# GOVERNANCE: THE NEW AGE OF LEADERSHIP

13 February 2019 | Australia
Legal Briefings – By **Michael Vrisakis, Tamanna Islam and Beth Waterfall**

Recent shareholder action against executive remuneration, the expansion of APRA's ambit to include a greater focus on culture and remuneration, the introduction of the BEAR and the rise of the "community expectations" standard shows the new microscope penetrating boardrooms and the upper echelons of management.

The recommendations contained in the Final Report are designed to have a major impact on governance. The recommendations show a reinforcement of a concept emphasised by ASIC, which is now familiar to financial services institutions: "tone from the top". The Final Report has largely endorsed this trend by recommending the implementation of existing proposals for reform. In particular, the Sedgwick Review (2017) and the Financial Stability Board's Principles, Standards and Supplementary Guidance for Sound Compensation Practices (2009) have come back into prominence.

## THE BIG PICTURE

A macro perspective reveals the following key issues for governance and leadership in financial services institutions:

- executive and staff remuneration;
- culture; and
- accountability.

We consider each of these in turn.

## REMUNERATION

Remuneration and incentives for executives and staff have long faced regulatory and public scrutiny. Financial services law contains prescriptive regimes on remuneration, such as:

- disclosure of executive remuneration for superannuation trustees;
- the prohibition on conflicted remuneration and volume-based incentives for financial advisers; and
- deferral of executive variable remuneration under the BEAR.

The Royal Commission, Sedgwick Review and the Financial Stability Board's Principles and Standards for Sound Compensation Practices 2009 (**FSB Principles and Standards**) articulate key principles in relation to remuneration practices. In essence, there is no "one size fits all" approach, but the end result must be balanced.

For example, the Royal Commission showed considerable interest in remuneration mechanisms that calculate variable remuneration with regard to a variety of metrics, including financial performance, risk management and compliance, and client outcomes. In this regard, the Royal Commission considered that an important aspect of variable remuneration is an "intuitive synthesis" of relevant financial and non-financial factors.

The Royal Commission's Final Report recommended that APRA give effect to the:

- **FSB Principles and Standards**, which recommend that compensation rewards prudent rather than excessive risk taking behaviour. The FSB Principles and Standards sought to address some of the major factors that caused the Global Financial Crisis and one of the issues that it identified in the industry was a focus on high short-term profits rather than long term risks, which were exacerbated due to the structure of generous bonus schemes common in the large financial institutions.

In addition to the FSB Principles and Standards, the Financial Stability Board in 2018 released Supplementary Guidance (**FSB Guidance**) which focused primarily on the use of compensation tools to address misconduct risk. Some themes that emerge from the Guidance are greater emphasis on the role and responsibilities of the board in ensuring accountability for misconduct and actively challenging compensation recommendations where misconduct has occurred. The Guidance recommends that financial institutions should have the ability to adjust compensation in accordance with misconduct and that adequate amounts of compensation should be deferred with a risk of reduction in case of adverse outcomes that arise over time; and

- **Sedgwick Review**, which made several recommendations pertaining to culture, leadership and incentive payments. In a nutshell, these included not paying incentives to retail staff based directly or solely off sales performance, a customer orientated culture with a primary focus on ethics, diversification of factors to be considered in relation to variable rewards and board and senior managers adopting reward payments consistent with those recommended for front line staff. Importantly, the Sedgwick Review provides prescriptive recommendations, including quantitative limits on scorecard metrics.

## ACCOUNTABILITY

The introduction of the BEAR in 2018 saw the implementation of an enhanced accountability framework for Australian deposit taking institutions (**ADIs**) and persons in certain senior management positions, known under the regime as Accountable Persons. The Final Report recommends the extension of the BEAR to all APRA-regulated financial services institutions, including insurers and Registrable Superannuation Entities. The Morrison Government, in its official Response to the Royal Commission, has taken this recommendation further and promised to introduce a new ASIC-administered accountability regime that will apply to AFSL and ACL holders, market operators, and clearing and settlement facilities. This represents a global trend across the UK, Singapore, Hong Kong and Australia to impose increased accountability on senior management in financial services institutions, beyond traditional principles of board accountability.

In addition, the Final Report recommended expanding the BEAR to include a senior executive who is responsible for product design, delivery, maintenance and remediation. This concept has been referred to as “end-to-end” accountability and comes in the context of the growing complexity of financial products. This complexity and concept of end-to-end accountability are also recognised in the current proposed legislation on design, distribution and product intervention by ASIC before Parliament, which prescribes requirements in relation to the design and distribution of financial products.

## CULTURE

ASIC has, for a number of years, focussed on corporate culture and the “tone from the top”, by stating that the “bad apples defence” could not be justified in the face of repeated and widespread misconduct in the financial services industry. Regulators have since focussed on cultural factors that have led to misconduct, such as complacency, being reactive rather than proactive, a failure to learn from past mistakes and a pursuit of consensus rather than individual issue ownership. In layman’s terms, culture is described in the Final Report as “what people do when no-one is watching” and was identified as an integral aspect of company’s approach to addressing misconduct.

Themes that emerge from the FSB Guidance and the Final Report include:

- the role of supervisors in actively engaging and ensuring “good” culture is fostered and maintained;
- a greater focus on the role that the company’s board, senior executive and management team play in relation to culture and conduct;
- the importance of making sure risk governance frameworks are well resourced and supported;
- promoting fair treatment of customers as well as investors; and
- implementing a remuneration system which encourages prudent risk taking and conduct that is emblematic of the values held by the institution.

The Final Report stresses that cultural assessments should be more than a “box-ticking” exercise and that ultimately the responsibility lies with boards and senior management. The above-mentioned proposals in relation to remuneration and accountability are seen as central to improving corporate culture to be in line with legal and community standards.

## INSIGHTS AND TRENDS

As a result of the focus on governance, we are seeing distinct trends emerge in the market, as follows:

- **Disaggregation**: Despite vertical integration surviving the Final Report relatively unscathed, there is a growing trend of vertically integrated institutions divesting certain aspects of their business. This is due to a strategy to re-focus on traditional banking products and stymie complexities and conflicts that naturally arise with vertical integration. The separation process generates considerable complexity for corporate groups as they seek to untangle banking services from wealth management services; and

- **The shareholder strikes back:** We have seen increased action among shareholders of the Big Four Banks, as shareholders have expressed their dissatisfaction with bank conduct by protest voting against the remuneration reports or initiating shareholder class actions. This, in combination with commentary contained in the Final Report, heralds a change to current remuneration and disclosure practices.

## SO WHAT DOES THIS MEAN FOR THE INDUSTRY?

We should expect to see more prescriptive prudential standards and guidance on remuneration systems, including, possibly, defined metrics limiting variable remuneration, as well as increased supervision of culture and misconduct risk. In addition to this, the relatively new BEAR was recommended to be expanded to apply to a wider group of institutions with a specific role to be established with responsibility for the life cycle of all products offered to customers.

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## KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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