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The Dialogue

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CEOs Say One Thing and Do Another:

An Insight Provided by a Royal Commission

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Actuaries Institute

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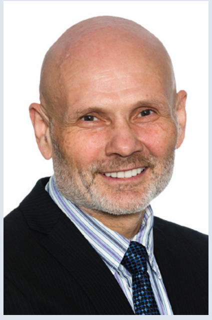

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Context

The Hayne Royal Commission found systemic misconduct in the Australian financial services industry. My review of the Commissioner's findings uncovered a paradox; senior executives acted in ways that contradicted their organisation's ethical values.

How can that be?

The Royal Commission provided significant insights into the justifications made for decisions which organisations themselves admitted did not meet community standards and expectations. A key finding of my research is that while boards of directors appear to act ethically, routine actions of CEOs and other executives do not reflect their organisation's espoused values. This finding is important because it appears that board engagement in espoused values is a necessary, but not sufficient, condition to prevent organisational misbehaviour. Organisations that say one thing but do another can underperform those organisations that behave in line with their values.

This study identifies a serious flaw in the board governance practices of large complex organisations. Boards need to espouse values that can be operationalised and appropriately monitored. Boards need to be aware of the values-in-use of their senior executive teams.

Individual executives, including CEOs and actuaries, also need to assess their values-in-use. Actuaries, like other professionals employed by large organisations, need to be guided not only by the espoused values of their companies, but also by their codes of professional conduct.

1. Introduction

The Royal Commissioner concluded that the poor behaviour of many organisations was systemic, and the boards and senior management of these entities were ultimately responsible.

In Australia, a Royal Commission was established to investigate widespread misbehaviour[1] in the financial services industry (Hayne, 2018). The Commissioner submitted his 1,000-page three-volume final report in February 2019. The Royal Commissioner examined 134 witnesses over 69 days. Included amongst the witnesses were the CEOs and directors of many of Australia's leading financial services organisations.

The Royal Commissioner concluded that the poor behaviour of the organisations was systemic within the entities, and the boards and senior management of these entities were ultimately responsible (Hayne, 2019, p. 4). A motivation for the misbehaviour "seems to be greed – the pursuit of short term profit at the expense of basic standards of honesty" (Hayne, 2018, p. xix). The Commissioner further concluded that while boards and senior executives were actively involved and engaged in setting standards of ethical behaviour, the evidence revealed that the ethical values were not applied in practice.

Large organisations typically define and promote their values and the leadership is expected to embrace them (Al-Kazemi & Zajac, 1999; Kabanoff & Daly, 2002). However, some organisations misbehave to the point where there is "an intentional action by members of organisations that defies and violates either (a) shared organisational norms and expectations and/or (b) core values, mores and standards of proper conduct" (Sagie, Stashevsky, & Koslowsky, 2003, p. 3). According to Khandelwal & Mohendra (2010), excellent companies (i.e. those that return strong long-term profits to shareholders) are clear about what they stand for and actively operate by their advocated ideals (Khandelwal & Mohendra, 2010, p. 19).

This Dialogue will first investigate potential causes for organisational misconduct, it will then develop the idea of 'theories-of-action' to provide a useful framework to consider the evidence from the Royal Commission and draw some broad conclusions from the evidence regarding the role of the board.

1 Misbehaviour included misconduct i.e. law breaking, and behaviour that did not meet community standards and expectations.

2. Organisational Misbehaviour

Academic research has identified four categories of causes of organisational misbehaviour namely:

1. The individual(s) subconsciously made a decision that breached ethical values.
2. The individual consciously breached ethical values because they considered that there were other priorities.
3. The board and/or governance system broke down.
4. The board and CEO were weak, i.e. not up to the job.

The following summarises research into each of these causes.

Executives may be conscious of their breaches of espoused values, even arguing that their breaches aren't illegal, and that regulators should have set defined limits.

According to de Klerk (2017) and Palazzo (2012) executives may be unaware that they are making decisions that breach their own values. Moral blindness can result from the suppression of guilt or anxiety in the unconscious mind. The unconscious mind builds a defence mechanism by "upholding the fantasy of a moral self". Ethical blindness is a psychological state that unfolds over time. It may be a temporary state that is neither rational nor conscious and is a result of individuals' working environment that provides the framing and context where individuals can make decisions that deviate from their own, or their organisation's, values.

On the other hand, research has pointed to executives and directors consciously breaching their organisations espoused values (Kvalnes and Nordal, 2019). Executives involved in the 2008 financial crisis in Iceland were conscious of their breaches of espoused values. Icelandic bankers justified their questionable activities by claiming that they did not breach any law. They argued that the regulators should have set limits on the actions of the banks.

Burns et al. (2020) interviewed directors of large financial services companies in Australia in advance of the Royal Commission. It was found that "finance, in terms of short-term profitability, was considered before all espoused values such as customer centricity, integrity, trustworthiness, *Failures of corporate governance and risk management at many systemically important financial institutions were a key cause of the GFC.*

and professionalism". Further, the interviewed directors admitted that there was a large gap between espoused and practised values, one director said that "shareholders want a 5% dividend every year" more than they want an ethical business. Directors also commented that staff were under pressure to sell products to get commissions. According to Burns et al., directors have a fear of being replaced by the shareholders if they do not meet financial objectives (Burns, Houghton, & Stewart, 2020, p. 1171).

Investigations into the causes of the Global Financial Crisis (GFC) have primarily blamed governance and risk management for misconduct. The Financial Crisis Inquiry Commission concluded that the responsibility for the GFC was "the result of human action and inaction, not of Mother Nature or computer models gone haywire" and specifically: "we conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis" (The Financial Crisis Inquiry Commission, 2011, p. xviii).

The Group of Thirty review of the global banking crisis blamed the boards of these organisations, specifically their "poor cultural foundations and significant cultural failures" (Group of Thirty, 2015, p. 11). Murray recognised that "ultimately, the board is accountable for the actions of the institution" (Murray D, 2014, pp. 3-45).

Lastly, research by Soltani (2014) has identified situations where misconduct is caused by lack of competence of directors and senior executives and concluded that misbehaviour runs deeper than purely governance practices. A comparative analysis of corporate fraud between America and Europe discovered many similarities between the two geographies "notably with regard to poor ethical climate, greed, corruption, fraud, management misconduct, lack of effective control and governance mechanisms, and impaired auditor independence within these groups" (Soltani, 2014, p. 264). The research identified that corporate scandals are a reflection of weak boards including boards who cannot manage their CEO.

Directors have overall responsibility for deciding on espoused values and ensuring that compliance programs are established to monitor the ethical behaviour of their organisation.

3. Espoused Theories Versus Theories-in-Use

Argyris and Schön (1974) have researched organisational reasoning processes. They have developed the idea of 'theories of action' which provides a useful theoretical framework to consider actions flowing from decisions made within organisations. According to Argyris and Schön, people are designers of action to achieve an outcome and there are two theories of action: espoused theories and theories-in-use. Espoused beliefs and values are the ones we espouse to ourselves and are the ones we openly believe justify our actions. Espoused theory can be contrasted with theories-in-use which provide the real time mechanisms for actions. Theories-in-use are the theories implied by our actions which can often be unknown to us (Dick & Dalmau, 2014, p. 4). Embedded in these theories-in-use are value systems that guide our actions. Our actions are justified or defended with reference to our espoused values but are actually directed by our values-in-use.

Large organisations typically espouse values. These espoused value statements are public and are actively promoted by the organisation on their website and in their formal reporting.

These espoused values signal to other stakeholders such as customers and the community generally the ethical basis on which an organisation operates.

Directors are appointed by shareholders to oversee their long-term interests. Directors also operate within a community of expectations – and community expectations are often prescribed in codes of conduct.

Directors have overall responsibility for deciding on espoused values and ensuring that compliance programs are established to monitor the ethical behaviour of their organisation. While directors are appointed by shareholders to oversee their long-term interest, directors also operate within a community of expectations. These community expectations are often prescribed in codes of conduct, for example, regulators such as the Australian Stock Exchange (ASX) set expectations on directors, in particular:

> *A listed entity's values are the guiding principles and norms that define what type of organisation it aspires to be… Investors and the broader community expect a listed entity to act lawfully, ethically and responsibly and that expectation should be reflected in its statement of values. (ASX Corporate Governance Council, 2019, p. 16.)*

As a result of the Royal Commission, Australian Securities and Investments Commission (ASIC), the market regulator of conduct, commissioned a report to "examine governance practices of large listed entities in Australia ... to provide expert advice on the way mindsets and behaviours within Boards might influence their effectiveness" (Kiel Advisory Group, 2019, p. 2). According to this report, boards and the senior executives of financial services organisations are, in fact, aware of their organisations espoused values. By observing boards, Kiel Advisory did find "significant emphasis on ethical role modelling in the behaviour of directors. Many executives reported that their boards were highly engaged when ethical issues were on the agenda, and particularly when those issues related to the customers" (Kiel Advisory Group, 2019, p. 3). Yet notwithstanding the substantial engagement of the board and senior management with their organisation's espoused values, the Royal Commissioner concluded that the organisations investigated did not meet community standards and expectations (Hayne, 2019).

There was significant fallout during and after the Royal Commission. The fallout included four directors of the AMP, their CEO and senior counsel resigning, the CEO and chair of the NAB resigned, all of the major banks decided to sell their insurance and wealth management businesses and the regulators took action against a number of the financial services institutions (Maley K, 2019). Analysts have forecast that the cost to the financial services industry of the Royal Commission will exceed \$10b (Eyres J, 2019). Much of this cost is related to fines and remediation costs of refunding fees to customers for services that were not provided. There are also ongoing regulatory actions against various institutions and a move by the prudential regulator the Australian Prudential Regulation Authority (APRA) as well as other regulators to strengthen their prudential supervision of financial services institutions and their senior management and boards (APRA, 2019).

4. Case Studies

I have selected two case studies from the Royal Commission that relate to specific actions of the CEOs of two large Banks: namely Westpac and CBA. These cases were selected because each of the CEOs expressly shared the values that guided their actions at the time. These decisions were considered routine for a CEO and thus provide insights into potential explanations for gaps between the respective organisation's espoused values and the individual CEO's values-in-use. I have anonymised the individuals involved. The first case considers the decision made by CEO1 of Westpac Banking Corporation (Westpac) to continue with a profitable line of business knowing that customers, including the most vulnerable, were being exploited. The second case considers the differences that existed amongst three senior executives of Australia's largest bank, CBA, to continue selling a product that created significant profit for one part of the bank risking the reputation of another division of the bank.

Data Collection and Management

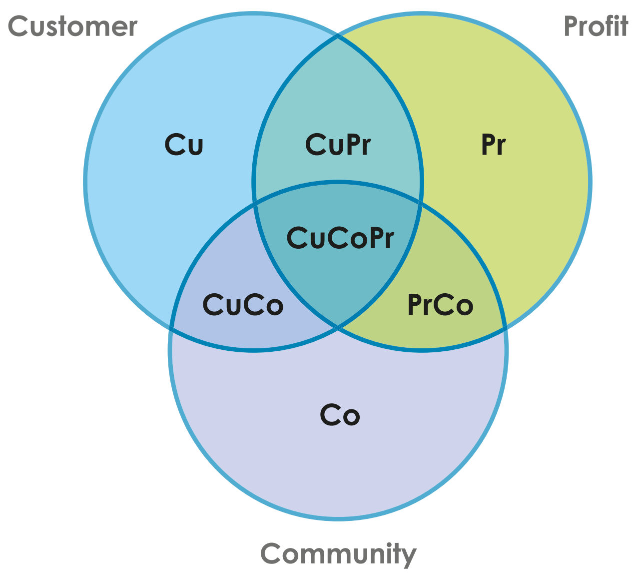
The transcripts of evidence of the individual CEOs are interpreted as written. The CEOs were under oath; they were examined by experienced and senior counsel (QC); and the examiners were prepared because of broad access to significant evidence that corroborated the testimonies of the CEOs.

The analysis applies the framework of 'theories of action' developed by Argyris and Schön to identify and categorise the values-in-use and the espoused values of each of the CEOs and to highlight justifications for decisions made.

I identified three broad classifications or themes of values: the 'profit' label identifies the financial values of the organisation and specifically relate to the short-term interests of the shareholders; the 'customer' label identifies the values that relate to customer benefit; the 'community' label identifies the values that impact the broader society.

The relationship between espoused values versus values-in-use can be conceptualised in the following diagram. Each circle represents espoused values classified between the themes identified namely customer (Cu), profit (Pr) and community (Co). Each of the zones identified represent the values-in-use. These zones are mutually exclusive and collectively exhaustive. To illustrate, zone Cu represents customer focused values-in-use that do not overlap with Profit and Community espoused values. Zone CuCoPr is the area where values-in-use align with espoused values.

Chart 1 – Conceptualising espoused values vs values-in-use



The relationship between espoused values versus values-in-use can be seen in the overlapping influences of the three themes of Customer, Profit and Community.

5. The Findings

Case A – Car Dealer Loans

CEO1 was examined at the Royal Commission about automotive loan programs. These programs were based on relationships that Westpac had developed with private-entity automobile dealerships (hereafter, car dealers) who initiated automotive loans on behalf of Westpac. Car dealers had signed agreements with banks, particularly Westpac, that permitted the car dealer to process loans for any dealer customer at the point of purchase. Without the background information or data about the customer, car dealer employees were permitted to adjust the commission the dealership earned on the loans by making independent decisions at will, to increase the interest rate that a car purchaser paid. Higher interest rates led to near 10-fold increases in the commissions paid to the car dealer (ASIC, 2017a). This adjustment was known as ‘flex commissions’.

After significant feedback from consumer groups and consultation with the finance industry, including Westpac, the regulator introduced legislation to ban the practice of flexing commissions by car dealers (ASIC, 2017b).

Westpac’s espoused values were set out in Westpac’s Group Risk Appetite Statement (GRAS). The GRAS was approved by the board and is publicly promoted. Westpac’s vison is “to be one of the world’s great service companies, helping our customers, communities and people to prosper and grow” (Westpac Banking Corporation, 2018, p. 3). Espoused values stress benefits to the customer (“products and services to support fair, clear and suitable outcomes for our customers”), the community (“we conduct our business in a sustainable and ethical manner that reflects positive community and professional standards”) and shareholders (“in so doing, delivering superior returns for shareholders”) (Westpac Banking Corporation, 2018). Westpac is targeting values-in-use in Zone CuCoPr of Chart 1.

These decisions were considered routine for a CEO and thus provide insights into potential explanations for gaps between the respective organisation’s espoused values and the individual CEO’s values-in-use.

The Evidence

The following excerpts highlight that CEO1's values-in-use were all in Zone Pr of Chart 1. The page number of the transcripts is shown in brackets. No concern was expressed for the known harm of flex commissions to the customers. CEO1 agreed that "flex commissions were only in the interests ... of dealers and Westpac?" and stated that "they flex commissions were in the interests of dealers because dealers could make more money by flexing up the commission" and "they were in the interests of Westpac because they were an incentive for the dealer to deliver business to Westpac" (TP 6819).

CEO1 did claim that Westpac are "providing a service to the customer that is around the convenience of being able to finance the car on – on site" (TP 6824). It is possible therefore that CEO1's values-in-use fall in Zone PrCo that is benefit to the community and shareholder but not the consumer. But CEO1 was more interested in keeping competition out of their market than protecting the customer. CEO1 said "we didn't think that making – being the first mover that is, in not offering the product would actually achieve the elimination of flex commissions, because we didn't think the others would change, if they weren't required to" and "we felt that that would mean we were no longer effectively in the business" (TP 6820). Keeping competition out does not seem to be in the community interest.

CEO1's values-in-use were to exploit customers to make the profit until such time as ASIC, the regulator, banned the practice of flexing commissions (ASIC, 2017b). CEO1 was aware of harms to customers but preferred continuing the practice so as to prevent competitors from gaining a larger market share, thus taking over their business, and hence their profit. CEO1 said "the fact that flex commissions needed to be banned despite industry participants knowing that it was harmful to consumers suggests that there is a problem with the intermediated market" (TP 6821). And, "well, there's clearly a continuation of a practice that puts some customers at risk of bad outcomes" (TP 6822), and "… we felt that it offering flex commissions ... should be banned by ASIC. … we felt that a – a constructive way to deal with it was to make our view plain that it should stop, to be supportive of that, and to advocate with ASIC for it to stop"(TP 6821).

The CEO was aware of harms to customers but preferred continuing a practice so as to prevent competitors from gaining a larger market share.

CEO1 admitted that "there's an obvious conduct risk [reputation risk] involved with flex commissions" and "'Westpac ... has no appetite for conduct risk" (TP 6820). CEO1 said "if we thought that there was not a pathway to eliminating that risk, then we would make that decision to stop selling the product, but we saw the possibility through intervention with the regulator to eliminate the practice and, thereby, eliminate the risk" (TP 6821).

On my Chart 1 CEO1's values-in-use were in zone Pr, that is only for the interests of the shareholder. CEO1 was conscious of their values-in-use and was clear that consumers were being harmed by the product. CEO1 relied solely on the regulator to protect the interests of the customer and the community more generally.

Values-in-use were not aligned with espoused values – instead, the values were simply to maximise profits within legal boundaries.

Case B – Temper Your Sense of Justice

CEO2 was examined at the Royal Commission about the decision to defer closure of a profitable product the bank was aware was being intentionally sold with exploitative practices to customers known to be financially naïve. CBA executives with knowledge of this practice included the previous long-term CEO (hereafter, the previous CEO), CEO2 and the head of the Wealth Management (hereafter, the HWM) business a subsidiary of CBA. These bank executives were aware that the consumer credit insurance product (CCI product) exploited many customers but ignored this in favour of high profits.

CEO2 had been appointed to the incumbent role in January 2018 i.e., after the commencement of the Royal Commission. CEO2 was formerly the head of Retail Banking Services (Retail Bank), a division that sold the CCI product under investigation. The CCI product had been promoted by the Retail Bank since 2003. The CCI product was 'manufactured' by the Wealth Management business, a subsidiary of CBA.

CBA's espoused values were stated in their annual report. The values espoused that the bank's activities were to provide a balance between the needs of all stakeholders, and in particular, "to improve the financial wellbeing of our customers and communities" and to "deliver[s] balanced and sustainable outcomes for our customers, community, our people and shareholders" (Commonwealth Bank of Australia, 2018, p. 13). Espoused values fell in Zone CuCoPr of Chart 1 with the need to achieve 'balance' between the three key stakeholders.

The Evidence

As with Case A, Case B's values-in-use were not aligned with espoused values. Instead, the values were simply to maximise profits within legal boundaries that is in Zone Pr of Chart 1.

There were many examples where CEO2 admitted that the bank put profit considerations ahead of the customer interest. The most prominent examples are presented. Firstly, CEO2 admitted that the remuneration to employees selling the product "placed too much emphasis on financial measures instead of promoting accountability and encouraging employees to ensure that the organisation was delivering good outcomes for customers" (TP 6519). And "we have relied too much on legal, finance and consultant's views on how to run our business at the expense of customer and community expectations. We are too reactive..." (TP 6525).

CEO2 explained that the head of the Wealth Management business (HWM) advocated against CEO2 ceasing the sale of the CCI product because of the adverse impact it would have on the Wealth Management business' own profits. The HWM valued sales over the customers; "people can actually see is sales data, we are missing plan and the pressure is rising" (TP 6612).

There were several occasions in the evidence where CEO2 appeared to be motivated by CBA's espoused value of improving financial wellbeing of the customer. However, a closer analysis of these occasions reveals that the concern was aligned with reputation and regulatory risks. There was more concern that significant profits may hurt the brand's reputation and trigger regulatory scrutiny along with fines, rather than the obvious effects on customers. CEO2 said "I held concerns about the sale of consumer credit card products for – by CBA for some time... and ... My concerns varied from the value of the product, the eligibility criteria, ..., whether we were meeting a genuine need, the claim payout ratio, a number of elements of the product and whether they provide appropriate value and benefits for customers" (TP 6596).

The values-in-use were to sell as much of the product as possible by exploiting ambiguities in the law.

It was revealed in the evidence that all of the leadership – CEO2, the previous CEO and the HWM – had received clear direction from their colleagues in the UK that they should cease selling CCI products because of the poor customer outcomes and, hence, the risk of triggering regulatory intervention (TP 6614). Further, CEO2 advised that a competing Australian bank had ceased selling their CCI products already (TP 6610). The previous CEO appeared to have considered the differences in the views of the two executive teams, but ultimately favoured profit over customer outcomes. CEO2's evidence was that "the head of the wealth management part of the organisation did not want to relinquish the profits from this product" (TP 6622).

CEO2 made a file note that was produced in evidence "temper your sense of justice" made during a May 2015 meeting with the previous CEO (TP 6624). CEO2 stated that the comment was made by the previous CEO which was taken to mean "calm down... that I needed to focus more on my personal conviction. … And to pick which battles. ... it was a significant comment from my perspective" (TP 6624). CEO2 said "then in periods of 2015, I discussed my concerns about the CCI product with the then chief executive. I discussed my concerns again in 2016 with the chief executive and on at least three occasions raised those concerns. Ultimately, when I had the decision rights in March of 2018, we ceased the sale of two of the three products that you're referring to ..." (TP 6597).

The values-in-use were to sell as much of the product as possible by exploiting ambiguities in the law. The potential miss-selling of CCI products was raised by ASIC, the regulator, in their report 256 which was issued in October 2011 (ASIC, 2011). Counsel Assisting sought clarification from CEO2 about the bank's response to ASIC's concerns. CEO2 responded "It was clear, at least from my reading of that report, that we knew or certainly had reason to suspect that we were not complying with all aspects of that – of the recommendations" (TP 6601). The failing was that the sales scripts used by CBA in discussions with prospective customers were misleading and lead people to purchase products that they may never have been eligible to claim for.

CEO2 admitted that "the Group took a narrow and legalistic approach in the discussion with ASIC regarding remediation of customers" (TP 6525).

In my Chart 1, the previous CEO and the HWM were making decisions based on values-in-use in Zone Pr, that is for the interests of the shareholder only. CEO2 did appear to be motivated to act in Zone CuCoPr that is where espoused values and values-in-use coincide. A less sympathetic view is that CEO2 saw the risk of regulatory intervention as happened in the UK and was also only motivated to act in Zone Pr.

6. Conclusions

There appears to be a paradox between ethical expectations and legal restriction.

The findings of this study show that the values espoused by the organisations were not applied in practice to routine actions taken by the CEOs or the senior executive team. The boards of the organisations studied appeared to be fully engaged and committed to acting ethically but the CEOs consciously made decisions that breached their espoused values to maximise short term profit.

This study shows that these executives were fully aware of the impacts of their decisions and provides a reliable reinforcement of the findings by Kvalnes and Nordal, and Burns et al., that maximising profit within the bounds of the law was the only value considered by the CEOs examined (Burns et al., 2020; Kvalnes & Nordal, 2019).

This study also challenges some of Soltani's conclusions (Soltani, 2014). Soltani observed that a common characteristic of a misbehaving organisation was a weak board. In my study the boards of the major banks are not weak. They could plausibly be argued to be the most capable of boards of all sectors as directors in financial services in Australia have the highest remuneration of any other segment (Egan Associates, 2017). Excusing misbehaviour on incapable boards does not explain misbehaviour in the Australian banking sector.

There appears to be a paradox between ethical expectations and legal restriction. Simply complying with the law does not necessarily mean executives' action is right for customers. The evidence indicates that the senior executives used their legal responsibilities as an excuse for not meeting organisational espoused values. The remuneration of the executives biased short term financial performance over management of non-financial risk. According to Boyd however, boards of Australian businesses appear to be leaders in incorporating ESG factors into senior executive remuneration (Boyd, 2021). My research indicates that notwithstanding measures that may exist in setting CEO remuneration, the board is not aware of the values in material decisions made by the CEO and other senior executives.

The findings confirmed that misconduct was generally motivated by individuals' pursuit of gain.

In my Chart 1, Zone CuCoPr represents values-in-use that align with espoused values. To ensure that the actions of a complex organisation, like a bank, are consistent with the espoused values boards need to:

1. Set espoused values which enable values-in-use in Zone CuCoPr.
2. Review routine decisions made by the senior executive team and establish how they align with espoused values.
3. Design remuneration systems that penalise senior executives for practising values that do not align with the organisations espoused values.

The espoused values set by the board need to be more than just for 'branding' and 'marketing' purposes, they set the tone for how decisions are made. Boards need to understand, through reflection, why the values-in-use in the routine actions of the senior executive team do not fall within Zone CuCoPr. Based on feedback and reflection the board and the senior executive team may decide that either, the trade-offs in espoused values are not able to be operationalised effectively and hence should be amended, or the operationalising of the espoused values is de-prioritising an important value. Further, executives need to be rewarded for making decisions in line with espoused values. The Commissioner confirmed Murray et al's. (2014) findings that that misconduct was motivated "by the individuals' pursuit of gain, whether in the form of remuneration for the individual or profit for the individual's business" (Hayne, 2019, p. 1).

7. Implications for Actuaries

Actuaries, along with other senior executives, need to assess their own behaviours to see whether there is a gap between their espoused values (as represented by both the Code of Conduct and the company's values statements) and their values in use. Any discrepancies should be raised with the Board especially where the board relies directly on reports from the actuary. For those actuaries involved in product design or pricing, the new Design and Distribution Obligations legislation specifically requires that organisations have a principles-based approach to designing and distributing products. These principles will need to reflect the espoused values of the organisation.

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Directors have overall responsibility for deciding on espoused values and ensuring that compliance programs are established to monitor the ethical behaviour of their organisation.

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