Impacts on Boards and Non-executive directors

Themes from the
Royal Commission Final Report

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Recent Australian headlines have been dominated by misconduct in financial services. However, misconduct in non-financial sectors and the implications for Boards can be just as profound, as global experience demonstrates: Volkswagen/Audi (manipulation of emission software results), UBER (allegations of poor culture) and Starwood & Sony (large scale security data breaches).

So, whether you're a director on a financial services Board or on a Board in a different sector, the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Final Report) is important reading for you. Together with the 2018 APRA Inquiry into CBA, there are unequivocal messages for your role as a director and heightened expectations for Board governance and oversight.

The Final Report emphasises on many occasions that the primary responsibility for the misconduct it examined lies with the entities concerned and those who managed and controlled them: their boards and senior management.

In addition to this, we see six significant themes flowing from the Final Report which are applicable to all Australian Boards:

1. Directors' duties are owed to the corporation, not shareholders, which means maintaining the company's social licence to operate should be a key priority for boards in performing their role. Boards need to consider the interests of all stakeholders in making decisions: customers, employees, shareholders and the community.
2. Boards must oversee the culture and conduct of their organisation and change what is not right. This will require different skills and capabilities and a similar rigour to that brought to the oversight of strategy and financial performance.
3. Boards must bring stronger oversight to non-financial risk and apply consequence management in relation to these risks in remuneration decisions.
4. There are higher expectations on Boards to hold management to account.
5. Individuals will be held to account by having specific accountabilities ascribed to their roles (extension of BEAR to all APRA-regulated organisations).
6. With ASIC directed to be more litigious in its enforcement role, and other regulators considering a similar approach to their enforcement, the consequences for directors of misconduct in their organisations are likely to be more profound and more public: a greater likelihood of criminal and civil proceedings, reputational impact and loss of directorships.

Theme 1

Directors' duties are owed to the corporation, not shareholders, which means maintaining the company's social licence to operate should be a key priority for boards in performing their role. Boards need to consider the interests of all stakeholders in making decisions: customers, employees, shareholders and the community.

Commissioner Hayne roundly rejects the "Pursuit of profit above all else", in particular, "above the interests of customers, and above compliance with the law".

Although shareholders appoint the Board, it does not follow that shareholder returns is the only consideration for directors to take into account when making decisions. Directors must act in good faith in the interests of the corporation and for a proper purpose. That duty is owed to the corporation, not to shareholders. It follows that the Board needs to consider its social licence to operate, including the interests of shareholders, customers, employees and the systemically important role that a financial institution plays in the national economy. The longer-term interests of these stakeholders converge with the corporation's long term financial advantage and should not be seen as mutually exclusive.

The Final Report also calls out the need for Boards to understand and give effect to what is the "right" thing to do (having regard to community standards and expectations) and ensure that their people do the same. This requires a consideration by Boards (and executive teams) of what is efficient, honest and fair. This echoes the APRA report into CBA which invited Directors to consider "Should we?" and not just "Can we?" when proposing a course of action. These observations highlight that Boards need to bring a moral and ethical compass to the work they do in the Boardroom and ensure this approach is cascaded through the organisation.

Theme 2

> The Board's role is to oversee and change the culture and conduct of its organisation, not just its financial performance. Boards will need more active oversight of these matters, requiring different skills and capabilities and a similar rigour to that brought to the oversight of strategy and financial performance.

The expectations on Boards and senior management for culture oversight and change have stepped up significantly.

Commissioner Hayne describes culture as shared values and norms that "shape behaviour and mindset", or more practically: "What people do when no one is watching". The culture of each organisation is unique and cannot be legislated or prescribed, however each organisation is responsible for its culture and Boards are called on to assess and oversee it.

Hayne draws heavily on global thought leadership of the G30[1] and the FSB (Finance Stability Board)[2] which responded to conduct issues contributing to the GFC and instances of global bank misconduct since that time.

Hayne makes it clear that Boards must do more than monitor and measure their culture, they also need to manage it. This means taking action to address risk culture and conduct issues. These efforts are not one-offs, but continuous and ongoing.

For instance, recommendation 5.6 requires the Board to take proper steps to assess their culture and governance, identify and deal with culture and governance problems and determine that the changes they make are effective. This is not a "set and forget". Boards are expected to review the culture as often as possible. APRA will also be more active in its supervision of these activities.

There are a number of steps Boards need to take to respond:

- Insist on the right reporting and visibility into the organisation's culture. Measuring culture is a difficult and emerging field.
- Ensure the Board has the right skills and capability for culture oversight; invest in understanding behavioural science and other developments in this field.
- Plan the Board agenda to have sufficient, regular time for culture discussions and also weave them into, for example, strategy and risk discussions.
- Be absolutely clear on the aspired culture compared with the prevailing culture and have a Board endorsed plan to respond to differences.
- Assess the effectiveness of the plan to change behaviours and monitor its impact on better outcomes for customers.

Theme 3

> Boards must bring stronger oversight to non-financial risk and apply consequence management in relation to these risks to remuneration decisions.

This was a key message coming out of the APRA Inquiry into CBA and is reinforced by Commissioner Hayne. The Board must demonstrate effective oversight of the prudent management of non-financial risks by the company and treat them as if they are as important as financial risk.

Hayne observes that many financial services entities have given priority to financial risks and left their frameworks for management of non-financial risks under-developed.

Non-financial risks include conduct (e.g. fraud, mis-selling, employee behaviour negatively impacting customers etc), cyber and technology, operational and regulatory/ compliance risks.

Boards will need to demonstrate sufficient time and resource is being allocated to non-financial risk. This means rethinking Board agendas and how much time they actually spend on financial v.s non-financial risk discussions across the year. Boards will need to ensure that they are considering not only existing risk but emerging risk. As a result, it is likely that most Boards will need to revisit the reporting to the Board on risk to ensure they are able to meet these expectations.

Boards will need to ensure that there are sufficient resources and capability being applied to the identification, reporting and management of non-financial risks and that they are applying proper oversight of these processes.

1 G30 is the Consultative Group on International Economic and Monetary Affairs Inc, an international body of leading financiers and academics.
2 The Financial Stability Board was established by the G7 Finance Ministers and Central Bank Governors in 2009.

Theme 4

There are higher expectations on Boards to hold management to account.

Commissioner Hayne emphasises the role of the Board to challenge management robustly and hold it to account. In particular, there must be no undue delay in fixing issues for customers when misconduct occurs. Hayne is particularly critical of cases where negotiations with ASIC have dragged on (to the detriment of customer remediation) or patterns of delayed breach reporting.

Many of the scenarios played out in case studies before the Commission were boards being reassured by management that issues were in hand (when they were not) or being faced with a management team confident in its ability to fix an issue (when in fact, it was unable to do so in a timely manner), leading to delays for customers and the business continuing to breach its obligations.

Demonstrating trust and support for management while holding management to account is a fine and delicate line for Boards to walk. Hayne is telling Boards that they need to be more be emphatic in the face of delays by management and be prepared to intervene and say "Enough is enough. Fix this, and fix it now".

In relation to interactions with regulators, a new obligation will be placed on Banks and "Accountable persons" to deal with ASIC and APRA in an open, constructive and cooperative way. This will reinforce the Board's role to oversee appropriate interactions with regulators (and the avoidance of undue delays or an overly legalistic approach to resolving issues).

Commissioner Hayne understands that, for Boards to do their job, they need the right information from management. This is an issue that weighs heavily on the minds of non-executive directors and their ability to know what they need to know in order to provide effective oversight.

Hayne cites two examples (CBA on AML and NAB on Fees for no service) where management failed to provide sufficient information for the Board to discharge its duties. In such cases, the Board must seek out that information. It cannot accept management's assurance that things are in hand (where the Board should be able to see that they are not) or to accept an unsatisfactory response from management and let the issue lie.

Theme 5

> Individuals to be held to account by ascribing individual accountability to roles (extension of BEAR to all APRA-regulated organisations).

Effective governance requires clarity of individual accountability. Diffused accountabilities were seen to contribute to the misconduct identified in the Commission, such as Boards not applying individual consequence management because they didn't know *who* was responsible.

BEAR is seen as helpful to enable this clarity. As a result, the BEAR regime will be extended to all APRA-regulated entities (i.e. to the Directors and Executives of Superannuation, General Insurers, Life Insurance and Private Health insurers).

However, ascribing accountabilities under BEAR is not in itself enough. Boards, irrespective of the industry, need to face into the issues, assess what the right thing to do is, understand why things went wrong and, when they do, actually hold their people to account through remuneration impacts or other consequences.

This focus on individual accountability can create a different challenge for boards, by swinging the pendulum too far away from collective accountability, which the APRA report into CBA highlighted was essential for business processes and issues that cut across different divisions and teams.

The reality is that it is very difficult to ascribe individual accountability within a complex value chain, when many hundreds or even thousands of roles are collectively influencing customer outcomes.

In response, the Final Report recommends that there is one person identified as accountable for product in each Bank. That is, accountable for the end-to-end value chain for the design, delivery, maintenance and remediation of all products to customers. Hayne asks APRA to work with the four major banks to designate such a person as an "Accountable person" under the Banking Act. Similar constructs could be considered outside of the financial services industry. For a deeper analysis of the extension of BEAR, see PwC's paper of February 2019: Banking Executive Accountability Regime, Extending Accountability beyond ADI's.

Theme 6

> With ASIC directed to be more litigious in its enforcement role, and other regulators considering a similar approach to their enforcement, the consequences for directors of misconduct in their organisations are likely to be more profound and more public: a greater likelihood of criminal and civil proceedings, reputational impact and loss of directorships.

ASIC has been directed to take, as its starting point, the question of whether a Court should determine the consequences of a contravention (Recommendation 6.2) over the use of infringement notices or negotiated enforceable undertakings, in other words, "why not litigate?".

Boards should therefore expect ASIC (and other regulators) to be more proactive in commencing legal proceedings and less conciliatory and willing to reach a negotiated (and often-times a more expedient) outcome.

This is likely to place individual Directors and executives at a greater risk of criminal and civil proceedings against them in the future, if the organisation they oversee or manage is found to have breached the law.

In terms of evidence laid out in the Royal Commission itself, no criminal charges against individuals were announced in the report, yet the potential for charges is flagged. Commissioner Hayne has referred evidence to ASIC to determine if criminal charges should be commenced against (at least) three unnamed entities.

In addition, Hayne articulates in each case study in the Final Report, whether the conduct described amounts to misconduct (or *might* be misconduct, which he distinguishes). He has, likewise, referred this evidence to ASIC for potential criminal or civil charges.

On 18 February 2019, the Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill 2018 was passed by both houses of parliament. This Bill significantly increases penalties and prison terms for corporate and financial sector misconduct and adds penalties for provisions which were not previously the subject of financial penalty. It only applies to conduct occurring after the bill receives royal assent, but together with ASIC's increased enforcement mandate, will likely mean tougher penalties in more circumstances for companies and individuals found to have breached the law.

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