Governance Series • No.2

The Dialogue

Leading the conversation

The Special Needs of Financial Services Boards

Was the misconduct in financial services enabled by directors who did not understand their businesses?

Barry Rafe and Ian Laughlin

Actuaries Institute

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This is the second in a series of papers dealing with important issues in governance, targeted particularly at non-executive directors and C-suite executives. Actuaries have a long history in supporting and working in these roles.

Acknowledgement of country
The Actuaries Institute acknowledges the traditional custodians of the lands and waters where we live and work, travel and trade. We pay our respect to the members of those communities, Elders past and present, and recognise and celebrate their continuing custodianship and culture.

Published October 2021

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About the Actuaries Institute

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Actuaries have a reputation for a high level of technical financial expertise and integrity. They apply their risk management expertise to allocate capital efficiently, identify and mitigate emerging risks and to help maintain system integrity across multiple segments of the financial and other sectors. This expertise enables the profession to comment on a wide range of issues including life insurance, health insurance, general insurance, climate change, retirement income policy, enterprise risk and prudential regulation, finance and investment and health financing.

The Special Needs of Financial Services Boards

Was the misconduct in financial services enabled by directors who did not understand their businesses?

Barry Rafe and Ian Laughlin

Table of Contents

Key Points

- Recent reviews into the financial services industry in Australia identified widespread and systemic misconduct.

- While the senior executive teams of these business carried direct responsibility, this paper argues that the poor behaviour may have been enabled by boards who lacked the necessary skills and capabilities for complex financial services businesses.

- This lack of necessary skills and capabilities calls into question the processes for setting and realising a board composition that meets the special needs of complex financial services businesses.

- We have provided a *Financial Services Board Assessment Aid* to help in director selection for financial services businesses. Much of what we cover is relevant for any type of financial services business, though our thinking is focused on banks and insurance companies regulated by APRA. These approximately 350 institutions had total assets of greater than $5 trillion at 30 June 2020 (APRA, 2020, p. 16).

Executive Summary

Many recent reviews into the financial services industry have identified widespread and systemic misconduct. Whilst some misconduct has been unlawful, much has been behaviour that has not met community standards and expectations. The responsibility for the identified misconduct has been attributable to their board of directors and senior executive teams.

This paper addresses a gap that we believe exists in the literature of the capabilities required by directors of large complex financial services businesses. The aim is for this paper to be a reference tool for Chairs of boards and nomination and remuneration committees of large financial services companies and to also be used in annual board assessments.

Financial services organisations have unique features that impact on the composition of their boards.

We argue that financial services organisations have unique features that impact on the composition of their boards. These unique features emerge primarily from the long-term contingent nature of the financial products offered and the trust that individuals place in these products. The pressure to make short-term profits traded off against the long-term financial commitments that are made to the community has important implications for the capabilities of the board and hence its directors.

The trade-offs required to be made by financial services business has led to stringent regulation, including the need for the directors to proactively consider the long-term interests of the organisation's customers.

We conclude with a discussion of the capabilities required by directors of these organisations and provide an aid that may facilitate director selection of financial services businesses, assessment and which could be used on an 'if-not-why-not' basis.

We do not specifically consider the boards of superannuation fund trustees in this paper. Whilst superannuation funds are regulated by APRA, the directors of these funds are often a function of sponsor nomination with specific trust obligations to the members of the funds and so have different needs again.

While it is not unusual to have one or more executive directors on financial services boards, our focus in this paper is on non-executive directors.

1. Why Financial Services are unique

The many reviews into recent misconduct by financial services organisations have identified that the misconduct was caused by failures of the boards and senior executive teams. Our assertion is that the peculiar features inherent in financial services companies have implications for the composition of their boards of directors. While much has been written about board selection, including by the Australian Institute of Company Directors (AICD, 2017), we focus on the particular needs of boards of large, complex financial services businesses.

Uniqueness of financial services

Financial services businesses have inherently unique characteristics that impact on the necessary composition of their boards. In particular:

- financial services businesses can be extremely complex, with very long-term contractual obligations to customers;
- products and the servicing of them are often complex with uncertain future outcomes for both the organisation and the customers;
- there is significant information asymmetry between individuals and the organisation requiring the customer to trust that the organisation will do 'right' by them;
- there is often a third-party intermediary between customer and organisation, with customers relying on advice from third parties as part of their purchase;
- virtually all adults have a relationship with a financial services organisation;
- customers often have a large financial exposure to the institution – for example homeowners often have a heavy mortgage, and their house may be insured for its full value, or an individual may insure against loss of their future earnings due to disability;
- financial services businesses, and banks in particular, have a critical role in the functioning of Australia's economy;
- recent reviews into the financial services industry have highlighted widespread and systemic misconduct, with boards and senior executives being found accountable; and
- there is a community expectation that financial services organisations are trustworthy.

Financial services businesses, and banks in particular, have a critical role in the functioning of Australia's economy.

Regulatory consequences

In recognition of the unique features of financial services organisations, the vulnerability of their customers to misconduct, poor management or governance and high community expectations, a stringent regulatory regime has been put in place to govern financial services businesses. It includes:

- comprehensive and unique-to-financial services laws and regulations, some of which are directed to the business being governed and some relate directly to boards/directors;

- prudential regulation and supervision through the Australian Prudential Regulation Authority (APRA);
- conduct standards and regulation through the Corporations Act and the Australian Securities and Investments Commission (ASIC); and
- specific Fit and Proper tests for directors of APRA-regulated institutions.

It is crucial that directors really understand the services and products being sold and the customer needs being addressed.

It is therefore crucial that directors really understand the services and products being sold and the customer needs being addressed. This will help them to understand the material risks of the business so that both the sustainability of the business and customer needs are being met.

In response to the findings of recent reviews, far more focus has been given to non-financial risk, governance, culture, remuneration and accountability. Further powers have been provided to the regulators to help with this. In addition, CEOs themselves are subject to public scrutiny through various parliamentary committee processes and the media.

Recognising the comparative vulnerabilities of consumers of financial services products, each sector of the financial services industry is governed by an Act of Parliament – the Insurance Act 1973, the Life Insurance Act 1995 and the Banking Act 1959. In each case, there is an intent to protect the interests of customers, and, in this context, responsibilities are specifically imposed on directors and/or the board. Appendix B has more details.

APRA is the prudential regulator of the financial services industry and its prudential standards, including those on governance and remuneration, build on the Acts noted above. APRA's core mandate "is to maintain and promote the safety and stability of the financial system for the benefit of the Australian community". APRA pays close attention to the role of the board of directors and its role in influencing the culture of the organisation, including setting expectations of the boards.

Social licence to operate

The notion of a social licence to operate was implied in the terms of reference of the reviews undertaken into organisational misconduct discussed in detail below. For example, the recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry had, as part of its terms of reference, a requirement to assess organisational behaviour against community standards and expectations.

"Business enterprises invoke the 'social license to operate' (SLO) to indicate that their activities are considered as legitimate in the eyes of society" (Demuijnck & Fasterling, 2016, p. 675). The term 'social licence' implies some type of a formal agreement that enables the corporation to keep operating, however, in practice there is no such formal agreement in place. Alan Joyce, CEO of QANTAS, claimed that "profitability and sustainability go hand in hand ... social licence disappears if you are not part of the community and doing the right things by stakeholders" (Whyte, 2018).

As moral agents, leaders of corporations are expected, and do, make moral judgements when deciding on the appropriateness of the actions of the corporations they lead. The actions of corporations are judged by the broader community and assessed against contemporary moral norms, not just the law.

As Laughlin and Bernau (2019) highlight, the rationale of social licence "is particularly strong for financial services businesses as they effectively make money by helping their customers manage their financial affairs" (Laughlin & Bernau, 2019, p. 14). As a result, directors of financial services businesses need to be attuned to the expectations placed on them by the community generally and not just their shareholders.

"There can be no doubt that the primary responsibility for misconduct in the financial services industry lies with the entities concerned and those who managed and controlled those entities: their boards and senior management."

– Kenneth M Hayne, Commissioner (p.4, 2019)

2. Insights from recent reviews into misconduct

There is extensive recent literature about misconduct specifically intended to inform how future misconduct can be avoided.

The Recent Banking Royal Commission

The Banking Royal Commission concluded that the conduct of many of the institutions investigated caused direct loss to a significant number of customers because of the institution's pursuit of short term profits.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Banking Royal Commission) was established to investigate misconduct in the financial services industry. The Commissioner, the Honourable Kenneth Hayne AC QC, concluded that the conduct of many of the institutions investigated caused direct loss to a significant number of customers because of the institution's pursuit of short term profits (Hayne, 2019, p. 1). While some of the misconduct breached laws, other conduct was determined to be within legal bounds but "has fallen short of the kind of behaviour the community not only expects of financial services entities but is also entitled to expect of them" (Hayne, 2019, p. 1). Under examination, all of the CEOs and Chairs of the major banks admitted such misconduct. For example, the CEO of the Commonwealth Bank of Australia (CBA), Matt Comyn, agreed that "CBA has acknowledged to the Commission ... it's engaged in a range of misconduct and conduct that fell below community standards and expectations" (*Royal Commission into Misconduct In the Banking, Superannuation and Financial Services Industry – Transcript of Proceedings*, 2018, p. 6516).

In summary, Commissioner Hayne found:

1. There was widespread and systemic misconduct by financial services businesses. The misconduct was either in direct breach of the law or it was conduct that did not meet community standards and expectations;
2. Boards and senior executive teams were responsible for the misconduct. There was no evidence of fraud or corruption at board level but there was sufficient evidence to indicate that boards were not close enough, or did not fully understand, the businesses they directed. There was inadequate oversight and challenge by the board of the executives; and
3. The misconduct was preventable through improvements in governance, reporting, remuneration and risk management processes (Hayne, 2019, p. 4).

Commissioner Hayne attributed the cause of misconduct to poor leadership, governance and the remuneration policies in place with the organisations (Hayne, 2019, p. 412). Commissioner Hayne made no specific comments about director capabilities but drew attention to a number of instances where directors did not avail themselves of information that would have informed and enabled them to assess the systemic risk (Hayne, 2019, p. 396). For example, while under examination the Chair of the board of the CBA admitted that "her colleagues on the audit committee did not give sufficient attention to the significant non-financial risks associated with CBA's failings in relation to AML/CTF [Anti-Money Laundering/Counter Terrorism Financing]" (Hayne, 2019, p. 397).

There was significant fallout during and immediately following the Banking Royal Commission's hearings, including:

- four directors of the AMP, the CEO and senior counsel resigned;
- each of the major banks sold all or part of their insurance and wealth management businesses;
- the regulators acted against several financial services institutions; and
- the Chairman and the Managing Director of the National Australia Bank resigned (Maley, 2019).

Analysts have forecast that the cost to the financial services industry of the Royal Commission will exceed $10 billion (Eyres J, 2019). Much of these costs related to fines and remediation costs of refunding fees to customers for services that were not provided. There are ongoing regulatory actions against various institutions and a move by the prudential regulator APRA to strengthen supervision of financial services, the institutions, and their senior management and boards (APRA, 2019a). ASIC is also committed to accelerating enforcement activities including "litigating as much as we can" (Pelly, 2021).

Regulator reviews into organisational misconduct

There have been several reviews of conduct in the financial services and other similar industries that have observed similar misconduct in their board practices.

APRA undertook a review into the misconduct identified by the Banking Royal Commission at CBA (APRA, 2018). The objective of the review was to "examine the frameworks and practices in relation to governance, culture and accountability within the CBA Group that have contributed to these incidents". There was no specific request for the Inquiry to investigate the specific capabilities of the directors of CBA, but the ensuing report provided some insights into CBA's director capabilities.

APRA found that many directors did not challenge management sufficiently on non-financial risk.

The Inquiry noted that there was "inadequate oversight and challenge by the Board and its gatekeeper committees of emerging non-financial risks" (APRA, 2018, p. 3). It was observed, for example, that the high level of collaboration between the Chair of the Board Risk Committee (BRC) and the Chief Risk Officer led other members of the BRC to consider that decisions had already been made and, as a result, were not challenged (APRA, 2018, p. 18). APRA found that many directors did not challenge management sufficiently on non-financial risk, in that decisions were made from information provided by a sole individual or committee, rather than the information used to inform the whole of committee decision-making discussions.

As a result of the Banking Royal Commission's findings, ASIC's Corporate Governance Taskforce undertook a review of Australia's largest financial services companies. As was the case with other reviews, this one identified shortcomings in director oversight of non-financial risk. In particular "some companies lacked awareness of the underlying issues, heightening deficiencies in practices" and "boards approved risk appetites that were intended to articulate the level of risk acceptable for company operations, but management operated outside this appetite for years at a time with the board's tacit acceptance" (ASIC, 2019, p. 6).

ASIC's review also noted that directors of two major financial services businesses could not provide explanations of the metrics used to measure the risk appetite statement (ASIC, 2019, p. 17). ASIC determined that directors "cannot simply sit back and accept information provided on face value" (ASIC, 2019, p. 48). ASIC considered that "boards need to exercise active stewardship to ensure they have meaningful oversight of their organisation and management" (ASIC, 2019, p. 8). ASIC expects that directors understand the information they require from management to make informed decisions.

Other relevant reviews

On 1 February 2021, a report into the suitability of Crown Casino to hold a licence in NSW was provided to the Independent Liquor and Gaming Authority. The report by The Honourable P A Bergin SC provided interesting insights into the capabilities expected of directors. Whilst Crown Casino is not a financial services organisation, it is a complex business and some of Bergin's observations can assist in consideration of essential director capabilities of any complex business (Bergin, 2021).

Bergin noted that each director must be capable of exercising 'active stewardship' and hold management to account when an organisation operates outside of its stated risk appetite (Bergin,

2021, p. 329). Bergin considered suitability of directors against a number of criteria, including having sufficient experience and business ability to operate the casino (Bergin, 2021, p. 335).

"When a company operates outside the Board's stated risk appetite, the Board must exercise "active stewardship" and hold Management to account."

The Honourable P A Bergin SC, (p.329, 2021)

The report into the collapse of HIH also drew conclusions about the capabilities of directors of a complex financial services organisation. Justice Owen said that "it is incumbent on non-executive directors to understand the nature of the company's business regardless of their own particular expertise or experiences. They need to attain a working grasp of the essential drivers of the business, the competitive environment and the nature of the risks to be managed" (Owen, 2003, p. sec 6.2.3).

An Actuaries Institute taskforce conducted a comprehensive review of issues within the troubled individual disability income insurance sector (Actuaries Institute Disability Insurance Taskforce, 2021). As part of its review, the Taskforce considered the capabilities of directors. It recommended that boards should review their capabilities and bolster life insurance experience to target substantial representation by directors with deep strategic and operational understanding of the life insurance business, garnered through working in the industry (recognising that this should not come at the expense of appropriate board diversity). It also recommended there should be regular board access to independent expert advice (Actuaries Institute Disability Insurance Taskforce, 2021, p. 28).

Implications for director capabilities from the above reviews

None of the above-mentioned reviews examined the capabilities of the individual directors, focusing instead on observations of shortfalls in governance, oversight and culture of the organisations. Commissioner Hayne made direct comments about the capabilities of various chairs and CEOs. Those he criticised resigned soon after the publication of the final report. In the aftermath, there has been substantial change in the membership of financial services boards.

This evidence suggests that the misconduct identified by all the reviews was enabled by boards of directors that did not adequately understand the complex businesses they directed – clearly reflecting systemic gaps between essential board skills and capabilities and board appointments.

3. Skills and capabilities required by directors of complex financial services businesses

Directors, collectively need to have the necessary skills, knowledge and experience to understand the risks of the institution and to ensure that the institution is managed in an appropriate way taking into account these risks.

Directors are individually accountable for the collective decisions of the board, and therefore directors of the board "must work together and bring to bear their collective ability to provide both the leadership and the checks and balances that corporate governance demands" (Owen, 2003, p. sec 6.2). The board makes various resolutions that directly impact on the success of the corporations they direct. As Garratt notes, a "director is a unique role protected by law in most national jurisdictions" (Garratt, 2010, p. loc 122). Garratt goes on to state that directors are not managers with siloed responsibilities. Whilst there has been significant research around the capabilities required to be a manager, "we know little about directors and their effectiveness" (Garratt, 2010, p. loc 128).

APRA states that "the board is expected to provide clear direction and leadership for the institution in its approach to risk management" (APRA, 2014, p. 5). APRA also requires that "the Board must ensure that directors and senior management of the institution collectively have the full range of skills needed for the effective and prudent operation of the institution, and that each director has skills that allow them to make an effective contribution to board deliberations and processes. This includes the requirement for directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of the institution, including its legal and prudential obligations, and to ensure that the institution is managed in an appropriate way taking into account these risks. This does not preclude the board from supplementing its skills and knowledge by engaging external consultants and experts" (APRA, 2019a, para. 19).

The terms 'competencies', 'capabilities' and 'skills' are often used interchangeably. In discussing the capabilities required of directors of complex financial services business, it became evident that these terms need to be more carefully defined. Hadziomerovic (2017) argues that these terms refer to different aspects of the contributions made by directors and it is these differences that are important to identify the correct director capabilities. The term 'skills' has been adopted here to refer to technical or domain competencies – for example finance, actuarial, HR and technology could all be considered technical skills. These skills may be achieved through experience, be professionally recognised, and/or arrived at through specific training. In the case of directors, these skills need to be demonstrated through experience. Capabilities refer to behaviours that are required to apply the skills as a director, for example the ability to be a team player, the ability to adapt to new situations, the ability to dig deep into detailed information, and the ability to comment on critical information so that it is understood by other directors. Again, as for skills, capabilities require the specific ability with supporting behaviour at director level.

Observations by Hadziomerovic show that an individual may have specific technical skills but may not be able to apply these skills effectively, as needed for a director. The AICD explains that directors need "the attributes and competencies enabling individual board members to use their knowledge and skills to function well as team members and to interact with key stakeholders" (Australian Institute of Company Directors, 2020). The AICD recognises that there is no absolute list of capabilities or skills for boards except that all directors should be financially literate (ASIC, 2021).

A joint report by the AICD and Australian Council of Superannuation Investors (ACSI) on governing company culture gained insights from interviews with directors and observed that "effective oversight starts with motivated directors and diverse boards" (Australian Council of Superannuation Investors and Australian Institute of Company Directors, 2020, p. 18). In addition, it was noted that directors needed to have curious minds and an interest in the business demonstrated through them talking to people in the business.

In short, we are arguing that a board of directors requires a collection of skills and capabilities which have been demonstrated to be at a director level. Not every director requires every skill, but every director would be expected to have the ability to apply their skills as a director of a financial services business.

4. Insights from Boardroom insiders

The 2021 Actuaries Virtual Summit hosted a panel discussion focussed specifically on director capabilities for financial services firms. The panel of six included four current or former directors of major financial services organisations, a recruiter of directors, and the CEO of a major proxy advisor firm.

There was consensus that boards needed a minimum of three directors with deep operational experience, including the chair.

There was consensus that boards needed a minimum of three directors with deep operational experience, including the chair. Preferably, the chair of the board will have served as a CEO or senior executive of a similar financial services business. A significant number of directors need to identify with management and understand the trade-offs that are required in management decision-making. Boards without deep experience in the relevant business can distract management with matters that are of lesser importance. Further, inexperienced directors may be so risk averse as to drive cost cutting strategies that undermine key capabilities. To illustrate, one panellist stressed that two core capabilities in insurance are claims management and underwriting, and that these capabilities have been lacking on boards of the major life insurers – a contributing factor to poor claims experience.

Irrespective of their domain skills, directors need to have the capability and motivation to study the detail in areas where they are particularly skilled. Directors must know the type of key reports to request and need to focus particularly on the high-risk areas of the business they direct.

While the panellists agreed that all directors needed to understand the financial drivers of the business, it was noted that having strong financial literacy is not the same as having a deep understanding of the business.

Individual directors need to understand desired outcomes from the customers' perspective, be connected to the community and understand what community expectations are.

Diversity of skills is important; “having an extra banker on a board with seven other bankers adds little … the issues revealed in the banking Royal Commission were not a result of directors not understanding ‘financials’ of the bank but directors not understanding product design and customer needs.” As another panellist noted, directors “don’t need … a director with domain expertise to decide if products are wrong”.

Directors need the fortitude to listen to and understand bad news. There was a strongly held view by the panellists that some directors be appointed from other industries. It was noted that management and directors within an industry speak the language of that industry and that this language embeds obstacles to good product design. One panellist expressed frustration at the insurance language that embeds product complexity, such as “reversionary bonus, terminal bonus, … rubbish bonus”. Such terms have no meaning beyond traditional insurance.

Having directors with diverse backgrounds and industries has been proven to reduce “unconscious bias” inherent in us all, and the collective bias that arises from all directors from the same industry because they ‘speak the same language’ and lack essential industry diversity (Australian Council of Superannuation Investors and Australian Institute of Company Directors, 2020).

Directors with a non-financial services background can potentially add considerable value by drawing on their diverse experience.

Directors with a non-financial services background can potentially add considerable value by drawing on their diverse experience. While this experience can contribute to diversity of thinking of the board in a general sense, it was noted that it may be of particular benefit if the director is skilled in ‘pattern recognition’. That is, they can identify issues in the financial services business with a structure or pattern which is like one they had dealt with in another industry, and then apply the lessons learnt in that other situation.

A major barrier identified by a panellist was the preference for directors to maintain the appearance of a ‘golden career’, meaning that directors with career mishaps and blemishes are not likely to be appointed. Directors with first-hand experience in organisations where there have been major financial or other business-negative issues are not represented on many boards. It was suggested that all boards should have at least one director who has direct experience with solvency or existential challenges.

Another panellist expressed the notion that directors from unrelated disciplines can offer beneficial insights. For example, academics may have suitable director capabilities because they are accustomed to rigorous peer review processes and managing failure, such as the inevitably low success rate of grant applications.

5. A way forward

The findings of the Banking Royal Commission and other reviews, together with the various other points considered previously suggest that:

1. the pool of directors may not include sufficient directors with the skills and capabilities to direct complex financial services organisations; and/or
2. director recruitment and nomination are deficient – this could be due to lack of understanding of needs, poor process, and/or low perceived importance or priority.

For a board to effectively direct a complex financial services business it requires directors who have both specialist skills and capabilities as a director.

Further, since these reviews the major banks have all but sold out of their wealth management and insurance businesses (Smith, 2021). The media is reporting these divestments as a return of the banks to their core businesses but they may also reflect the challenge in understanding these businesses and ensuring strong governance of them.

For a board to effectively direct a complex financial services business it requires directors who have both specialist skills and capabilities as a director, i.e. not as a line manager or executive.

The ASX Corporate Governance Council recommends that “a listed entity should have and disclose a board skills matrix setting out the mix of skills that the board currently has or is looking to achieve in its membership” (ASX Corporate Governance Council, 2019, p. 13). However, the current standard skills matrix does not go far enough as it often focuses more on domain skills than on both skills and capabilities as distinguished above.

For a sizeable organisation there would need to be a detailed description of the skills and capabilities developed and directors would need to be objectively assessed against those various skills and competencies, based on demonstrated experience and behaviour.

Financial Services Board Assessment Aid

Set out in Appendix A is a pro-forma tool – the ***Financial Services Board Assessment Aid*** (the ‘Aid’) – which focuses on the special needs of boards of financial services businesses. It is intended to help develop a stronger, broader and more effective skills matrix, and to assess the board overall against the special needs of the boards of financial services businesses.

A mix of directors from different industries is necessary to recognise various patterns between industries and enable more lateral thinking.

The Aid is not intended to take the place of generally accepted principles and practices for board composition, including the need for the board to have diversity in other dimensions. Rather it is intended to supplement these principles.

The Aid has been populated with illustrative skills and capabilities, together with supporting rationale.

In practice the chair and the nominations committee would refine and particularise based on the characteristics and needs of the organisation. An assessment would need to be made about the balance of skills and capabilities required on the board as a whole.

The following illustrates some board composition goals that might emerge by the application of the Aid:

- At least three directors with **deep operational experience garnered through working in the financial services industry** within which the company operates. These directors need hands-on management experience to enable them to understand the trade-offs that are often required in routine decisions made by management.
- A **mix of directors from different industries**, to recognise various patterns between industries and enable more lateral thinking that is not limited by industry specific jargon. Often lessons learned from one industry are applicable or adaptable to other industries.
- The **chair of the board should be a former CEO or senior business line executive of a similar financial services business**. The Chair at times is needed to be a coach and mentor of the CEO, and hence there is distinct advantage if they have some commensurate experience, for example having been a CEO themselves. A chair who has not served in a CEO role is less likely to be able to effectively challenge management decisions. We acknowledge that, because fewer women have held very senior business line or CEOs roles than men to date, this could introduce a bias against appointing a woman as chair. The board would therefore need to balance this with its diversity intent.
- At least one director who has **direct experience with a solvency issue or business existential challenge**. Directors with the 'golden career' are often selected ahead of those with a non-optimal career. The risk aversion to director selection may result in boards lacking directors with foresight for emerging challenges and a lack of experience to be able to effectively recognise and manage them.
- Directors who **understand the broader community expectations**. The director needs to be capable of providing ethical leadership to the organisation within the broader community. Ethical decision making, underscoring the mission and values of a company, comes from understanding community standards and expectations.

Of course, boards of directors do not appear overnight; they evolve over time as directors come and go. Effective boards therefore need to have a long-term plan involving director assessment and skills/capabilities matching for the changing needs of the organisation.

Notwithstanding the distinctive nature of financial services, it is likely that the conclusions drawn about director capabilities above would be applicable to the boards of complex organisations in other industries.

Appendix A

Board Assessment Aid – special needs of financial services businesses

The following provides an example of a skills and capabilities matrix that may be adapted for complex financial services businesses. We have populated it with illustrative skills and capabilities to highlight how it may work, with a particular focus on the special needs of financial services businesses. It would need to be tailored to a specific organisation with more details included on defining skills and capabilities.

We are taking it that:

Skills refer to technical or domain capabilities demonstrated through experience – for example finance, actuarial, HR and technology could all be considered technical skills. These skills may be achieved through experience, they may be professionally recognised, or they may be arrived at through specific training.

Capabilities refer to abilities and supporting behaviour to apply skills as a director – for example, the capability to be a team player, the ability to adapt to new situations, the ability to dig deep into detailed information, and the ability to comment on critical information presented to the board so that it is understood by other directors.

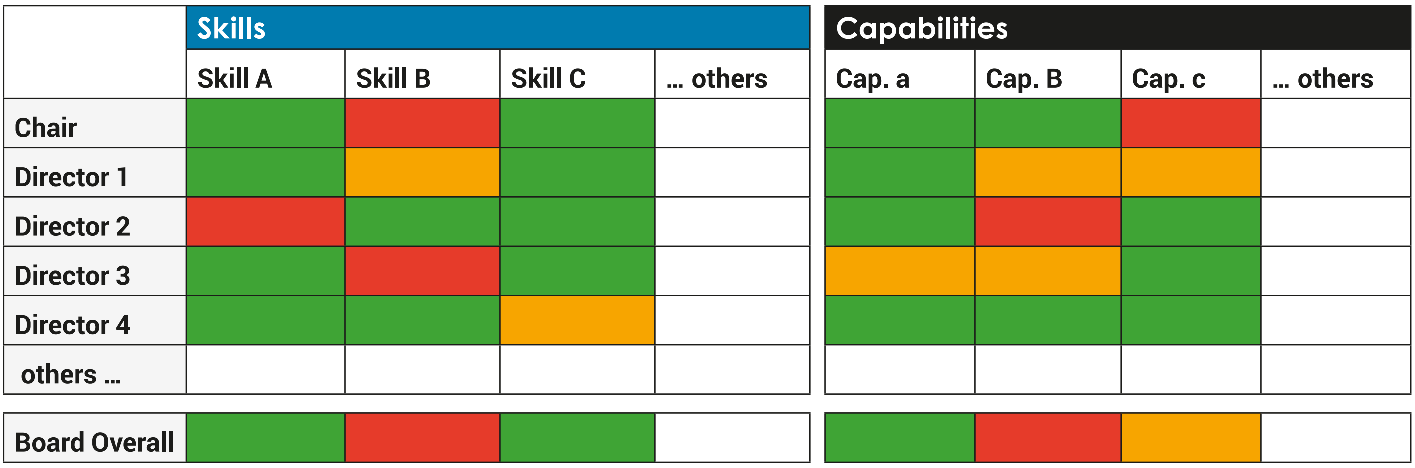
Rating Scales

Each director is rated for each skill and capability using the scales below, recording the colours in a matrix to give a visual representation. The board can then form a view on rating for the board itself for each skill and capability, and then decide on what should be done about gaps and deficiencies.

Skills Assessment Rating Scale		
Rating Scale		**Definition**
Low	(red)	No qualifications/technical ability but possibly conversant
Moderate	(amber)	Qualifications/demonstrated technical ability but limited recent practice; and/or significant understanding gained on boards
Strong	(green)	Formally qualified and with deep technical skills and operational experience/practice

Capabilities Assessment Rating Scale		
Rating Scale		**Definition**
Low	(red)	Little to no demonstrated capability
Moderate	(amber)	Some lack of abilities and/or supporting behaviour
Strong	(green)	Obvious capability, with demonstrated abilities and supporting behaviour

The assessment summary could then look something like this:



The 'board overall' assessment would be made based on the composition goals set by the board.

Table of Skills

Skills	Financial Services Special Needs	References
Financial literacy	Society (supported by regulation) demands highly secure financial services institutions. In turn this requires high quality financial management and reporting, and strong governance thereof. **All directors should be financially literate, but there should be at least three directors with deep skills in understanding financial statements and management reporting – for both the primary organisation and key subsidiaries.**	AICD Financial Fundamentals for Directors https://aicd.companydirectors.com.au/resources/bookstore/financial-fundamentals-for-directors-2nd-edition
Legal & Compliance	Financial services are subject to very particular legal requirements and strong regulation. The board needs to be able to assess the quality of compliance management and reporting. **There should be at least one director with deep knowledge and skills in the regulations governing financial services business, and/or the board should have access to regular expert advice, independent of management.**	Appendix B below APRA Prudential Standards Australian Securities and Investments Commission Act 2001; ASIC regulatory guidance
Risk Management	Because of the financial promises to customers, risk management is of fundamental importance to the operation and prudential soundness of a financial services business. Strong oversight of risk management by the board is critical, and particular responsibilities are imposed on the board in APRA prudential standards (for example, to set risk appetite).	ASX Corporate Governance Council. (2019). *Corporate Governance Principles and Recommendations 4th Edition.* APRA Prudential Standard CPS 220 Risk Management

Skills	Financial Services Special Needs	References
Risk Management (continued)	To aid the board in understanding the quality of risk management and associated reporting **there should be at least one director with deep risk management experience in an operational role or risk management specialist role in a financial services business.** *See Risk Management Mindset below also.*	
Governance/ Board	Particular expectations are placed on financial services boards/directors via laws and regulations with respect to governance. For example, APRA has requirements and expectations over and above generally accepted practices. **All directors should have unequivocally sound understanding of generally accepted standards and practices for strong governance and of the particular requirements for financial services.** The board may need specialist support from management and/or external advisers if it does not have sufficient expertise amongst directors.	APRA Prudential Standard CPS 510 Governance APRA Information Note GCRA APRA Prudential Standard CPS 510 Fit and Proper
Senior Management	Financial services can be very complex, and without long experience in senior roles, it is very difficult for a director to have a complete understanding. To ensure the board: • has a deep understanding of management reporting, business performance and risks; • knows 'where to look' and can engage effectively with management experts; and • is able to appropriately challenge management; **there should be at least one, and it is highly desirable that there are three or more directors, who have deep operational experience garnered at senior level, in the particular financial services industry. Skills and experience in product and distribution/ financial advice are particularly valuable.** It is desirable that some other directors also have experience working in financial services. To help the understanding of the challenges facing the CEO, **there should be at least one director with CEO experience in financial services or another industry**. It is particularly helpful if the Chair has this experience.	

Skills	Financial Services Special Needs	References
Technology	Financial services businesses are heavily reliant on technology to provides services to customers, prudently manage the company's financials etc. Further, the world of financial services, the nature of competition, delivery of products etc is changing rapidly – often built on technological developments. To help ensure the board can maintain a strong appreciation of the threats and opportunities posed by technology, **there should be at least one director with deep up-to-date technology skills, knowledge and understanding, and/or the board should have regular expert external support, independent of management**.	
Financial Asset/ Investment Management and Liability Management	Financial asset and liability management lie at the heart of financial services businesses, because of their very nature and the fact that there is a high level of gearing inherent in their balance sheets. Not only is the financial performance of the business highly dependent on the quality of this management, but customers outcomes can be directly impacted. It is therefore **highly desirable that at least one director should have deep skills in credit management (ADIs) or liability management (insurance), and/or the board should have regular expert external support, independent of management.**	
Regulatory Supervision	Financial Services are highly regulated, and the regulators – particularly APRA – are active supervisors. Amongst the many regulations and supporting guidance, there are multiple requirements applying directly to boards. **Experience on the board in dealing with regulators and understanding their intent and expectations is highly desirable.** In any event, strong support from management and/or external advisers is essential for the board to govern soundly and to fully understand its own obligations.	APRA Prudential Standards and Practice Guides APRA An Aid for Directors of ADIs and Insurers https://www.apra.gov.au/sites/default/files/Aid-for-Directors-October-2014_0.pdf
People, Conduct, Culture, Remuneration	The needs of a financial services board with respect to people matters are similar to those of boards in other industries.	ASX Corporate Governance Council, 2019, p. 13

Skills	Financial Services Special Needs	References
People, Conduct, Culture, Remuneration (continued)	However, in financial services: • business performance often is based on leveraging other people's money; • remuneration tends to be a good deal higher than in other industries; and • ultimate performance related to individual decisions and actions can take years to emerge clearly. All of this can drive management priorities, decisions, behaviour and culture and requires close consideration by the board. As demonstrated by the Banking Royal Commission, the character of individuals (both management and board) can have profound implications for conduct and culture. The Banking Royal Commission also highlighted the importance of incentives in driving behaviour, and this is driven home by the Banking Executive and Accountable Regime (BEAR, soon to be Financial Accountability Regime (FAR)) legislation, supported by APRA requirements. To add a harder edge, there are specific 'fit and proper' requirements imposed by APRA. It is highly desirable therefore that a financial services board: • **has at least one director with deep expertise in remuneration and related behavioural implications; and** • **has at least one director deeply skilled in matters of culture and conduct** and/or the board has expert external support, independent of management. *See **Prudential/Customer Outcomes** Mindset below also.*	APRA Prudential Standard CPS 220 Risk Management APRA Prudential Standard CPS 510 Governance APRA Prudential Standard CPS 510 Fit and Proper APRA. (2019b). Transforming governance, culture, remuneration and accountability: APRA's approach. Australia: Australian Government Financial Accountability Regime https://treasury.gov.au/consultation/c2021-169627 APRA (draft) CPS 511 Remuneration and (draft) CPG 511 Remuneration
Customer Service	Financial services organisations are, as the name implies, essentially built on customer service. There are no tangible products, and the customer relationship is often for many years – sometimes contractually. **The board must be able to understand details and associated nuances in information presented about customer service, complaints etc., appreciate deficiencies (for example, the use of averages can hide a multitude of sins), know what to ask for, seek other insights as required, and draw conclusions.** A director with first-hand deep operational customer service experience can help with this.	Appendix B APRA Prudential Standards Australian Securities and Investments Commission Act 2001; ASIC regulatory guidance

Table of Capabilities

Capabilities	Financial Services Special Needs	References
Business and Financial Acumen, Insightfulness, Strategic Thinking	Financial services businesses are complex and often large. As with any business with such characteristics, **capabilities in business and financial acumen and strategic thinking are critical for the board to conduct its role effectively.**	
Prudential/ Customer Outcomes Mindset	In a general sense, the board is obliged to act in the best interests of the company. In most cases, this results in a very strong focus on the interests of shareholders. However, by law and regulation, supported by community expectations ('social licence'), a financial services board has responsibility for protecting the interests of customers. For life insurance, policy owners have outright priority over the interests of shareholders, and for superannuation the fund must be operated in the interests of members. Every director must understand and accept these responsibilities. That should be reflected in board priorities, strategic thinking, decisions and supporting arguments. **This demands a mindset – individual and collective – which places very high importance on customer outcomes.**	Appendix B below APRA Prudential Standard CPS 510 Fit and Proper
Social Awareness and Insights	A financial services business – much more than most others – relies on the trust and respect of their customers, and of society more generally. The Banking Royal Commission highlighted the poor awareness of, and response to, community expectations amongst both management and boards. The Commissioner later laid down six principles supporting community expectations. To help build and maintain that trust and respect, it is critical that a financial services board is able to assess and respond to community expectations. It must be able to keep its finger on society's pulse. **All directors should be alert to the importance of this issue and it is highly desirable that at least one director should have deep skills in this field, and/or the board should have regular expert external support, independent of management.**	Hayne, 2019, p. 8

Capabilities	Financial Services Special Needs	References
Board Style and Behaviour – Influence on Culture	For financial services businesses, culture is widely accepted to be of fundamental importance to sound prudential management and appropriate conduct throughout the organisation. This is reinforced through regulation. It is also widely accepted that the 'tone from the top' has a critical role in development of the desired culture. The behaviour of the board is therefore critical in influencing culture. In this sense, there is no particular difference for a financial services board. In the interests of good governance, the board must be able to challenge management and where appropriate hold them accountable. It also needs to empathise where appropriate. The manner employed sends messages down through the organisation. The degree of collegiality amongst directors is a function of the board's desired style and culture. However, the way directors behave towards each other influences those who observe the board in action. A financial services board should be conscious of the findings in the CBA Inquiry and the view expressed that one of the cultural themes that have inhibited sound risk management in CBA was "collegial, high trust environment, leading to some over-confidence and over-collaboration". It should also be particularly aware of the APRA requirements and expectations with respect to culture, and the implications this has for culture/behaviour of the board itself. **A financial services board must understand its role in this context and have the ability, and exhibit the behaviours needed, to meet its obligations. This has implications for the capabilities of all directors,** as good work can be readily undermined by one or two individual directors sending the wrong messages through their behaviour of lack of appreciation of the issue of culture.	Hayne, 2019, p. 396 APRA. (2018). Prudential Inquiry into the Commonwealth Bank of Australia Final Report. Australia page 83 APRA. (2019b). *Transforming governance, culture, remuneration and accountability: APRA's approach.* Australia: Australian Government ASIC. (2019). *Corporate Governance Taskforce – Director and office oversight of non-financial risk report.* Australia: Commonwealth of Australia
Risk Management Mindset	The board should understand that APRA requires the board to establish the risk appetite and approve a formal risk management strategy, and it has multiple other specific requirements that are of direct importance to the board.	APRA CPS 220 Risk Management

Capabilities	Financial Services Special Needs	References
Risk Management Mindset (continued)	To properly and effectively address these requirements the board needs more than the risk management skills referred to above. Critically, risk management is of fundamental importance to customers in financial services businesses, and this requires a commensurate mindset by the board. **Risk appetite and risk management with clear consideration of the customer perspective must share centre stage in the board's governance.**	

Appendix B

Specific responsibilities placed on directors of financial services businesses

Insurance Act 1973

The main objects of this Act are ... to protect the interests of policyholders... imposing primary responsibility for protecting the interests of policyholders on the directors and senior management... promote prudent management.

Life Insurance Act 1995

The principal object of this Act is to protect the interests of the owners and prospective owners of life insurance policies...[and]... The director's duty is to take reasonable care, and use due diligence, to see that, in the investment, administration and management of the assets of the fund ... priority is given to the interests of owners and prospective owners of policies... in the event of conflict between the interests of owners and prospective owners of policies ... and the interests of shareholders of a life company, a director's duty is ... to see that the company gives priority to the interests of owners and prospective owners of those policies over the interests of shareholders.

Banking Act 1959

The main objects of this Act are ... to protect the interests of depositors in ADIs … heightened accountability for banking directors and senior executives through the Banking Executive Accountability Regime.

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Critically, risk management is of fundamental importance to customers in financial services businesses, and this requires a commensurate mindset by the board.

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