Many Hats

Australia's Non-Executive Director Centre

APRA's wake-up call: A practical path forward

APRA's prudential inquiry into CBA has extinguished any lingering doubts about the extent of the shift in stakeholder expectations affecting both the financial services sector, and corporate Australia.

The regulator's findings and recommendations were insightful and provided a perspective on the current deficits in risk and governance frameworks, particularly for the management of 'non-financial' risk.

Boards know that to rebuild trust, fundamental change is required.

Given the undoubtedly lengthy governance journey ahead, the critical question now is: how do you take the first step forward?

To explore this challenge, PwC hosted a roundtable session with non-executive directors and executive management, prompting important introspection and challenge about the practical implications for corporate governance in Australia.

Here's a snapshot of our insights into the APRA report, as well as views and suggestions from those who attended the session.

Reassess accountability fundamentals

Both the Financial Services Royal Commission and APRA's prudential inquiry into CBA has shone a light onto the complexity of organisations. While the findings may not come as a surprise to industry insiders, the public has been justifiably surprised and disappointed. What we need to remember, is that for the public, this is the first time they are seeing this laid bare. Customers naturally want to know how mistakes were made and who was – or will be – held accountable.

In financial services specifically, the Banking Executive Accountability Regime (BEAR) provided a welcome motivation for action on accountability, but there are still a lot of grey areas, particularly around end-to-end processes. To remove any notion of ambiguity on accountability, corporate Australia must face into the tough scenarios that are occurring, and be passionate about resolving them.

Boards across all industries should begin by completely reassessing the fundamentals of their company's approach to accountability. While this is no simple exercise, it can enable significant positive change in an organisation, such as faster decision-making, rapid resolution of trade-offs and a greater willingness to take and manage risk.

Ensure remuneration reflects changing expectations

Remuneration is the most tangible outcome for demonstrable accountability. Both financial services and non-financial services companies continue to face increasing pressure on their remuneration frameworks, with regulators seeking to promote stronger risk-alignment and increased accountability.

A key question we are seeing emerge from the various remuneration influences is *"what does it mean to remunerate fairly, and how does this align to the full gamut of responsibility?"* In addressing this, organisations are re-examining the role of remuneration in driving excessive risk-taking and short-term decision-making.

Boards should be mindful of four key themes as they revise their approach to remuneration.

1st There needs to be a greater acknowledgement of the fact that remuneration is not just a key indicator of culture, it's also a creator of culture.

2nd Remuneration must recognise the full range of executive accountability, including both financial and non-financial outcomes.

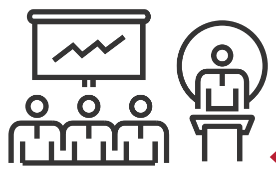
3rd The fairness test now extends beyond shareholder outcomes to include broader stakeholder interests including those of customers and employees.

4th Governance must be a robust and ongoing process, with rigorous challenges over all substantive remunerations decisions.

Legal compliance is not enough

The APRA inquiry made it clear that mere compliance with legal regulations is no longer a viable strategic position for financial services organisations. To earn and maintain a social licence to operate – and protect long-term value – companies must have regard to the interests of all their stakeholders, not just shareholders.

The critical question for all boards is: *"Will the market accept potentially reduced returns while companies broaden their focus from short-term financial performance to preserving their social licence and meeting community expectations?"*



Directors must give serious thought to how they will help their companies navigate these inevitable and competing tensions, and whether their board has the right operating model, processes and skills to meet changing community expectations.

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Address the ‘underlying assumptions’ of culture

When it comes to influencing culture, the biggest challenge for boards is not about getting the values statement right. Instead, it’s understanding the underlying assumptions that drive observable behaviours, irrespective of the ‘official’ position on culture.

For example

While management may say things like ‘the customer is at the centre of everything we do’, the underlying cultural assumption may be ‘you’ve got to hit your sales numbers’.

Organisations cannot choose not to have a culture. Directors need to consider whether they are making conscious choices about really getting to the bottom of culture, about influencing and governing it, or whether they are just hoping culture will take care of itself.

Accept a state of ‘chronic unease’

One of the cultural themes identified in the APRA inquiry was a ‘widespread sense of complacency’ and an ‘overly collegial and collaborative working environment’. The subtext here is that perhaps it’s ok to worry about the things that matter, the things that could go wrong-

Being ‘chronically uneasy’ may be a sign that you are actually on top of your risks.

Take the mining industry, for example. Over the last twenty years, it has been obsessed with worker safety to the point where a single death is one too many. Even though Australia, compared to many of its peers, has an enviable record on health and safety, mining leaders still say ‘we have to do better’. Could it be that boards need to accept a state of chronic unease about meeting changing community expectations?

What do Boards and their key stakeholders think?

Here are some key reactions to the findings of the APRA inquiry, as well as suggestions about how boards can move forward.

> *“One of the biggest challenges for boards [is] in knowing what’s going on; information is critical. We need to make sure we get the right information from management and that the information is valid and relevant. But we also need to understand culture and what’s driving behaviours, and to do that we need to get out and spend time ‘in the business’.”*

> *“While boards need to get close to the business to understand risks, they also need to keep their objectivity and distance and resist the urge to impinge on decision-making. In other words: ‘noses in and fingers out’.”*

> *“Boards must have a thorough understanding of their organisation’s risk appetite; what it will tolerate and what it will not. Unfortunately, the voice of finance has drowned out the voice of governance.”*

> *“Boards must have a diversity of skills, talents and ways of thinking, including domain expertise. We should also have directors who are willing to ask the so-called ‘obvious’ questions – the questions we often need to ask but are afraid to do so.”*

> *“If we want to truly understand customer satisfaction, we must understand what it’s like at the coal face, which means acquiring an appreciation of both the customer experience and the process of complaint handling.”*

> *“There needs to be a greater degree of scepticism and robust challenge, at both the board level and with management. But this should not be allowed to create a ‘fear culture’ where management only delivers what it thinks the board wants to hear. We must do more to encourage an open, healthy and vigorous debate.”*

> *“The job of the board is to take a long-term view on performance, both financial and non-financial, and to make sure management is aligned with that view. We also need to be realistic, persistent and patient; change, particularly cultural change, can take years.”*

> *“To better manage non-financial risk we need better metrics, but metrics that can’t be easily ‘gamed’.”*

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