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Geoff Nunn & Associates
Governance and Board Specialists

Royal Commission Uncovers Serious Failures of Corporate Governance

Geoff Nunn & Associates - A New Direction

On the 31 December, 2016 Geoff Nunn & Associates (GNA) officially closed for day to day remuneration services. We continued to offer high level board and executive remuneration strategy advice on a limited basis. Visions of semi-retirement did not eventuate.

The bulk of the GNA business was taken on by the National Remuneration Centre (now InsightPay). Mark Chillcott and Laurie Wood offer very high standard remuneration services to the corporate and government organisations.

Since that time a new field of endeavor has emerged. One that builds on the 25 years spent working with boards, CEOs and executive teams and that involves the provision of specialised corporate governance advice. We offer:

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

See: www.gna.net.au

The bulk of this work is structural and provides the basis of for sound governance practice. We are very fortunate to have a well established affiliation with Australia's Leading Board Dynamics and Transition Specialist, Di Percy.

See: www.dipercy.com

Good governance goes beyond structure. How directors interact, resolve differences, make decisions, follow ethical practices and develop strategy all impact on organisational performance.

We can offer support to corporate and government organisations to ensure good governance practice. Drop us an email if you want to meet or talk on the phone:

Email: gtnunn@gna.net.au

Revelations from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry continue to shock the community*

The Royal Commission *into Misconduct in the Banking, Superannuation and Financial Services Industry* in Australia has uncovered, and continues to uncover, a litany of corporate transgressions that have shocked the community. The pursuit of profit at the expense of key stakeholder groups, primarily customers, appears to be widespread. The boards and executive teams of many major financial corporates are in damage control and public trust in these institutions has been seriously eroded. Heads are rolling and some directors and executives face the prospect of criminal prosecution. Many company directors are squirming in their board room chairs. They are ultimately accountable for these failures.

Nearly every day we hear about yet another corporate transgression. Be it the provision of poor quality financial planning advice resulting in the loss of an individual's retirement savings or market manipulation by our major financial institutions. The Royal Commission recently uncovered transgressions by the AMP including 'fee for no service', interference with external legal advice and misleading reporting to the regulator. Commonwealth Bank staff were found to have meddled with school children's savings accounts in order to meet performance targets and qualify for incentive payments.

These transgressions promise to be the tip of the iceberg as various inquiries and regulators probe into what has become a pervasive norm in corporate culture: The pursuit of sales and profit at all costs without due regard for the impact on various stakeholder groups. The standard of business ethics in some sectors in Australia appears to have sunk to an all-time low.

Revelations from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry continue to shock the community (continued)*

Two recently released reports into the Australian Retail Banking and Mortgage Broking Sectors have recommended reduction or removal of performance based incentives from the remuneration packages of staff involved in the provision of front line service and advice to customers. The findings indicate that financial incentives might be encouraging sales staff to behave in ways that are not always in the best interests of the customer. That is, promoting products and services that the customer doesn't need, don't fit well or cannot afford. Some Financial Planners have been described as little more than sales people for their company's products.

A similar argument can be made that the structure of executive remuneration in our major corporates is reinforcing behaviour that may not always be in the best interests of all stakeholder groups; in particular, customers, suppliers, employees, the environment and the community .

This phenomena is not limited to the Financial Services Sector. It is widespread across a range of industry sectors. We expect a little bit of argy-bargy in the highly competitive business world. But sustained negative corporate behaviour is unacceptable and does not accord with community expectations. Boards need to set a high standard when it comes to corporate ethics.

The 2009 Productivity Commission Review into Executive Remuneration in Australia

In December 2009 the Productivity Commission released its long awaited report into Executive Remuneration in Australia. In the wake of the GFC there was widespread government and community concern that contemporary executive remuneration practices, particularly in the United States, United Kingdom, Europe, Australia and other developed economies, had been a contributing factor in the 2008 financial collapse. This concern covered both the quantum and structure of executive remuneration. Not only had the level of executive remuneration been rising at a significantly higher rate than average weekly earnings for the past 20 years but many believed that the structure of performance based incentive plans was encouraging short termism and excessive risk taking.

In undertaking its review the Productivity Commission was asked to consider trends in executive remuneration both in Australia and internationally including fixed remuneration, short and long term incentive plans, equity based incentive plans, and the relationship between remuneration and corporate performance. It was also asked to examine the effectiveness of the existing governance framework regarding executive remuneration for disclosing entities in Australia.

The 520 page report provided an extensive analysis of executive remuneration trends and practices in Australia and overseas. In compiling its report the Productivity Commission considered submissions from companies, remuneration consultants, professional associations, proxy advisors, trade unions, academics and members of the general public. It also conducted a number of public forums and considered input from roundtable discussions of Chairs and CEOs.

The report proposed a range of measures to strengthen corporate governance requirements around executive remuneration. These measures will be well known to most readers and resulted in subsequent changes to the Corporations Act. The report did not recommend any fundamental changes to the way executive reward is structured in Australia. And for executives in the top listed companies this structure is usually via a combination of Fixed Annual Remuneration (FAR), Short Term Incentives (STIs) and Long Term Incentives (LTIs) as illustrated in the following:

Fixed Annual Remuneration	Short Term Incentives	Long Term Incentives
Job Evaluated and Market Aligned Progression via Individual Performance	Combination of Annual Corporate & Individual Performance	Strategic Long Term Corporate Performance
30% to 40% of Total Reward	*30% to 40% of Total Reward*	*30% to 40% of Total Reward*

The Structure of Executive Remuneration and the Corporations Act 2001

In broad terms the larger the company, as measured by revenue and market capitalisation, the greater the 'At Risk' component in the executive's remuneration package. The Key Performance Indicators (KPIs) which drive STI and LTI schemes are generally aimed at 'aligning' the interests of executives and shareholders. Retail and institution shareholders are primarily focused on financial returns. Thus the emphasis measures such as Net Profit After Tax (NPAT), Total Shareholder Returns (TSR), and Growth in Share Price. Sections 180-184 *Corporations Act 2001 (Cth)* enshrine in legislation that directors must act in the interests of the corporation (meaning shareholders).

There is nothing in the Corporations Act that precludes directors from considering the interests of other stakeholder groups, such as employees, customers, suppliers, communities, the environment and governments in their decision making. This is just plain good governance. Many corporations have statements in their annual reports and on their websites emphasising the importance of these groups to their ongoing operations and outlining their credentials as responsible corporate citizens. However, the lived experience of customers, suppliers and other stakeholder is often vastly different from the promise made in these carefully crafted messages.

In the UK the Companies Act 2006, Section 172 was amended in 2008 to read:

"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:

Revelations from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry continue to shock the community (continued)*

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 between members of the company."

This wording remains contentious with some asserting that it raises more questions than it answers. Explanatory guidelines have been issued. However the intent is clear.

Various inquiries in Australian have held that the current wording of the *Australian Corporations Act 2001* is adequate to enable directors to consider the interests of all stakeholder groups. However, this may again be cast into doubt by the Financial Services Royal Commission.

<u>Corporate KPIs Driving Executive STI and LTI Plans</u>

When it comes to Executive STI and LTI Plans the Key Performance Indicators (KPIs) driving these plans are usually heavily weighted toward financial performance:

Some STI Drivers typically include:

- Earnings Before Interest and Tax (EBIT)
- Net Profit After Tax (NPAT)
- Gross Revenue/Turnover
- Total Operating Costs
- Opex/Capex Targets

Many companies also include measures related to staff retention, diversity, safety, environmental performance, customer and community relations in their executive STI Plans. Although the relative weighting is usually fairly low when compared to financial measures.

LTI Drivers typically include:

- Total Shareholder Return (TSR)
- Earning Per Share (EPS)
- Return on Investment (ROI)
- Compound Annual Growth Rate (CAGR)

Non-financial KPIs are seldom used to drive LTI Plans.

These KPIs provide useful measures of corporate financial performance. All informed shareholders, particularly institutional shareholders, will be keen to follow their performance in relation to their portfolio. However their heavy weighting in relation to executive STI and LTI Plans may be a cause for concern from a Corporate Social Responsibility (CSR) perspective. If financial KPIs make up a significant percentage of the weighting in an executive LTI Plan what message does this send to executives? And what message does the executive, in turn, send to the rest of the organisation.

Some listed corporations have "minimum executive shareholder requirements". That is, the executive is required to hold a minimum level of equity in the employing organisation. The equity is usually accumulated via STI and LTI Plans. In the case of the Westpac CEO this is 500% of Fixed Annual Remuneration or approximately $13.5m. This is another tool to align the financial interests of executives with those of shareholders. But the notion of tying up a significant portion of an executive's personal wealth with the employing organisation creates the potential for self-serving behaviour. One might ask whether it creates a potential conflict of interest when it comes to impartial decision making.

Some key questions for Boards, Remuneration Committees and Heads of People & Culture might consider when formulating their executive remuneration strategies:

1. Is the heavy weighting attached to financial metrics in executive STI and LTI Plans influencing corporate behaviour which has the potential to negatively impact on some key stakeholder groups?
2. Does the trickle-down effect of corporate financial KPIs to other groups have potentially negative implications for stakeholders? In particular, commercial managers, sales managers, front line banking staff, key account managers, business development executives, financial planners, stock brokers and other market traders, particularly where a high proportion of remuneration is at risk?
3. Is there any evidence to suggest that decoupling, or reducing the weighting, of corporate financial KPIs in executive remuneration (and remuneration for other groups of employees) will have a negative impact on financial and other aspects of corporate performance?

It is vital that the interests of shareholders be at the forefront of director and executive thinking. Share ownership carries risk and a fair return is a reasonable expectation. And most boards and executive teams work very hard to deliver these returns.

However, we ask whether the heavy weighting attached to financial KPIs in executive remuneration plans is linked to cases of questionable corporate behaviour? Is it one of a number of factors leading some corporations and executives to neglect, or place a low value, on their responsibilities to other stakeholder groups. Especially when the executive's STI and LTI payments and their personal wealth are linked to financial results.

From a corporate culture perspective the real message coming down from Boards and Executive Teams might be about maximising profit whilst maintaining a show of concern for other stakeholder groups.

Human resource and organisation development practitioners are well aware that corporate culture is not something that is set by directive. It evolves through a complex process of conscious and unconscious messages that flow in all directions within the organisation. It is influenced by sector, markets, regulatory environment, leadership behaviour and significant events in the organisation's history.

Revelations from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry continue to shock the community (continued)*

Current executive remuneration models are based on the notion that positive re-enforcement through reward systems will result in continuous improvements in corporate and executive performance, however it is measured. Media Commentator and Editor, Dan Pink *(Drive, Cannongate, 2009 p 50)* argues that setting focused performance measures attached to substantial reward may have an adverse effect on certain aspects of performance:

“Like all extrinsic motivators, goals narrow our focus. That’s one reason they’re effective; they concentrate the mind. For complex or conceptual tasks offering a reward can blinker the wide-ranging thinking necessary to come up with an innovative solution. Likewise, 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. As a cadre of business school professors write: ‘Substantial evidence demonstrates that in addition to motivating constructive effort, goal setting can induce unethical behaviours.’”

In an interesting article in the Harvard Business Review in February 2016, Professor Dan Cable and Associate Professor Freek Vermeulen of the London Business School argue for the abolition of performance based remuneration for executives.

Two quotes are particularly relevant:

“As the incoming Chief Executive of Deutsche Bank, John Cryan, recently said in an interview: ‘I have no idea why I was offered a contract with a bonus in it because I promise you I will not work any harder or any less hard in any year, in any day because someone is going to pay me more or less.’“

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“We (Cable and Vermeulen) argue in favour of abolishing pay-for-performance for top managers altogether. We propose that, instead, most firms should pay their top executives a fixed salary. *Note:* We are not arguing that top managers such as CEOs should be paid less. That may very well be the case too, but that’s not the focus of our analysis. Here, we are merely arguing that regardless of the size of a top manager’s pay package, it should be fixed salary, rather than a variable amount of money dependent on performance criteria.”

Stop Paying Executive for Performance HBR Feb, 2016

There is no evidence that executives in organisations that have a high at risk component as part of their executive reward system, perform better than their counterparts in other organisations that have moderate levels or no at risk reward. This notion holds true for listed, private and government owned corporations. Many papers have been written on this subject.

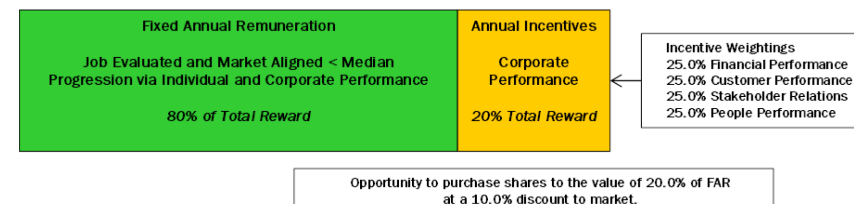
We are not arguing for a complete de-coupling of corporate and individual performance from executive remuneration. Rather we suggest that boards and remuneration committees consider whether the existing FAR, STI and LTI model, where there is high proportion at risk driven primarily by financial performance, is the best approach for remuneration of executives in Australia and whether the interests of all stakeholder groups are best served by this model. This model emerged during the 1980s in the USA and we in Australia have followed it closely, often on the advice of professional remuneration advisors.

Toward Another View

We ask whether it’s time to return to a more simple model of executive remuneration. A model that focuses primarily on Fixed Annual Remuneration and one which discontinues or substantially reduces the percentage of ’at risk’ component. Then to develop a mechanism which more closely integrates corporate as well as individual performance into an annual review process for Fixed Remuneration.

In this way, executives still share in rewards associated with strong corporate performance, but need to maintain a balanced perspective.

The following model illustrates:



Discontinuing or reducing the potential value of STI and LTI Plans does not mean that the pursuit of financial and non-financial performance targets is no longer a central focus for executives. It simply means that less remuneration is attached to them. It changes the message and suggests that a broad based view of what constitutes corporate performance is more appropriate. One that will filter down to all organisational levels and assist to maintain a real focus on the interests of all stakeholder groups.

Positioning Fixed Annual Remuneration below the market median will result in downward pressure on the executive remuneration market. Although, considering the substantial growth in executive remuneration over the last decade, it will take a long time to come back unless board’s actively reduce the offering with executive turnover.

We propose that Boards consider the question of annual incentives or STIs, and if employed at all, that they are kept to a moderate level of say 20% of Fixed Annual Remuneration and that the KPIs driving the STI reflect the interests of all stakeholders.

We also propose that boards consider abolishing equity based LTIs altogether. To concentrate part of an executive’s personal wealth around equity participation (in the employing organisation) creates the potential for self-serving behaviour, if not a direct conflict of interest.

...continued

Whilst this might be in the immediate financial interests of shareholders it is ultimately not in the best interests of the community. Equity participation for executives might be achieved by offering executives the opportunity to purchase shares in the company, on an annual basis, at a discount to market (say 10.0% to 15.0%) outside of the remuneration package. The choice should be theirs and not mandated by remuneration strategy. This practice was widespread in Australian corporates up until the late 90s and continues with other groups of employees.

To make these changes challenges the existing executive remuneration orthodoxy and as Jay Lorsch and Rakesh Khurana argue in the May-June 2011 edition of Harvard Magazine:

"Re-thinking the nature of executive pay within the context of our larger economic and social system and the challenges we face may enable us to create a new model of compensation rooted in a more realistic recognition of the social context in which firms operate. It should, and can, rest on valid assumptions and fundamental values that allow us to build a more inclusive and sustainable economic future …"

Discontinuing or reducing the potential value of STI and LTI Plans does not mean that pursuit of financial and non-financial KPIs is no longer a central focus for executives. It simply means that less remuneration attaches to them. But it does change the message and suggests a broad based view of what constitutes corporate performance is more appropriate. One that can then filter down to all organisational levels.

The focus for boards must be to return to a more balanced and equitable approach to executive remuneration. Not one that encourages corporate excess and the pursuit of profit at the expense of other stakeholders.

Geoff Nunn, Director

Contents are extracted from Geoff's Submission to the Royal Commission

Group Think and Corporate Ethics

In the March, 2008 Edition of Company Director John Adams stated:

"Directors have a legal and ethical responsibility to ensure that their boards make the most effective decisions in the interests of all stakeholders. However, despite all the best intentions, boards often fail in this endeavour. Managing a board's decision making activities is one of the most difficult tasks because this process is often plagued by the complexity of qualitative, subjective and psychological elements."

Given the magnitude and extent of the failures of business ethics that the Royal Commission continues to uncover we are left to wonder whether a culture of "Group Think" might have been present in the Boardroom and Executive Suite of some of our major financial institutions. A culture where highly capable directors and executives somehow misplace their moral compass in the pursuit of shareholder returns.

The recent APRA Report (by John Laker, Jillian Broadbent and Graeme Samuel) into the Commonwealth Bank (April, 2018) found a culture of complacency and over-collaboration amongst the executive team. Group Think occurs when team members, including board members, fail to challenge underlying assumptions and conform for the sake of unity in their decision making .

This is a very powerful psychological phenomenon, particularly in a banking environment where conformity and compliance are highly valued cultural norms. Stepping outside of the prevailing ethos is not usually encouraged. The challenge for directors and executives is to maintain a balanced and independent perspective in their decision making and deeply question assumptions and premises where they do not appear to be valid or ethical.

Geoff Nunn, Director

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, CEOs and Executive Teams in the areas of corporate governance, business advice, board and executive remuneration strategy, organisation structuring and design. 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.

Contact

Geoff Nunn, Director
Phone: 0418 595 107
email: gtnunn@gna.net.au

Website www.gna.net.au

Postal Address: PO Box 19, Hepburn Springs
Victoria, 3461 AUSTRALIA