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Geoff Nunn & Associates - Governance and Board Specialists

Governance Update

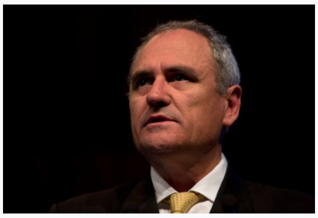
Corporate Governance - Have We Reached a Turning Point?

The Final Round of the Banking Industry Royal Commission concluded on 30 November 2018. Fundamental questions regarding the nature of the corporation and its role in society were raised. Could the final report, due 1.2.2019, herald a fundamental shift in governance?

A Fundamental Shift in Governance Perspective?

It was NAB Chairman Dr Ken Henry, who spoke the words that everyone knew but were reluctant to hear. The purpose of the corporation was to maximize profits for shareholders regardless of the impact on other stakeholders:

"The capitalist model is that businesses have no responsibility other than to maximize profit for shareholders."



NAB Chairman Ken Henry 27.11.2018

The notion of shareholder primacy has been the subject of debate for many years. There are frameworks to safeguard the interests of customers and other stakeholders although their effectiveness is sometimes questionable. But it's a fine balancing act for boards. Shareholders, particularly institutional investors, can be demanding.

A fundamental shift seems to be occurring in governance. For the first time in a generation boards, regulators, governments and others are beginning to question our underlying model of doing business.

NAB CEO, Andrew Thorburn said on 26.11.2018 "We never had a purpose! Now we do." This quote from the 2018 NAB Governance Report summarises:

"In 2018, we have continued our long-term, proactive approach to creating a governance culture that values our customers, promotes ethical and responsible behaviour, and contributes to sustainable value creation for our shareholders." *Credible? Time will tell.*

The next 12 months is going to be challenging for the boards of some corporates. With the Royal Commissioner's final report just around the corner there's much speculation about content and impact.

Proactive boards won't wait for the report. Some would be wise to have a look to recent developments in the UK which seems to be ahead of Australia in this regard. The Financial Reporting Council (equivalent to APRA) released a new Corporate Governance Code in July, 2018. It emphasises the role of the corporation in the community and their relationship with a wide range of stakeholders.

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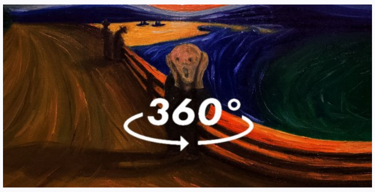
A Short Story About Congruence in the Banking Sector

Corporate culture has been much discussed lately as a boardroom imperative. Boards need to get busy. If there are negatives fix them pronto. To understand culture we need to be present and open to listening. What gets measured by questionnaires has little depth. To really understand culture imagine someone asked you to do a painting or write a short story about what it was like to work at Sonic Sounds Ltd: Could it be like this?



Some years ago I worked on a forced merger in the banking sector. The acquiring organisation endeavored to impose its culture and values on the acquired by circulating hard copy pamphlets, delivering slick presentations and introducing structural constraints. What was imposed was the antithesis of the way the acquired organisation worked as a highly innovative investment bank. At their end of year gathering the MD of the acquired organisation made a statement to staff: "We're now part of the WTF Banking Group. You've all got your vision and values statements. I'd like you to place them in an appropriate place so you can study them in privacy while you're sitting down."

In this statement the MD captured the essence of congruence. This MD understood what underpinned the culture of the Bank. It's underlyinmg ethos was intensely controlling, compliant, impersonal and totally alien to an investment bank which flourished on entrepreneurship, teamwork, innovation and creative ideas.

The new Investment Banking Division of WTF was totally stifled and quickly died.

UK FRC Corporate Governance Code 2018

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Emphasis on Purpose and Stakeholder Relations

The UK code places emphasis on purpose:

"A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society."

UK Governance Code 2018 p 4

The notion of core purpose is well established in government owned businesses in Australia and usually captured in their *Statements of Corporate Intent*. However, it's only just beginning to emerge in commercial corporations.

As mentioned on Page 1 the Banking Royal Commission has again raised the question of shareholder primacy. Many have pointed out the *Corporations Act 2001* does not specifically state that companies must put the interests of shareholders ahead of other stakeholders. However, various legal cases have held this to be fact. The Royal Commission brought home the question of whether sufficient attention is paid to the interests of other stakeholder groups such as customers, suppliers, distributors, employees, the environment, communities and governments.

Market operators understand the drive to optimise returns. The notion of the free market is based on the assumption that capital will move to the location where the best return is achieved. Fund Managers, including Super Funds, are in the business of doing exactly this. This investment, together with the shares held by retail investors, provides the organisation's capital base and shareholders demand the best return achievable. Being listed on the ASX, sends a powerful message to boards and executive teams and presents a great challenge: *striking the right balance?*

ASX Governance Principals and Recommendations

In June this year the Australian Stock Exchange (ASX) released a discussion draft of the fourth edition of its Corporate Governance Principals and Recommendations. It has been proposed to change the title of Principle 3 from "Act Ethically and Responsibly" to "Instil the Desired Culture"!

The proposed change talks extensively about an organisation's social licence to operate:

"Preserving an entity's social licence to operate requires the board and management of a listed entity to have regard to the views and interests of a broader range of stakeholders than just its security holders, including employees, customers, suppliers, creditors, regulators, consumers, taxpayers and the local communities in which it operates."

To date the ASX has received around 100 submissions in relation to the exposure draft. Principal 3 has given rise to a stark polarization of views. Support for the Principal has come from some surprising quarters including AMP Capital. However many have argued against it including the AICD's own former CEO, John Colvin:

"There is no place, in our view, for a concept like "social licence" in the Principles which acts as a quasi-legal document and which regulates (on an if not, why not basis) for listed entities on the ASX."

Boardwalk Consultancy Submission 3.8.2018

Interestingly for the AMP:

"AMP Capital is supportive of the re-wording of Principle 3 to a 'listed entity should instil and continually reinforce a culture of acting lawfully, ethically and in a socially responsible manner.'"

AMP Capital Submission July 2018

This debate is likely to rage for some time before a landing place is found. Whilst we support the notion that social licence must be earned, the thought that a board might be able to instill a particular culture is problematic for the reasons discussed on Page 3. Interestingly support for the proposed change came in the form of an article commissioned by the AICD Governance Leadership Centre (CGC) by Professor Bryan Horrigan, Dean, Faculty of Law at Monash University: The Changing Landscape for Corporate Governance and Responsibility. In the face of criticism he states: "The ASX CGC should hold its nerve."

Bolt-On Solutions?

In Australia we have a tendency to bolt partial solutions onto existing frameworks. A new clause in the Corporations Act, a new APRA Regulation or a change to the wording of the ASX Principals (as discussed above). We might even set up a new regulatory body to work along side our already complex array of regulators and ombudsmen.

Seldom do we go back to basics and have a good look at what we're really trying to achieve. It takes time and effort to do this. We don't mean that boards and other governance bodies should forget prior learning and dismantle good structures. But when there are deep systemic issues, such as those we face in governance today, we need a fresh perspective. The problems uncovered by the Royal Commission are not limited to the financial services organisations. They require new thinking to in order to move forward.

Re-Defining Corporate Governance

A Fresh Perspective

Any review of the literature on corporate governance will confirm the role of the board is to oversight financial viability, corporate strategy, business risk, compliance and manage the relationship with the CEO. The AICD Company Director's Course curriculum sets this out clearly and anyone who has tried to wade through the 500 page *Australian Corporations Act 2001* will understand the all pervading legalistic environment. Just consider this definition:

"Corporate governance can be defined as the framework of rules, relationships, processes and systems within and by which authority is exercised and controlled in organisations."

Directors Tools—The Role of the Board AICD 2016 p3

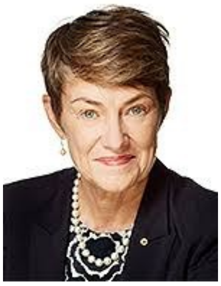
Definitions like this create a narrow world view. One that is tightly prescribed with very clear boundaries. As discussed earlier the term corporate culture has begun to appear in director literature. But again the mechanistic overlay on how culture is defined and "measured" inhibits meaningful conversation.

Boardroom Language as a Prison System

In her introduction to a recent AICD publication Chairman, Elizabeth Proust captures the problem in her forward:

"At a time when directors face increasing expectations in relation to their responsibility for setting organisational culture and building trust, the importance of using words which align intent and impact is critically important."

Muth M. and Seldon B. Setting the Tone From the Top. AICD 2018 p ix



The language used by Ms Proust is somewhat troubling. It is a bit like the board can pull a few levers and culture will change as a result. Just find the right levers. But this might be more challenging than it seems at first glance.

Whilst there is a separation of the board from the executive team and staff, they are all parts of the same organism. The underlying connection is non-linear and coterminous.[1] In complex organisations there are many domains: "a series of micro-cultures".[2] What occurs in the boardroom affects them differently. Somehow there is an assumption that a unitary ethos is achievable and even desirable. As mentioned on Page 1 what might be appropriate for a retail and corporate banking organisation might be inappropriate in an investment bank or stockbroker (and vice versa).

1. *Acknowledgement, B. Alan Wallace, Philosopher and Scholar.*
2. *Submission to the Royal Commission, Dr Kym Sheehan, Sydney Law School 22.10.2018*

Toward A Different View

What if we were to seek a new way of defining corporate governance? The term itself imposes its own limitations. However, a wise heart in the boardroom readily transcends structural encasements. As mentioned on Page 1 we might be on the cusp of something new. Something that continues to emerge. There is a polarisation of views.

Some are clinging to the present and talking about more regulation, tightening up board reporting, director induction and even improved minute taking. As if we don't know about these things already! Some think board renewal is about finding new directors. Over-boarding is about getting rid of old ones.

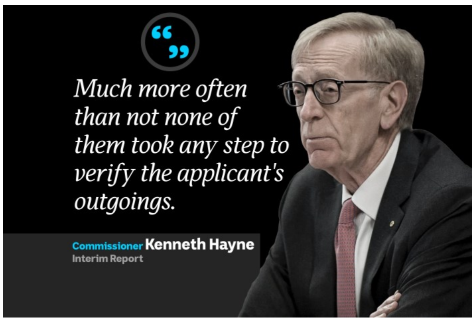
But there are others who are beginning to see things a little differently. Directors who want to be present and visible across their stakeholder base. Who reflect on how their decisions impact the communities in which they operate. In other words; redefining board purpose. Perhaps something like this:

"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."

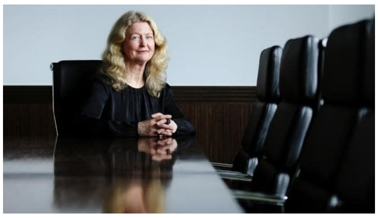
In this way we move beyond current legalistic definitions of governance to one that opens up possibilities. We can't avoid the legal obligations but introducing new terminology would be a positive step. The language we use prescribes the limits to our thinking. If we change the language, even a little, we shift meaning. But it can't be superficial, or more of the same. It will be interesting to see who steps forward to challenge the orthodoxy of corporate governance when the Royal Commission's report is released in 1 February!



Royal Commission Ramblings

1. Edward Lawler talks about “Stakeholder Alignment” in his 2016 paper with Susan Mohman; *Corporate Stewardship, Achieving Sustainable Effectiveness.* Is this a fanciful notion in a competitive marketplace where corporations struggle to attract investors and vie for the consumer dollar? It will take a different world view to achieve that as an outcome. Many banks have issued messages to this effect in their 2018 annual reports. Some commentators remain unconvinced.

2. In response to questions raised by the Royal Commission Australian Shareholders Association CEO, Judith Fox noted that:



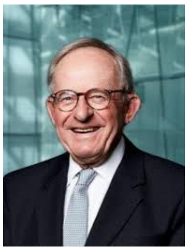
“Given that many question whether the law and community expectations sufficiently coincide, there is strength to the argument that only a change to director’s duties will ensure that alignment. An amendment could be introduced to section 181 of the Act which would permit directors to have regard to the interests of stakeholders other than shareholders.”

Judith Fox, CEO ASA Company Director Dec. 2018/Jan. 2018 p 67

We were initially troubled by this quote from Judith Fox . Did we really need to change the *Corporations Act 2001* to enable directors to consider the interests of a broad range of stakeholders? Maybe she is right. This could be what it takes!

But again the legalistic language was concerning. Directors already have the authority they need to act in the interests of all stakeholders. They don’t need “permission”!

3. In response to the Royal Commission some have called for a cut in director fees in the major banks. Former Origin and Macquarie Bank Chairman Kevin McCann made this comment:



“Another issue is the workload of directors in financial institutions. In present circumstances, directors face a much broader range of responsibilities while banks work to implement programs to deal with issues the Royal Commissioner has identified. Cutting (directors) fees is not the way to go. Directors need to be paid to reflect the workload they have undertaken. If the directors of financial institutions are required to sit on fewer boards they need to be compensated for the additional work they have taken on their bank boards.

Kevin McCann, Former Chair Origin Energy and Macquarie Bank, Company Director Dec./Jan. 2018 p 67

We do not support an increase in fees for Bank Directors. They are already well paid. It makes no sense to pay them more for working on governance issues that occurred on their watch.

So What Happens Next

Between now and 1 February, 2019 Royal Commissioner Hayne and his team will compile their final report and recommendations for the Governor General. It’s a fine balancing act. Many of us, either directly or through our super funds, hold shares in the major banks. We’ve already lost a lot of money. Any move by the Royal Commissioner to re-structure the industry might spook the market causing further losses which many retirees can ill afford.

On 19 December, 2018 an aggrieved shareholder confronted NAB Chairman, Ken Henry with this statement:

“You have destroyed billions and billions of shareholder value. You’re the unacceptable face of capitalism.”

NAB Shareholder, Chris Schott at the NAB AGM 19.12.2018

The NAB 2018 Remuneration Report received a staggering 88.1% “no vote” at the AGM. A record in Australian corporate history. Mostly for reasons other than ones we would argue. But a strong rebuke none-the-less. Three of the Big 4 scored a first strike as did the AMP in 2018. Board credibility is not looking too good. It’s tempting to quote Jeremy Clarkson of Top Gear fame when said of various dud car models: “What were they thinking!”. The concern is that institutional investors will force the NAB, and other major banks, to do more of the same; stiffen the financial KPIs and keep the same underling incentive model. It will be an interesting debate. As we’ve been arguing for some time, if boards really want to balance the interests of all stakeholders they need to consider whether the continuance of equity based incentives is appropriate.

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, New Zealand and Singapore.

Our Services

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

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