

AUSTRALIAN INSTITUTE  
*of* COMPANY DIRECTORS

# Royal Commission Interim Report

*Consultation Paper*

**Friday 5 October 2018**



# 1. Overview

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Your views are sought on key policy questions raised by Commissioner Hayne in the interim report, as well as the policy questions raised separately by the Royal Commission in relation to the Round Six (insurance) hearings (see section five below).

Commissioner Hayne’s interim report was released on 28 September 2018. It addresses the case studies from the first four rounds of Royal Commission hearings (consumer lending, financial advice, loans to small and medium enterprises and issues affecting Australians who live in remote and regional communities) and raises a number of policy questions.

In the report, Hayne does not make adverse findings in relation to breaches of the law (on the basis that is the role of a court), but does identify conduct that may have amounted to misconduct or fell below community standards and expectations. He expresses a view that entities and individuals have been motivated by financial gain or short term profit at the expense of basic standards of honesty.

Hayne expresses a preference for simplification of the legal framework rather than additional regulation, noting that complexity can promote a ‘tick the box’ approach to compliance and obscure the simple principles that should govern behaviour in the financial services industry.

While Hayne states that each financial services entity is responsible for its own conduct, he also addresses the failings of the regulators. He is particularly critical of ASIC as the conduct regulator and notes that its approach so far has been insufficient to achieve deterrence.

The report also raises a number of policy questions, many of which go to core governance issues such as remuneration, culture, accountability, and risk management.

The Royal Commission has also separately released policy questions in relation to issues arising out of the Round Six (insurance) hearings.

The structure of this paper is as follows:

- **Section 2:** Implications for directors and the regulators;
- **Section 3:** Key observations on regulation and the regulators;
- **Section 4:** Key observations on culture, governance and remuneration; and
- **Section 5:** Potential areas of policy focus for the AICD.

## 2. Implications for directors and the regulators

The interim report's implications for directors, particularly in the financial services sector, are potentially wide-reaching. At a minimum, the report will prompt questions such as:

- Whether existing remuneration structures are appropriate, particularly variable incentives, including for senior executives?
- What governance and risk management practices do we have in place to prevent misconduct?
- How do we engage with the regulators, and is that appropriate?
- How much visibility does the board have of misconduct and poor customer outcomes?

Given the significant criticism levelled at the regulators – particularly ASIC – the report is likely to prompt some introspection. For example, for ASIC, the report will raise expectations from government and the community more broadly that it will take a more litigious approach to enforcement, rather than favouring negotiated outcomes (such as enforceable undertakings). While for APRA, there will be pressure to adopt a stronger focus on the link between misconduct and remuneration, and to ensure that it has a clear view of governance and risk culture in financial institutions.

Commissioner Hayne also makes a salient observation for directors to reflect on:

*As commercial enterprises, each of the entities whose conduct was considered in the first round of hearings rightly pursues profit. Directors and other officers of the entities owe duties to shareholders to do that. But the duty to pursue profit is one that has a significant temporal dimension. The duty is to pursue the long term advantage of the enterprise. Pursuit of long term advantage (as distinct from short term gain) entails preserving and enhancing the reputation of the enterprise as engaging in the activities it pursues efficiently, honestly and fairly. And, lest there be any doubt, it also entails obeying the law. But to preserve and enhance a reputation for engaging in the enterprise's activities efficiently, honestly and fairly, the enterprise must do more than not break the law. It must seek to do 'the right thing'.*

## 3. Key observations on regulation and the regulators

In Chapter 8 of the report, Hayne focuses on the issues of regulation and the regulators, the key elements of which are outlined below.

Overall, Hayne expresses the view that additional regulation is not the answer. He notes that most of the conduct identified and criticised in the report contravened existing norms of conduct (i.e. either existing laws or regulation, or promises made in industry codes or more directly to consumers), and that breaches of existing laws are not prevented by passing new laws.

He states that neither ASIC nor APRA has marked or enforced the bounds of permissible behaviour set by the law in a way that has prevented the conduct that has come to light during the hearings.

Hayne criticises ASIC's approach to regulation in particular, and notes that ASIC's approach to enforcement to date has not been effective to achieve deterrence (including because it has disregarded the need for strategically important litigation). While ASIC's powers are limited (all such powers are limited), ASIC has greater enforcement powers than it has used.

Hayne also points to the following issues: (1) the size of ASIC's remit; (2) an entrenched culture of negotiating outcomes rather than insisting on public denunciation and punishment; (3) ASIC's focus on remediation of consumers which, while vitally important, is not the only consideration; (4) failure to appreciate that an amount outlaid to remedy a default may be much less than the advantage an entity has gained; and (5) no effective mechanism to keep ASIC's enforcement policies and practices congruent with the needs of the economy more generally.

In terms of APRA, Hayne acknowledges that its chief focus is on governance and risk culture, and that it has a core objective of promoting financial system stability. Understood in that light, APRA's lack of action in response to the conduct may, perhaps, be more readily understood.

However, until the APRA report into CBA, Hayne notes that APRA had taken no public step pointing to any deficiency in the governance and risk culture of any of the major banks or any of the other large financial services entities falling within APRA's remit. Hayne notes that there is a question as to whether other financial services entities have the same or similar deficiencies of governance and risk culture identified in relation to CBA.

(We note that APRA Chairman, Wayne Byres, has called on all regulated institutions to conduct a self-assessment 'to gauge whether similar issues [to that identified with CBA] might exist in their institutions' and said APRA supervisors will expect institutions to demonstrate how they have considered the issues raised in the report. We understand that relevant institutions' self-assessments are due with APRA by November 2018).

Hayne also criticised APRA for having insufficient regard to the link between remuneration and conduct risk. The APRA Prudential Practice Guide on remuneration, issued in 2009, said nothing about conduct risk, compliance or regulatory risk, or reputational risk, suggesting to regulated entities a sole focus on management of financial risk-taking.

## 4. Key observations on culture, governance and remuneration

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In Chapter 9 of the report, Hayne makes a number of observations regarding the causes of misconduct by entities, in particular at the intersection of culture, governance and remuneration. His key observations are outlined below.

Specifically, Hayne notes that all the conduct identified and criticised in the report was conduct that provided a financial benefit to the individuals and entities concerned, and that the culture and conduct of the banks was driven by, and was reflected in, their remuneration practices and policies. Despite the Sedgwick review of bank remuneration, banks continue to remunerate in ways that emphasise sales (this was contrasted with the UK where banks had severed, or at least loosened, the connection between conduct and entity profit).

He observed that eliminating incentive based payments for front-line staff will not necessarily affect the ways in which they are managed if their managers are rewarded by reference to sales or revenue and profit. Further, if more junior bank employees should not be remunerated with variable incentives, why should managers or more senior executives? In Hayne's view, the unstated premise that staff and intermediaries will not do their job properly and to the best of their ability without incentive payments must be challenged.

Hayne also notes that in each instance where conduct has been contrary to law, the existing governance structures and practices of the relevant entity and its risk management practices have not prevented that unlawful conduct. However he also notes that good culture and proper governance cannot be implemented by passing a law. Culture and governance are affected by rules, systems and practices but in the end they depend upon people applying the right standards and doing their jobs properly.

## 5. Potential areas of policy focus for AICD

Hayne declined the opportunity to present draft recommendations for policy reform, instead outlining a series of (often broadly expressed) questions. This suggests that he is open to public consultation and wishes to ensure that his ideas are well-tested before formulating recommendations. The final report (due 1 February 2019) is likely to draw significantly on the submissions received in response to the interim report, as well as the November 2018 round of policy-focused hearings.

Chapter 10 of the Interim Report highlights a number of questions which the AICD may wish to submit on. The main questions, grouped by theme, are set out below. Also outlined below are the relevant policy questions raised in relation to the insurance hearings that apply to the financial services sector more broadly.

### Causes of misconduct

- What should either or both of banks and regulators be doing to meet the danger of conduct risk?
- Should any customer facing employee be paid variable remuneration? If the answer is either no or some should not, what follows about incentive remuneration for managers or more senior executives?
- Should other changes be made to the remuneration practices of banks?
- Is the BEAR regime relevant to the intersection between remuneration and culture more generally than its application to particular senior executives? Should the BEAR be altered or extended in application?

### Regulation and the regulators

- Should there be annual reviews of the regulators' performance against their mandates? Is ASIC's remit too large?
- Are ASIC's enforcement practices satisfactory? If not, how should they be changed?
- If the recommendations of the ASIC Enforcement Review are implemented, will ASIC have enough and appropriate regulatory tools?
- Should ASIC's enforcement priorities change? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that is in the public interest not to do so?
- Are APRA's regulatory practices satisfactory? If not, how should they be changed?
- Does the conduct identified and criticised in the report call for reconsideration of APRA's prudential standards on governance?
- Having examined the governance, culture and accountability within the CBA group, what steps (if any) can APRA take in relation to those issues in other financial services entities?

## Questions raised in relation to Round Six (insurance) hearings

The Royal Commission has also separately released a number of policy questions for public consultation in response to the insurance hearings. We have confirmed with the Royal Commission that the questions – which are relatively broad – are not confined to insurance.

The key policy questions to consider from an AICD perspective are as follows:

- What is the purpose of infringement notices? Would that purpose be better achieved by increasing the applicable number of penalty units in section 12GXC of the Australian Securities and Investments Commission Act 2001 (Cth)? Should there be infringement notices of tiered severity?
- Is there sufficient external oversight of the adequacy of the compliance systems of financial services entities? Should ASIC and APRA do more to ensure that financial services entities have adequate compliance systems? What should they do?
- Should there be greater consequences for financial services entities that fail to design, maintain and resource their compliance systems in a way that ensures they are effective in:
  - preventing breaches of financial services laws and other regulatory obligations; and
  - ensuring that any breaches that do occur are remedied in a timely fashion?
- When a financial services entity identifies that it has a culture that does not adequately value compliance, what should it do? What role, if any, can financial services laws and regulators play in shaping the culture of financial services entities? What role should they play?
- Are there any recommendations in the “ASIC Enforcement Review Taskforce Report”, published by the Australian Government in December 2017, that should be supplemented or modified?

## 6. Member feedback sought

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To help inform our submission in response to the interim report, we would welcome member views on the above policy issues. If you would like to provide written feedback, please submit on the above questions via the web form [here](#). If this is not convenient you can provide a response in an email to the AICD policy team at [policy@aicd.com.au](mailto:policy@aicd.com.au) – please note that a Microsoft Word document is preferable so we can easily amalgamate responses.

**Responses must be submitted by 16 October 2018.**



## Member feedback

The AICD is currently preparing a submission for the Commissioner to consider on the issues raised by the Interim Report. Interested members can contact us at [policy@aicd.com.au](mailto:policy@aicd.com.au) with their feedback.

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