the global crisis, the collapsing available credit for Australian banks, and interventions by government, such as guarantees of deposits, guarantees by governments of bank wholesale borrowings, allowing even further consolidation to take place. So mortgage brokers, which had provided a disruptive, competitive element in the industry, mostly ended up getting bought by the major banks. And – and the funding available to them then got funded through government-guaranteed wholesale borrowings. So we've seen a great, in a sense, consolidation of the industry. Perhaps just one other thing I mention, Commissioner, is that there has been a substantial change in the way banks are regulated as a result of what we call advanced accreditation. So large sophisticated banks – and this was part of the kind of deregulatory zeal, if you like, of the 1990s. Large sophisticated banks that could convince the regulator they had the systems to cope with this, were, basically, able to set their own capital requirements. So risk weight – in particular, risk weightings for particular classes of assets, the banks could themselves set. So we saw in – as a result of the global crisis, central banks and governments, effectively, flooding the finance system with cheap money – and in Australia, while we had avoided the problems – the credit problems of the Global Financial Crisis, there were lots of concerns. And so a lot of that funding was pushed into the domestic centre – domestic area of the economy. And so housing, for example, became a way that we were going to continue to – to keep economic activity up despite the – the crisis. And so the major banks, now with the benefit of their expanded business bases, the mortgage brokers, the other banks that had got into problems – as a result of the funding that was available to them through the – through the support mechanisms, invested hugely in to this domestic area. And, of course, they were relative – to say unconstrained would be too much, but they were free to – or they were relatively free to set their own risk limits in those things. And so we've seen the expansion of domestic credit. So in Australia we now have – from our perspective, we, basically, have a two-tier banking system. We have a group of four major banks that dominate the market, have the benefit of that advance accreditation system that I described. Even though the regulator has pulled back on the extremes of the – of the implications of that, major banks still have the benefit of the implied government guarantee on wholesale borrowings. And then you have a large – a large number, but over the years relatively stable number, of smaller players who try to provide alternatives and find a place in that finance system. Is that enough?

MS ORR: Thank you. In the submissions that Bendigo and Adelaide Bank provided to the Commission following the interim report, the bank expressed the view that many of the issues identified in the interim report reflected a departure from the simple notion that banks perform a fundamental service to society which should benefit all parties. And could you just explain a bit more about that simple – what you have described as that simple notion?---So Bendigo Bank is 160 years old this year. And I – we had a celebration held just over the road from where the first meeting – foundation meeting was held. So it was founded by a group of 100 people who came together. This was not long after Europeans arrived in central Victoria to dig gold. And they said they were sick of living in tents. And they agreed to pool their resources, pledged a certain amount of money on a regular basis and they would take it in turns to build houses. That's – that's the genesis of our company. And, in a way, that's still the foundation of it. We serve – we're there to help our customers and stakeholders get access to credit, provide sources for – ways for them to safely save to improve their material prosperity through access to a finance system. If they improve their prosperity, then their communities will prosper. If they and their communities prosper, so will we. But it's in that order.

And that's reflected in a statement in those submissions that Bendigo provided that the role of a bank is to feed into community prosperity, not off it?---You don't have – you won't have a prosperous bank if you have an impoverished community.

Your submissions contained a list of 10 things that Bendigo believes the community expects it to strive for. And they were:

> *To act honestly and fairly, to listen to customers and respond to their needs, to act for the long-term benefit of the community, to promote financial inclusion, to securely hold customers' money and personal information, to derive a fair return on the shareholder capital provided by the community, to pay a fair share of profit in tax, to operate within the law, to ensure staff are fairly rewarded, and to provide staff with a safe workplace, free of harassment, discrimination and bullying.*

Now, these all sound like attractive and somewhat obvious propositions, Mr Johanson. Why do you think so many banks have had so much difficulty conducting their operations in a way that is consistent with many of those propositions?---Well, I'm reluctant to start to disparage other members of the industry that I'm – that I'm proud to be part of. But in my story of the history of – of – you know, the big events in the last 30 years, or whatever it was, I think you can see that – and, you know, where do you want to go back to? But if you go back to the – what we did as a result of the Global Financial Crisis, I think what I was trying to say was that banks became almost the vehicle through which we were to keep the economy humming. And banks were rewarded and applauded for getting on with the business of getting credit out there, keeping investment going. Banks became an astonishingly large proportion of the stock exchange, for example. And it's still the case that – I think it's almost a third of dividends come from the major – from the banking system. So – and if you had suggested nine years ago that we needed to ensure that our regulator was properly funded to crack down on practices in the finance system, people would have said what are you trying to do? And, indeed, funding was cut from them. So I think – I think that it's not just the banks or the people who are running the banks

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that we need to reflect on when we think where we go to from here. But in our case, you know, we – we weren't part of that – what, from my perspective, would seem to be a kind of favoured group of players in the market. We had been through a very difficult experience of effecting the merger, confronting the implications of the global crisis, getting through all that, dealing with lots of problems that emerged as part of that. And we had a new chief executive. And, for us, it was a good chance to stop, sit back, think, reset, and think what a sustainable position for us was in that new marketplace.

The submissions that Bendigo provided the Commission suggest that the way that banks have structured their remuneration arrangements has been a major cause of some of the problems that we've seen in the Commission this year. Is that your position, Mr Johanson?---We certain – well, again, I'm reluctant to prescribe for others what their – what's appropriate for them, but we've certainly taken a quite different approach to remuneration.

That's what I would like to talk to you about, Mr Johanson. I want to ask you about the remuneration arrangements at your bank, both at the executive and at the frontline level, and how they differ from what we've seen from some of the other arrangements we've looked at over the course of this fortnight. And I want to start with how you remunerate your executives in your bank. And for the moment I want to focus my questions on the remuneration model that you have for your managing director, your CEO, the chief financial officer, the chief risk officer, and the chief people officer. Now, in broad terms, the model that you use for those people has three components: base remuneration, a short-term incentive component, and a long-term incentive component?---Yes.

And, over the last two weeks, we've heard that a number of other banks defer part of the short-term component of their executives' variable remuneration and all of the long-term component is deferred?---Yes.

Have you heard that evidence - - -?---Yes.

- - - Mr Johanson? But Bendigo does more than that. Bendigo also defers part of its executives' base, fixed remuneration?---Yes.

Is that right?---Yes.

So they receive part of their base salary in cash paid immediately and another part in shares which are held on trust for a period of time?---Yes.

And do those shares vest automatically at the end of the deferral period?---No. There's always the discretion that – for the board that if things emerge in that period of deferral, as it were, that they can be recovered.

And why does Bendigo Bank defer part of its executives' base remuneration? What do you see as the advantages of that different approach?---Well, we think it's better

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to have a large proportion of the total package in the form of base, but, as you say, we pay part of that base in the form of shares. So it's – as shareholders often tell me, they like to see executives and directors with skin in the game. So it gives them skin in the game. But where – because of the deferral process it sets – if – if they're interested – if it alters their perspective on things, it's saying you're not going to get them for some years out, so that's the timeframe you need to be thinking about.

Do you know of any other banks that defer part of their executives' base salary?---No.

And are there any disadvantages that you see flowing from your system of deferring part of the base salary?---It has worked very well for us.

So I want to ask you in a bit more detail about what Bendigo does with each of the three components of executive remuneration, base remuneration, short-term incentives and long-term incentives. I want to start with that base. Now, in particular, what I want to ask you about is the balance between base remuneration and variable remuneration. And you say in your statement that your bank has historically weighted its executive remuneration not towards variable remuneration, but towards the base pay, the fixed pay. Is that right?---It is. That's right.

And can I take you first to a table in your statement that shows us how that works for some of the key people in your organisation. If we go to your statement, which is BAB.9000.0003.0001, and we turn to paragraph 14 at .0005, we see in the table underneath paragraph 14 the target remuneration mix for each relevant executive committee member for the 2018 financial year. And we see that in this target mix, the fixed base for the managing director is 40 per cent?---Yes.

And the deferred base for the managing director is 25 per cent. So there's a total of 65 per cent base remuneration?---Yes. Of course, that – the value of the deferred base - - -

Yes?--- - - - in the form of shares - - -

Is yet to be?--- - - - can go up and down.

Yes. And in this target mix for your managing director, only 10 per cent is a short-term incentive?---Yes.

And the remaining 25 per cent of the target mix is a long-term incentive?---Yes.

And for your chief financial officer, the target mix is 50 per cent fixed base, 10 per cent deferred base, so a 60 per cent base remuneration for that role. Is that right?---Yes.

And 20 per cent short-term incentive?---Yes.

And for your chief risk officer, the target mix is 60 per cent fixed base, 10 per cent deferred base, so 70 per cent base remuneration?---Yes.

And only 10 per cent can comprise a short-term incentive?---Yes.

Now, how does that target remuneration mix compare to the other banks?---Well, I understand others have a much larger share of – or proportion of the – of the income – or at least the potential income of these executives in these positions, in the form of what they call short-term incentive.

Well, taking CBA as an example, base remuneration appears to be around 25 per cent of the total target remuneration mix for the CEO?---Yes.

And I see from your statement that the bank has done some of its own benchmarking of its executive remuneration against your peers. If we could turn to exhibit 9 to your statement, which is BAB.5037.0001.1882?---Yes.

We see when this comes up on the screen – and you have it there in front of you, Mr Johanson – that this is a submission from – from the people and performance unit within the bank to the governance and HR committee from July this year?---Yes.

And if we turn to 1888, we see that it attached the result of a benchmarking exercise undertaken by the bank comparing the remuneration of your chief financial officer and your chief customer officer against equivalent roles at other banks and institutions?---Yes.

And we can see that for your chief financial officer, the maximum short-term incentive opportunity and long-term incentive opportunity were both 32 per cent of that person's fixed remuneration?---Yes.

And we can see that for each of that person's peers listed here, including NAB and ANZ and Suncorp, the percentage was far higher?---Yes.

None of the CEOs at the other banks listed here had a short-term remuneration opportunity that was lower than 100 per cent of their fixed remuneration?

THE COMMISSIONER: CFOs, I think.

MS ORR: I'm sorry. Did I say CEO?

THE COMMISSIONER: I think so.

MS ORR: CEO. I apologise?---Yes.

So none of them were less than 100 per cent of the fixed remuneration. And NABs CFO, that person's short-term remuneration opportunity was the highest. That was fixed at 175 per cent of their fixed remuneration?---Yes.

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So very considerable differences between the way that you reward your chief financial officer and the way that these entities reward their chief financial officer?---Yes.

And we see a similar comparison for the chief customer officer, who at that time was Ms Baker, now your CEO. Her maximum short-term incentive opportunity was 29 per cent of her fixed remuneration?---Yes.

Do you see that?---Yes.

And her maximum long-term incentive opportunity was 32 per cent?---Yes.

While her peers at the other banks listed there all had a short-term remuneration opportunity of or above 100 per cent of their fixed remuneration?---Yes.

And NABs chief customer officer, again, in this list of peers had the highest short-term remuneration opportunity at 175 per cent of their fixed remuneration?---Yes.

So, having set all of that out, Mr Johanson, why? Why does Bendigo and Adelaide Bank have such a low proportion of short-term variable remuneration for its executives?---We believe we're trying to build a business for the long-term. We're trying to establish a strategic position to be the bank of choice for Australians. That's an articulation of it that's come with the new managing director. We used to say we wanted to be the most customer-centred bank in – in the country. And we feel that to build long-term relationships with customers – so that's – that's a relationship that hopefully will include lots of parts of their banking business, not just making a loan, but getting deposits from them, helping – helping them through generational issues, all those sorts of things. It has got to be because we focus on those things and focus on building a trusted business for the long-term. That's why we set our remuneration arrangements in these way, because that – that works for us to build that strategic position in the industry.

You also say in your statement that:

> *The board has a long held view that remuneration which is leveraged towards short-term performance can create a disconnect between the individuals' interests and the long-term interests of shareholders and other stakeholders, especially customers, including increasing the risk of poor culture within an organisation.*

You recall that?---I do.

Now, can you explain what you mean by a disconnect between the individuals' interests and the long-term interests of shareholders?---Well, on any – on any day if there's an opportunity for someone to do something that makes a profit, for example, if their – if their concern – and if, in fact, the form of their remuneration forces them or leads them to think that the things to worry about is this month or this year's

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revenue target or profit target, that's what they will think about. What – what's the implications of this transaction for that objective? If we're trying to build a relationship with customers that goes for their life or for a long time, if we want them to come back to us for second and third pieces of business, if we want to build the trust in their communities and be seen to be – then we don't want them to do that. We want them to say. No. No. Here is something that's better for you.

And what about the board's view that remuneration leveraged towards short-term performance can increase the risk of poor culture within the organisation? Can you explain that view?---Well, as I say, I think the way culture – culture gets used as the device but, in fact, it's the describer of what's there.

Yes?---So if you are concerned about profits, often individual transaction, for example, that's not the culture that we want. That doesn't reflect a behaviour – a set of behaviours that we think are going to be for the long-term betterment of the business and the stakeholder group.

Now, can I ask you about the short-term incentives that you offer for your executives. We've talked about the composition and their weighting within that composition. But your short-term incentive payments are made from a single bonus pool?---They are.

And that bonus pool is shared by all salaried employees of Bendigo, including the senior executives?---Yes.

And at the beginning of each financial year, the board sets parameters for the creation of that bonus pool?---Yes.

And what sorts of parameters are they?---Well, we – it comes as we – as we – and part of considering the targets, the budget, if you like, for the following – for the next 12 months. So, usually in June or July, we will be presented with a here's what – here's a budget for the next 12 months. We will set a target, an earnings number in that. And as part of that there will be a budget. Included in the budget will be an allowance for a bonus pool. And we also say that if that budget – if that target is exceeded, how much of that excess, as it were, goes into a bonus pool. And then we cap it. So in this current year, I think if we achieve our target, the bonus pool will be of the order of 12 or $13 million. But it can never exceed $20 million. So even if we wildly outperform the target, the bonus pool won't be more than $20 million.

And why do you have that cap on the size of the bonus pool, Mr Johanson?---Well, if you think about the long-term and managing – banks are complicated businesses with lots and lots of moving parts. And if suddenly – and, basically, we make money by buying money and selling money at different prices, deposits and loans. If the numbers got a long way out of expectation, something unusual – something is happening in the base of the business that's worth paying attention to. So we don't want to stimulate that. That's why we cap it. And that's how we set it.

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Are you aware of other banks capping a bonus pool?---Not that I'm aware.

And if the parameters that the board sets at the start of the year are satisfied, the board then has a discretion to create the bonus pool. Is that right?---Yes.

And, as I read your statement, the pool will only be created – I think this is what you've said today, as well – if your performance at the bank exceeds, rather than simply meets expectations. Is that - - -?---No - - -

Is that right?---About half the potential pool - - -

I see?--- - - - is created, as it were, if we hit that target.

Okay. So - - -?---It's not all – unless you hit it – unless you exceed it, you don't get anything.

I see?---There's a kind of margin in the middle there.

About half is there - - -?---About half – a bit more than half. As I say, I think this year about 12 and a half of the 20 million potential will be available if we reach our target.

And having a portion that's only available if you exceed, rather than meet, your expectations – that's right, there is a portion that's - - -?---Yes.

- - - only available in those circumstances – I understand you in your statement to be saying that you do that because you consider that short-term incentives should not be a payment to people for doing their job. That is the role of base remuneration?---Yes.

Is that your view?---Yes.

So how does that work with the 12 and a half million pool that is there - - -?---Well - - -

For?--- - - - I mean, to some degree it's arbitrary where you set the starting point and the numbers. And you don't want – you want it to come in gradually, as it were, as you're working through the year, rather than there being a – a point at which suddenly it appears and – so you – it's really a process of managing the expectations and the – and the construction of the pool.

So is there part of the pool that's available to people for doing their job, as opposed to - - -?---Nothing – nothing is paid unless the pool is created.

And the pool is created depending on financial performance?---Yes.

And also the exercise of the board's discretion?---Yes.

And what are the factors that influence the board, having met financial performance, to decide whether or not to create the pool?---Well, we look at a – a range of measures to see – just to check that the pool has resulted from behaviours that are consistent with the risk appetite that we have. So in the – as I recollect, in the paper that we considered for the creation of the pool, there were a number of metrics considered. We considered metrics like risk-weighted assets over total assets. We considered return on equity. We considered return on risk-adjusted equity, risk-adjusted capital. So there was a range of measures that we – we check to make sure that the business was – had achieved this pool – achieved the results that created the pool, but it wasn't being manipulated to do so to distort the – the risk appetite that we – we want.

In your time at the bank, has the board chosen not to create a bonus pool?---Well, there has been a couple of times in the last nine years where the pool was not created. So the pool is – the creation of the pool is, in the first instance, at least a mechanistic exercise, what's the – what's the – what's are the earnings that has been achieved, what's the result of that. But then we apply our – but, yes, in the – in the last nine years, I think twice no pool was created. I think only in one of those years did we get close to the maximum pool. Most of the time the pool created has been of the order of 50 or 60 per cent.

And what led to the decision not to create the pool on the two occasions that you've just described?---Our earnings weren't good enough.

I see. I see. And the size of the pool, when you said that on average it was 50 to 60 per cent, is the size of the pool, again, determined by earnings?---Well, as I say, that – that's set at the initial process. So the pool this year is 20 million. It was 20 million last year. That was the maximum size of the pool. The pool created last year was, I think, 12 and a half million.

Based on earnings?---Based on earnings.

Is that right? Now, in your statement you emphasise that the bonus pool is a product of the collective performance of the organisation, rather than being associated with individual performance. Why do you consider that to be significant, Mr Johanson?---Well, in the way I've described it. I hope you can see where – it's really a profit sharing mechanism. It's – it's not a individual reward exercise. It's a profit sharing mechanism. And if we're going to be profitable and live within the risk framework that we talk about, if all those other things are going to be achieved that we're trying to work on to build the business and – then people should share it. But it's a collective effort, and we are – we want to emphasise that everyone is a contributor and part of this process and responsible for it.

Is there any limitation on the amount of award that can be paid out to an individual from the pool?---Yes. We – we set – we set the amount – the maxima that they can get at the start of the year.

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And how do you set that? Is that the same amount or different amounts for different roles?---Different amounts for different roles. So it vary – the maximum for – I'm not sure what the number is – category something or other of the salaried staff, it can vary between 20 or 15 or 10. The potential at the senior levels, you've seen the numbers there.

And what happens when an award exceeds – an award out of the pool exceeds $100,000? What happens then?---It gets put into equity and it's deferred.

So the entirety is deferred?---Of the amount over 100.

I see?---Yes. I think that's right.

Yes. Now - - -?---Or is it – sorry. I think that's right.

Given the strong views that Bendigo seems to have about the risks associated with remuneration that's weighted towards short-term performance, can I ask you to explain why Bendigo offers its executives short-term variable remuneration at all?---Well, as I say, I think it's seen as if we've had a good year, then it's appropriate that we share – share that – some of the financial outcomes of that amongst other stakeholders.

Because it is a profit sharing mechanism?---Yes.

Now, can I turn to asking you about the long-term incentive component of your executive remuneration model. How many of your employees are eligible to receive long-term incentive payments?---I think it's really only the senior management group.

So quite a small number?---Yes. Don't hold me – 15, maybe 20.

And you say in your statement that:

> *The bank offers long-term incentives to drive and reward long-term growth and sustained company value, and to align the interests of participants with shareholders and other stakeholders.*

?---That's the objective.

And who are the other stakeholders that you're referring to there, Mr Johanson?---Customers.

And what do you mean then by:

> *To align the interests of participants with shareholders and customers.*

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?---So some of our – well, so we – our stakeholders are, of course, a very wide group of people. And for the investor group, the people who give us their capital to look after, for them, of course, it's important that we're able to – to generate good returns on – on the capital that they've invested with us. And it has become accepted through the – you know, really, corporate – corporate world that incentive programs are an essential part of packages for senior executives. But I think, properly structured and properly managed, they can provide the – the mechanism to get employees to think about not just their job and their particular concerns, but also the interests of other stakeholders. Now, the way we structure our long-term incentive program, of course, for senior – is not the only way we give them exposure to that, but it's one way and it's an important way.

So can I talk to you about how you do structure - - -?---Yes.

- - - that. Each year the employees who are eligible to receive long-term incentive payments get a certain number of performance rights?---Yes.

And at the end of a deferral period, those rights vest?---Yes.

But there are certain conditions - - -?---Yes.

- - - that govern the vesting. Is that right?---Yes.

And the deferral period is four years for your managing director, and three years for the other executives?---Yes.

And why does the managing director have a longer deferral period, Mr Johanson?---We're trying to – we're trying to have the managing director think about a longer perspective than – and that's the job of the managing director.

And if the performance rights vest, they're converted into shares?---Yes.

And I want to ask you some questions about the conditions that determine whether those performance rights vest. Now, you've exhibited a copy of the bank's most recent remuneration report to your statement, which is exhibit 2, BAB.5039.0002.0038?---Yes.

And if we bring up 0043 and 0044 together, we can see a summary of the different conditions that determine whether performance rights vest. Now, if we could blow up the table on the top left-hand side. We see that there are three sleeves there referred to, Mr Johanson. They're three performance hurdles. Is that right?---Yes.

And they determine how many of the performance rights will vest?---Yes.

And there's also something called a service condition. What is the service condition?---Means they have to be employed.

I see. And the first performance hurdle is a customer hurdle?---Yes.

And that determines whether 30 per cent of the performance rights vest?---Yes.

And the next two performance hurdles are an earnings per share or EPS hurdle and a total shareholder return hurdle?---Yes.

And together they determine whether the other 70 per cent of the performance rights will vest?---Yes.

And 35 per cent of that 70 depends on both hurdles, and the remaining 35 per cent depends solely on the total shareholder return hurdle?---Yes.

And that total shareholder return hurdle is similar to the relative TSR hurdle used by other banks?---Yes.

Now, you introduced the customer hurdle, the one we see in the first column here, in 2016?---Yes.

And why did you do that?---I described earlier our strategy, our point of difference, is that we want to – we think the way to create a long-term value in our business is to be the most focused on customer outcomes. So the – the most – well, one of the most important criteria, then, for – consistent with that strategy is what do customers think of us.

And you measure that using the net promoter score?---We do.

And, to satisfy that hurdle, your net promoter score over the deferral period has to be 20 per cent greater than the median performance of your peer group of Australian banks. Is that right?---Our – yes, it is. Our – our net promoter score is much higher than other banks. So a relative net promoter score wouldn't be much of a target.

I see. As far as you're aware, Mr Johanson, do any other Australian banks currently have a customer-related performance hurdle in their long-term incentive schemes?---I'm not sure about long-term. I know some are starting to introduce these things. Yes. Look, I couldn't tell you what specifically other plans are, but this – the question of whether you can move away from purely shareholder return criteria for long-term incentive programs is a fraught issue at the moment.

Do you think that the introduction of the customer hurdle at your bank changed the way your executives behave?---No, but it reflected what we were concentrating on. So it was appropriate that for this program we – we introduced it.

Now, you decided to change the structure of your long-term incentives in September this year?---Yes.

Is that right?---Yes.

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And could I ask that you look at BAB.5037.0004.0063. Now, this is a submission that was put to the board by the talent and reward and people and performance parts of the business at a meeting on 4 September?---Yes.

And we see from 0065 that the submission recommended, in the part towards the bottom there, that the board approve a recommendation to modify the design of the long-term incentive grant in line with option 2 in this paper?---Yes.

Now, if we bring up these two pages, 0064 and 0065, we can see a summary of the existing scheme and the two options to change that scheme that you were considering. Now, the options we see were put forward – we see this from the paragraph above Market Practice on the left?---Yes.

They were put forward to ensure that the:

> *The plan continues to engage and motivate participants to create sustained company value and align their interests with shareholders.*

And this was taking into account the challenging financial environment for FY19?---Yes.

Was the board concerned that it would not be possible to meet the earnings per share hurdle?---I think – well, certainly this year is a challenging year. And when we looked at the – at the budgets and things there was a lot that – a lot that was in that. So, yes, probably that was one of the considerations.

Well, we see that the first option for change at 0065 was to retain the existing weighting between the customer measure and the two shareholder measures, but to make the earnings per share hurdle easier to meet?---Yes.

And the second option was to remove the earnings per share hurdle entirely and adjust the weighting between customer and shareholder measures?---Yes.

Decreasing the amount of performance rights that depend on the total shareholder return hurdle from 70 to 65 per cent, and increasing the amount that depend on the customer hurdle from 30 to 35 per cent?---Yes.

And that was the option that the board adopted?---Yes.

And why did the board adopt that option, Mr Johanson?---Well, I think the – I explained perhaps sufficiently why we're interested in the net promoter score.

Yes?---Why that's, we think, crucial and important. Long-term - - -

You increase the reliance on it, though, by increasing the customer hurdle from 30 to 35 per cent?---Yes.

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And that's what I'm interested in. So not only was it a significant component, you made it a larger component in September this year?---It has become for us even more important that we focus on those outcomes.

And why is that?---Because that's – in the very competitive banking market that we now have, where growth – the availability of sort of almost unlimited credit has stopped, it's becoming even more important that if we're to continue to build our business and grow our business and be able to invest in it, that we attract more customers. So we want people to concentrate on customer outcomes.

I tender that document, Commissioner.

THE COMMISSIONER: Submission to board meeting, 4 September '18, concerning LTI performance hurdle modification, BAB.5037.0004.0063, exhibit 7.142.

EXHIBIT #7.142 SUBMISSION TO BOARD MEETING CONCERNING LTI PERFORMANCE HURDLE MODIFICATION DATED 04/09/2018 (BAB.5037.0004.0063)

MS ORR: Have your shareholders tended to support your bank's approach to executive remuneration?---Yes.

All right. Could I ask that you look at BAB.5041.0001.0028. This is a report issued by ISS Governance in relation to Bendigo's 2018 annual general meeting?---Yes.

And ISS Governance is a proxy adviser firm?---Yes.

And proxy adviser firms recommend how shareholders should vote on certain resolutions put at an AGM. Is that right?---They do. They've become a really important part of the process of shareholder engagement, very much.

Could I ask you to look at 0029, where we see the recommendations made by ISS Governance. ISS governance recommended a vote against a resolution approving a grant of performance rights and deferred shares to Ms Baker at this year's annual general meeting?---Yes.

And the report records, in the section underneath "nevertheless", in the second dot point that one of the reasons for this recommendation was the increased:

> *...weighting given to the customer hurdle in the long-term incentive plan.*

We see that the proxy firm advised that:

> *This measure had no direct link to shareholder wealth outcomes.*

?---Yes.

And that:

> *Customer-centric measures should be considered and assessed as part of a banking executive's day job.*

?---Yes.

Now, do you think it is right to say that the customer hurdle in your long-term incentive plan has no direct link to shareholder wealth outcomes?---Well, no, because we think – we think that is crucial, as I – as I've said, for the long-term growth of profitability of the business.

And do you agree that customer-centric measures should only be assessed as a part of a banking executive's day job?---Well, no. I – but I think that the – the day job, as it were, includes thinking about, hopefully, all the parts of the remuneration package are working together to achieve common outcomes. The – the share – the proxy advisers, of course, are employed by institutions, and it provides, really, a pretty rigorous way for institutions – large numbers of institutions to get to grips with these questions when often they historically they haven't been that interested in them. So it's – it's an important process. But – but those – the people who pay the proxy advisers themselves are assessed on, typically, short-term financial outcomes. So it's no surprise that a fund manager is interested in short-term financial outcomes, because we all, as investors through superannuation funds, are concerned about whether this – this six months our fund has done well or not. It's a – I think there's a kind of, you know, a dilemma in all this, but you need to balance – balance the different outcomes.

THE COMMISSIONER: Well, it's reducing some quite complex questions to binary outcomes, isn't it?---That's – and in – so, sir, in our case, maybe 40 per cent of our shares are held by institutions. Maybe – and so 60 per cent are held by retail shareholders. And, of those institutions, a number of them hold shares as an index fund and – so there's a mix of objectives in the institutional market, as well. But this is a central part of the process of discussing and ventilating those things.

MS ORR: In your experience, do the views expressed by proxy advisers in reports such as this, in relation to executive remuneration, tend to align with achieving good customer outcomes?---Not always.

Do they align with the long-term sustainability of the bank?---Not on their own.

In the submission that Bendigo provided the Commission following the interim report, the bank said that:

> *Institutional shareholders and proxy advisers typically require executive remuneration to have a substantial weighting towards incentive-based pay that*

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is directly exposed to financial performance and share price performance, and criticise remuneration structures that do not do so.

?---I think the report you just led us to shows that.

And do you write to investors who take advice from particular proxy firms such as this ahead of annual general meetings to provide a different point of view?---We do. We have a – we try and have a very kind of active engagement with shareholders in that period leading up to the annual general meeting.

Well, I will tender the ISS Governance report.

THE COMMISSIONER: ISS Governance proxy analysis concerning Bendigo and Adelaide Bank for meeting October '18, BAB.5041.0001.0028, exhibit 7.143.

EXHIBIT #7.143 ISS GOVERNANCE PROXY ANALYSIS CONCERNING BENDIGO AND ADELAIDE BANK FOR MEETING OCTOBER '18 (BAB.5041.0001.0028)

MS ORR: And can I take you now to a letter that you wrote ahead of this year's annual general meeting, which is exhibit 16 to your statement, BAB.5039.0003.0001?---Yes.

Now, this is a letter that you wrote to a particular investment manager about the advice from the proxy adviser firm that I just took you to on 24 October this year. Is that right?---Yes.

This is the second document in that exhibit?---Yes. Yes. Yes.

And in this letter you set out the rationale for the board's decision to recommend each of the resolutions?---Yes.

If we turn to 0002, we see, a bit lower than halfway down the page, your explanation of the rationale for the recommendation to approve the issue of deferred shares and performance rights to your new CEO. We see you said:

In setting the new managing director's remuneration, the board determined that the managing director should have relatively lower levels of incentive-based pay, and in doing so has sought to align senior executive pay with shareholders' interests by having a portion of base pay paid in equity (we refer to it as "deferred base pay" or "deferred shares"). The recent focus on the importance of culture and the risks associated with incentive programs support this view.

?---Yes.

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And, further down, you said, in the paragraph starting “the board”:

> *The board has also determined that it is appropriate for a component of the long-term incentive to include a measure (35 per cent) that is based on customer advocacy performance, which is particularly relevant for the banking industry given the reputational issues driven by poor customer outcomes that have been exposed through the Financial Services Royal Commission.*

?---Yes.

So this was advocacy on the part of the board in response to the advocacy from the proxy adviser firms - - -?---Yes.

- - - ahead of this year’s annual general meeting?---Yes.

Now, did the resolution in relation to the grant of performance rights and deferred shares to Ms Baker pass - - -?---It did - - -

- - - at your recent AGM?---It did.

And what proportion of voting shareholders voted against it?---I think we had about 200 million of our 500 million shares voted. And the problem – well, I don’t know if it’s a problem, but the reality is that fewer of the retail shareholders actually vote. So of the 200 million that voted, I think there were about 20 per cent voted against this resolution. So it passed.

Your ASX announcement indicates 19.2 per cent voted against it?---Right.

And did the resolution in relation to the approval of your remuneration report pass?---It did.

And what proportion of your voting shareholders voted against that?---Very few.

Yes?---Less than five, I think.

Yes. Your ASX announcement indicates 4.4 per cent. I want to understand, Mr Johanson, do you have to work hard at Bendigo to convince institutional shareholders, in particular, to support your remuneration framework and decisions such as the one that we saw you writing about in the previous letter?---Well, we are conscious that we are a bit different, but, indeed, that’s – that’s what we say we are. We are – we – we think we – we play a different position in the – in the market. So it’s not surprising that our remuneration structure is different, too. We do work hard. But we work hard with all our stakeholder groups and shareholder groups to try and let them see what we’re – what we’re doing.

And all of that work takes place against the backdrop of the two strikes rule?---Yes.

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And you may have heard me ask questions of other witnesses in this round of hearings about the two strikes rule. Do you have any views on whether it would be desirable to modify the two strikes rule in any way?---Well, I think that what this example shows is that the two strikes rule can mean that a relatively small proportion of the total shareholder group can have significant influence on the direction of the company. To – to do – to run two strikes would be a very disruptive, costly – and I just don't mean in dollar terms – but costly exercise for an organisation. And so where voting participation is relatively small, and I think we do quite well to get 40 per cent of our votes – our shares to be voted, it does mean that those institutional holders can have a big influence.

So do you think modifications ought be made to address that problem?---I do. But I'm also – my – my caution is that it has turned out to be a very effective way to have people focus on this stuff. So instead of just blindly assuming it away, people do now work hard on this stuff. So I'm - - -

People – which people? People within the bank or people - - -?---Within companies.

People who are trying to gets the resolutions passed?---Within companies engaging with shareholders, with proxy advisers, reaching out to other shareholder groups who aren't represented, necessarily, by proxy advisers, finding new ways of – of contacting them, of engaging with them. I think we all do a lot more work on that, which is good. And I'm sure the two strikes rule has been very much part of that.

So I think, based on your evidence so far, Mr Johanson, the position is that there are a number of significant differences between the executive remuneration model at your bank and the model at a number of other banks. Can I list these to see if I have them correct. Your bank defers a part of its executives' base remuneration?---Yes.

It has a lower proportion of short-term variable remuneration, as opposed to fixed remuneration?---Yes.

The short-term variable remuneration is based on collective performance?---Yes.

And it's only paid – I just want to make sure I've understood this – is it only paid in the event of exceeding the bank's expectations or in the event of meeting expectations?---Part of it is – is - - -

Meet?--- - - - paid on meeting.

And part on exceeding?---And part on exceeding.

And under your long-term incentive scheme, there's a customer performance hurdle that determines whether 35 per cent of your performance rights vest for executives?---Yes.

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Now, each of those is a feature of your bank's executive remuneration system that is different to other banks'?---Yes.

And do you think that those differences in your model make it difficult for you to attract the right employees?---We have a terrific group of people working for us. We've been able to recruit – continue to recruit people. I'm sure there are some people who don't come to us as a result of looking at the – at the packages that we offer. And I'm sure there's some people who have left as a result of being able to be – get different structures in different places. But we have an outstanding group of executives.

So do I take from that that you don't feel that it impedes your ability to get the right people running your bank?---But the people who are interested in coming to us are those who probably see this as being the right kind of - - -

Yes, I understand?--- - - - package.

Do you think that the differences in your remuneration model make you a less competitive business?---No. I – it's not the remuneration model that determines our competitiveness. And, indeed, given that our strategy, our – how we choose to compete is on service and trust, it actually complements that.

And do you think that the differences in your remuneration model diminish your returns to shareholders?---Not – no. I – I think that – that our – the model, because it works for that section of the business and for that section of the market, it enhances it, that - - -

Which section of the business?---Sorry. For the industry is what I meant.

Yes?---I'm not – not all the industry. Not everybody wants to bank with the Bendigo Bank. Some people want to bank with different sorts of organisations. And, indeed, we think that one of the big problems we've got is that other models of competition have become very difficult as a result of the financial factors that apply to us and to other regional banks. So the returns that are available to us we think the way we run the business, our customer – our focus on customer service is the best way for us to achieve those outcomes.

Do you think that your remuneration model has had an effect on the conduct of the people who run your business?---Yes.

And at – within your witness statement you say that you consider that your approach to remuneration has assisted your bank in avoiding some of the issues that have affected other participants in the industry in recent times. What sort of issues are you referring to there, Mr Johanson?---Some of the mis-selling sorts of issues that I think we're now all familiar with.

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And why do you consider that it has assisted you to avoid those issues?---Because we haven't provided incentives for people for the short-term outcomes to do – participate in those behaviours.

Now, could I turn to asking you some questions about the way you remunerate your frontline staff?---Sure.

Are you familiar with the recommendations made by Mr Sedgwick in his report?---Yes.

And did Bendigo adopt practices which were consistent with those recommendations in many respects long before that report was published?---We did.

When did your bank remove all sales-based incentives and commissions?---We certainly – there was – in 2004 or '06, as I recollect, we – we had a joint venture in a financial planning business that we ended up taking in-house. And we, at that time, thought about a lot of these issues and removed commissions. So certainly since then we haven't paid for frontline staff those sorts of – those sorts of payments.

So was it the - - -?---I don't remember that we ever – certainly at Bendigo, I – I can't remember that we ever paid - - -

Yes. So is it the case that sales-based incentives weren't prevalent within Bendigo at the time that you brought in this wealth component to your business?---Yes.

And then when the wealth business came in, you considered what to do with sales-based incentives and commissions in that part of the business?---Yes.

And you made the decision that in that wealth part of the business, you would remove - - -?---Yes.

- - - sales-based commissions and incentives?---Yes.

And was that regarded at Bendigo as a significant decision?---I don't think it was, at the time, particularly shocking. It was consistent with the way we had run the business.

But, again, a very different approach to the approach of your peers?---Apparently.

You say in your statement that you're unable to express a view on whether that move, away from sales-based incentives, has reduced employee misconduct or conduct that falls below community standards and expectations, because it's just so long ago that you did this. Is that right?---Yes. I mean, we've had instances that you look back on and think – but – but I think we've done pretty well.

Are you able to make any broader observations about whether you feel Bendigo has historically been disadvantaged in some way by not using sales-based

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incentives?---I'm sure it has – it has, to some degree, determined the kind of business that we end up doing. I'm sure that's right.

Do you think it has affected the motivation of your employees to serve your customers?---No. They get – they get their satisfaction from being trusted and customers, you know, feeling they're doing a good job.

Would you consider making further changes, such as reducing variable incentives as a proportion of your overall remuneration?---We – every year, we – we go through this and think about what's the right mix and what's the – every year we interrogate the – the incentives and the pay systems through the organisation. To some degree, we're in a marketplace where I don't think it's an option, really, just to give up on the idea of any long-term incentive for senior executives. So we – and people, to some degree, are prepared to let us be unique, but they don't want us to be too different in some ways. So we're in a marketplace, so we need to fit within those broad parameters, but I'm sure we will continue to – to check that the behaviours we're measuring and rewarding are the ones that are really the ones we want for the long-term growth of the business.

The final topic that I want to ask you about, Mr Johanson, is the remuneration of mortgage brokers. How important are mortgage brokers to your bank?---Not very.

And what proportion of your loans come through mortgage brokers, do you know?---It's – it's about seven – I – I did check how many – what we wrote last year. So I think in the last 12 months mortgage brokers as such is less than 10 per cent.

Less than 10 per cent?---Yes.

And when home loans come to your bank through mortgage brokers, you remunerate those mortgage brokers in the conventional way of upfront and trail commissions. Is that right?---Yes.

And do you accept that the ASIC review into mortgage broker remuneration and the Sedgwick review both found that there were conflicts of interest inherent in that existing model of remuneration for mortgage brokers?---Yes. We've – we've never – it may be why we've got so few, but we've never participated in bonus schemes and some of those other system – or arrangements within the industry.

And what about the conflicts inherent in the simple upfront and trail commissions structure. ASIC described two types of conflict: the product strategy conflict, which flows from the incentive for brokers to earn greater commissions for getting a borrower to take out a larger loan; and the lender choice conflict, which flows from the incentives that brokers have to favour lenders who pay higher rates of commission. Do you agree that both of those conflicts exist in the current model?---They can, yes.

And do you agree that changes need to be made to address those conflicts?---Yes.

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Now, the reforms recommended by the Productivity Commission in this area included banning the payment of trail commissions to mortgage brokers for all loans originated after the end of this year. What are Bendigo's views on that proposal?---Can I just – just take a minute to tell you how else we get loans - - -

Yes?--- - - - Other than just through branches or through - - -

Brokers?--- - - - mortgage brokers. So the largest group of our loans come through our partner network, the community bank network. So almost a third of the loans last year came to us through our partners, local communities who own their own distribution. We also get about a fifth of our loans from what are called mortgage managers, who aren't brokers, in the sense of simply writing loans with commission, upfront and trail, but they provide – we, effectively, provide them a cost of funds, a line of funds, and they then go and write mortgages with customers at a premium to that. But they take on for themselves the costs of fees - - -

Yes?--- - - - expenses. So we might provide a line at, say, three and a half – the mortgage is written at four and a bit. The difference goes to the broker. So – and we also have a – we've now invested in online mortgage system where, if you're a complying person, you can get a line – a loan through – using all sorts of data validation processes, very quickly purely online. So there's a – there's a great range of ways that we source mortgages, as there is in the industry. So the mortgage – mortgage brokers have become the one – the thing everyone wants to talk – they were originally this disruptive force, because they provided a way for customers to get access to help to negotiate through this financial system. But, as a result of what happened in 2008, the effect as, I think, the Productivity Commission says they've become part of the establishment. And, indeed, many of them are owned by the major banks. So – but 60 per cent or 55 per cent or something of customers choose to use third parties, rather than go direct. So it's crucial, I think, that we don't interfere with the ability of customers to choose how they want to interact with this system, that we don't end up with a fee structure that impedes different ways of providing that access to customers. The customers choose. And we don't interfere with other potential disruptive processes. So – that's a bit of a preamble. But if we're now trying to think about what are the problems with brokers as brokers, it's important that the solutions we come up with don't interfere with the ability of other organisations to provide that service. So in our community banks, they get rewarded by, effectively, a revenue share. So we share the revenue on an ongoing basis. We don't pay them upfront commissions, but what we're trying to do is to ensure that they build a long-term business where they look after clients that come back to them and come back to them. And so we do it by way of a revenue share. So I wouldn't want any solution that we imposed for the problem of brokers to interfere with that sort of arrangement.

So do I - - -?---But I think to – yes.

Just pausing there for a moment, Mr Johanson, do I take from that answer that Bendigo has found a number of ways to bring in home loan business other than through its branch network? You've talked about online measures, you've talked about through community partnerships, a number of measures that are different to the mortgage broker channel?---Yes.

And where the people you are dealing with are not remunerated on a commission basis?---Yes.

With the conflicts that flow from remuneration on a – on a commission basis?---But I think – and if I can say, I think an interesting paper on conflicts in the – in the – that the Commission - - -

The Commission's paper?--- - - - has available shows the difficulty of actually structuring this in ways that achieves what I've said are the objectives. One is don't interfere with people's ability to choose the way they want to engage, don't interfere with the capacity of the system to continue to innovate and cut costs and those things, but deal with conflicts adequately. I mean, that shows how difficult it is. So I think – so the idea of an upfront commission, even a volume-based commission, if it's properly disclosed, if it's clear to the customer what the implications of that are for their loan, if the responsibility of the person who's getting the commission is clear, who are they working for, and – then I think that addresses a lot of those issues.

THE COMMISSIONER: Who do you think they work for?---Well, I'm clear - - -

Who do you think they should work for?---I'm clear. They work for the customer.

Yes?---Otherwise, why would the customer go for them? I'm – I must say, in the – thinking about all this, I am surprised there's any question about that. And I'm surprised that the role of their responsibilities seem to be somewhat in question – somewhat in question.

MS ORR: Whilst an upfront commission remains that is linked to the size of the loan, there is an inherent conflict, is there not?---Well, there could be, though, of course, the size of the loan, in part, will reflect the amount of care and complexity possibly. Simply locking on size can be a problem.

But does it not incentivise a broker to press the customer for a larger loan, because that will earn the broker a larger upfront commission?---It could, yes.

And I had – we had started this discussion with a question that I asked about trail commissions and the reforms suggested by the Productivity Commission, which included banning trail commissions. And I had asked you what Bendigo's position on that proposal was?---Well, I'm concerned that a banning of trails doesn't catch what I think are those – doesn't catch any of the other distribution systems that I described.

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Is that a reason to keep the trail commissions?---If it – if a result of banning trails we force customers only to deal through banks and bank branches, I think that would be a very bad outcome.

Why would that be the result of banning a trail commission?---It may not be the result, but I am – I am – you know, do we ban it entirely? Let's not have those other extreme outcomes.

Well, what do you see as the value that a customer gets in exchange for the trail commission?---Well, it could only be if the customer – and the problem at the moment is, I think, the customers are – even though there might be some formal disclosure system, the customer is unaware that trails are paid and the amounts are paid. Perhaps there ought to be a requirement that if – if a loan has a trail connected to it, the customer is made aware of it. Maybe the – maybe the adviser needs to do something actually in relation to that.

Yes. Maybe they do, Mr Johanson?---I don't have – I don't have an answer. I'm just – I'm just – brokers in their current form and third – other third party distribution mechanisms have become an essential part of the financial system in Australia. And that's largely as a result of customer choice. You wouldn't want to impede customers being able to choose different systems of – of getting access to lending.

Well, is it a result of customer choice, Mr Johanson? The Productivity Commission said that trail commissions were most likely a traditional form of remuneration, common in the 1990s, when brokers emerged as this disruptive force that you've described, which has simply persisted long after it has been found to be detrimental to consumers in other financial product markets?---Yes. Look, I'm – please, I'm not defending trails to brokers. But I – but the package for brokers in their current form have become, as I say, an essential part of the distribution network for a lot of players in this market.

Well, why could they not be replaced with a fixed fee, Mr Johanson?---They could be, if it were fully recompensing the broker. If it were done in a way that ensured that customers still get access to the advice and help they want. But I am – I heard the evidence of Mr Elliott - - -

Mr Elliott?--- - - - who was talking about let's not – let's not just keep advice or help through this system only to the very large borrowers.

Yes. I understand. But the fixed fee, if a fixed fee was used to replace the commission structure, do you have a view on whether that would more appropriately be paid by the lender or by the borrower?---I think it should be – I think it should be apparent to the borrower that the amount is being paid and its impact on the loan. So – and I think the proposal – the suggestion that should we, effectively, add to the amount of the loan the commission so all those things are transparent, that could work, but it – but it – but, in some way, for a bank using a broker means it doesn't

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have to invest in a – in a branch network, for example. So it's a bit unfair that all the costs that are loaded to the borrower where the bank is, effectively, saving money.

Well, you found plenty of ways at Bendigo to bring in home loans other than through your branch network or through brokers?---Yes, we've got a good network.

Yes. I have no further questions, Commissioner.

THE COMMISSIONER: Thank you, Ms Orr. Yes.

MR BATT: No questions, Commissioner.

THE COMMISSIONER: Yes. Thank you very much, Mr Johanson. You may step down.

<THE WITNESS WITHDREW [12.53 pm]

MS ORR: Commissioner, I see the time.

THE COMMISSIONER: Yes. 2 pm.

MS ORR: Thank you, Commissioner.

THE COMMISSIONER: 2 pm.

ADJOURNED [12.53 pm]

RESUMED [2.00 pm]

THE COMMISSIONER: Yes, Mr Hodge.

MR HODGE: Commissioner, the next witness is Mr Byres.

<WAYNE STEPHEN BYRES, SWORN [2.00 pm]

<EXAMINATION-IN-CHIEF BY MR DICK

THE COMMISSIONER: Do sit down, Mr Byres. Thank you. Yes, Mr Dick.

MR DICK: Mr Byres, is your full name Wayne Stephen Byres?---It is.

And your current business address the APRA offices at 1 Martin Place, Sydney in New South Wales?---Yes.

And are you the chair and a member of APRA?---Yes.

Have you received a summons to appear at this round of hearings before the Commission?---I have.

And do you have that summons with you?---I do.

I tender the summons, Mr Commissioner.

THE COMMISSIONER: The summons to Mr Byres is exhibit 7.144.

EXHIBIT #7.144 SUMMONS TO MR BYRES

MR DICK: And, Mr Byres, have you prepared a witness statement for this Commission, dated 27 November 2018?---Yes, I have.

And do you have a copy – do you have the original of that statement?---Yes, I do.

Are the contents of the statement true and correct, to the best of your belief?---Yes.

Mr Commissioner, I tender the statement.

THE COMMISSIONER: The statement of Mr Byres is exhibit 7.145.

EXHIBIT #7.145 WITNESS STATEMENT OF MR BYRES DATED 27/11/2018

MR DICK: No further questions.

THE COMMISSIONER: Thank you, Mr Dick. Yes, Mr Hodge.

<CROSS-EXAMINATION BY MR HODGE [2.02 pm]

MR HODGE: Thank you, Commissioner.

Mr Byres, you're presently a member and the chair of APRA?---Yes.

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And you joined APRA in 1998, at the - - -?---Yes.

- - - time of its establishment?---Yes.

Your term was – as the chair, was recently renewed for a further four years?---A further five years.

I'm sorry. A further five years?---Yes.

You have held various roles within APRA, including being the executive general manager in the Diversified Institutions Divisions?---Yes.

In 2011, you were appointed to the role as Secretary General of the ..... committee on banking supervision?---Yes.

And you left APRA a short time after that?---Yes. At the end of 2011.

And then returned in July 2014?---Correct.

To take up the role that you hold now - - -?---Yes.

- - - as the chair of APRA?---Yes.

What I would like to start by doing is just asking you some questions about the executive board of APRA and the way in which APRA is governed. APRA is constituted by four members: yourself, Mrs Rowell, Mr Summerhayes and, more recently, Mr Lonsdale?---That's correct.

The four members have a collective ultimate responsibility for all aspects of the administration and operation of APRA?---Yes.

In practice, what has happened, at least until the appointment of Mr Lonsdale, is that the members have divided their responsibilities principally along industry lines?---So given a primary focus for each member along industry lines, yes.

So your primary focus is on banking?---That has been, yes.

Mr Summerhayes' primary focus is on insurance?---Yes.

Mrs Rowell's primary focus is on superannuation?---Correct.

And Mr Lonsdale, now that he has joined the executive board, what will his primary focus be on?---So John will have some role in response – in responsibilities in relation to banking or authorised deposit takers. So he will take some of the responsibilities that I previously had. And we've also asked John to take a lead member level responsibility for a range of issues that go across industries. Our work

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on governance and our work on culture, remuneration, enforcement, including the BEAR, and crisis management.

I see. And the way in which APRAs operating model works, you explain in your statement, is that each of the members is required to keep the other members abreast of what it is that's going on within their areas of oversight?---That's correct.

But APRA, I think, again, you explain in your statement, doesn't have any processes or guidelines to determine whether a matter in one member's area of responsibility should be considered by the whole board?---Well, there – there are – there is a charter for the board that determines the sorts of things that the board would get involved in, but members are not normally, and particularly collectively, responsible for day-to-day supervision matters.

I think if we just focus, though, for a moment on my question. One of the things you explain in your statement is APRA does not have additional processes or guidelines to determine whether a matter within any member's area of primary responsibility should be considered by the whole executive board?---So I think that said additional. So additional to the charters and the other charters for other committee structures, etcetera, that's correct.

The terms of reference?---Terms of reference. Sorry. Yes.

For the committees. Is that right?---That's correct.

Is that what you are talking about?---Sorry. That's what I meant.

And the terms of reference define what the responsibilities are for the particular committees?---Correct.

In terms of what needs to be elevated up to the board, what is the process by which APRA determines – or the members determine what should be elevated to them?---I assume your question is if it's not obvious from the charter or the terms of reference of the committee. Typically, it would be issues that – so ad hoc issues would be those that have either significant resourcing implications, significant public interest, significant – might involve significant piece of work or may involve, for example, significant engagement with government or – or others.

One of the things, I think, you explain in your statement is that what APRA relies upon is that all of the members are collocated in APRAs Sydney office?---That's – that's one of the things, yes.

And by virtue of the fact that they are collocated, they can speak on a daily basis about what it is that's going on within their areas of responsibility?---Yes.

And then there may also be discussions that occur at the formal monthly meetings of the executive board?---They're two possibilities, yes.

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And what I wonder, then – I want to try and explore with you is the way in which the strategic direction or strategic decisions that APRA will make within each industry is made at a board level, as distinct from a committee level. Do you have a view about that?---So when it comes to – if we're talking about strategic issues within an individual industry – that's your question? Sorry.

Yes?---Yes. So they would come up. We would have for each of the industries that we supervise, the five industries that we supervise, we have what's termed an industry group. So there's an ADI industry group, a superannuation industry group, etcetera, etcetera. They bring together the relevant industry experts from around APRA. The relevant APRA member, so in the case of ADIs, I would be participating in that group. Not chairing it, but participating. Mrs Rowell would be in the superannuation industry group, etcetera, etcetera. That industry group would be tasked with identifying the key themes and issues that exist within an industry sector. And particularly where we felt there needed to be strategic or thematic work undertaken identifying the highest priority areas that we might want to focus on. And then each year we have a cycle where the board receives papers on the industry sectors, and through the exercise the issues are reported up to the board and ultimately there's an opportunity for the collective group to hopefully endorse the recommendations and endorse the activities that are being undertaken, but otherwise provide input as needed.

So, to take the industry group that I assume you're the most familiar with, which is the ADI - - -?---Yes.

- - - industry group, is it your understanding that within the terms of reference for the ADI industry group there are particular processes or requirements or rules as to when something should be escalated up to the executive board?---So, other than the annual cycle, it will depend largely on the nature of the issue being considered. And whether – so if, for example, there was identification of a gap in the policy framework, or an issue that we needed to escalate to government because it related to legislation that we felt was needed, then those issues, obviously, would be escalated up.

That's something that you would expect to be escalated up?---Yes.

It's defined or determined by the individual decisions made within the group. That is, it's not defined according to there are particular types of decisions that have to go up?---No, it's particular – it's the nature, it's the materiality of the issue, and recognising that members sit on these groups. So there's an opportunity, if I think this is an issue that I think the other members would need to opine on, then I could weigh into the discussion and say I think it should be escalated.

I see. And a layer down from the members, there are six, I think, executive general managers. Is that right?---That's correct.

And the six executive general managers report to the members?---Yes.

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Presumably, those six executive general managers are also divided according to particular industry lines?---No.

How are they divided?---So we have within our organisational structure – we have two frontline supervision divisions, which are responsible for the day-to-day interaction with the supervised entities that we have. We have one called diversified institutions which is the large and complex end, if you like, and another called Specialised Institutions, which is the smaller end and institutions that are single industry institutions. So we have two supervision divisions, effectively, large entities, small entities. We have a division which is Risk and Data Analytics where we have our risk specialists and our data teams that are providing expert advice. And, as the name implies, data analytics, into the supervisors. Then we have Policy and Advice Division, as the name implies, where supervisors – well, where our policy work is done and where supervisors would go if they were seeking advice on how to interpret policy or they wanted legal input, etcetera. Then we have, obviously, the corporate division, as the name implies, running the corporate, keeping the lights on in the organisation, make sure everyone gets paid, etcetera, etcetera. And then, finally, what's termed Enterprise Performance Division, but does a range of issues from our strategic planning, quality assurance, risk management, compliance, and some other special project work. So six divisions.

And how many of the executive general managers would sit on one of the industry groups?---I don't think any sit on the industry groups.

I see. So, in terms of decisions for a particular industry, the most senior person sitting on, say, the ADI industry group will be you?---I'm the most senior person, yes, but I don't chair the group.

There will be – there won't be any of the executive general managers who are sitting on that industry group?---There are not.

And then there will be people who are below the level of executive general manager who sit on the industry groups?---Yes.

And one of them will chair - - -?---Yes.

- - - the industry group?---Usually a general manager.

Yes. And what I ultimately want to understand is how the structure of APRA compares to some other possible structures. And so, if we just keep working through this, the executive board has ultimate responsibility for the day-to-day administration and operations of APRA?---Well, it has responsibility for everything to do with APRA, yes.

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That is, it has responsibility – you understand the distinction that might be drawn in some organisations between, on the one hand, the board of a regulator that might have responsibility for things like strategic direction setting and approving policies and frameworks and things like that, and, on the other hand, having somebody like a CEO who has a particular executive responsibility for the day-to-day administration of the organisation. I'm just trying to understand – if we can just cut to the chase – how APRAs structure compares to that type of structure?---So we – we have, as the name implies, executive board. I think if you look at the terms of reference for the executive board, it talks about organisational strategy, it talks about frameworks, it talks about monitoring performance. So it talks about the sorts of issues that I think you are alluding to might normally be filled by the board of a regulated entity that we would supervise. We don't, though, have a chief executive role.

And, in that sense, APRA is different from the structure used by the ACCC?---No. I don't think so. The ACCC has a set of Commissioners, full-time Commissioners. Mr Simms is chair. So he has a similar role to me. And they have full-time Commissioners in the same way that we have full-time members.

They have a CEO as well, don't they?---Sorry. They do have a CEO, but in terms of the governance and the – the roles that are assigned under the relevant enabling legislation, APRA consists of the APRA members. Below that, the structure is for us to determine.

Is there a contrast, do you think, between the structure of APRA and the structure of other prudential regulators or, in particular, the Prudential Regulation Authority in the UK?---Well, that's very different, because that's not really a separate – it's not a truly separate agency. It's – it's part of the Bank of England.

The day-to-day administration of the Prudential Regulation Authority is delegated down to a CEO of the PRA?---Well, the – the head of the PRA is a deputy governor. So he is both deputy governor of the Bank of England and I don't – I'm not quite sure what his title is but, yes, he is the equivalent of chief executive. If that's not his title, it's something similar.

Are there non-executive directors of the PRA?---There are . I'm not quite sure of the structure. There is, obviously, the court of the Bank of England which is overseeing the entirety of the Bank of England, which has non-executives on it. I – I think there is some sort of board of the PRA, but, I must confess, I'm not sure of the current arrangements.

Do you think that APRA would benefit from having non-executive directors or members of the board?---We had that. It was deemed not to be an effective governance structure. The HIH Royal Commission recommended that it be abolished and replaced with the structure we have now. At the same time, the government – back in 2002 or '03, the government did a review of public sector governance arrangements by John Urich and he came to a similar view – not looking specifically at APRA, but looking at different agencies – that for agencies like ours,

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with the level of independence but also, in some cases, lack of independence that we have, the for want of a better term Commission or member model was the preferred structure.

Do you think that what was encapsulated in both what came out of the HIH Royal Commission and the later review of general governance was this idea of responsibility for a particular industry being placed predominantly within the care of just one member of APRA?---No. I don't think that was necessarily envisaged. I think that was a practical outcome of the – the three APRA members who were originally appointed to the job thinking about how they would go about the task of dividing up the responsibility of managing the organisation. Reflecting the background that those three members came from, one had a banking background, one had an insurance background. It was a natural division of responsibilities. And it proved, I think, over the subsequent period – there has been various iterations of the APRA members and they have always felt – and we have continued to feel – that it – it is the optimal structure for balancing all of the things that we have to carry.

One way, perhaps, of evaluating that would be to have an external review of whether that is the optimal way to govern APRA. Do you agree?---That's – if – we're always open to having helpful advice.

Well, that's what the financial systems inquiry recommended, wasn't it, that there be an external capability review of APRA?---A capability review, yes.

And there hasn't been one to date?---No.

There has been a capability review of ASIC?---Yes.

One of the particular issues that the capability review panel noted in their report in relation to ASIC was that they believed that a dual governance and executive line management role inherently undermines accountability?---Yes.

And that, despite best efforts, individuals responsible for particular executive functions are unlikely to be consistently able to detach themselves from their concerns as an executive to take a fully independent and organisation-wide perspective when acting in their governance role to hold the executive team, including themselves, to account?---I – I will assume that's right.

Do you agree with that view?---Well, I think in – in essence, what – what that was saying, and what ASIC is now doing in response to that recommendation, is moving to a model that is more similar to ours, in that previously in ASIC they would have their operational divisions, and particular members were responsible – particular commissioners – sorry – were responsible for specific divisions. In the APRA structure, the divisions are run day to day by the relevant executive general managers, and the members are sitting above. So I – I think the ASIC structure, in some sense, as I understand it, the way Mr Shipton is taking things, is shifting towards our structure.

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I see. I think the way ASIC has framed it is that its commissioners will no longer have day-to-day operational and executive responsibilities, and instead would adopt a strategic oversight review and external engagement role?---Yes.

That's the way in which you see APRA operating at the moment?---Yes. So if I take – if I try and explain my role a bit more. I'm not involved in day-to-day supervision. I don't take day-to-day supervision decisions, delegated decisions, authority that we have to make decisions under the prudential standards, etcetera, delegated, obviously, important decisions to the executive general managers, but more routine decisions further down through the organisation. So I would not be, as a member – and this applies to the other now three members, as well – not doing the day-to-day supervision decisions. I would not be setting supervision strategies for individual organisations. I would not be doing – looking at approving individual risk assessments. My operation in respect of ADIs is trying to sit above that and think about the industry themes, the broader issues, how do we keep APRA fit for purpose, if you like, into the future.

I think what is implied in what you're saying is you don't see a difficulty with having just one member of the board primarily focused on one industry?---No, because it's not – it's not a complete authority to take charge of those issues. So if we are thinking about policy matters in – in banking, it's not as though, ultimately, they come up to me and I approve or disprove them. They go to a policy committee. All of the APRA members sit on that committee. So as we're doing banking policy or we're doing insurance policy or we're doing superannuation policy, all of the members are involved in the shaping of that policy and ultimately the approval of that policy. So what we have in – in the assignment of the members to an industry is – is, as much as anything, it's a lead face to the industry. So you will not hear me talking much about other things other than banking in the public domain. Mrs Rowell you will hear talk about superannuation, Mr Summerhayes you will hear talk about insurance. The purpose is really to make sure that industry knows, in a sense, who is the point person, who is in charge. And it helps, to be clear, that institutions, you can't forum shop. There's a member, they're overseeing it, and they have the lead responsibility.

I see. We might move then to another topic, which is culture and remuneration, and, also, related to that, governance of entities. Now, I think you would agree that each of those areas, governance, culture and remuneration, can have an effect on the financial stability of an institution?---Absolutely.

And, in addition, therefore, have a – have an effect on the financial stability of the industry or the financial sector - - -?---Yes. Ultimately, yes.

And failings by particular financial institutions in any of those areas, that is, governance, culture or remuneration, can also act as drivers of misconduct?---Yes.

Now, APRA does work, and has done work in each of those three areas, governance, culture and remuneration?---Yes.

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But its focus in relation to each of those areas, at least historically, has been on financial stability, as distinct from misconduct?---So, just to clarify, I would normally talk about financial stability as the system and financial soundness as the institution. So both financial soundness and financial stability, but, yes is the short answer to your question.

And APRA began its work on remuneration in the period immediately after the GFC?---Yes.

And that was prompted, in part, by the work of the Financial Stability Board on compensation practices at financial institutions?---Yes, which we were part of that work.

And ultimately, the FSB – I am not sure if it's the FSB or its predecessor, the FSC, but - - -?---FSB is correct.

The FSB published its principles for sound compensation practices in 2009?---Correct.

And APRA incorporated those principles into CPS 510 in 2010?---Yes.

And APRAs focus on culture began more recently?---Yes. Probably the – the work on, in particular, risk culture probably started to emerge in 2013/14, that period.

In 2014 that was when you published the draft of CPS 220?---Yes. I can't remember the exact date, but the – it was finalised in late 2014. I can't remember when the draft was first put out.

I think the final standard came into effect at the beginning of 2015?---Correct.

And it required or introduced a requirement for the board of an APRA-regulated institution to form a view of the risk culture in the institution?---Yes, with the caveat that CPS – sorry – yes. CPS 220 doesn't apply to superannuation.

Yes?---There's a slightly different form of words in the equivalent superannuation standard.

And then, later in that same year, in 2015, APRA established its governance culture and remuneration team?---I think we announced that in the early part of 2015, yes.

And one of the early projects of that team involved working on ways to assess the culture of APRA-regulated institutions?---Yes.

Now, APRAs work on governance predates the GFC?---Yes. The early work we did on governance was, really, a product of HIH – the HIH Insurance failure and the recognition that shortcomings in governance had been a contributor to the failing of

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that organisation and that APRA needed to pay additional attention to that area in our supervision.

And, more recently, is BEAR something that's, effectively, a continuation of the development of governance regulation?---I think it's a – I guess you can put it on that continuum.

What we might do, I think, in order to explore these areas is to deal with each of them in turn and finally, later this afternoon, to come back to BEAR. We spoke about CPS 510, which was published in 2010. There's also a guide that goes along with that that was, I think, published at the end of 2009?---I think so, yes.

And that would be - - -?---I don't – I can't remember the dates, but they sound right.

All right. And the standard under CPS 510 is legally binding?---Yes.

And it sets out guidance about how it – how APRA expects APRA-regulated institutions to structure their remuneration arrangements?---Yes.

The requirements for superannuation which were in CPS 510 were slightly different?---A bit different, yes.

I think we will just stick with?---CPS.

CPS - - -?---Okay.

- - - 510 which deals with banks and insurers?---Yes.

The FSB that we've spoken about, that is an international body that monitors and makes recommendations about the global financial system?---Yes.

And its aim is to promote financial stability?---Yes.

APRA, I think you were making the point before, is a member of the FSB?---So Australia is a member of FSB. The – there are various bodies within the FSB. The primary body, the plenary of the FSB, the RBA, is the main member. Treasury is also there. We participate in one of the working groups, in particular, that deals with supervision and regulation.

Was APRA involved in the drafting of the principles for sound compensation practices?---2009?

Yes?---Yes.

And the 2009 principles then formed the basis of CPS 510?---Yes.

And that standard hasn't been updated since 2010, has it?---Not in any material way.

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So the principles which, as we understand it, are still current from the FSBs purpose – or for the FSBs purposes are also still the basis of - - -?---To all intents and purposes, yes.

And we might just bring those – bring up CPS 510. That's RCD.0014.0082.0001. So this is the prudential standard?---Yes.

And then if we go to paragraph – page – I'm sorry – .0015 which deals with remuneration. You address this in your statement and explain what the focus is of the remuneration policy. And I think you point particularly to paragraph 54 of the standard to begin with?---Yes.

And that explains that:

> *The remuneration policy's performance-based components of remuneration must be designed to encourage behaviour that supports the institution's long-term financial soundness and the risk management framework of the institution.*

?---Correct.

And then, in paragraph 55, which you also point to, you note that:

> *The performance-based components of remuneration must be designed to align remuneration with prudent risk-taking and must incorporate adjustments to reflect –*

And then there's three subparagraphs that we see there?---Yes.

And then the other paragraph that I think you pointed to in your statement was paragraph 56, which requires that:

> *The remuneration policy must provide for the board of the APRA-regulated institution... to be able to adjust performance-based components of remuneration downwards if such adjustments are necessary to –*

And (a) is:

> *Protect the financial soundness of the institution; or (b) respond to significant unexpected or unintended consequences.*

?---Yes.

And we had understood from your statement that the point – or a point that you were making about these paragraphs is that they highlight that, at least as published, the standard is concerned with remuneration policies that protect financial soundness and financial stability?---That was certainly the intent. And I think it's also, if you go back to the Financial Stability Board principles that – on which they were – from

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which they were derived, it's a similar sort of issue. It was – coming out of the financial crisis we were concerned about the safety and soundness of institutions and this was a response to safety and soundness concerns. And so that's where the focus of the standard is.

And the distinction that you're drawing is between focusing on remuneration policies as they affect conduct or misconduct, and remuneration policies as they affect financial soundness and financial stability?---Yes. You could damage the bank, you could be damaging customers. This – the focus of these issues is to what extent does this risk damaging the financial institution.

And then if we bring up RCD.0014.0082.0090. So this is the practice guide that goes along with the standard and was published on 30 November 2009?---Yes.

And if we go to page .0107. This sets out the nine principles the FSB had set out in their paper?---Yes.

And the first three are concerned with, effectively, governance, and how governance of compensation is to work – or ought to work?---Yes.

And then the next four principles are concerned with how compensation ought to be aligned with prudent risk taking?---Yes.

And if we just stop for a moment on principle 4, which is that:

> *Compensation must be adjusted for all types of risk.*

We can bring this up, if it helps, but the FSB explain that a little further, don't they, to say that all types of risk include difficult to measure risks?---My recollection is that is somewhere there in the document, yes.

And difficult to measure risks would include things – and I think this is specifically called out by the FSB in 2009 – liquidity risk, reputation risk and cost of capital?---Yes.

Would difficult to measure risk also include the conduct risk?---As a – as a general observation, yes.

But I think – and tell me if I'm wrong – that a point you would make is, back in 2009 and 2010, both you and the FSB were not focused upon conduct risk simpliciter; you were focused upon financial risk?---Financial soundness. That's a – that's a fair observation, yes.

And insofar as there was any consideration of conduct risk, it was something that might tell you something about the risk appetite or approach to risk of the organisation, as it would affect financial risk?---Yes.

Now, a little later in 2014, I think, the – I'm sorry – I will jump forward a bit further than that. In 2018, the FSB published a supplementary guidance to those principles?---Yes. I think – I think that was the year, but yes, they have published supplementary guidance.

I can bring that up. That's RCD.0014.0082.0052?---Yes.

And we see this is published earlier this year?---Yes.

And this was now concerned with how compensation tools might be used to address misconduct risk?---Yes.

And, again, we can go through the document, if it helps, but, broadly, it can be said the FSB was not suggesting that its principles were changing in relation to compensation?---No. It was saying we should have a wider focus than just the strict financial soundness.

And that the principles, as they had enunciated them in 2009, continued to apply?---Yes. Yes.

But, consistent with those principles, and, in particular, the idea that remuneration ought to account for all types of risk, including difficult to measure risk, that would embrace misconduct risk?---Yes. Absolutely. The FSB took this up because of issues like LIBOR and other issues that were happening in financial markets where there was significant misconduct and a recognition that the original set of principles were probably too narrowly drafted.

I'm not going to disagree with you about this, but when you say too narrowly drafted, they haven't reframed the principles, have they?---No. No. No. Well, maybe too narrowly focused may be a better term. But they were strongly focused on financial soundness. They deal with a range of things. They talk about what about if there needs to be government support for a financial institution. They go to the heart of financial soundness. There's very little in the original principles other than, perhaps, implicitly that would lead you to think there's should be a strong focus on misconduct and conduct. And this is an attempt to, in a sense, make clear a broader focus is needed.

THE COMMISSIONER: Well, would you accept that the focus on conduct and conduct risk really comes about post-GFC with the emergence of events like LIBOR, Wells Fargo and other - - -?---Other mis-selling issues - - -

Mis-selling in PPI had been brewing – well and truly brewing pre-GFC, but emerges with a degree of prominence?---Yes. I think you're absolutely right, Commissioner. The immediate post-GFC environment in 2009 and '10, which the guidelines and the FSB guidelines, people were still trying to make sure the banking system didn't fall over, it was stable, sound, recapitalised. But as - - -

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Well, banks had fallen over in the US and elsewhere?---Thankfully not here, though, Commissioner.

Yes, exactly?---But you are right. But as people went back and then investigated how did this happen, where was this risk-taking, how was it so reckless, they identified a range of things, which were unacceptable behaviours that didn't go to financial soundness but had adverse impacts on the broader community. And that's where the FSB stepped in again.

MR HODGE: Now, the FSB's publication of these supplementary guidelines in 2018 didn't come out of the blue. It had been in the work for some time?---Correct. There was consultation document. That's why I wasn't quite sure of the date when you first referred to the document, because there had been a consultation document, I think, a year earlier. And, because of our role in the FSB – APRAs role in the FSB working group, we had seen drafts of this, we had had people on the working group that was involved in drafting some of the material.

And the work plan to develop this supplementary guidance, that had originated, I think, in May of 2015?---Sorry, the FSB work plan?

Yes?---Yes. I couldn't tell you the date, but I'm happy to – that sounds about right.

In any event, it was – it was a few years ago that the FSB set in place a work plan to try to address the issue of misconduct within financial institutions?---Correct.

And this, then, is one of the products of that work plan?---Correct.

And, at the same time as the FSB was developing its thinking, was APRA also considering and developing its thinking in relation to how remuneration practices would affect misconduct?---I think we were. As I think you alluded to before, we – we – I think you alluded to before, we set up a governance culture and remuneration team in 2015, because we felt we needed a deeper expertise in this area. Those three areas, governance, culture and remuneration, are very closely interrelated. And we felt we needed more capability. We wanted to also be better equipped to tap into the international work and work that our peer regulators were doing. So yes is the short answer. We were developing our thinking, but we were doing so, by and large, in – in parallel with other regulators, and in – in forums such as the FSB.

One of the things that APRA did last year was to commence a review of remuneration practices across a large – across a sample of large APRA-regulated institutions?---Correct.

And that was published – or the report in relation to that was published in April of this year?---Correct.

And you've exhibited that information paper to your statement?---I think I have, yes.

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I think it's exhibit WB-56. But the document ID, so it can be brought up, is APRA.0076.0001.0010. And if we then go to pages .0015. Perhaps, actually, bring up that page on one side of the screen and page .0016 on the other side of the screen. This is the introduction where it's setting out the context for APRAs remuneration review?---Yes.

And, in the fourth paragraph down, we see:

> *APRAs focus on remuneration is aimed at ensuring that remuneration practices, including the governance of remuneration outcomes, support prudent risk management and the long-term financial soundness of APRA-regulated institutions. In other words, the prudential framework seeks to ensure that remuneration practices are supportive of a strong risk culture.*

?---Yes.

And then, if we take that down and pop up the next paragraph, we see here APRA addresses the link between financial soundness and misconduct and says:

> *A number of recent reviews conducted by other financial regulators and industry bodies have also focused on remuneration, largely from the perspective of limiting the potential for misconduct. The link between remuneration and misconduct is also of interest to APRA as a prudential supervisor, because conduct issues can provide additional insights into an organisation's attitudes towards risk more generally.*

?---Yes.

And what I want to test with you is the extent to which this continues to represent APRAs view of the link between conduct and APRAs role?---I think that's an area that's evolving. I think we started – as you said before, when our first standard was introduced with one that had a very traditional, for want of a better term, focus on traditional financial soundness issues. We've expanded our thinking into risk culture and how to think about culture within organisations and the connection between remuneration and risk culture. And, consistent with the work that's been done internationally, thinking about how we, as a prudential regulator, should think about misconduct and the way those two things come together.

Can we try to tease out some of the ways you might think about it and look at – or consider how you should think about it. One way you might think about it, which seems to be the most traditional way of thinking about it, is that the attitude of an organisation to the risk of misconduct tells a prudential regulator something about the attitude of the organisation to risk more generally and, therefore, to financial risk?---I think that's – that's a nice summary of what we call the traditional view.

Another way of thinking about it, which seems to be picked up by the supplementary guidance of the FSB and some of the work that's happening in the UK, is that

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misconduct itself can pose a financial risk?---Yes, if it's – obviously, if it's material misconduct, then, yes, it can directly create a financial risk.

If it's sufficiently systemic within the financial system or sufficiently significant within the scope of a particular institution?---Yes. If you look at – if you look at some of the penalties that some of the very large international banks have had to pay for some behaviours, very significant amounts of money which have a very material impact on their capital position and that's the traditional domain of a prudential supervisor. So, yes, I agree with that proposition.

And then the third way of looking at it is misconduct is a problem and there are changes that might be made to the risk frameworks and culture frameworks and remuneration frameworks within an organisation that can minimise the possibility of misconduct. And those are frameworks that a prudential regulator like APRA looks into and attempts to manage?---I think I'm agreeing with you. I mean, I think some of the issues – you know, one of the issues we're grappling with is actually prudential issues and conduct issues, I think, in the – what I call the traditional view. They sat in different boxes. And, increasingly, it's clear that, in fact, issues overlap with one another, and that prudential requirements – and you've said we're going to come back to BEAR – and this might be a good example – where a prudential requirement potentially also has significant benefits in relation to limiting or helping mitigate the risk of misconduct.

THE COMMISSIONER: There's a chicken and egg problem, isn't there, Mr Byres? Whether remuneration is reflecting culture, whether culture is reflecting remuneration, whether governance is reflecting culture, culture is reflecting governance. They're all intermeshed, at least to an extent, aren't they?---I think that's right. And – no. Absolutely that's right. And that's why we created a team on governance culture and remuneration, rather than three teams, because these things are inextricably linked and just fixing one – whatever fixing is – but just dealing with one without dealing with the other two will not solve the problem.

But if your culture is driven by immediate financial year bottom line - - -?---Yes.

- - - it would not be surprising if the remuneration structure reflected that idea, and if governance is directed to that idea?---Or more – or if your remuneration is focused on that, it's inevitable your culture and governance - - -

And round you go?---You have to have them – they have to be mutually reinforcing of one another.

Yes?---Or they will be mutually undermining one another.

Yes. Sorry, Mr Hodge. Go on.

MR HODGE: Thank you, Commissioner.

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You, I think, Mr Byres, address some of these issues in your statement. And if we bring up your statement and go to page 106. And we pop out paragraph 427. This is where I think you're making a point that you've already made this afternoon, which is the information paper had a particular narrow focus because of what it is that APRA was concerned about at the time?---Yes. I think I was just a bit sensitive to a criticism in the Commissioner's interim report that our information paper had a narrow focus. And he expressed some concern about that. And I was simply making - - -

THE COMMISSIONER: That's why you get a word now, Mr Byres. That's why you get your chance?---And I was simply trying to make the point that the paper was responding to the standards. The standards have the traditional narrow focus. It was looking at application of the standards as they are. You might say, and I would – I would say they need to evolve and improve. But that was why the paper had the narrow focus.

MR HODGE: Well, then, if we bring up paragraph 429, you make the point in the first sentence that:

> *APRA believes that it is important that it continues to ensure prudential considerations are front and centre in remuneration design and decision-making.*

?---Yes.

But then accept the point made by the Commissioner and what you have accepted today, which is thinking needs to continue to evolve and a broader examination of the issue is required?---Absolutely, yes.

And then, in the last sentence, you go to what seems to be the heart of the potential issue, which is APRA is concerned with prudential regulation, but ASIC is concerned with conduct regulation?---That's the – the fundamental architecture that we have, the starting point, the twin peaks model, yes.

So a concern you express is about the possibility of the responsibilities of the two agencies becoming blurred?---Well, I think, just to, perhaps, be precise about that, it's not necessarily my concern. And I don't actually think it's Mr Shipton's concern, if he was here. We think we can work together, but there is a lot of external commentary, for want of a better term, that the lines between APRA and ASIC are getting blurred, and so the point, really, is as we step in more to looking at factoring in issues of misconduct and ways to mitigate against misconduct into the prudential regime, I'm sure we will get more criticism and more concerns expressed about the blurring, and we will need to work together to see how that can best be done, as I said, without exacerbating those concerns.

Can we try to tease out the detail of that. APRA has the power to set prudential standards, but ASIC doesn't?---Correct.

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And there's, at least at present, no suggestion that ASIC would have the power to set prudential standards?---Or, probably for them, conduct standards, rather than prudential, but, yes, set standards. That's correct.

And so if there are to be standards in relation to risk culture and governance and remuneration that would address the possibility or the risk of misconduct and those would presumably be standards set by APRA?---As things currently stand, yes. And they would only apply, obviously, to APRA-regulated institutions.

Yes. And do you have a view at the moment as to whether APRA should change its prudential standards and guidance to expressly address the potential for poorly designed and implemented remuneration systems to increase the risk of misconduct?---Sorry. Could you repeat that question again.

Yes. Do you have a view as to whether APRA should change its prudential standards and guidance to expressly address the potential for poorly designed and implemented remuneration systems to increase the risk of misconduct?---Yes is the short answer. The longer – slightly longer answer is it is our intention to take those FSB supplementary guidance, the learnings from the CBA prudential inquiry, the learnings from this Commission, the learnings from a range of work that we've done and improve the current set of prudential standards.

And is there a timeframe for doing that?---So currently we would certainly plan to be going out for consultation on something next year. There's internal work going on now, drawing together all of those things that I just talked about, the FSB work, the CBA inquiry findings, our own work on remuneration, the April paper that we talked about before, what we've observed through this Commission's process and findings, other international work, and trying to produce what we've called the paper that – so what does good look like? So, taking all of that together, what would a really good remuneration framework look like? And we envisage going out for consultation on that. I hesitate to put a date on it, because the staff will probably not be very happy at me. They're still working on it. But as soon as possible. Next year, certainly.

And what role does ASIC have in relation to that?---So we would be consulting with ASIC. The – the team that is driving the work is our governance culture and remuneration team, as you might expect. They are engaged in their – they engage quite regularly with their counterparts in ASIC, who are looking at similar sorts of issues. So they would be – we would be getting the ASIC input and advice along the way.

Does ASIC, as you understand it, have much, if any, expertise in relation to the relationship between remuneration frameworks and misconduct?---I probably don't have a good picture. I know – all I can say is they've got a team of people who are dedicated to looking at it and who liaise with our team.

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And, for your team, your team presumably has the expertise in relation to the design of remuneration systems and also financial risk?---We've – sorry – remuneration and financial risk?

The design of remuneration systems and financial risk?---I think that's something that we've been thinking about for a while, yes. So we would always like to have more expertise, but we think we can deal with the financial risk-taking side of things.

And so is the potential gap there that you understand remuneration systems, ASIC understands misconduct, but actually attempting to bring those things together is something that at the moment there's nobody who has the full view of?---No, I wouldn't – I wouldn't say it's necessarily a gap. I think it's – like most things, most regulators would like to have more expertise, more resources to tackle whatever issue is on their plate.

Can I ask you about some particular observations you make in relation to remuneration practices for senior executives at the moment?---Yes.

And, in particular, about long-term incentives and TSR. If we bring up paragraph 448 of Mr Byres' statement, which is on page 110. Here, you're agreeing, I think, to begin with, with a point raised by the Commissioner in the interim report which is about the alignment between outcomes and remuneration?---Yes.

And you make the point in the last sentence which is:

> *The current structure of long-term incentives in Australia is particularly problematic in this regard, and is out of step with how best practices in remuneration are evolving internationally.*

?---Yes.

And could you just explain to the Commissioner what you mean by that?---So it's – it's, obviously, two legs to that sentence. I think that there is still too much focus, particularly in the long-term incentive measures, on particularly the relative TSR measure. I don't think that's conducive to the broader more holistic assessment of performance that I think we all would think was desirable. So that's a specific issue to Australia. And then in relation to internationally, we are seeing a shift away from financial metrics towards a greater weighting given to non-financial metrics. Sometimes voluntarily, but often because of new regulation that's imposing that shift.

We might come to the new regulation in a moment. You make a point, if we bring up paragraph 453 of your statement, which is on page 111, that:

> *APRA has been encouraging boards to move away from the current approach, but many boards report resistance amongst their investors to changing the current LTI model.*

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?---Yes.

And then, in paragraph 454, you explain that APRA had hoped that its April 2018 paper would cause or bring about an evolution in remuneration models but one of the difficulties that boards are faced with is the highly likely prospect of a first strike against their remuneration report if they move away from the current conventional model?---Yes.

Do you have a view that the two strikes rule is contributing to performance hurdles for long-term variable remuneration being excessively weighted towards financial metrics?---I don't know if I could blame the two strikes rule, but it is – when we talk to boards – and most of my engagement has been with the large banks – we talk to them about the findings that were in that April 2018 paper. They didn't push back greatly. Many actually recognised they would like to move. But many – some have had a strike, obviously. Some are in the process of moving. And, you know, it's a likely prospect that they will get a strike. And others are very wary a strike. There's – to use a phrase that has appeared in this Commission elsewhere, no one wants to go first. There's a first mover disadvantage here. So it's a problem.

Do you have any view as to whether it would be desirable to change the two strikes rule?---I don't have a particular view. I mean, it might help solve this problem, but I think it is important that – equally important that shareholders have a say and have a voice in these things, and it is a way in which shareholders can express dissatisfaction. So, you know, there are pros and cons. And that's why I think – I conclude my paragraph, which is there, with it may be that if we want to get a material change, it will have to be driven by regulation imposing that change, so that boards can say to shareholders I have no choice.

Just to help you expand a little bit on the point you were making about shareholders, in the end the shareholders own the company. Sometimes that seems to get forgotten?---Well – so it's important to talk about shareholders versus investors at this point, probably, because investors – a large constituency of investors – or a sufficiently large constituency of investors don't necessarily like the shift away. But, of course, the ultimate shareholders are all of us, in our super funds or wherever. Personally, I know what I would like to see in a ..... but whoever is holding my money and ultimately investing it in the shares has a different perspective and then their own incentives, which are not necessarily aligned with me or any other member of the community.

I think, though, the – I think a point that you're trying to make is the two strikes rule reflects something else, which is a decision made by government to empower shareholders of large companies to be able to have a say in relation to - - -?---Yes.

- - - remuneration. And to remove that right from shareholders in order to address this specific issue might not necessarily - - -?---I don't - - -

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- - - be the logical way to deal with it?---And, if there was any mistake, my view about regulatory intervention is not a suggestion to get rid of the two strikes rule.

Your view is if there's going to be regulatory intervention on this issue, it has to be more targeted and concerned just with this issue?---Yes. Well, from – I think – if I can be really blunt about it, I think what I am saying is to get change, APRA will have to do it.

And that's the last thing, then, that I wanted to just bring out from you about this point. The regulatory intervention that you're talking about is not an enactment of some new statute; it's a change to the prudential guide that – or the prudential standard that APRA sets in relation to remuneration?---Yes. So, I mean, if government wanted to change the statute in some way, that's fine. If they wanted to institute something in the Banking Act, that's fine. And in the BEAR they have done something in relation to bank remuneration in the law. So if the government wished to do that, that was fine. But, absent that, if I look at the problem and I look at the issues that we have called out and this Commission has called out and the FSB has – has addressed, then I think it's a rewrite of the prudential standards to give a more – for want of a better term, a more holistic focus to performance and risk than what's currently there now.

And does that mean rewriting the prudential standards in order to limit the extent of links between long-term variable remuneration and financial returns or pure financial returns?---It's – it's about – yes. It's about – I mean, I've used the phrase a more holistic and more comprehensive set of what is performance. So I think the current frameworks are still too focused, although some banks are trying to move away, to give them credit, but are still too focused on performance equals profit and share price moves. And, you know, performance of an executive or an executive team is clearly more than those two things.

Would that mean a prudential standard that departs, at least to some extent, from the pure principles base to be more prescriptive about the types of links there could be between, for example, TSR and the vesting of long-term incentives?---Yes. Probably it ends up more prescriptive than it is today. But I – I have to also be wary of it can't be so prescriptive that it doesn't allow for the fact that the standard applies to the four major banks, it applies to regional banks, it applies to credit unions, it applies to insurance companies, general insurance companies, life insurance companies. It has got to have sufficient flexibility to be able to cope with different businesses, different risks, different scale of – of operation. But it is probably inevitably going to be more – more prescriptive in some way than it is today, yes.

And these types of things that we're talking about, are they part of the consideration that APRA is presently undertaking in relation to the prudential standard?---So I think what we're trying to do at the moment is articulate what – as I said, what does good look like; it's a good framework, a good set of principles that we think would be generally applicable. If we can settle that and – and there's generally consensus that that's a good model, then you think about how you translate that into a standard.

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And, again, just to come back to the timeframe that we're talking about, you said you were hoping – though you didn't want to commit anyone to anything – that what does good look like might be something that you would be publishing next year?---Yes. Early part of next year.

And what does that mean then in terms of a timeframe for a revised prudential standard?---Probably a revised prudential standard, given the process that we have to go through, of due consultation on the standard means the standard wouldn't be finished until the following year.

I see?---And – sorry – if I can just say then, of course, to the extent that current employment contracts don't adhere to the standard, it would be necessary to allow some period of transition for industry to, you know, make appropriate arrangements.

Whatever the standard ultimately ends up being, there's then a follow on question, which is what will APRAs approach be to actually enforcing and monitoring compliance with the prudential requirements in relation to remuneration?---Yes.

And what I would like to do is to consider that by looking at the FSB principles, and then what happened in relation to CBAs remuneration in 2016?---Yes.

So can we start with the principles. If we bring up RCD.0014.0082.0072. And if we go to page – bring up, actually, page .0075 and .0076 on the screen. And we see here's the nine principles. If we look at the principle on the right-hand side of the screen under the heading Effective Supervisory Oversight and Engagement by Stakeholders. And start with the last principle:

> *Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.*

?---Yes.

At the moment, listed companies are required to disclose certain information about executive remuneration in their annual reports?---Yes, they are. Yes.

And that includes the total amount of variable remuneration received by senior executives?---Yes.

But they're not required to disclose information about risk-related adjustments to remuneration for executives?---There's – as far as I know they're not required to. That's correct.

And, in particular, they're not required to set out the reasons why the board made particular risk-related adjustments to executive remuneration?---No, they're not.

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You may be aware that last week Ms Orr asked Ms Livingstone, the chair of CBAs board, about whether CBA should disclose more information in its remuneration report about risk-related adjustments to executive remuneration?---I didn't hear it specifically, but I understand she did ask that question, yes.

And Ms Livingstone said that there would probably be merit in disclosing more detail on an individual basis as to what the risk-adjusted outcomes were?---I will accept that, yes.

Do you have a view about whether financial institutions should disclose more information about risk-related adjustments to executive remuneration?---I think there are pros and cons. It – it's a bit of a double-edged sword. So on one hand you would say if there's – if there's an expectation that rewards are disclosed, it might be reasonable to have more information to explain how those awards were determined. There will be sensitivity about these issues, obviously, and in some cases the disclosure – I guess the thing that's in the back of my mind is the risk that the disclosure in and of itself actually deters people from making adjustments, because of the, you know, external reaction to whatever that issue is. And that boards might – they may wish to penalise someone, but they may not wish to have that broadcast more broadly. So that would be my only question mark. It's a bit like a disclosure of remuneration more generally. People think it's good, but I think – my observation would be disclosure of remuneration has meant across the system it has got higher and more generous. So the disclosure is good, but an outcome has been a race to the top. And my reservation about more and more and more disclosure would be that question of whether it may actually lead boards to be more reticent to exercise discretion.

Can we try to just pull out a few of the ideas you're talking about, just to make sure we've itemised them all. A point that you're making is if boards knew that whatever their reasons were for risk-related adjustments were going to have to be made public, then they might be reticent about making those types of adjustments?---It – it, obviously, depends on the level of detail, but the more and more detail, and particularly the more and more it becomes associated with individuals, and it becomes a – or an exercise in naming and shaming, boards may not feel that's appropriate.

And then what seems to go along with that is it may ignore the potential consequences or the potential effects on the individual employee, and, in particular, as you say, the amount of detail might vary, people might make assumptions about an individual's direct involvement in conduct when, in fact, they've been penalised because it was their group, for example, that has - - -?---Yes.

- - - engaged in the conduct?---So, to be clear, these are all possibilities.

Yes?---I'm not saying they would be the outcomes, but that – that strikes me as a possible reasonable outcome, or possible outcome.

And, on the flipside, a potential benefit for the company might be, as I think Ms Livingstone said, it would send a powerful message about the way the institution responded to misconduct?---Absolutely.

And it may also then help to set a standard, a behaviour – behavioural or ethical standard within the company, because this approach is made public and everybody knows what the consequences are?---Absolutely, yes.

On the other hand, it may be that it's quite possible to achieve and instil that type of culture within an organisation without needing to publicly name and shame your senior executives?---Well, maybe just to clarify here, there's an issue of showing that people have had a consequence. And to some extent that could be evidenced simply by the amount. There is a meaningful downward adjustment. That would be, I think, if – if, for example, some – there were some bad outcome, some inappropriate behaviour, some inappropriate risk taking in a particular line of business, and it was clear from the numbers that executive – relevant executive had clearly been penalised, that sends a message without having to write chapter and verse this was the board's consideration. So all of these things, it's – it's a question of detail. I think the – as much as anything, it's evidence that there has been material adjustment rather than, necessarily, having to, as I said, write chapter and verse on why there was adjustment.

Can we look – I'm sorry, Commissioner. Did you want to ask something about that.

THE COMMISSIONER: No.

MR HODGE: And then can we look, then, at principle 8, which is just above that paragraph, which is about:

> *Supervisory review of compensation practices must be rigorous and sustained and deficiencies must be addressed promptly with supervisory action.*

And, presumably, that is what APRA aspires to do?---Yes, that's why we've been trying to build the capability in the governance culture remuneration team to be better equipped to do this.

What I would like to consider and get your view about is what happened in relation to CBAs executive remuneration in the 2016 financial year?---Yes.

You know that was – or the decisions in relation to that executive remuneration were the subject of criticism in the final report of the prudential inquiry?---Yes.

And are you familiar with those decisions?---Not of individuals, but I - - -

Broadly?---Broadly, there wasn't much negative adjustment made to anyone in the CBA in that year.

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Now, Ms Livingstone said in her evidence last week that she and her fellow directors at CBA regard the process that led to the remuneration outcomes in that year as significantly inadequate?---Yes.

And she described the actual remuneration outcomes as inappropriate?---I'm assuming that's correct, yes.

In any event, you know that the outcomes were the subject of criticism - - -?---Yes.

- - - by the prudential inquiry?---The inquiry, yes.

And at the time of those 2016 outcomes, ASIC and APRA had announced – or had ongoing investigations into CBAs life insurance business?---Yes.

And there were a number of other issues in relation to CBA that became public over the course of the following year?---Over the course of '17, yes.

But CBA was already aware of those issues back in FY16?---Yes.

And that included issues like the compliance with anti-money laundering and counter-terrorism financing laws?---Yes.

And the charging of fees to customers for a service that hadn't been provided?---Yes.

And the mis-selling of credit card insurance?---Yes.

And do you know whether APRA was aware of all of those issues in – within CBA in August of 2016?---I think so.

And we understand APRA had concerns in 2016 about the effectiveness of CBAs operational risk management framework?---Yes.

And it believed that CBAs operational risk management framework was not identifying, escalating and addressing significant operational risks?---Yes.

And it was concerned about a number of persistent significant risk issues that were not being addressed effectively by CBAs operational risk management framework?---Yes.

And then, in August of 2016, CBA announced its executive remuneration outcomes?---Yes.

On 22 August 2016, a principal analyst in APRAs Diversified Institutions Division prepared a memorandum for the general manager of that division. And I will just bring that up. That's APRA.0095.0001.0022. Have you had a look at this document, Mr Byres, in the course of preparing to give evidence?---Briefly, yes.

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And we see that the memorandum says that the remuneration outcomes for the CBA CEO were broadly consistent – I'm sorry – I will work from the top. That – you will see the memorandum says that:

CBA has in place a group-wide remuneration policy that generally adheres to the principles established in CPS 510.

?---Yes.

And then you see, the third bullet point down:

The CEOs performance-based remuneration was derived based on principles>broadly established by the institution to align remuneration outcomes with prudent risk-taking.

?---Yes.

But then the memorandum identifies that:

The supervision team does not have visibility over the application of these principles to determine specific remuneration outcomes in particular reporting periods.

?---Yes.

And is that something the supervision team should have had visibility over?---Not as a routine matter. We wouldn't normally collect all of that detailed information in the normal course of events. My recollection of this – it was actually triggered by some work that the relevant executive general manager asked to be done after the CBA results came out.

Should you collect that sort of information routinely?---Well, that's a good question. So another piece of Financial Stability Board work which was published last Friday is a – I've forgotten what it's called, but, essentially, it's a set of data that it is recommended that supervisors collect on a routine basis to understand to this sort of detail on how remuneration decisions are being taken, and – because it's a follow-on some of those documents we've referred to earlier, how you would identify whether conduct-related matters are being considered through remuneration decisions. So we have not had that as a matter of course. We have not been collecting that as a matter of course. There is a question about what we should be collecting going forward, part of which will be, as I said, guided by the latest FSB material.

Has it been possible, do you think, to have rigorous and sustained supervision – supervisory review of compensation practices and promptly addressing deficiencies in compensation without collecting that sort of information?---No, we clearly have to collect – if we want to be able to systematically analyse this sort of stuff for every

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institution every year, we would have to collect a lot more information and devote a lot more resources to it.

And are there practical difficulties or funding difficulties with being able to do that?---It's a – I mean, it's always a resource prioritisation issue. We – we don't have supervisors sitting around looking for things to do. So we have been fortunate we've just been given some extra money by the government – or our funding has been increased, because we're funded by the industry. But they've approved some additional funding to allow us to devote some extra resources to this area of activity. So the question for us is, I think, how much more information? Do you do it for just the largest institutions? Do you do it for the entire APRA flock? How would you go about doing it? What level of detail would you want? How far down in the organisation do you go? There's a whole raft of issues we will have to think through.

And when are you planning to think through those issues?---Well, it will be part of the work that we're doing on remuneration, because I think we have to think about a standard, what should be in the standard, what will be the new requirements, and then what's our capability to be able to supervise to that. And, particularly – to come back to the point we were talking about before – particularly in, as we have issues that deal with conduct-related matters, should we be opining on whether conduct has been adequately taken into account, or misconduct has been adequately taken into account, should ASIC be opining on that, how do we form some views. On the application, it's all very well to have the framework, but then who's forming views about application? We would probably naturally feel we're quite capable of thinking about it in the context of financial soundness risk. But when it comes to misconduct risk, we may have a view, ASIC may have a different view. How are we going to bring those views together?

It feels a little like we're all agreeing these are important questions - - -?---Yes.

- - - that you need to figure out the answer to – or somebody needs to figure out the answer to?---We're going to give it a go.

And you're going to try to do it, but you don't have the answers as of yet?---Well, I think there's a lot of answers already there in terms of what a good framework should look like. There's a lot of material in the public domain from the FSB, elsewhere, our own learnings. I think crafting that, the issue that I think you're getting to is it's all very well to put out the framework, how do you make sure it's policed and adhered to. And that is a – that's a resourcing question that we are going to have to grapple with going forward.

I tender that document, Commissioner.

THE COMMISSIONER: APRA memorandum 22 August 2016 concerning CBAs CEO remuneration arrangements, APRA.0095.0001.0022, exhibit 7.146.

EXHIBIT #7.146 APRA MEMORANDUM CONCERNING CBAS CEO REMUNERATION ARRANGEMENTS DATED 22/08/2016 (APRA.0095.0001.0022)

MR HODGE: Now, what came out of that memorandum was APRA sought further information from CBA about the lack of risk-related adjustments?---Yes.

And CBA provided the information?---I understand so, yes.

And if we bring up APRA.0095.0001.0027. So this is then a further memorandum prepared after the information had been provided, again, going up to the senior manager to explain what was revealed by CBAs response?---Yes.

And can I draw your attention particularly to two paragraphs in the middle of the page where it says:

> *Despite a number of matters being raised in the board's risk management declaration and continuing investigations taking place regarding CommInsure, the group CRO assessed that there were no risk matters that should impact on the award of variable remuneration to the CEO or group executives.*

?---Yes.

Continuing:

> *This raises a question about the threshold applicable to the risk gate-opener, and if it could be enhanced by taking a more holistic and forward looking view on risk management effectiveness.*

?---Yes.

And then, if we go over the page to page .0028, we see there's a recommendation of proposed actions for further consideration?---Yes.

And the first is discussing further internally with APRAs GRC team – that's the - - -?---GCR team. Yes, the governance culture risk.

Governance – is it governance, remuneration and culture?---It's actually GCR - - -

I'm sorry?--- - - - but anyway. No. No. No.

Governance, culture - - -?---Culture, remuneration

- - - and remuneration team?---Yes.

Continuing:

Our expectations in respect of factoring risk into remuneration outcomes.

?---Yes.

Continuing:

Discussing with the CEO the materiality threshold applied to advising that risk management should impact on remuneration.

?---Yes.

Continuing:

Requesting further information about the inputs into the process to determine the group executive for wealth management's FY16 remuneration.

?---Yes.

Continuing:

And then making some other requests for further information or seeking confirmation for clarity about how the CEOs deferred equity awards received in FY16 were calculated.

?---Yes.

And then do you know what it is that happened after this?---So I think those – a couple of things. I think at least some of those discussions were had. My understanding is a lot of – and – there was a view within CBA that many matters were on foot and hadn't been determined yet, CommInsure being an example. And, therefore, it wasn't necessarily appropriate to decide on an outcome until an issue had been fully investigated. So that was sort of one – one of the issues that came up. The other issue was that it just reinforced the need for us to do the broader industry work, because I think what discussions inside of APRA concluded was that what we were seeing here we were seeing elsewhere, perhaps to different degrees, and that we should commence the work which we ended up undertaking that led to the – the review across the industry.

One possibility would have been to raise this with the board of CBA?---Yes. So a couple of weeks before that we had had a meeting with some of the directors, including the chairman of the board. I think it was the day the – if I remember the file correctly, it was the day that the results had come out. And – and they talked about the fact that the CEOs remuneration in particular was a large number that year and offered some views on why that was. By the time – so we did this work, we looked at the issues. By the time we went back to the board again we went back in – my recollection is December of that year. But we often had a meeting with the CBA board at the end of the year, so I will say December. By that stage, they had had a strike against their remuneration report. It had been announced that the – the chairman was going. And they were clearly having to have a pretty fundamental rethink about the way they approach remuneration. And so we used that opportunity in December to encourage them to rethink on some of these issues.

I tender that document, Commissioner.

THE COMMISSIONER: APRA memorandum 25 October '16 concerning CBA CEO remuneration arrangements, APRA.0095.0001.0027 exhibit 7.147.

EXHIBIT #7.147 APRA MEMORANDUM CONCERNING CBA CEO REMUNERATION ARRANGEMENTS DATED 25/10/2016 (APRA.0095.0001.0027)

MR HODGE: Do I understand, Mr Byres, that you recall that this was an issue that was raised at your meeting with the CBA board in December of 2016?---Not this specific issue. I – I think what happened was in the passage – in the passage of time between the results announcement and the earlier discussion that I referred to, which I think was on the day or the day after the results announcement and the remuneration report was published, by the time we went to the board in December they had had the strike against the remuneration report and were pretty despondent, for want of a better term, about what had happened, and quite reflective of what they were going to need to do differently in future. So it wasn't – it was an opportunity for us just to reinforce the point that they did need to – what worried me, perhaps, if I can just take a slight step back – what worried me was they had made some steps in 2016 to try and reduce the financial metrics in the scorecards and have more focus on staff and customer-related metrics in the scorecard. And that had been voted down. And my recollection of most of the discussion that we had at that December board meeting was me saying, well, I think that's actually – you're doing the right thing. So please don't give up on that – give up on that direction.

I see. Can I show you the briefing paper that was prepared in advance of your meeting with the CBA board. That's APRA.0095.0001.0040. And I think you will see in item 2, Risk Culture and Remuneration:

> *APRA to engage with the board regarding its current assessment of group risk culture and how this is influenced by remuneration arrangements.*

?---Yes.

And then, if we go over the page to page .0043, we see this is the section dealing with risk culture and remuneration where you're the person with suggested primary responsibility?---Yes.

And under the heading Remuneration we see the reference to what you've talked about which is:

CBA received a first strike in relation to its remuneration report.

?---Yes.

And then, about three-quarters of the way down the page, you see a paragraph that begins:

Whilst acknowledging.

Popped up there?---Yes.

It says:

Whilst acknowledging there is no right answer, at present the frontline team is challenged to see how CBAs remuneration arrangements and the risk gate opener in particular strongly –

I think that should be "incentivise":

…
proactive risk management.

?---Yes.

And then, if we go over the page, we see at the top:

However, we have been informed that from 2017 CBA is moving from a risk gate opener approach to a risk moderator approach (as currently applies in Bankwest) in part to seek to create incentives for good risk management.

?---Yes.

I tender that document, Commissioner.

THE COMMISSIONER: Briefing paper for CBA board meeting of 6 December '16, APRA.0095.0001.0040, exhibit 7.148.

EXHIBIT #7.148 BRIEFING PAPER FOR CBA BOARD MEETING DATED 06/12/2016 (APRA.0095.0001.0040)

MR HODGE: But then it seems from the notes of the meeting, which we can bring up, which is APRA.0096.0001.0013 – and I assume you've looked at these in the course of preparing to give evidence, Mr Byres?---Yes.

We can see in the third bullet point that the message that was conveyed was:

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From a risk management and culture perspective, we noted that there had been positive steps taken that are encouraging, but further work remains to be done.

?---Yes.

But otherwise, and we can probably put both pages up on the screen – can we put one page up on one side and the other page up on the other side. There doesn't seem to have been a discussion or an issue raised as to what exactly had happened with CBAs 2016 executive remuneration?---No. That's probably fair. The discussion was dominated by the results of the strike, and how they were thinking about what they were going to do – need to do in response to that strike.

In hindsight, do you think that APRA should have moved earlier to raise concerns about CBAs remuneration practices with CBA?---I – I guess it's always possible with hindsight to say the issues could have been pushed harder.

I tender that document, Commissioner.

THE COMMISSIONER: APRA notes of CBA board meeting held on 6 December '16, APRA.0096.0001.0013, exhibit 7.149.

EXHIBIT #7.149 APRA NOTES OF CBA BOARD MEETING DATED 06/12/2016 (APRA.0096.0001.0013)

MR HODGE: Until the Prudential Inquiry, had APRA taken any action against CBA in respect of its inadequate remuneration practices?---By what do you mean action, sorry?

Had it raised the remuneration practices with them? Had - - -?---No, I think we – yes, we had certainly raised the remuneration practices with them. As I said, there was a discussion to try and understand what they were going to do in response to the strike. My reservation was that I thought they had been trying to move away from financial metrics and it would be disappointing if they reverted from the direction or they reversed course from where they were trying to head.

That's – that issue, though, of whether they're trying to move away from financial metrics is a different issue from how risk is being taken into account in making adjustments to senior executive remuneration. Do you agree?---No. That's true. Sorry. And that work got folded into the broader work we were doing across the industry.

I see?---I think the view was within APRA we didn't actually have a good enough view of what good practice was, and we needed to do that more holistic view – get that more holistic view of industry practice and then tackle it on an industry-wide basis.

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I see. Can we bring up APRA.0054.0001.2412. See this is a document titled Reflections Following Prudential Inquiry (Supervision Perspective Only)?---Yes.

And this is a document prepared by Mr Douglas?---Yes.

And what was Mr Douglas' role?---He was a – a principal analyst within the CBA supervision team. And he was – so before the prudential inquiry started, and he was the – the engine room of the secretariat of the prudential inquiry, once it – it got underway.

I see. And if we go to page .2415, you will see there's a heading which is:

> *With hindsight, what could or should APRA have done differently prior to commencing the inquiry?*

?---Yes.

And you will see, about halfway down the page, a sentence which begins:

> *The adverse ratings – not counting the prudential inquiry – are based on the below.*

?---Yes.

And then you see the second bullet point is:

> *APRA could and should have called out inadequate remuneration practices earlier (at least by late 2016).*

?---Yes.

Do you share that view?---Yes, I think that's a fair – a fair assessment. James was tasked with doing a lookback and say with the benefit of hindsight what do you wish you had done differently? And I think that's a – a fair comment. We – we could have.

And should have?---And should have. Yes.

And have you turned your mind, then, to why you didn't do what you could and should have done?---I think because in the remuneration space we – as I talk a little bit about in my statement, we don't have a – we didn't have – I think we are better now – but we didn't have a lot of expertise in remuneration. It was an area that is not the natural forte of a prudential supervisor. We were still building our capabilities and we were probably not – as I said, we weren't really sure of where we stood as to what was good practice, etcetera. So it's a learning for us.

I just want to test that a little bit. The problem with the remuneration practices – or the application of the remuneration policy in 2016 had been identified by APRA. We've seen the memorandums already?---It was certainly an issue that we thought it doesn't look as though sufficient adjustment is being taken.

So the problem wasn't identifying the issue, because the issue had been identified?---Correct. The issue had been flagged and called out, yes.

So the problem then seems to have been with actually challenging the institution - - -?---Yes, so - - -

- - - about the issue?---So I think that's true. The – you know, the questions were asked. The response, at least to some of the issues, that were being looked at at the time on behalf of CBA was these issues are not yet resolved, it's not quite clear what the conclusions are, we don't quite know who to attribute accountability for yet. So they remain open issues. The issue didn't go – we didn't push beyond that point.

Do you think there's anything to learn about APRAs willingness to challenge institutions on issues like this?---The issue that I think this brought – this just brought home the fact that we didn't have – this was not an area where we had sufficient expertise to really be confident challenging. If this had been – I don't know – at the same time this was happening we were talking to CBA a lot on mortgages. Mortgages are bread and butter. Credit risk is bread and butter for a prudential supervisor. We were pushing very hard on those issues. This was an area that was – you know, our expertise was still relatively new in the GCR team. We don't have – didn't – certainly didn't have then the same capability and skills and, therefore, confidence to push as hard as we would for what I would call a traditional prudential issue.

And those traditional prudential issues are ones where it's possible to measure things?---Not necessarily. So, obviously, financial metrics, yes, we're very good at that. That is the bread and butter. But the work we've done on mortgages is around systems – systems and controls. It's not measuring things per se. It's about how do you make decisions, how do you make judgments, how do you set a policy framework that translates into processes that translates into people doing things. So – so that – but that particular area is a longstanding area of expertise for any prudential supervisor. We've had a long-established credit risk team that provides really strong advice to our supervisors on what does good look like, and what we should push on and where we should push. This was an area where we didn't have the same capability. And so, you know, we were less sure of our ground as to what was reasonable to demand.

THE COMMISSIONER: Well, didn't have the same capability about what? About remuneration narrowly identified? You had a deal of skill and experience about systems?---Yes.

The way in which things were translated from high level articulated idea down to nitty-gritty outcome?---Yes. So, Commissioner, I - - -

Were you looking at this only through the lens of remuneration, do you think?---My comment is sort of specific to the detail of remuneration. So is it legitimate and is it indeed common practice for a board to say I am not going to make any adjustment to executive X because a matter is under investigation and it would be premature for me to make any sort of adjustment whatsoever until every I is dotted and every T is crossed on an investigation. Or is it actually sort of evident that even if we don't know whether the problem is a small, medium or a large one, I don't know what the final consequences will be, I know there is some issue and I'm going to take, if you like, an interim step and then I will work out how to balance it all up later on. And I – I just don't think we had enough knowledge of industry practice, enough expertise in this area to know – have confidence about was CBA actually doing something that was unreasonable or was CBA doing something that was actually quite conventional practice amongst directors in the way they thought about the issue.

Yes.

MR HODGE: I tender that document, Commissioner.

THE COMMISSIONER: Reflection following prudential inquiry by James Douglas – is that the - - -?---Yes, Commissioner.

- - - gentleman's name?---Yes.

APRA.0054.0001.2412, exhibit 7.150.

EXHIBIT #7.150 REFLECTION FOLLOWING PRUDENTIAL INQUIRY BY JAMES DOUGLAS (APRA.0054.0001.2412)

MR HODGE: Let me ask you about a related reflection on the CBA inquiry. Can we bring up APRA.0054.0001.2430. So this is part of an executive board paper for APRA. You will see it's dated 19 June 2018?---Yes.

And this is also considering implications for APRAs supervision practices following the CBA inquiry?---Yes.

And if we go to page .2434. I think you've exhibited this to your statement, haven't you, Mr Byers?---I think I have, yes.

And you see the last issue on the page, which is Supervision Mongrel?---Yes.

Continuing:

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The CBA supervision team were aware of most of the issues identified by the CBA inquiry, with the inquiry providing absolute clarity of evidence to support the findings.

?---Yes.

Continuing:

Stronger support of supervisory gut feel, together with strengthened supervisor tenacity and more –

Can we go over the page –

frequent use of sanctions can be considered.

And then, if we come back, what's then said in the next column is:

Supervision mongrel is an attitude, rather than a framework issue. Senior leadership in APRA would need to set the tone on how this supervision mongrel would operate in practice.

?---Yes.

And do you have a view as to, without needing to put it in terms of supervision mongrel, whether there was a problem within the CBA supervision team with its willingness to act on gut feel and demonstrate tenacity in relation to CBA?---I think the – so the CBA supervision team was actually – I think, demonstrated a great deal of tenacity. There were a raft of issues that they were pursuing, and they were at loggerheads with CBA on a number of fronts. So I – I would never in any way question the tenacity of the supervision team. They were doing a good job. And the CBA inquiry, I – I mean, obviously, it went deeper and broader and so it found some extra things. But the starting hypotheses that the supervision team provided the panel as they went about their task were, I think, proved to be spot on.

Well, the implication of what's written here may be that the problem is not so much at the supervision team level; the problem is at the senior leadership level in terms of the tone that is set. Do you have a view about that?---Yes. I think – so perhaps I should just say that – that supervision mongrel phrase, we had the panel into the board the – the meeting before that one. And the three of – the three of them came in and talked about their reflections and their observations, not just about CBA. But as they had identified issues, they were, obviously, also alert to whether APRA had been aware of the issues, not aware of the issues. And so we talked through all of that. And generally they gave a good report card. But Dr Laker, the chair of the panel and my predecessor, finished – finished the session with some parting words about just rallying the troops and the fact that we had had the inquiry shouldn't be seen to be in any way a failing of APRA, and that it was really important that

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supervision teams pursued issues aggressively, even when the institution concerned was pushing back quite aggressively.

Perhaps if we just go back to my question?---Sorry.

The implication of what's written here is that the problem may be the tone that is set by senior leadership in APRA. And my question was do you have a view about that?---I think the comment was – the way that I interpret that comment is simply that supervisors will be very ready to ratchet up the mongrel, so to speak, as long as it's clear that senior management will – will support them when they are being more aggressive in their approach.

And - - -?---So it's important for leadership to signal, if – if there is to be a ratcheting up of supervisory aggression, for want of a better term, it has got to be clear that when there's pushback from institutions, that the organisation from the top down will back that.

And so if we try to see whether this idea connects with the issue about remuneration practices, Mr Douglas identified that APRA could have, and should have, called out the problems with CBAs remuneration practices at least by the end of 2016. Do you agree? That's what he identified?---That – yes, with – and, with the benefit of hindsight, yes.

Of course. And you, I think, were trying to encapsulate the problem as being that there was a lack of confidence about the judgment about remuneration practices because of a lack of experience within APRA about remuneration?---Yes. Broadly, yes.

But this – it does seem to suggest the supervisory team, their gut feel was there is a problem with remuneration at CBA?---I think we all – so that work started, as I said, because we had a meeting with the board, the chairman, the chair of the audit committee and the chair of the risk committee. And we all saw the numbers on the day they were published, and thought this is worth looking into.

And it was looked into?---Yes.

And it was observed internally in memorandums that there appeared to be a problem?---Yes.

And then there was a meeting that you attended - - -?---Yes.

- - - where the issue wasn't raised - - -?---Well - - -

- - - with the board?---It wasn't raised in that specific way, because it had been overtaken by events. We didn't have to ask them are you going to – you know, how could you do this, because they were reflecting on they were going to have to change things. They had got the message that the market, investors were unhappy that –

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that there hadn't been consequences. That was part of the dissatisfaction with the remuneration outcomes.

The dissatisfaction was about trying to change things in relation to financial metrics, wasn't it?---It was – I would say there were a range of factors in play here, because it was – there were lots of question marks being asked about the generosity of the awards. The concern about the non-financial metrics was a concern about the fact that they seemed woolly, and that, therefore, there was too much board discretion as to how they would be applied. And the evidence was that the board didn't apply much discretion at all, but it just waved things through. So these things were interrelated.

I don't want to spend too much more time on this. I just – I want to give you a chance, as best you can, to think about this, because you recall earlier when we were talking about CBAs remuneration practices you made the point first – they had had a first strike against their remuneration report in 2016?---Yes.

Second, that the board was slightly shell-shocked by that?---Yes.

Third, that the message you wanted to convey to them was. "Stay the course. You should do the thing that you're proposing to do, which is to change or make the change away from financial metrics"?---Yes.

But then now what you're saying is "no" – or I think you're saying - - -?---No. Sorry. Go on.

Actually, the strike against the remuneration report was also about failing to take into account making risk-related adjustments and they had also got that message and that was a message you actually wanted to reinforce?---Yes, but – so we went to that meeting without thinking we actually had to rub their nose in it. They had got the message. There was also a new chair coming in who was pretty determined to change things. So there was nothing to be had by banging the table there. The discussion was how are we going to go forward from this point?

All right. Do you know whether APRA has taken action against a financial institution for failing to comply with CPS 510?---No – sorry. The – yes, I do. The answer is no.

All right. And until its review of - - -?---Sorry. Can I - - -

Yes?---Can I come back again. So I assume in your question you are talking about CPS 510 in relation to remuneration, in the sense that there are other things in CPS 510.

Yes. Yes. In relation to remuneration?---So my previous answer is correct.

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Until APRAs review of remuneration practices at large financial institutions last year, had APRA taken steps to review actual remuneration outcomes for senior executives at APRA-regulated financial institutions?---Not in a – in a systematic and – not in a systematic way and not in a way that looked at individual by individual cases.

And I think the point you were making before was until very recently it lacked the confidence about its understanding of those issues to be able to do that?---Well, it lacked the confidence, because we lacked the expertise.

In the future where, say, APRA sees that decisions about risk-related adjustments to remuneration are, to take the CBA example, being made on the basis of a high level statement from the CRO that no adjustments are necessary, will APRA take some action in response to that?---So premised, I think, in your question is an assumption that you disagree with the CROs assessment. So if we – as we develop our expertise - - -

Sorry. Perhaps we should just clarify this. The CRO recommended no risk-related adjustments?---Yes.

And - - -?---If we conclude that that's am erroneous assessment - - -

Well, let's just stop. The other part of that is that what Ms Livingstone said last week was the information that was provided to the board in support of that was inadequate. So hence the reason why I described it as a high level statement from the CRO that no adjustments are necessary. So it's not just whether the conclusion is wrong; it's about what information is provided?---Sorry. It's about the quality of the material - - -

Yes?--- - - - the board has. Yes. And I think, as we think about upgrading the standard and the practice guide, we would be thinking about how we could make clearer what boards should be getting to empower them to make good decisions.

In the UK, the FCA reviews individual remuneration adjustments at large firms on a line by line basis for misconduct events to ensure policies are being consistently and robustly applied?---I – I understand they – they do do it. I don't know for how many executives they cover, but I understand they do some sort of assessment, yes.

Is that something that APRA would consider doing?---I think all of these things, it's a question of resourcing prioritisation. Certainly, I think we could do more to spot-check those sort of things. Whether we would be doing it for every organisation, every year, that would be quite a challenging task.

Commissioner, I was going to move to another topic but I notice the time. Is that a convenient time?

THE COMMISSIONER: Yes. What time do we need to begin tomorrow?

MR HODGE: Could we begin at 9.45 Commissioner.

THE COMMISSIONER: Yes. Is that going to be convenient to you, Mr Byres?---Fine. Thank you.

If we come back at 9.45 tomorrow.

<THE WITNESS WITHDREW [4.09 pm]

MATTER ADJOURNED at 4.09 pm UNTIL FRIDAY, 30 NOVEMBER 2018

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