

**Geoff Nunn & Associates**  
**Governance and Board Specialists**

## **Governance Update - Special Edition**

### **Banking Royal Commission - Round 7 Hearings Conclude**

*With the final report of the Banking Royal Commission just weeks away many boards will be considering their own dynamics and agenda. In this issue we focus on the final round of hearings and reported changes to executive remuneration packages.*

### **Banking Industry Royal Commission - Final Report Due 1.2.2019**

On 1 February, 2019 Royal Commissioner Kenneth Hayne, will deliver his final report into Misconduct in the Banking, Superannuation and Financial Services Industry to the Governor General. The boards and executive teams of the major financial services providers are anticipating the report with some trepidation. Recommendations which include industry restructuring and breaking up the banks have been raised. Talk of criminal charges is worrying for some.

Australian Banks are amongst the most profitable in the world and represent the largest sector of the Australian Economy.

During the last two weeks of November, 2018 Chairs and CEOs of the Banks, AMP ASIC and APRA fronted the Commission.

This is the first time the Chairs have been called to give evidence. Up to now only the CEOs and executives have taken the stand.



On Wednesday 21st November, 2018 Catherine Livingstone, Chairman of the Commonwealth Bank, looked decidedly uncomfortable as she faced off against the formidable Rowena Orr QC. When questioned about culture and tone Ms Livingstone indicated that "behavioral norms, systems and processes" all had an impact on the organi-

sation. The terms "setting" and "tone" were used in connection with organisational culture. Various directors and regulators have recently appropriated these terms into their language. This is a most curious development and displays a complete misunderstanding of the way that culture evolves.

When asked what the Board had done following the recent APRA Report (April 2018) Ms Livingstone cited board renewal, a new 'risk appetite' statement and improved interaction with the CEO. There was no indication of what board renewal actually meant and a quick check of the line-up revealed that two long serving directors, Andrew Mohl and Brian Long have now retired following this year's AGM and been replaced by the highly credible and experienced Anne Templeman-Jones.

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### **2018 Bank Remuneration Reports - Business as Usual**

Over the last two months the major Banks have released their 2018 Remuneration Reports. All have talked up the level of change in executive packages to better balance the competing interests of different stakeholder groups. But a quick review reveals that not much has changed to date. It's a tough call. The current model has become deeply embedded over the last twenty years. See tables:

It's become a hot topic at the Royal Commission hearings. Chairs and CEOs all support the current configuration from which they have done so well.

*Continued on Page 4*

CEOs	FAR	STI	LTI
	% of Total Reward	% of Total Reward	% of Total Reward
Commonwealth Bank	26.00%	26.00%	48.00%
National Australia Bank	33.00%	67.00%	
ANZ Bank	33.33%	33.33%	33.33%
Westpac Group	34.00%	34.00%	32.00%
Bendigo & Adelaide Bank	65.00%	10.00%	25.00%
Other Executives	FAR	STI	LTI
	% of Total Reward	% of Total Reward	% of Total Reward
Commonwealth Bank	26.00%	26.00%	48.00%
National Australia Bank	37.00%	63.00%	
ANZ Bank	33.33%	66.66%	
Westpac Group	34.00%	34.00%	32.00%
Bendigo & Adelaide Bank	60.00%	20.00%	20.00%

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## Banking Industry Royal Commission - Final Report Due 1.2.2019 (Continued)

*Continued from Page 1*

“CBA chairman Catherine Livingstone, who last year flagged “ongoing” board renewal at the bank announced Anne-Templeman-Jones would be appointed as a non-executive director.”



*Clancy Yates, Sydney Morning Herald, 3 March, 2018*

There was no indication from Ms Livingstone that the Board of the Commonwealth Bank might be considering some deep introspection into how their own conduct and dynamics might have been a contributing factor to the dilemma the Bank now finds itself in. Her demeanor reflected a chair under siege.

### Corporate Credibility Again in Question

Like many other chairs and CEO's Ms Livingstone has committed to oversee improvements at the Bank on a range of fronts:

“Dear Shareholders,

This has been a difficult year. Confidence in the Bank has been severely tested due to a series of conduct and compliance issues. As a result, trust in the Bank, and its reputation and standing, have been damaged.

The Board and I regret, without reservation, the Bank's failings over recent years, and apologise to all of our stakeholders for what has happened.”

*Commonwealth Bank Annual Report 2018 P4*

CEO Matt Comyn was similarly contrite and yet the underlying message remains strong:



“The work we are doing to become a simpler, better bank will deliver balanced and sustainable outcomes for all our stakeholders, and importantly, drive long-term and sustainable outperformance for you, our shareholders.”

*Commonwealth Bank Annual Report 2018 P4*

All of the major banks have made similar statements in their annual reports.

In an unusual move ASIC has “embedded” half a dozen staff at the Commonwealth Bank to oversee compliance and has plans to do the same at the ANZ, NAB, Westpac and the AMP. This sends a strong message to all stakeholders that the Regulator has little confidence in the boards and executive teams of these institutions to get their house in order. Mind you, the Regulator is not looking too good at the moment either for cutting deals and agreeing press releases with offenders.

Like David Murray and Francesco de Ferrari at the AMP the chairs and CEOs of the major banks have their work cut out for them. To restore

credibility and rebuild reputations will take some time.

### The Factory Reveals its Secret

Macquarie Bank's outgoing CEO, Nicholas Moore fared a little better than his Commonwealth colleagues under questioning. He made the point that oversight of risk and compliance had been removed from operating units several years ago to ensure greater independence. Well configured no doubt. He also talked at length about the Bank's profit share remuneration model. More about that later.

### Westpac Chairman Not Questioned

Brian Hartzer, CEO of Westpac provided extensive commentary to the Royal Commission on Wednesday 21 November, 2018. Interestingly Chairman, Lindsay Maxted was not called.

Mr Hartzer provided a balanced commentary and talked of the difficulties in managing a professional financial advice business and cited lack of training, self-interest, inadequate supervision, deliberate circumvention of systems and management system deficiencies for some of their own problems in this area.

Mr Maxted offered an extensive commentary on the Bank's response to the Royal Commission and various other inquiries in the 2018 Annual Report. He pointed out that, as quoted in the Commissions' terms of reference, the financial services sector in Australia is very strong and underpins our economy. He challenged shareholders to make their own assessment of Westpac's performance in relation to the various issues raised by the Royal Commission and assured all stakeholders of the extensive Board and Executive Team efforts to see that their house is in order.

### NAB Chairman Ken Henry Comments on Corporate Culture

On Monday 26 November, 2018 NAB Chairman, Ken Henry followed CEO Andrew Thorburn to appear. He commented that it would take 10 years to change the NAB's culture.

Corporate culture is not something that can be measured by multiple choice questionnaires. If an organisation really wants to understand its underlying culture it needs look at the way anthropologists study indigenous populations. They don't hand out questionnaires! Rather they observe and record over a long period of time and consider rituals, language, artifacts, belief structures and social mores. Think of the parallels between tribes and organisations. This is little evidence that the banks, or other corporates are considering organisation culture at a deeper level.

He argued that the regulators, in particular APRA, had a role to play in shaping corporate culture. Without doubt the regulatory environment has an influence as does the board's approach to governance.

“Orr asks him if he thinks it's appropriate or possible to prescribe particular culture for financial services entities.

Henry says it's not possible.”

## Banking Industry Royal Commission - Final Report Due 1.2.2019 (Continued)

### NAB Chair Ken Henry (Continues)



Later under intense questioning Henry's manner became combative, his demeanour reflecting a style typical of the big end of town. It bordered on flippancy and disregard for the work of the Royal Commission.

He offered little by way of reasoned explanation as to how the NAB itself found itself at the pointy end of the issues facing the Sector. Lengthy and evasive answers clearly frustrated Counsel Assisting, Rowena Orr QC and terse words were exchanged.

In a somewhat humorous moment Henry proposed having lunch with his Commonwealth Bank counterpart to put her straight on how the NAB's new executive remuneration model worked. See Page 4.

The debate about the primacy of shareholders as the main focus for boards and executive teams at the expense of customers was raised by Ms Orr. The Royal Commissioner raised Section 912A of the Corporations Act which requires all companies to act efficiently, fairly and honestly in dealing with their customers. Dr Henry conceded that this was "pretty challenging for boards really". So does their new corporate vision ring true in the light of this comment?

**"To be Australia's leading bank, trusted by customers for exceptional service."**

*NAB 2018 Corporate Governance Statement p2*

### AMP's Mike Wilkins Faces Scrutiny

You had to feel a bit for Mike Wilkins as he was questioned by Michael Hodge QC. Mr Wilkins was appointed acting Chair following the sudden departure of Catherine Brenner in April, 2018 and acting CEO in June when David Murray took over as Chair. He was not involved in the executive leadership of the AMP when the alleged breaches took place.

He conceded that Financial Planners for the big banks, insurers and wealth managers were effectively a distribution channel for their employing organisation's financial products. In theory this ceased with the Future of Financial Advice Reforms in 2012 however disclosures cast considerable doubt on this.

He discussed ongoing negotiations with ASIC over remediation for the application of changes to customers that have become known as "fee for no service" and advised that the AMP has 150 staff working on this. But that refunds were unlikely to occur for 3 years.

Swiss-Italian Banker, Francesco De Ferrari commences as AMP CEO on 30.11.2018. Along with Mr Murray he will face considerable challenges.



"I'm confident we can earn back trust which will underpin the recovery of business performance."

*Francesco Di Ferrari  
finews.com 28.8.2018*

### ANZ's Chair Nowhere in Sight

Like Westpac's Lindsay Maxted, David Gonski seems to have escaped being called by the Royal Commission. However, these is a good dose of authenticity in his Chairman's Message in the 2018 Annual Report:

"The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has been confronting for all of us at ANZ, including the Board. We are unanimous in our resolve to build a company of which we and all of our stakeholders can be proud.

We recognise this has not been the case in the last decade and that we have failed in some circumstances to do the right thing and to keep the needs of our customers as our priority."

*ANZ 2018 Annual Report, p 7*

Throughout the Royal Commission CEO Shayne Elliot has been relatively open about the Bank's failings. When he spoke at the Centre for Ethical Leadership on 28 June this year he received wide acclaim for his preparedness to speak earnestly about the ethical issues confronting bank leadership.

He did not however escape unscathed. Rowena Orr produced an ANZ internal document asserting that remediation for breaches by the Bank was not a priority. It was seen as a distraction from the real game of earning revenue. In response the ABC's Michael Janda posted a classic line from *Gone With the Wind*: "Frankly my dear, I don't give a damn."

In perhaps the most intense discussion to date the Commission reviewed the ANZ's executive remuneration practices in some detail. However, they skirted the key issue of whether the fundamental principles were sound.

Mr Elliott was followed by Bendigo & Adelaide Bank Chairman, Robert Johanson, who sought to differentiate his Bank of the grounds of community commitment, executive remuneration structuring and long term strategic thinking:

"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."

*29.11.2018*

## 2018 Bank Remuneration - - Business as Usual (Continued)

Continued from Page 1

Movement to an all fixed model has been discussed at Commission hearings and rejected by the Banks. One commentator suggested that innovation would dry up if the banks removed the variable component. We're not sure what our scientific community would make of this.

All of the major banks have continued with a high proportion of "At Risk" variable remuneration based on a range of KPIs.

### Primary Model Remains - But Are its Days Numbered?

On Page 1 we described the remuneration model as it appears in the 2018 Remuneration Reports of the Big 4 plus the Bendigo and Adelaide Banks. The AMP model is similar. The Big 4 have argued that a level of re-balancing has occurred during 2018 in response to the Royal Commission's interim findings. However it isn't much in evidence from the 2018 reports. The following STI and LTI analyses indicate the break-up of financial versus non-financial KPIs driving the model:

#### Short Term Incentives (STIs)

Individual performance is factored into all STP Plans but the relative

Bank	Financial Drivers	Non-Financial Drivers
	% of Total	% of Total
Commonwealth Bank	60.00%	40.00%
NAB (Combined with LTI)	75.00%	25.00%
ANZ Bank	50.00%	50.00%
Westpac Group	60.00%	40.00%
Bendigo & Adelaide Bank	Not Disclosed	Not Disclosed

weighting of corporate versus individual is not usually disclosed. Most STIs are delivered by a combination of cash and deferred equity.

#### Long Term Incentives (LTIs)

Again the heavy focus on TSR and CAGR as the primary drivers of LTIs

Bank	Financial Drivers	Non-Financial Drivers
	% of Total	% of Total
Commonwealth Bank	75.00%	25.00%
NAB (Combined with STI)	75.00%	25.00%
ANZ Bank	100.00%	0.00%
Westpac Group	100.00%	0.00%
Bendigo & Adelaide Bank	100.00%	Customer Hurdle

remains. The Commonwealth Bank has includes two non-financial measures in its LTI Plan: Trust and Reputation and Employee Engagement.

The NAB's has combined its STI and LTI Plans as indicated on Page 1. They are shown separately here for ease of reporting only. The non-financial component relates to "Transformation". A combined NPS and productivity measure. Dr Henry made much of the NAB's new model at the Royal Commission hearing on 27/11. We remain unconvinced.

The ANZ has a combined approach for Executives other than the CEO.

All LTI are delivered in equity which vests over a 3-5 year period.

### Minimum/Mandatory Shareholding Requirements (MSR)

Bank	CEO	Other Executives
	% of FR	% of FR
Commonwealth Bank	300.00%	200.00%
National Australia Bank	200.00%	100.00%
ANZ Bank	200.00%	200.00%
Westpac Group	500.00%	\$1.2m
Bendigo & Adelaide Bank	Not Disclosed	

The Big 4 have minimum/mandatory executive shareholding requirements for their CEOs and executive teams. These are designed to further align the interests of executives with those of shareholders. We've been arguing for some time that this creates a potential conflict of interest when it comes to independent and balanced decision making. Very little mention has been made of the fact that most NEDs in the big banks are also required to accumulate one year's board fees in equity in the employing organisation.

#### The Macquarie Model?

During the Royal Commission hearing on Wednesday 23.11.2018 Nicholas Moore, CEO of the Macquarie Group talked up the Bank's executive remuneration model. Which is essentially a profit share scheme from which Mr Moore did very well in 2017/2018 with earnings of around \$19.0m of which \$4.5m is immediately available and \$14.5m to be delivered at a future date.

Royal Commissioner Hayne was interested in the Macquarie model and was perhaps wondering if it might be applicable to the Big 4. Macquarie is primarily an investment bank and makes a significant proportion of its profit from doing deals and making infrastructure investments. It does not have the retail and community focus of the Big 4.

#### APRA Weighs In To the Debate

APRA Chairman, Wayne Bryes took the stand on 29 November, 2018. The Regulator has oversight of executive remuneration in the financial services sector. He noted that in the UK the APRA equivalent monitored individual finance executive remuneration outcomes. Overkill perhaps! However he did flag the need for a re-alignment:

"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 executive team is clearly more than those two things."

The same day the Australian Council of Superannuation Investors CEO weighed into the debate:

"This idea has emerged that at risk pay is not really at risk - if that's the case then make it part of fixed pay."

Age 30 November, 2018 p10

## 2018 Bank Remuneration Reports - Business as Usual (Continued)

### Back to Basics?

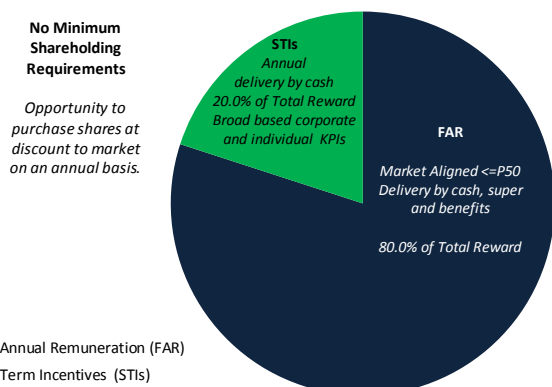
For some time we've been arguing that the Banks, and other corporate organisations, need to abandon the current model of executive remuneration, with its heavy focus on financial metrics and equity participation and go back to basics.

Elaborate equity based models are not required and most executives would be happy to work within the framework outlined below.

We are not arguing that the overall quantum of executive remuneration should be reduced. This may be a desirable outcome from a community perspective but it is not our primary focus.

### An Alternative Model

This model is in place in many highly successful organisations. Whether or not the STI component is included is open to debate.



In this chart readers will note the suggested positioning of Fixed Annual Remuneration at or below Percentile 50. Positioning below Percentile 50 will bring the market back over time if enough organisations adopt this approach.

The question of whether to retain a modest STI Plan is an interesting one. There is a case for a modest Plan in commercially focused organisations. However it should not be of such magnitude as to compromise ethical decision making.

Performance against broadly based corporate KPIs can be rewarded, together with individual measures, either via an STI or the annual fixed remuneration review process. Whichever model is preferred the corporate KPI weighting might be (as adapted to each organisation).

Measure	Weighting
1. Key Financial Metrics	25.0%
2. Customer Performance Ratings	25.0%
3. Community & Stakeholder Engagement	25.0%
4. Regulatory Compliance	12.5%
5. Employee Retention	12.5%

To move to this model will require organisations to “cash out”, in full or in part, existing STI and LTI opportunity and roll an amount into Fixed Annual Remuneration. In making this decision remuneration committees will need to consider:

- The level of STI and LTI awarded over the past 3 years.
- Whether this level of award was justifiable given the finding of the Royal Commission.
- Where any revised package sits relative to the market.
- How the revised package will be received by stakeholders.

Our intuitive nose says around 50%. In making such a structural changes there is a need to work closely with the Remuneration Committee, CEO and Executive Team from a behavioural perspective to ensure positive outcomes are achieved.

Breaking the direct equity nexus with executive remuneration will require skilful stakeholder engagement with institutional investors, shareholders and regulators.

### Remuneration Strategy Issues

Boards and Remuneration Committees need to consider the findings of the Royal Commission (to date) and seek to re-balance their executive remuneration strategy in a way that fosters the interest of all stakeholder groups.

The pursuit of financial returns, positive customer outcomes, presence in the community and maintenance of good stakeholder relations are core accountabilities for executives in many industry sectors.

Individual performance must be a factor in the model and how this is best assessed remains contentious. Most of the Big 4 have balanced executive KPIs which make provision for the imperatives of the business unit which the executive manages. This makes good sense but needs to be tempered by sound judgement and not administered in an overly mechanistic way.

The prospect of real change in corporate sector behaviour while the current model of executive remuneration remains in place is slim. It's best described as an artefact of a broken system. This has been demonstrated by the findings of the Royal Commission and it may take a strong recommendation in the Final Report to change thinking. The challenge for Boards and Remuneration Committees is to take this opportunity and move ahead now with considered reform.



Significant Mandatory Shareholding Requirements?

## Banking Royal Commission—Concluding Comments

We'd like to wrap up with some overall comments about the final round of Royal Commission hearings and findings to date. This quote from the Royal Commissioner's Interim Report (28 September, 2018) goes to the heart of the matter:

"One simple, but telling observation informs these 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*



Dr Henry recognised this governance dilemma when he appeared before the Royal Commission on 26 and 27 November, 2018. How do boards effectively balance the drive for shareholder returns with the needs of customers and other stakeholders? It goes right to the core of our way of doing business. The looks of concern on the chairs and CEOs faces at the Commission's hearings reflect this dilemma. It's all about a significant clash of paradigms

Until very recently the major financial institutions received great accolades for delivering outstanding shareholder returns. This is what the market wanted. This is what investors wanted. Everybody was happy (*well clearly not everybody*)!

Then, all of a sudden, the Royal Commission looms. It finds that these healthy returns have been achieved, at least in part, in a manner that challenges the legislated requirement to act fairly, honestly and efficiently. Significantly below community expectations and, at times, in breach of the law and regulatory requirements. Intense competition has caused boards and executive teams to overlook ethical issues in favour of shareholder returns. Complex structures, systems and processes support and sustain this imperative. Management and staff receive intense training to on-sell and cross-sell products. As Shayne Elliott acknowledged, maximising revenue is the name of the game.

So, what comes next? Are deals being done behind the scenes? Are the banks and major corporates too powerful to touch? Can they really carry-on with business as usual by issuing a few carefully crafted messages in their annual reports?

The Royal Commission's findings to date provide boards and executive teams across all sectors with a unique, once in a decade, opportunity to get their house in order. They won't do it by issuing messages about customer primacy and balancing the interests of all stakeholders. A sceptical media and public just won't buy it. Mechanistic models and tinkering around the edges won't make much difference. Increased regulation will just add to an already overburdened system.

The deep reflection required to chart a new course has not been much in evidence to date. It takes courage to lift the lid on boardroom dynamics and examine what's really going on. Shared assumptions can look a little shallow under a powerful spotlight, as we've seen during the Royal Commission hearings.



Final Report due 1.2.2019.

## 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. Projects have been completed in over 1000 organisations across Australia, New Zealand and Singapore.

## Our Services

- Board Advisory Services
- Board Governance Advice
- Facilitated Boardroom Dialogue
- Focused Board Renewal
- Board & Committee Charters
- Board and Executive Remuneration Strategy Advice

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