



FINANCIAL SERVICES ROYAL COMMISSION FINAL REPORT

**Part 2: Culture, Governance and
Remuneration**

6 February 2019

CLAYTON UTZ

www.claytonutz.com

The Financial Services Royal Commission's findings in the Final Report, delivered on 4 February 2019, place the primary responsibility for misconduct in the financial services industry with the entities concerned and those who managed and controlled those entities: their boards and senior management. While the Commission examined the conduct of individuals, it also looked to factors internal to organisations which have an impact on that conduct: the organisation's culture, how it governs itself and how it remunerates and incentivises its people. These matters are interrelated, and the Commission points out that positive steps taken in one area will reinforce positive steps taken in the others, while failings in one area will undermine progress in the others.

Although Commissioner Hayne's findings relate to entities in the financial services industry, most of its recommendations and observations, including those discussed below, are relevant to companies more broadly.

Causes of Misconduct

Corporate culture and governance in the Australian financial services industry has now been scrutinised both in the context of the findings of the CBA APRA Prudential Inquiry and the Commission's. The following themes have emerged from that public examination and the Final Report:

- ▶ **The role and responsibility of the Board:** The importance of the Board providing direction to the organisation, setting the tone from the top (and regularly assessing culture and governance), and finding the right level of engagement with executives and key stakeholders has now assumed a prominence in Australian corporate governance never before seen. The requirement for a level of rigour, urgency, and transparency of Board interaction was a focus of the CBA APRA Prudential Inquiry, and this has again been scrutinised in the Commission's Final Report. Inevitably, this increased focus on the role and responsibility of the Board is likely to drive greater Board engagement, scrutiny and accountability within organisations.
- ▶ **Understanding legal obligations and compliance with the law:** The Commission examined the legal duty of directors and observed that this duty demands consideration of more than the financial returns that will be available to shareholders in any particular period. In some of the case studies, Bank executives recognised that long-term financial return is more often than not aligned to a focus on customers and an effort to treat their employees fairly. Further, in some cases, the Commission unearthed a lack of clarity of a financial services entities' legal obligations – to whom were duties owed and what was the content of that duty? The corollary of this is, if an entity does not have a clear and solid grasp on its duties and obligations from the top down, it cannot possibly hope to comply with the law (even if its systems and processes are state of the art).
- ▶ **Identification and management of non-financial risks:** A key theme arising from the APRA Prudential Inquiry and the Commission was the failure of financial services entities to pay sufficient attention to non-financial risks – a failing associated with a breakdown in both culture and governance. Culturally, financial institutions have been criticised for prioritising profit (eg. market and credit risk) over customers (eg. non-financial risks: compliance risk; conduct risk and regulatory risk) and from a governance point of view, failure to have appropriate governance frameworks have led to an inability to appropriately identify, escalate and address non-financial risk.
- ▶ **Accountability:** Commissioner Hayne states in the Final Report that notions of accountability lie at the heart of governance and are centrally important to any consideration of culture, governance and remuneration. While there is no doubt that the roll-out of the Banking Executive Accountability Regime (**BEAR**), which came into force for the largest banks from 1 July 2018, has heightened standards of personal accountability on senior executives and directors as well as clear

consequences in the event of a material failure to meet those expectations, Commissioner Hayne emphasises the importance of ensuring that employees, at all levels of seniority, are accountable.

- ▶ **Variable remuneration:** Despite indications made by Commissioner Hayne throughout the hearings that variable remuneration was partly (or wholly) responsible for misconduct, in the Final Report, Commissioner Hayne acknowledged that there is a role for variable remuneration in reducing risks, especially non-financial risks and risk of misconduct. He focused on the importance of having an appropriate remuneration framework design and a robust and effective implementation plan for remuneration (noting that certain conduct seen in the Commission was largely due to poor implementation, rather than design).

Recommendations – Regulatory Engagement and Self-Assessment

Reflected in Commissioner Hayne's observations and recommendations about improving the corporate culture and governance in Australia's financial services industry is his belief that the way to solve the issue is not to prescribe or legislate for culture, governance or remuneration frameworks, but rather to provide effective guidance and regular assessment.

The relevant recommendations are set out at Annexure A, however, by way of summary:

- ▶ **Remuneration:** Commissioner Hayne has recommended increased supervision, guidance and supervision action from APRA on the design and implementation of institutions' remuneration framework models and has stated that as part of the revision of Prudential Standards, APRA should ensure there is greater focus on non-financial risks and reduction of risk of misconduct, requirement on boards to make regular assessments of the effectiveness of the remuneration system in encouraging sound management of non-financial risks (including, where appropriate introduction of a clawback mechanism) and improvement in quality of information provided to boards / their committees about risk management performance and remuneration decisions.
- ▶ **Culture and Governance:** Commissioner Hayne has recommended that all financial services institutions should take proper steps to assess, identify and adequately address problems with culture and governance (as often as reasonably possible). Further, he recommended that in conducting its prudential supervision of APRA regulated institutions and in revising its prudential standards and guidance, APRA should: build a supervisory program focused on building culture that will mitigate the risk of misconduct; use a risk based approach to its reviews; assess the cultural drivers of misconduct in entities; and encourage entities to give proper attention to sound management of conduct risk and improving entity governance.

The practical implications

The emphasis that Commissioner Hayne places on the regular assessment of culture and governance, both in terms of APRA supervision but more importantly, entity self-assessment, means that financial services entities will need to ensure that they have in place sophisticated frameworks to conduct rigorous and routine assessment to test the efficacy of their governance frameworks and the health of their culture.

While the Commission examined misconduct which has arisen in the Financial Services industry, its findings and recommendations have implications for corporate Australia more generally. In particular, the observations made by Commissioner Hayne about what the law demands, but perhaps increasingly importantly, what the community expects of an entity's culture, including its governance structures, the role of Boards, the accountability of its management and how they are remunerated, are matters which should be carefully considered.

GET IN TOUCH

We welcome conversations on Commissioner Hayne's report. If you wish to have your own conversation with us on the report and how it may affect you and your business, please contact us:

FinancialServicesRC@ClaytonUtz.com

You can also keep up with our rolling coverage at our dedicated Financial Services Royal Commission hub <https://www.claytonutz.com/financial-services-royal-commission/hub>.

ANNEXURE A

Topic	Recommendations
Remuneration	<p>Recommendation 5.1: In conducting prudential supervision of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should give effect to the principles, standards and guidance set out in the Financial Stability Board’s publications concerning sound compensation principles and practices.</p> <p>Recommendation 5.2: In conducting prudential supervision of the design and implementation of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should have, as one of its aims, the sound management by APRA-regulated institutions of not only financial risk but also misconduct, compliance and other non-financial risks.</p> <p>Recommendation 5.3: In revising its prudential standards and guidance about the design and implementation of remuneration systems, APRA should:</p> <ul style="list-style-type: none"> ▶ require APRA-regulated institutions to design their remuneration systems to encourage sound management of non-financial risks, and to reduce the risk of misconduct; ▶ require the board of an APRA-regulated institution (whether through its remuneration committee or otherwise) to make regular assessments of the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing the risk of misconduct; ▶ set limits on the use of financial metrics in connection with long-term variable remuneration; ▶ require APRA-regulated institutions to provide for the entity, in appropriate circumstances, to claw back remuneration that has vested; and ▶ encourage APRA-regulated institutions to improve the quality of information being provided to boards and their committees about risk management performance and remuneration decisions.
Culture and Governance	<p>Recommendation 5.6: All financial services entities should, as often as reasonably possible, take proper steps to:</p> <ul style="list-style-type: none"> ▶ assess the entity’s culture and its governance; ▶ identify any problems with that culture and

Topic	Recommendations
	<p>governance;</p> <ul style="list-style-type: none"> ▶ deal with those problems; and ▶ determine whether the changes it has made have been effective. <p>Recommendation 5.7: In conducting its prudential supervision of APRA-regulated institutions and in revising its prudential standards and guidance, APRA should:</p> <ul style="list-style-type: none"> ▶ build a supervisory program focused on building culture that will mitigate the risk of misconduct; ▶ use a risk-based approach to its reviews; ▶ assess the cultural drivers of misconduct in entities; and <p>encourage entities to give proper attention to sound management of conduct risk and improving entity governance.</p>

Sydney

Level 15

1 Bligh Street

Sydney NSW 2000

+61 2 9353 4000

Melbourne

Level 18

333 Collins Street

Melbourne VIC 3000

+61 3 9286 6000

Brisbane

Level 28

Riparian Plaza

71 Eagle Street

Brisbane QLD 4000

+61 7 3292 7000

Perth

Level 27

QV.1 Building

250 St Georges Terrace

Perth WA 6000

+61 8 9426 8000

Canberra

Level 10

NewActon Nishi

2 Phillip Law Street

Canberra ACT 2601

+61 2 6279 4000

Darwin

17–19 Lindsay Street

Darwin NT 0800

+61 8 8943 2555

Disclaimer

Clayton Utz communications are intended to provide commentary and general information. They should not be relied upon as legal advice. Formal legal advice should be sought in particular transactions or on matters of interest arising from this communication. Persons listed may not be admitted in all States and Territories.

© Clayton Utz 2019

www.claytonutz.com