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Geoff Nunn & Associates - Governance and Board Specialists

Governance Update

Royal Commission Final Report - Implications for Directors

On 1 February, 2019 Royal Commissioner Kenneth Hayne delivered his Final Report to the Governor General. As well recommending structural changes to the Financial Services Sector and referral to the regulator for some, he focuses a spotlight on boards and executive teams and invites them to consider a more enlightened approach to corporate conduct and governance.

The Final Report - Implications for Directors Across All Industry Sectors

Royal Commissioner Hayne and his team have done an extraordinary job over the past 12 months. Events have moved a long way from the Inquiry that we didn't need to have to one of stark revelations of corporate misconduct.

Revelations so confronting they have challenged the values underpinning our market driven economy and model of corporate governance.

Not surprisingly, industry bodies have been somewhat muted in their response. They are in a difficult position.

On 31 January, 2019 a very sober Australian Bankers Association CEO, Anna Bligh, stepped up to the mark with all of the courage she'd displayed as Premier of Queensland (2007-2012) and told ABC radio:

"I think that anybody who has done the wrong thing needs to face the consequences. Obviously if there are referrals, then those matters will have to be dealt with by the courts," Ms Bligh told AM.

"The banking system understands that it's not above the law."

She followed through strongly on the ABC TV on 4 February, 2019 and fully acknowledged Bank failures.

With the skill of a master tactician, Commissioner Hayne has crafted the Final Report in in a balanced and thoughtful manner. Some longer term market fallout is inevitable as the industry confronts a level of reform and tightening of regulatory requirements. Many have argued he has used a soft touch by not calling for structural separation. Nor has he called for changes to the Corporations Act along UK lines, although this may well emerge through the work of the implementation task force.

Hayne holds boards and executive teams directly accountable for the conduct of their organisations and challenges them to refocus their approach. He points out that social licence is not an entitlement.

The prospect of civil and criminal charges loom and recommendations have been passed to the regulators. Directors, CEOs and executives remain on tenterhooks as the regulators and possibly the Commonwealth DPP consider how to proceed.

The Report has profound implications for directors across all industry sectors. It provides them with a unique, once in a generation, opportunity to examine their own conduct and that of their organisations:

"Because it is the entities, their boards and senior executives who bear primary responsibility for what has happened, close attention must be given to their culture, their governance and their remuneration practices."

Royal Commission Final Report Page 4

In this Governance Update we focus on four key opportunities for directors:

1. The opportunity for boards to reflect on their own processes, with external facilitation, and to find creative ways to engage in authentic dialogue about the issues identified in the Final Report. *See Pages 2-3.*
2. The opportunity for boards to focus on ethics, credibility and reputation. The 2019 Edelman Barometer shows Australia still lags on trust in our institutions. An Edelman of the Financial Services Sector in Australia at the moment would show very negative sentiment. *See Page 4.*
3. The opportunity for some larger corporates to consider the establishment of a board "Stakeholder Relations Committee" (as is occurring in some countries) to oversight the corporation's stakeholder engagement program. *See Page 5.*
4. The opportunity for boards to review their executive remuneration strategy and move to a simpler, more balanced model See *Page 5.*

All boards are considering the recommendations in the Final Report and governance implications for their organisations. We are here to help you deal with this effectively.

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1. Discovering New Energy in the Boardroom

For some time now the Electricity Sector in Australia has been wrestling with the impact of technology on it's traditional generation, poles and wires and retail businesses. Solar, wind, batteries, appliance efficiency, micro-grids and other developments have caused significant disruption to the energy supply chain.

Terms such as "New Energy" or "Future Energy" are beginning to emerge. The Sector is looking at new ways to source and deliver energy and potentially embrace new business models.

These terms are fitting metaphors for Board Renewal which has been widely interpreted as finding new directors and letting go others whose skill base is no longer relevant.

We have a different definition.

When a new idea takes hold it can be energising in quite remarkable ways. The nature of board meetings, board papers, agendas and minutes can be seen for what they are; the structural frameworks which support sound corporate governance.

In the January, 2019 edition of Governance Update we considered the question of board language and refining the definition of board purpose. Here it is again:

> "The role of an effective board is to balance the interests of all stakeholders, add value for shareholders and ensure that the corporation has a net positive impact on the communities and environments in which it operates.
>
> "In doing so the board will oversee legal and regulatory compliance, promote financial viability, manage risk and work closely with the CEO to achieve balanced results. It will navigate these complexities in such a way that purpose guides strategy development and informs decision making.
>
> "The effective board is visible to its constituents and present in the organisation it is part of. It does not intrude on the role of the CEO or Executive Team. It puts a face and voice to good governance."

Language prescribes the limits to our thinking. When we change the language we open up new possibilities. If the language of the boardroom is focused on legal obligations, finances, compliance and procedural matters, there's not much space for new ways of thinking.

Genuine renewal requires us to look beyond structural constraints. There is no escaping the rule bound nature of corporate governance. But let's consider how language shapes our thinking and constrains us from discovering future energy sources.

Board Language and Groupthink

Language is, in part, the glue that holds us together. Organisations develop language specific to their purpose, products and services, operating environment, regulatory framework and history. This language not only describes the way the organisation works but reflects its collective psyche and culture. It can vary significantly across different parts of a large corporation.

"...language is closely associated with symbolism, and so with emotionalism and conceptual thought and creativity."

How the Language You Speak Influences the Way You Think, Burton, N. Psychology Today August 2018.

This is true of boardroom language as well. Where director's accountabilities are closely prescribed in legislation, procedures and systems this shapes conduct and practice. When liquidity ratios, NPAT, ROI, TSR and a multitude of other financial measures are recognised as the primary drivers of organisational performance they influence culture and ethos.

We need these key measures to track financial performance. Institutional and some retail investors follow them closely. Financial viability is critical. But when combined with the legalism of governance they create a collective mindset with tight parameters: a self-generating reality which can set the scene for groupthink. The APRA Report of April, 2018 identified significant issues of this nature in the Commonwealth Bank culture and they have been largely backed up by the Royal Commission as an industry wide phenomena.

The challenge for boards is to introduce new language into their governance dialogue. It is necessary to retain a strong focus on the financial, legal and compliance matters. But in conjunction with these imperatives we need to introduce new and different language. Language that disrupts the orthodoxy in a positive way and confronts existing mind-sets. Just like we still need to rely on coal fired generation and electricity delivery via poles and wires. But alongside this essential infrastructure new energy sources and communication channels open the way for enhanced governance.

1. Discovering New Energy in the Boardroom (Continued)

Continued from Page 2

The language of real renewal is beginning to emerge. The 2018 annual reports of our major corporates contain messages about balancing the interests of different stakeholder groups. For the most part it is window dressing with a 'business as usual' model still operating in practice. Real change will take some time. The Commissioner's recommendations add impetus to change although some have questioned whether corporations have the will to take the message on board.

From our standpoint there are a few key initiatives which might assist:

- Reduce the formality of language at board meetings.
- Take time to work outside the usual meeting framework.
- Encourage authentic dialogue via facilitated engagement.
- Increase the opportunity for interaction between non-executive directors, the CEO, Executive Team and Managers.
- Increase the opportunity for selective interaction between non-executive directors and other stakeholders.

Finding new energy will assist boards and directors to address issues raised in the Royal Commission's Final Report. Particularly issues around the board's role in influencing corporate culture, oversight of stakeholder engagement, credibility and reputation, ethical conduct and finding a more balanced approach to executive remuneration.

2. Credibility and Reputation Risk

On 20 January the 2019 Edelman Trust Barometer survey results were released. Surprisingly, in light of the Banking Royal Commission, Australia rose 8 points when it came to the general population's trust in our institutions (from 40 to 48). Still in the "Distrust" zone and below the global average of 52. We improved slightly when it came to the survey results for an "Informed Public" that is the tertiary educated, high income, media savvy and business literate. *See table this page.*

72% of Australians surveyed believed corporations could be profitable and exercise a positive influence on the community. They were not asked whether they felt this was happening in practice.

Implications from the Final Report

So how does this relate to the Banking Industry Royal Commission Final Report? Consider this quote:

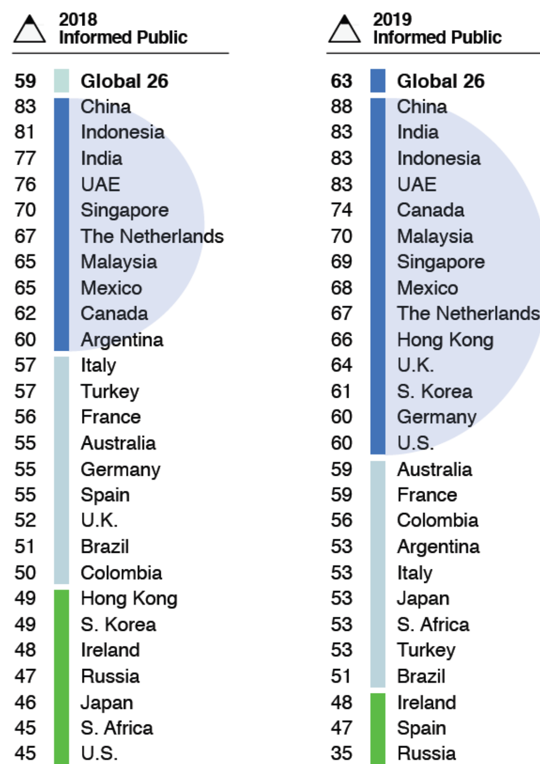
"..governance is not limited to questions of risk. Nor is it defined only by reference to how the board operates or what matters the board deals with. It embraces not only how, and by whom, decisions are made, but also the values or norms that the processes of governance are intended to effect.**"**

Royal Commission Final Report Page 335

This would seem to be self-evident. Where there has been systemic misconduct the board, executive team and management all bear responsibility.

The misconduct uncovered by the Royal Commission dramatically undermines trust in our corporations, their boards and CEOs. In the Financial Services Sector it will take a long time to re-build the public's trust. Boards have their task cut out to regain credibility. Resignations at the top of the NAB were inevitable.

We should not be under any illusions that inappropriate corporate behaviour is limited to financial organisations. It is widespread across many industry sectors.



2019 Edelman Trust Barometer Global Report p. 7

In a prelude to the upcoming AICD Governance Conference former Child Abuse Royal Commissioner, Robert Fitzgerald AM, reminds us:

"…. we need to look at what is the nature of ethical conduct in the delivery of goods and services in all public or private organisations. Surely, the least we should expect is for organisations to keep their promises to their members and consumers, to act in their best interests and to deliver goods and services in a responsible, lawful and ethical way. However, all the royal commissions suggest many institutions do not."

Don't Repeat the Mistakes of the Past Robert Fitzgerald 30.1.2019

The challenge for directors is to ensure that the organisations they govern pursue high standards of business conduct and maintain heightened visibility. Refer to our definition of sound governance on Page 2 of this Update.

3. The Stakeholder Relations Committee

Is This A New Board Requirement for Large Corporates?

The notion of active "Stakeholder Relations or Engagement" is well established in the Australian corporate landscape having emerged as a discipline in the 1980s. Many organisations have a "Stakeholder Relations/Engagement Manager" some at executive level.

Various organisations have committees set up to canvas the views of different stakeholder groups and collectively engage in developmental initiatives. This practice is quite well established in government owned organisations. Some commercial corporations are moving in this direction. On 9 November 2016 Westpac announced the formation of a "Stakeholder Advisory Council" comprising various industry specialists and ethics practitioners under the direction of the Group Head of Sustainability.

With the Banking Royal Commission Final Report now in the hands of the Federal Government some boards will be considering how they might better integrate the interests of a broad range of stakeholder groups into their thinking. In some parts of the world the idea of a board committee focused exclusively on Stakeholder Relations/ Engagement has begun to emerge. In Australia some corporations have board accountability for this oversight function included in the "Sustainability Committee" charter.

Consider this purpose from a Canadian health authority:

"The purpose of the Stakeholder Relations Committee (the "Committee") is to assist the Board of Directors (the "Board") in supporting management led external and internal communications responsibilities, as well as supporting Board specific goals and objectives with respect to stakeholder relations."

Terms of Reference: Stakeholder Relations Committee.
Interior Health Authority, Canada, 31.5.2016

A number of UK banks have pursued this approach under various guises:

- Barclay's; Board Reputation Committee.
- HSBC; Conduct and Values Committee.
- Lloyds; Responsible Business Committee.
- RBS; Sustainable Banking Committee.
- Standard Chartered; Brand, Value and Conduct Committee.

Titles vary considerably, as does primary focus, but all committees listed above have accountability for oversight of stakeholder engagement. Some UK companies place accountability with other board committees. Many endeavour to integrate it fully in all aspects of their decision making.

The existence of such committees in the UK is not limited to the Financial Services Sector. To a degree their emergence has been driven by the UK Companies Act 2006 which states that:

"A director of a company must act in the way he considers, in good faith, would most likely promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

a) the likely consequences of any decision in the long term,
b) the interests of the company's employees,
c) the need to foster the company's business relationships with suppliers, customers and others,
d) the impact of the company's operations on the community and the environment,
e) the desirability of the company maintaining a reputation for high standards of business conduct,
f) the need to act fairly as between members of the company."

UK the Companies Act 2006, Section 172

There has been discussion in Australian governance circles for some time about whether such changes are required to the *Australian Corporations Act 2001.* Commissioner Hayne's Final Report adds weight to this argument although no specific recommendations have been made in this regard. However, there is no need to wait for legislative change. Boards can take the initiative now in the following manner:

1. Establish a Stakeholder Relations Committee of non-executive directors, with the CEO ex-officio, to meet 3-4 time each year to oversight stakeholder engagement strategy and reporting.

2. Ensure that the executive with primary responsibility for stakeholder relations has a dotted line relationship to the Committee.

3. Maintain an active presence and dialogue with various stakeholder groups and ensure their interests are considered in board decision making.

Some will argue that non-executive directors are already over stretched with board and committee work. It may well emerge that some directors need to sit on fewer boards and devote more time to those directorships they retain.

The value of establishing such a committee for large corporates cannot be underestimated in terms of restoring credibility and re-building reputations.

"A board that is not attuned to the concerns of external stakeholders may be failing in its responsibilities to preserve the long-term success and sustainability of the organization it is duty-bound to serve."

Director Briefing - Stakeholder Engagement. Chartered Professional Accountants, 2018 p. 16

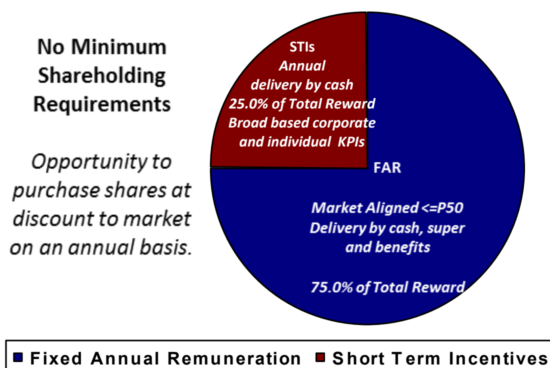
4. Executive Remuneration - A More Balanced Approach?

For some time we have been arguing that the current configuration of executive remuneration in many corporates is implicated in the type of misconduct uncovered by the Banking Industry Royal Commission. See: https://www.gna.net.au/royalcommission/. Commissioner Hayne suggests "Experimentation" to achieve the right configuration for each financial services organisation and strengthening the BEAR. We believe these measures will only add to confusion.

When significant amounts of reward are tied to financial metrics it influences behaviour. When delivery is in the form of equity it narrows the focus to metrics which boost shareholder returns. Many regard this as a positive design feature. It supports our way of doing business. But when returns are achieved, in part, by the conduct uncovered by the Royal Commission it indicates a systemic problem.

Executive remuneration strategy needs to balance the often competing interests of different stakeholder groups. In the wake of the 88.1% "no vote" on the NAB Remuneration Report in December, 2018, shareholders were sending a clear message to boards.

There is a case for simplification along the following lines:



Positioning executive FAR at, or just below, the Median will stabilise the market. If enough companies adopt a conservative approach, the market will come back to a more sustainable level over time. Some will argue this would restrict their capacity to attract the best executive talent internationally. But compared to some recent overseas appointments our home grown executives look pretty good.

There are arguments for and against retaining a short term incentive plan. Some companies with an FAR/STI configuration are moving to drop the STI component. If an STI is retained the right balance needs to be achieved between financial, operational, customer, stakeholder, safety, environmental and people performance measures.

Equity based LTIs are a concern. Concentrating a significant proportion of an executive's personal wealth in equity in the employing organisation inhibits independent decision making. Some regard it as a conflict of interest. Minimum shareholding requirements of up to 500% of FAR are a recipe for the misconduct uncovered by the Royal Commission.

We favour discontinuing equity based LTIs altogether and returning to the earlier model where the executive may elect to acquire shares in the company on an annual basis, at a discount to market. This should be offered outside of package and not mandated through policy.

To reduce STIs and discontinue equity based LTIs will require a certain level of cashing out of reward opportunity. Our suggestion is around 50%-60% of the notional award averaged over the previous three years. Undelivered LTIs will need to be grandfathered.

We are not arguing that directors and executives should be paid less than they currently are. Although, in the longer term, this will be an outcome of adopting the strategy outlined above.

Dan Pink's quote in relation to the Royal Commission's Final Report is very appropriate:

".....when an extrinsic goal is paramount – particularly a short term measurable one whose achievement delivers a big payoff – its presence can restrict our view of the broader dimensions of our behaviour."

Drive. Daniel H. Pink, Canongate 2009. P 50.

Our Offer

The governance and remuneration issues outlined in this Update have broad based applicability across all industry sectors. They reflect the contents of the Royal Commission's Final Report. Should you wish to avail of our expertise to assist your board and executive team review the implications for your organisation we would be happy to provide a focused presentation.

Call or email Geoff or Di. Our contact details are below.

About Geoff Nunn and Associates

Geoff Nunn & Associates was established in 1993 as an independent provider of organisation consulting services to the government and corporate sectors. We specialise in working with Boards and CEOs in the areas of corporate governance, board dynamics and renewal, governance structures, board and executive remuneration strategy. Advice has been provided to over 1000 organisations across Australia.

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