2018 Number 3

October, 2018

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Governance and Board Specialists

# Governance Update
# Board Hot Spots 2018—2019

**In this Governance Update we discuss emerging issues for Boards of Directors. Various inquiries have shone the spotlight on a range of governance issues.**

## Do We Need A Royal Commission Into the Energy Based Utilities?

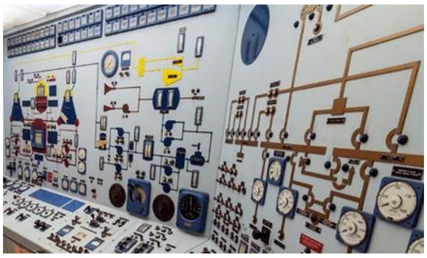
Recently there have calls for a Royal Commission into energy based utility companies. Suggestions of gold plating by electricity distributors and transmission network service providers (DNSPs and TNSPs) have been around for a while. Retailers have been accused of aggressive marketing techniques, confusing offerings, and harsh treatment of customers in distress. Some retailers are also generators and have been accused of market manipulation to maximize prices.

No doubt there is some truth to these accusations. However they represent only part of the picture. The boards and executive teams of all energy based utilities are closely following the Banking Industry Royal Commission and examining their own conduct in the light of the very startling revelations that continue to emerge.

Industry associations such as Energy Networks Australia and the Australian Energy Council conduct research and make considered policy submissions to government on a range of issues confronting the sector. AEMO's management of the nation's wholesale electricity and gas markets in highly effective.

Uncertainty around government policy, disruptive technologies and market forces continue to present challenges.

At no time in the recent past has the Sector faced such uncertain times. Solar, wind, battery storage, appliance efficiency, micro-grids and other technological advances have all contributed to a difficult operating

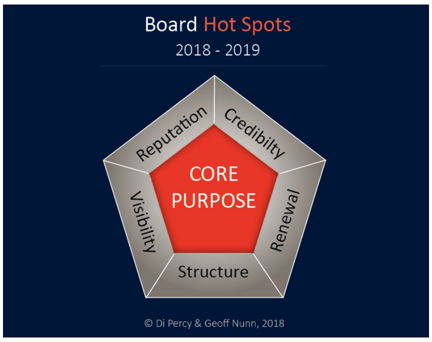


environment. Base load capacity is required to meet peak demand overlaid with overall declining consumption.

The imposition of a Royal Commission on a Sector facing such challenges would be ill-advised and counterproductive. Much better to have confidence in the boards and executive teams to learn from the lessons of the Banking Royal Commission and focus on innovative approaches to delivering energy to consumers in a reliable and cost effective manner.

## Board Hot Spots 2018-2019

Over the last few months Di Percy and I have been closely monitoring emerging governance issues in the Australian corporate landscape. We have developed a framework to provide advice and assistance. See summary:




In this edition of Governance Update we explore some of these "Board Hot Spots" and consider implications for directors.

**Core Purpose**

We hear a lot about "Vision", "Mission" and "Values" in the corporate and government sectors. Most organisations have the words prominently positioned on their websites, in their annual reports and at strategic places within their offices, factories and warehouses. They may be supplemented by in-house education programs to ensure that employees are on-board.

But we seldom hear about "Core Purpose" in corporate messages. So what exactly is it? According to leading authorities Collins and Poras (2008) core purpose is:

"the organisation's fundamental reason for being. An effective purpose reflects the importance people attach to the company's work—it taps their idealistic motivations– and gets at the deeper reasons for the organisation's existence beyond making money."

Highly regarded organisations often have a deeply realised core purpose that generates a sense of identity and connection to the communities in which they operate.

# Core Purpose— (continued)

## Articulating Core Purpose

Not many corporations or government organisation capture the notion of core purpose in their message to their constituent base.

The concept goes deeply into the organisation's raison d'etre. It's a larger than a product or service. Or even a highly visible CEO.

Consider the core purpose of the Reserve Bank of Australia. To ensure:

a. the stability of the currency of Australia;
b. the maintenance of full employment in Australia; and
c. the economic prosperity and welfare of the people of Australia."

Reserve Bank Corporate Plan 2018 P5.

This very clearly states why the Reserve Bank exists and how it is to be present in the lives of all Australians.

This is a message not only to the broader community but also to the Reserve Bank's employees and other stakeholders. It's a message they can rally around.

The Board can use this statement of purpose to test the decisions they make. The Executive Team and Staff can hold it in mind to guide their everyday activities.

This is an ideology based core purpose. Consider the assertion that the Reserve Bank Board will exercise it's powers (under the Act) in a way that will contribute to the economic prosperity and welfare of the people of Australia. This sends a clear message to the Australian public that this organisation is here primarily to use its position for their economic benefit.

## Applicability

Every organisation, large and small, has a core purpose even if it hasn't yet been articulated. Let's consider some:

**Banks**: very topical at the moment. The prevailing message coming out of the Royal Commission Interim Report on 28.9.2018 is that the banks exist primarily to deliver returns to their shareholders. In a highly competitive environment the sale of products and services and profitability has been their main focus.

However banks have a very real social purpose. Not only do they provide the liquidity which underpins our economy but they provide the transactional services we all need function in today's digital world. They underwrite most of our major life purchases and provide lines of credit which most businesses need to function.

How different might the landscape revealing in the Interim Report look today if the banks returned to their core purpose and lived by it.

**Mining Companies**

The mining companies are faring better than the banks at the moment. Although there have been moments in history when that hasn't been the case. We've only got to go back a few years and think about the environmental and social damage caused by OK Tedi and Bougainville Copper.

Most major miners are listed and very focused on value creation for their shareholders.

Australian history has been shaped by our resources sector. Iconic names like BHP, RioTinto, Hamersley Iron, Mount Isa Mines (MIM) currently form or have formed a valuable part of our economy. The whole country has been opened up and towns and communities established to support our resources sector.

Mining companies have a core purpose as well. Just think about that nail you just hammered into the wall, the car or train that take you to work, the wires that bring electricity to your factory. Mining exists to extract the resources that go into many manufactured goods that we consume, the ships and aircraft we travel in and just about so many applications that it would be impossible to list.

## Implications for CSR

Sound core purpose is underpinned by an inspiring ideology. One that tends to convey a number of ideas and engages the hearts and minds of all stakeholders. Sometimes the stated ideology and ethos are at odds with the underlying philosophy. For instance a company might make various public statements about participation in the community by supporting a local charity. But the underlying reality might be that it has no real interest in the community and the marketers have determined that the public relations value of such support will boost sales through branding.

Is it possible to hold both the idea of value creation for shareholders and social reason d'etre simultaneously. Clearly the answer is yes! The Bendigo and Adelaide Bank is a prominent example. It's community banks return 50% plus of their profitability to the community in which they operate: Consider the following statement:

"Many years ago our forebears established organisations that put their customers, and the communities they operated in, first. And it is remarkable just how similar this vision remains for Bendigo and Adelaide Bank today.

In fact, the bank's vision reflect the shared histories of Bendigo Bank and Adelaide Bank – both of which stretch back over a century....

Our approach begins with listening. How do local leaders see their community growing? What are their problems? Can Bendigo and Adelaide Bank help them address these threats and opportunities?"

Bendigo and Adelaide Website 25.9.2018

Bendigo and Adelaide Bank

Like other commercial organisations the Bendigo and Adelaide Bank is expected to deliver a return to its shareholders and has achieved 4.2% in FY 2017/2018.

# Damaged Reputations - A Major Governance Issue

## Reputation

When the Royal Commission into Misconduct into the Banking, Superannuation and Financial Services Industry uncovered instances of fee-for-no-service, interference with independent legal advice and misleading reporting to the regulator the AMP's corporate reputation disintegrated. It's share price plunged:


The then Chair, Catherine Brenner and CEO, Craig Meller took the fall. Former Commonwealth Bank CEO David Murray was appointed Chair. Despite seemingly good credentials Mr Murray indicated it would take some time to re-build the AMP's tarnished reputation.

Pursuit of profit and shareholder returns by engaging in dubious and ill advised conduct is highly detrimental to a company's reputation. It takes many years to build reputation. But only one incident to destroy it. Mr Murray has his work cut out for him.

In 2015 a Deloitte Global Reputation Risk Survey found reputation risk was ranked more highly than any other strategic risk for corporations. This is supported by the notion that at least 25% of a company's value is tied up with it's reputation. Reputation risk is associated with other business risks:

"Reputation risk is driven by a wide range of other business risks that must all be actively managed. Topping the list are risks related to ethics and integrity, such as fraud, bribery and corruption."

Deloitte Global Reputation Risk Survey 2015 P2

Accountability for reputation starts with the board and flows through the executive team. The nature of board dynamics and concern for ethical conduct impact the entire organisation. The consequences of ethical failure are reflected in the 2018 Edelman Barometer on trust with Australia ranking the 8th lowest of the 28 countries surveyed.

## Lessons on Reputation from the Interim Report of the Banking Royal Commission.

On the 28th September, 2018 the Commissioner delivered his Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry to the Governor General of Australia. The findings are confronting, particularly for boards and executive teams. Corporate reputations have suffered. At a recent House of Representative Economics Committee hearing the NAB's CEO, Andrew Thorburn admitted the Banking Sector has began to lose its way about 20 years ago.

The Commission's findings to date come as no surprise to anyone who has worked in or with the corporate sector for the few years. Shareholder returns are the dominant mantra. Financial viability is important and fair returns are a reasonable expectation. But not by engaging in the type of conduct that the Royal Commission has uncovered. It very directly causes reputational damage.

Without doubt boards and executive teams have a case to answer and much work to do. The Big 4 banks have achieved around 8-10% Total Shareholder Returns for the past few years and received great praise for doing so. Strong results by any standard. Shareholder associations can become very vocal when returns dip. Just a few short months ago the ABA launched an advertising campaign stating that 80% of bank profits were returned to shareholders. But by chasing returns we are all implicated, in part, in the issues that have been uncovered by the Royal Commission. The problems are systemic and deeply embedded in our way of doing business.

This comment from the Commissioner is revealing:

"One simple, but telling, observation informs those inquiries. All the conduct identified and criticised in this report was conduct that provided a financial benefit to the individuals and entities concerned. If there are exceptions, they are immaterial. For individuals, the conduct resulted in being paid more. For entities, the conduct resulted in greater profit."

Royal Commission Interim Report Page 301

Is more regulation necessary? Do regulators need more teeth? Is the BEAR going to do the job in the Financial Services Sector? A couple of weeks ago week the Commonwealth CEO, Matt Comyn wrote to all customers talking up the bank's moves to get its house in order. Yet a quick look at their 2018 Remuneration Report will tell you that while there has been some tinkering with the executive remuneration model it is conceptually much the same. An FAR/STI/LTI configuration with 75% at risk and continued heavy weighting on financial metrics.

The Commissioner wisely refrained from foreshadowing recommendations. Although he did signal that a strong regulatory response was unlikely. The seventh round of hearings and consideration of policy issues in November will provide more substance for the way forward.

# Corporate Credibility - A Board Challenge

## Credibility - Facing the Challenge

Corporate Credibility is often associated with brand profile in the market. We use the term in a slightly different context here. Credibility is associated with trust and reputation. Our focus is at the board level.

When an organisation acts in ways that are perceived as deceitful or dishonest by its stakeholders, it very quickly loses credibility. A loss of trust and questionable authority very erode an organisation's standing in the community. The Board sets the tone for a company's credibility. How directors are perceived both within the organisation and in the public arena is critical for maintaining a credible corporate presence.

Chairs and directors have been remarkably silent in relation to Commissioner Hayne's Interim Report into Misconduct in the Banking, Superannuation and Financial Services Industry. They've left commentary and expressions of contrition to the CEO's and Industry Associations. This does little to enhance the credibility of the boards of these organisations.

A major bank Chairman was recently reported in the Australian Financial Review as making the following statement at the Bank's 2017 AGM:

"The deterioration in the sector's reputation has been a great disappointment to me personally and the Board. It is our hope that, ultimately, the newly announced royal commission will play a role in restoring trust, respect and confidence in Australia's already strong financial system."

It is not clear from this statement that this director fully appreciates that, as Chairman of one of the organisations accused of failures of corporate social responsibility, he and his Board are ultimately accountable. Such statements do little to enhance credibility.

Consider this quote from ACCC Chair, Rod Sims:

"Many companies set high profit growth targets to meet market expectations. Often these targets are higher than real GDP growth which is currently forecast to increase by 3 per cent over this financial year. By definition, therefore, not all firms can meet or exceed market expectations. In some cases company executives push the boundaries to achieve short-term growth targets. Some appear to ignore the risk of reputational damage over the longer term to achieve short-term gains."

*Companies Behaving Badly, Rod Sims, 2018 Giblin, 13.7.2018*

## Board Renewal

The Macquarie Bank publishes its Board Renewal Policy on its website. A quick read indicates that it's about the term and criteria for selection of directors. Recently the Commonwealth Bank made an announcement regarding Board Renewal indicating that two directors were retiring and a new director being appointed.

APRA Prudential Standard CPS 510 contains a paragraph on Board Renewal:

"The Board of a locally incorporated APRA-regulated institution must have in place a formal policy on Board renewal. This policy must provide details of how the Board intends to renew itself in order to ensure it remains open to new ideas and independent thinking, while retaining adequate expertise. The policy must give consideration to whether directors have served on the Board for a period that could, or could reasonably be perceived to, materially interfere with their ability to act in the best interests of the institution. The policy must include the process for appointing and removing directors, including the factors that will determine when an existing director will be re-appointed."

What is apparent from the above examples is that some boards and regulators have little understanding that renewal is not just about appointing new directors to replace outgoing ones. It's about directors engaging with their governance work in a new and energising way. We all become a bit stuck if we stay in the job for too long. The key question is: how do boards embark on a process self renewal by looking at their own dynamics; by bringing unconscious processes into consciousness so that they can be worked on?

Like all human groups, behaviour in the boardroom is shaped by a range of conscious and unconscious process. What gets said at board meetings is only the tip of the iceberg. There's a lot more going on beneath the surface.

Sometime we need to be brave and peel back the cover to see what's really going on. And bring it into the room. This is confronting. These swirling dynamics can be positive and enhance functioning. But they can also be negative. The elephant in the room might be standing just behind the Deputy Chair and have been there for some time.

## Board Visibility

"Not much is known of what boards do from month to month, and in most organisations you would be hard pressed if you asked a staff member who was on the board to get a response beyond one or maybe two people (and usually only the name of the Chair)."

*The Faceless Board—Reconnecting to Your NFP Community.*

*Better Boards David Bartlett August 2012*

To most customers, employees, suppliers and other stakeholders directors can be shadowy figures in the background. Unless you're an informed shareholder you are unlikely to take much interest in the board of the company you've invested in. Even then you might only read about the board in the annual report. Or if you're an active shareholder you might go to the AGM and see a row of faces lined up behind tables each with a nameplate. Probably only the Chair, the CEO and CFO will speak at the AGM. Yet all directors have a significant role to play and being visible builds trust and understanding.

Being a company director is not a passive role. All directors need to be present in the organisations they govern and the communities in which their organisation operates. Not in a way that undermines the CEO and Executive Team. But in a way that re-enforces a valid good governance presence.

## Board Structure

The foundations of effective board functioning (structure) are not always applied with agility and awareness. Company and industry changes may call for structural review and development resulting in innovation and adaptation. That is, structures also need adaptation and fresh eyes in times of change.

For some time now most boards have followed a fairly standard structural model. The main board of 6-8 non-executive directors with 3-4 functional committees. The expectation, sometimes explicit, sometimes implicit, that each director will sit on at least one committee, usually two. And the committees are usually configured as:

| |
|---|
| Audit and Risk Management |
| Compliance |
| Nomination |
| Remuneration |

Governance bodies will argue that this model has stood the test of time and is appropriate for the Australian corporate landscape. There is variation in some organisations. But essentially the functions are simply moved around.

Special purpose committees are assembled for specific periods. Examples might exist around mergers and acquisitions or CEO succession.

The question remains; is current model appropriate in the contemporary business environment and is it best for your current organisational circumstances?

There are deep questions which continue to emerge in the corporate and governance landscape which may give rise to other structural models. Consider the following:

- Audit, finance and risk is a given and non-negotiable;
- Digital disruption is impacting many sectors. It requires in-depth consideration at the board level;
- Ethos, ethics and integrity have emerged as key issues for boards. No longer is the relentless pursuit of profit, at all costs, acceptable in our social context.
- Environmental and sustainability concerns will assume increasing prominence. They have been neglected and seen as a compliance issue for too long.
- Genuine participation in the community is an expectation of organisations of all types. It is a front facing activity for boards.

All of the above present opportunities for boards to think about their formal structure. Are the above, and the various other issues which abound in contemporary governance, just one more item which might appear on the board meeting agenda. Or do they require consideration of other structural models?

**About Geoff Nunn and Associates:**

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

**Our Services**

- Board Governance Advice;
- Board & Committee Charter Drafting;
- Business Advisory Services;
- Board and Executive Remuneration Strategy Advice;
- Remuneration Governance Advice.

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