



## **Culture, Customer, Purpose**

Key recommendations and impacts of the Hayne Royal Commission

6 February 2019

'Hasten slowly,  
there is a need to  
get this right'

# Light on the horizon

The final Hayne Royal Commission Report means different things to the industry, to regulators, to customers and communities. The overarching theme of the report is balance.

Commissioner Hayne has kept one eye on structurally reforming the system, while not rocking Australia's economic boat. His unequivocal message to all was that the principles that underpin the rules for the industry should be clear, obeyed, and enforced.

## Straight to the heart of it

Hayne saw four things clearly, which play to the heart of what he thinks went wrong:

1. The connection between **conduct and reward** – since the drivers of nearly every case he considered was both the entity's pursuit of profit, and the individuals' pursuit of gain. *Advisers became sellers, and sellers became advisers.*
2. The **asymmetry of power and information** – between financial services entities and their customers – which enabled firms to act in the way that they did.
3. The effect of **conflicts between duty and interest** – the interests of the client, intermediary and product provider are not only different, they are *opposed*. Self-interest is too powerful a force in the end; in the face of self-interest, effective management of a conflict collapses. Intermediaries should act only on behalf of, and in the interests of, the party that pays them.

4. **Holding entities to account** – deterrence depends on entities actually believing that misconduct will be detected, denounced and justly punished. Communities expect someone to be held to account. Issuing a media release just doesn't cut it.

Our articles consider these issues, Hayne's response and their impacts.

## The Big Six

The six fundamental statements that define the intent of the law are:

1. Obey the law;
2. Do not mislead or deceive;
3. Act fairly;
4. Provide services that are fit for purpose;
5. Deliver services with reasonable care and skill; and
6. When acting for another, act in the best interests of that other.

Commissioner Hayne foreshadows a significant shift ahead and outlines an ambitious task. Ultimately, we should strive for simplification of the law, eliminating exceptions and qualifications as a first important step.

This must be underpinned by the above norms, which set the 'true north' for the industry and regulators, and so for the interpretation of the specific rules and regulations.

It's a principles-led approach, which settles responsibility for understanding and implementing the rules deftly on the shoulders of the regulated.

But, here we have it. Perhaps not the expansive impact yet of UK's Treating Customers Fairly regime, but still important guardrails within which to reshape and simplify the environment.

As actual reform plays out, as always the devil will be in the detail. However, in the year up until now there has been a clarion call to all Australians that we are in a 'new normal'.

It is undoubtedly a long road ahead. Hayne himself has acknowledged it is no simple task. But there is light on the horizon.

Our further overview of the Report as it impacts key sectors will be released shortly.



# Economic impacts

## Key Points

Hayne's final report is not 'shock and awe'. Neither is it a heavy policy tome. What it does is send clear signals to re-orient the system towards the consumer; to do the right thing; and ensure that the rules are clear, followed, and enforced.

Hayne doesn't pull punches – but the sector has been put on notice. The impacts of the findings will be felt differently across the economy, some big and some small. For some it will not go far enough, for many it's the first step on the long road to reform

Within these important messages, the Royal Commission findings also mean different things to the economy – on competition and innovation and the access of Australians to sound financial advice.

For the economy, Hayne's recommendations do not materially change the near-term outlook. Australia's economic growth is solid, albeit set to slow over 2019.

The Commissioner signalled that any sense there was a free lunch is over. In the near-term, improved compliance with existing laws and regulations will be expected. Surprising to some, no tightening of responsible lending regulations reduces the risk of a big step down in credit growth.

This means that Hayne has side-stepped the potential for a crunch.

Longer-term, it is clear that the measures proposed for rebuilding trust will take time to be put in place and feed through into cultural change.

Hayne is clear that he believes the borrower should pay mortgage brokers, not the banks. While trailing commissions will go from July 2020, the rest of the model is referred to review over the next three years.

The prescriptions for mortgage brokers, while designed to improve transparency and incentives to act for and on behalf of consumers, can affect competition in the sector and access to finance in the housing markets.

Changes to remuneration and best interest duty requirements could easily tilt the playing field against mortgage brokers, and the lenders who lack large branch networks. Hastening with caution is the name of the game here.

The extension of the Banking Executive Accountability Regime (BEAR) throughout financial services, may also have some longer-term impacts on the economy. It is likely to add to the observed unwillingness of Australian businesses to take on risk.

The Commissioner appears to have kicked the can down the road to the Productivity Commission on the effects of vertically integrated businesses, marking it for review at a later date.

*Overseeing the overseer* – an outstanding reform from the Murray financial system inquiry has returned.

A new oversight authority for APRA and ASIC is welcome.

## Reflections

The long term policy goal is to ensure that *all* Australians have access to adequate and *appropriate* financial services. Hayne's work has focussed largely on the *appropriate* part.

Hayne places the onus squarely on the shoulders of industry and the regulators to rectify misconduct.

However, the 800-pound gorilla remains in the room – the role of shareholders in influencing corporate culture still needs to be addressed.

There is bipartisan acceptance of the recommendations. However, governments have to take the full picture into account.

That means having smart solutions that prevent misconduct and inappropriate behaviour, that have caused widespread consumer detriment. Solutions that also take into account the consequences for access to credit, for access to financial advice, and for competition and innovation in financial services.

Recommendations have been made for changes to systems and culture and institutions' treatment of customers, driven by community's expectations for these institutions.

These recommendations are likely to reverberate beyond financial services, to other sectors of the economy.

So hasten slowly, there is a need to get this right.

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# Protecting vulnerable customers

## Key Points

'Could', not 'should' - Hayne pointedly observed that the entities he examined acted in the ways they did 'because they could'. This asymmetry was bolstered by the unequal knowledge and power dynamic between the organisation and its customers.

In particular, where customers are more vulnerable, their financial wellbeing appeared to be disproportionately exposed to misconduct by financial institutions.

Uncovering how vulnerable customers were poorly treated was exposed throughout the hearings, dominating many submissions and evidence. So much so, that Round 4 of the Commission's hearings was devoted to issues affecting Australians in remote and regional communities, particularly agricultural lending and how Aboriginal and Torres Strait Islander people are treated.

Hayne's specific recommendations include solutions to improve access to justice and institutions' responses to the needs of vulnerable customers:

- The Banking Code should reflect that banks work with remote communities and poor English speakers to ensure they are able to adopt more flexible identification requirements, restrict informal overdrafts where customers have not consented, and stop dishonour fees on basic accounts.
- Enact a national farm debt mediation scheme.
- In areas declared drought affected or other natural disasters, suspend default interest on loans secured by agricultural land.
- Adopt specific strategies when dealing with agricultural loans, e.g. by offering early farm debt mediation for distressed loans, and making the appointment of receivers a last resort.

## Uncovering how vulnerable customers were poorly treated was exposed throughout the hearings, dominating many submissions and evidence

- Target pressure selling by enhancing anti-hawking provisions for insurance and superannuation.
- Improve protection for vulnerable customers from poor sales practices by including funeral expense insurance policies as financial products under the Corporations Act.
- Reinforce the need for a compensation scheme of last resort, which the Government has undertaken to establish as part of AFCA, and to fund the payment of legacy unpaid determinations from FOS and the CIO.

Hayne acknowledged the critical support provided to consumers by legal assistance and financial counselling organisations.

He noted the significant difference that these bodies have made in ensuring access to justice, bringing the consumer voice to policy debates, and reporting issues to the regulator. Hayne also notes that they are underfunded relative to the job at hand.

In response, the Government has undertaken to review the co-ordination and funding of financial counselling services, including the gaps and overlaps in current services, and appropriate delivery models for funding.

It is unclear however, what they intend to do to support the legal assistance sector.

## Reflections

An organisation's ability to appropriately respond to customers' needs that were out of the ordinary lay at the heart of the issues before the Royal Commission.

Too often, products and processes that were built for a mass market failed to respond to the individual needs of the most vulnerable.

## Impacts

Hayne's reforms are the tip of the iceberg. Financial services providers need to continue to work towards better responses to the challenging issues of mental health, financial abuse, and broader access to financial services for customers with lower financial literacy.

On the issue of effectively supporting vulnerable customers, and closing the gap on their financial wellbeing, there remains a long - yet worthy - road ahead.

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# Regulators

## Key Points

The final report devotes an entire chapter to the existing regulatory structure.

Firstly, and importantly, the report reinforces the 'twin peaks' model of regulation – APRA aligned to prudential supervision with ASIC focused on conduct. The remits of the individual regulators remain broadly unchanged.

The report however does call for a change in approach, and in particular for ASIC. It specifies that the starting point for enforcement should be to consider court action, and that infringement notices should only be used for administrative failings, and rarely be used for large corporations.

Greater cooperation also features strongly, with joint operation of the Banking Executive Accountability Regime (BEAR), a statutory obligation to cooperate, and a cooperation memorandum between APRA and ASIC.

BEAR has been extended to all APRA regulated entities, and a comparable accountability regime to be introduced for all AFSL and ACL holders. Both APRA and ASIC themselves will be subject to an accountability regime.

Finally, a new oversight authority will be established to assess APRA and ASIC on an ongoing basis.

## Reflections

There is extensive commentary throughout the report regarding shifting toward a stricter enforcement regime. The tilt toward court action and away from infringement notices and enforceable undertakings (EUs) combined with a more rigorous approach to EUs, including admissions of guilt, will play out over time. They will likely form one of the more lasting and fundamental changes for the industry from the Royal Commission.

The extension of the executive accountability regime to all licence holders and the regulators will likewise have a lasting effect.

Many of the issues uncovered during the Royal Commission came back to consequence management and executive decisions and responsibilities. So a broadening of the accountability regime was not unexpected.

However, all AFSL and ACL holders indicate that the Commissioner has chosen the broadest possible application. This is especially so when one considers that APRA and ASIC themselves, and so their executives that make enforcement and policy decisions, will be subject to such a regime.

While the regulators themselves have not seen dramatic structural changes to their remits and operations, a new body will be established to oversee APRA and ASIC. This has been canvassed for some time, and was one of the recommendations of the Murray Financial Services Inquiry. The specific remit and powers of this new body have yet to be developed. However it will certainly be structured with the core principle of holding regulated entities to greater account.

## Impacts

- There will be a noticeable change, with an expected immediate effect, in the interaction between industry and regulators. Interactions will be more at arms-length, outcomes will be more binary in nature, and enforcement actions will be more direct.
- Regulators themselves will be subject to far greater scrutiny, accountability and transparency, which will have flow on effect through supervisory activities and style of enforcement. The new oversight body will seek to ensure the spirit of the final report is being continually upheld
- The broadening of executive accountability, which includes responsibility mapping and consequence management, will require a significant lift from the industry; however will also have benefits within firms for understanding decision-making structures and streamlining governance.

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# Accountability at the top end

## Hayne recommends expanding the Banking Executive Accountability Regime to other financial services entities, and brings ASIC into the 'BEAR hug'

### Key Points

Hayne wants to see the Banking Executive Accountability Regime (BEAR) reinforced and expanded beyond banks, embracing ASIC in the BEAR-hug through a co-regulation model with APRA.

Hayne's recommendations cover:

- Extending a BEAR-style regime to all APRA-regulated institutions, possibly starting with RSEs (large first, then smaller) and then moving to insurers.
- Extending responsibilities for oversight of BEAR and any other proposed accountability regimes to ASIC, alongside APRA where the institution is prudentially regulated.
- For BEAR, ASIC's role will cover 'consumer protection and market conduct matters'. Whereas APRA will oversee the 'prudential aspects' of Part IIAA of the Banking Act.
- ADIs that are currently, or soon to be regulated under BEAR, will need to allocate a new prescribed accountability in Accountability Statements. This is to cover all steps in the design, delivery and maintenance of products offered by the bank to customers, and any necessary remediation in relation to those products.
- ADIs and their Accountable Persons regulated under BEAR will need to engage with both ASIC and APRA, in an 'open, constructive and co-operative way'. Currently, it's just APRA.
- Asking that the regulators 'internally formulate and apply

accountability principles of the kind established by BEAR' to its own management.

This is much like what the FCA and PRA have voluntarily done in the UK, in mirroring the requirements of the Senior Managers' and Certification Regime.

### Reflections

Adding ASIC into the supervisory and enforcement mix for BEAR and future executive accountability regimes makes complete sense. In fact, it is perplexing as to why it was excluded in the first place, when the regime clearly covers conduct.

However, an issue that has not been addressed, is where the line is drawn between ASIC's proposed mandate of supervising 'consumer protection and market conduct matters' compared to APRA's oversight of 'prudential aspects'.

There may have been a time when there was a clearer line between prudential and conduct regulation, but not so much anymore. Arguably, risk management, culture, and ultimately wholesale misselling amount to both conduct and prudential issues.

Hayne recommends expanding the Banking Executive Accountability Regime to other financial services entities, and brings ASIC into the 'BEAR hug'.

This co-regulation will need to rely on strong regulatory co-operation, underpinned by the proposed statutory obligations for APRA and ASIC to co-operate, share information and pre-emptively notify each other of breaches.

### Impacts

- Insurers, RSE licensees and AFSL holders should consider the impact a BEAR-like regime will have on them, particularly where there is more than one regulated entity within the group. The question is – could it result in conflicting obligations?
- For superannuation entities, the implications of having fiduciary duties to members and compliance with the Superannuation Industry (Supervision) Act 1993 (SIS) and their respective trust deeds, appears set to be bolstered by individual accountability at the executive and board levels.
- How will these duties sit comfortably next to each other, or will a conflict between them need to be resolved?

Although Hayne has called for plenty of preparation time for regulators and the regulated, organisations shouldn't wait. The time to define accountabilities for executives and directors is now.

As Hayne notes, clear accountability is vital to effective governance.

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# Culture and remuneration

## Key Points

One of the key observations in Hayne's Report is the connection between conduct and reward. He clearly places the blame for misconduct in the financial services industry at the feet of Boards and senior management.

The Report focuses on the profit-driven culture and inadequate systems of risk management and governance, which ultimately reflect a failure of leadership. It outlines several specific recommendations on culture and remuneration including that:

- APRA plays a stronger role in supervising culture and remuneration systems, principles and practices;
- Culture and remuneration systems focus on both financial and non-financial risk (including conduct);
- All entities regularly assess the effectiveness of remuneration systems in relation to non-financial risks;
- The Sedgwick review should be fully implemented;
- All entities to establish a system to assess culture, understand problems and their root causes, and demonstrate the outcomes achieved through any changes or interventions; and
- Executive accountability (and therefore executive culture) will be informed by professional expectations and an expansion of the BEAR regime.

## Reflections

Hayne called out the very worst of the industry over this past year. This awful exposure has called on the very best people in the industry to set higher goals for themselves and their organisations.

The Hayne recommendations direct Boards and executive teams to take a very real focus on building robust cultures, with a strong emphasis on remuneration.

To do this, they will need to consider how their structure, systems, governance and culture reflect their purpose and values.

Hayne reserves particular challenge for the systems of reward in the industry, wielding regulatory and governance oversight of remuneration like a scalpel to carve real change in executive and staff behaviour.

He reinforces that the Board and executive team are responsible for determining their desired culture; and then ensuring it is being lived through measurement and management.

A strong and ethical culture not only prevents misconduct; it enables organisations to thrive. It requires a clear and consistent tone from the top. It builds capability in good decision making, and provides the courage to safely challenge.

It requires every person in the organisation to understand, in the words of Lieutenant General David Morrison: *The standard you walk past is the standard you accept.*

## Impacts

The recommendations give new authority to regulators to oversee whether changes to culture and remuneration are actually delivering the right outcomes.

Each entity will have to ask: 'What are our purpose and values, and how do our customers, people and shareholders experience these?'

When an organisation is truly purpose-led, every employee understands his or her contribution towards achieving that purpose. The values frame '*how we do things around here*', and are continuously reinforced through accountability at

every level, underpinned by effective consequence management.

An important component of managing culture is the serious consideration of how remuneration for senior and middle management shapes decisions and behaviours.

## Hayne wields regulatory and governance oversight of remuneration like a scalpel to carve real change in executive and staff behaviour

Short term, profit based incentives need to be replaced with long term, broad-based measures that drive purpose-aligned decision making for the benefit of a wide group of stakeholders, including customers, employees and shareholders.

Hayne's requirement that the Sedgwick recommendations be fully implemented, challenge the industry and businesses everywhere to consider new models of measurement and reward for good behaviour. Indeed they could revolutionise remuneration systems.

The short-term impacts of these changes will depend on whether executives decide to meet the 'minimum standards' or pursue fundamental and profound change.

In the long term, truly purpose-led organisations will be the winners.

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# Conflicted remuneration

## Key Points

Hayne takes issue with the current legislative exceptions that undermine general principles of law.

For this reason, Hayne's key focus is to see all conflicted remuneration end – prudently and in a managed fashion. But end once and for all.

He stipulates two 'general rules' to make this plain:

- '- intermediaries should act only on behalf of, and in the interests of the party who pays the intermediary.'
- '- exceptions to the ban on conflicted remuneration should be eliminated.'

With firm adherence to these rules, he recommends:

- Fundamental reform of broker remuneration to see that, post a transition period, borrowers (not lenders) pay their fees. This should start with abolishing trail commissions.
- Swift repeal of ongoing grandfathered commissions in the financial advice sector.
- Reducing the cap on life insurance commissions to zero.
- A review of all other carve-outs to the ban on conflicted remuneration (e.g. general insurance and consumer credit insurance) as part of ASIC's review of the Quality of Advice (required to be completed by mid-2022).
- Removal of the point of sale exemption for retail dealers.

Commissioner Hayne also draws strong links to the issue of conflicted remuneration in the recommendations around executive and staff remuneration, with a call to greater regulatory scrutiny of the design and implementation of systems of reward across the sector.

## Reflections

Hayne has chosen conflicted remuneration as the poster child of industry inertia, self-interest and avoidable regulatory complexity.

## Conflicted remuneration – as a symbol of conflicts of interest – go under the knife

In this context of frustration with slow and resistant change, there is little surprise that the Commissioner recommends accelerating the evolution of both the mortgage broking and financial advice sector. He also encourages specific regulatory intervention in the executive remuneration arena.

## Impacts

Affecting the model of remuneration for tens of thousands of financial services participants will have a widespread impact.

- A protracted battle over mortgage remuneration is inevitable – and not just on the individual circumstances for brokers - but on the questions of access to credit and competition that previous reviews have pulled back from the recommendation made here.

- In addition to the radical evolution of some business models, there will be a potential knock-on impact to the cost of direct borrowing.
- Removing grandfathered commission models as well as commissions for life insurance and other exempt products will reshape the business models for many in the financial advice community, and likely lead to wholesale exit of some practices and practitioners.
- Such disruption will inevitably lead to new forms of online financial and lending products, as value for money across all stages of the industry value chain become far more transparent and scrutinised.
- Drawing attention to the issue of executive and staff remuneration as arrangements that give rise to bias, will reshape the reward systems in financial services and lead to personal changes for all current and future participants.

**Dr Deen Sanders** Partner, leads the Professionalism and Ethics practice

# Ethics, professionalism and trust

By our reckoning 34 of the 76 recommendations speak to issues of ethics and professionalism with the goal of restoring trust in the actions of individuals and corporations

## Key Points

Ethics and trust are carved into the very fabric of the recommendations in Hayne's Report.

Everything in the final report is about restoring trust, instilling community confidence, and seeking to embed ethical structures and commitment back into the financial services industry.

As promised, Hayne returned to first principles - the fundamental statements that define the intent of the law that we outline in the Executive Summary - and are the 101 of ethical conduct.

The strength of the final report is in the way Commissioner Hayne calls for structurally embedding change in the law and practice. He builds in issues of 'ethical and integrity infrastructure' through specific recommendations in:

Consumer lending:

- Best Interest requirements;
- Mortgage brokers as financial advisers; and
- Misconduct by mortgage brokers.

Banking services:

- Code amendments for vulnerable customers; and
- Enforceable code provisions.

Regulation:

- Banking executive accountability regime;

- Enforceable Code provisions; and
- Sanctions powers.

Culture governance and remuneration:

- All of the remuneration recommendations;
- All of the culture and governance recommendations; and
- Regulators also subject to BEAR.

Not surprisingly, Commissioner Hayne reserved his most substantial comments about professional expectation and ethics for the financial advice community, with recommendations covering:

- Truthful disclosure for a lack of independence
- Conflicted remuneration
- Professional discipline of advisers

These recommendations speak directly to expectations of professional behaviour and building a system of regulation and oversight that will embed the necessary components for trusted professionals to emerge.

## Reflections

Rather than surprises for the market, the final report is measured and profound. His response is remarkable for its lack of radicalism, as much as its quiet, yet substantive changes.

Commissioner Hayne wisely used the Interim Report as a tool to challenge the industry. In it and throughout the

very public hearings leading up to it, he motivated a deep consideration of complex cultural and ethical issues. These were then worked into his final report as a careful and calm entreaty for change.

Both the government and the opposition have indicated they will support all of the recommendations. In his press release, the Treasurer Josh Frydenberg said that: "The Government's principal focus is on restoring trust in our financial system."

In the case of the ALP, they have used the language of ethics as a catch cry. They challenge the banks and financial institutions to work 'on an ethical basis ... and to above all be ethical'.

## Impacts

Cultural change is at the heart of the recommendations. Let's be clear. Everything has changed and the recommendations in the area of ethics will lead to significant change on the path to restoring trust:

- Embedding the Hayne first principles as matters of principle interpretation, and formalising the law as a hard, bright line, will require engaging with ethics and accountability that will shape the industry in a whole new way;
- New regulatory responsibilities and relationships will lead the industry to 'nowhere to turn' in the face of regulatory scrutiny; and
- Increased accountabilities and individual responsibility will sharpen the mind and increase the pressure on individuals in the system.

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# Governance

## Key Points

While the Commission had a lot to say during the hearings on what 'good governance' should look like, Commissioner Hayne's final report simply addresses six governance themes:

1. Amend the law to make industry *codes enforceable*.
2. Financial services entities to take proper steps to assess their governance arrangements, identify problems, deal with them, and determine the effectiveness of changes made as a result of the assessment.
3. APRA *supervision* activities to focus on improvement of entity governance.
4. Over time, extend provisions modelled on the BEAR to all APRA – regulated institutions as well as other financial services licensees.
5. *RSE trustees* be prohibited from assuming any other obligations or office.
6. Reinforce, within the existing regulatory framework, the fundamental principle of the *norms of behaviour* that are expected in governing financial services entities.

## Reflections

Hayne's focus is on the *changes* entities might make. As such, the report makes the key point that culture, governance, and remuneration must be considered together because of the influence each has on the other.

Given his 'change' approach, rather than seek to make new rules for governance of financial services entities, Hayne has chosen to focus on compliance with existing rules, and the practice of governance by those entities.

He does this by looking at three key areas: the role of the Board, the entity's priorities, and accountability.

The key 'look again' message Hayne directs to those he says are ultimately accountable – the board and senior management – is that the change and self-reflection required demands *intellectual drive, honesty and rigour*.

The report contains some valuable guidance on achieving this.

## Impacts

Hayne challenges all financial services entities to *look* again at the way in which they govern themselves, in particular at how they perform their duties, take accountability, and effect real change.

The entity's priorities should be consciously set on acting in the best interests of the corporation, for a proper purpose, over the long-term.

Hayne says that the best interests of a company '*cannot be reduced to a binary choice*' (between the interests of shareholders and those of customers).

It must have regard to enduring requirements of sustainability.

Governance arrangements should also reflect the *values and norms* of the governance processes they are intended to effect.

This means refocussing on the *purpose* of the entity and ensuring the board role, entity priorities, and accountabilities within the entity support and promote that purpose.

The Board should be aware, and set the strategic direction of the business in relation to *significant matters* arising in its operation. Hayne notes that, critical to the proper discharge of this role may be giving directors '*less material and more information*.'

Hayne calls for comprehensive assessments of governance arrangements.

His report highlights the challenge that entities face in performing these assessments as they tend to be *blind to their own faults*. Assessments must give real consideration to:

- Clear accountability - who within the entity is to be held accountable, and for what?
- The decision-making processes.
- The adequacy of Board oversight and management challenge - the division of power.
- How non-financial risk is managed - conduct, regulatory, and compliance risk.
- The connections between compensation, incentive and remuneration practices.

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Every financial services entity must look again at the way in which it governs itself

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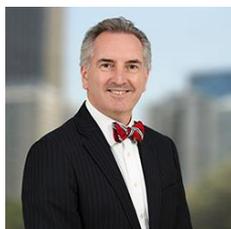
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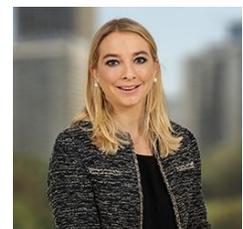
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