THE
# Frontier Line

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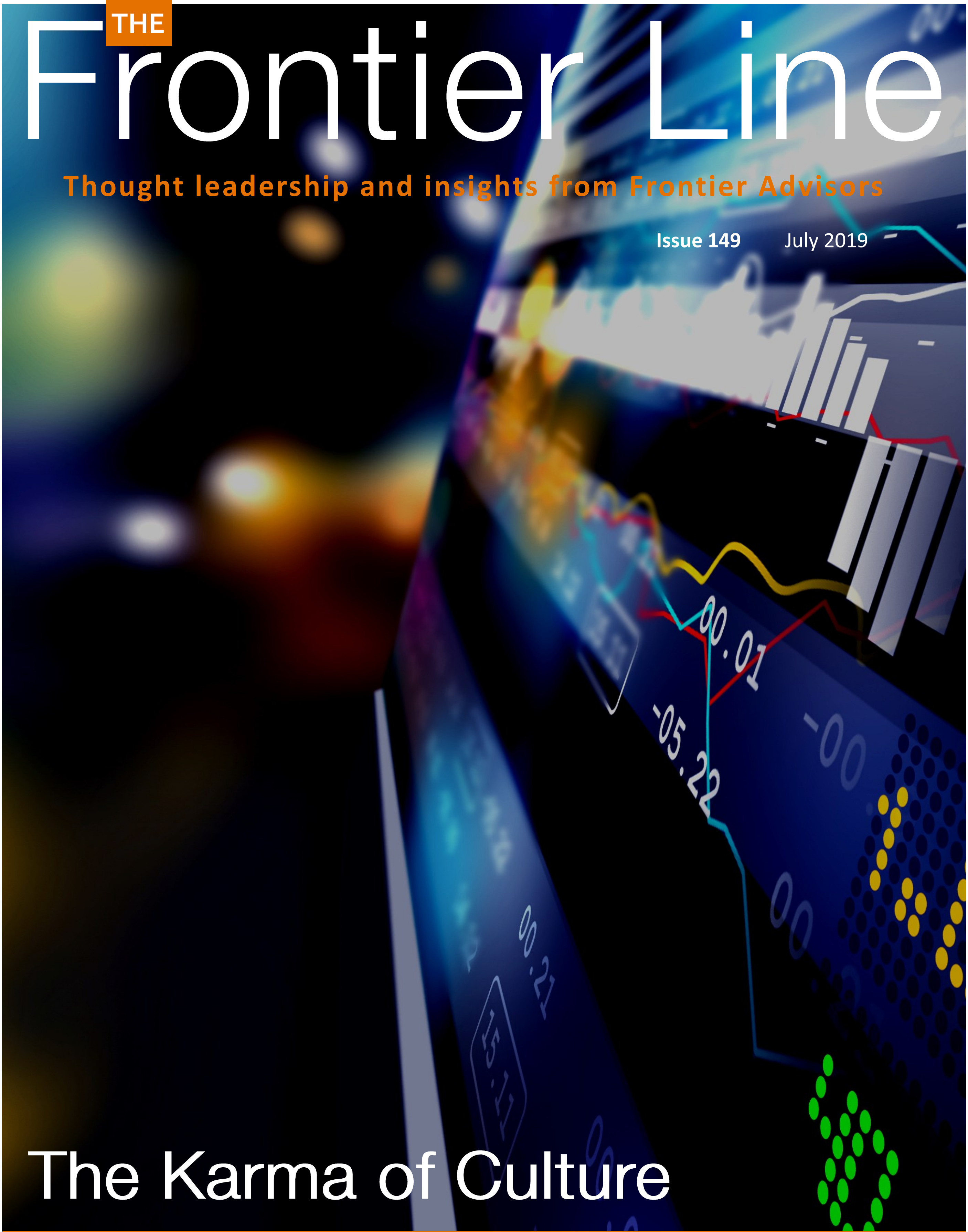

## The Karma of Culture

FRONTIER ADVISORS

# Frontier Advisors

*Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $320B in assets across the superannuation, charity, public sector and higher education sectors.*

*Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.*

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# Introduction

*“If you have a good culture, I think you can make the rules pretty simple.”*

*- Warren Buffett*

Culture is the set of values and behaviours of an organisation - it is the unwritten rules of how the organisation operates.

Culture is “what” people do.

It is how they do it.

Most importantly, it is “why” people do what they do.

The Board and the Directors play an integral role in shaping and maintaining the culture of an organisation.

Culture is often referred to as being like an iceberg. This is because 90% of an iceberg’s mass lies beneath the surface. Culture is similar as it includes the behaviours you can see, as well as everything you can’t see – the shared mindsets and shared beliefs that influence how people in an organisation behave.

Culture is complex and dynamic.

The right culture can be a key tool in achieving differentiation in a competitive environment. Academic research suggests that a good culture can sustain competitive advantages beyond shorter term advantages, such as product and service offerings. The premise behind this idea is that products and services are much easier to replicate than an organisation’s unique culture.

Commissioner Kenneth Hayne in the Final Report into the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry concluded that the wrongdoing was a result of three failings:

1. Organisational culture;
2. Governance arrangements; and
3. Remuneration systems.

Of the 76 recommendations in the Final Report, around half were in regard to culture and ethics. Commissioner Hayne also outlined the need for all organisations to:

- Assess their culture;
- Identify problems;
- Deal with the problem; and
- Determine whether changes have been effective.

There is no doubt that these are crucial steps for all organisations to consider and implement, but the real question for organisations is how are they going to do this? How are Boards going to assess and measure the culture of the organisations they govern, and are responsible for, on an ongoing basis? These are difficult questions, but perhaps a good place to start, is to think about what lessons can be learnt from previous cultural failings.

*“An organisation’s culture is its value and belief system, including any observed regularities, norms, rules for working and getting along, and the climate or how it feels to work in the organisation”*

*- Shein 1991*

# Lessons learnt

In 2004, four NAB foreign exchange traders were found to have falsely inflated the profits made on their trading desk to avoid the scrutiny of management, to preserve their jobs and receive their bonuses. It was estimated the rogue traders cost the bank around A$360 million and a great deal more when you consider the impact on NAB's reputation, staff morale, etc. The traders were subsequently found guilty and jailed. What made this scandal all the more alarming was that the NAB had very strong governance frameworks and strict risk limits in place to ensure trades did not get to unreasonable levels. So how could it have gone so wrong?

At the time of this NAB scandal, APRA released its findings stating that "cultural issues at NAB were at the heart of these failings." When sentencing NAB foreign exchange traders, the judge stated that "the mixture of personal ambition, arrogance and culture made these traders forget their legal responsibilities". Further, the judge stated that "personal ambition and a misguided sense of invincibility had led to the criminal acts."

The court heard the culture at NAB was one where profit was king and as long as traders were making money it did not matter how they were doing it. There was a culture of fear on the desk and people were too scared to stand up to the traders. This meant that it was almost impossible for the people doing the risk checks to do their job properly.

NAB is not alone in the existence of this type of culture. Lehman Brothers and Enron also exhibited similar toxic cultures. Prior to its collapse, reports found that Lehman Brothers had a culture of striving for higher pay and performance-related bonuses. New performance metrics were introduced, linking bonuses to profit and growth and these "…had become the purpose for which Lehman Brothers existed."[1]

The collapse of Enron has also been liked to a toxic culture. Post its collapse, reports have found that "an environment where there was no trust and openness between employer and employees resulted in a workplace filled with secrecy and suspicion that spurned internal competitiveness and negativity. Management ignored or fired anyone who challenged their decisions which in turn made the environment toxic for everyone.[2]

Cultural failings are by no means unique to the financial services industry. We've seen the Royal Commission into Aged Care, the Volkswagen scandal as well as several failings in the sporting world. If we take the Essendon Football Club as an example, their slogan as they prepared for the 2013 season was effectively "we can beat anyone, as long as we do *whatever it takes*." It's clear the Essendon Football Club had a culture focused on striving for high performance and management was prepared to push the boundaries beyond normally accepted limits in order to achieve its goals. An independent review into Australian men's cricket at the time of the sandpaper cheating scandal concluded that a "win at all cost" culture was at the heart of the cricketers' behaviour.

These are all different industries and very different organisations and while they all had stringent governance policies in place, these were completely overwhelmed by toxic cultures. In all of these examples, there were policies or laws which existed to prohibit the identified conduct, so why then was this not enough to prevent these issues from occurring? You guessed it, culture, or rather, lack thereof.

Robust policies and processes are futile if the culture of the organisation does not support it. For example, a whistleblowing policy that aims to protect whistleblowers from victimisation is worthless if there is a conflicting culture where the complainant is vilified and discredited. In many cases, the toxic culture overrules a robust policy. Interestingly, studies have shown this typically holds true regardless of whether the organisation has five people or 500 people.

Invariably, problems come down to a mis-alignment between what an organisation says it does and what it actually does in practice (their actions). For example, prior to the Royal Commission, AMP's Code of Conduct stated that it would act professionally with honesty and integrity. However, post the Royal Commission, the Australian Prudential Regulation Authority (APRA) has issued compliance orders to AMP Super. Areas identified for improvement include conflicts of interest management, governance and risk management practices, breach remediation processes, addressing poor risk culture and strengthening accountability mechanisms.[3]

This all comes back to an organisation's culture.

[1]Morgen Witzel, 2015 "When corporate culture goes toxic, from Lehman to Volkswagen"

[2]Jason Martin, 2017 "Orgnizational Culture and How Enron Did it Wrong"

[3]APRA statement, 14 June 2019

# What makes a good culture?

*"When it comes to culture, it's something that's not quantifiable, it's subjective and amorphous."*

*- Bill Coen, Secretary-General of the Basel Committee on Banking Supervision*

Culture needs to be organic. Unlike policies and procedures that can be set or required by management and the Board, culture has to grow and be nurtured like a living thing.

Culture needs to resonate with staff, the organisation and its goals. It is important to bring staff of all levels along on the journey – a more inclusive process fosters more united outcomes. For example, a company statement about culture - whether it is an internal or external statement, should be truly bespoke and have meaning for all employees.

We believe it is important to involve staff of all levels to participate in constructing (or reviving) the culture statement – spend time defining a statement that provides meaning and purpose to each individual and is unique to the organisation.

Figure 1: Features of a good culture

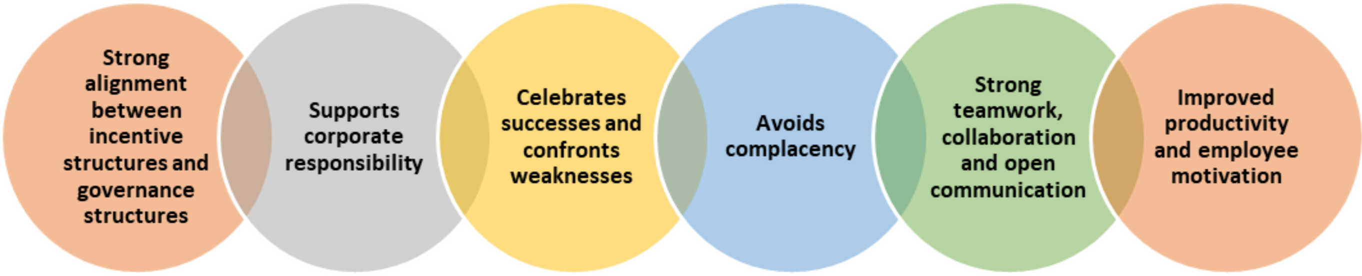



Figure 2 shows that a key element of a good culture is that it should involve everyone in an organisation and translate into all business practices, from recruitment, training and rewards.

Each person within the organisation plays a role in the evolution and maintenance of the culture. Staff from all levels should be both accountable and empowered to call out behaviours that do not align with the culture.

The Board and CEO are pivotal in establishing and embedding the culture within an organisation, but it is equally important for the leadership team/senior management to be clear and consistent in their application of culture (actions speak louder than words). Frequent and transparent communication between and amongst all is essential.

There is no doubt the risk culture of an organisation is inherently linked to the organisation's culture. Accordingly, the risk culture must be set from the top. The Board and senior management are the starting point for setting the core values and expectations and drive these values down through the organisation. Accountability is important such that all employees at all levels are accountable for their actions, having understood the core values of the organisation. Communication between employees and the ability to challenge one another is paramount. Remuneration and compliance with the risk management framework should play a part in the performance evaluation and appraisal, further supporting the value placed on risk culture.

Figure 2: Organisational roles in culture

# Avoiding cultural failings

There are three key areas all Boards need to be thinking about.

**Boards first need to define what culture they want in their organisation.** Culture needs to be set from the top (by the Board) and it needs to cascade to the rest of the organisation. While there needs to be participation from all levels of staff throughout the organisation, in order to instil the desired culture, it needs to be persistently led from the top down, assimilated by the leadership group. The main thing a Board can do then is to appoint the right CEO – the CEO appoints the leadership team (key roles may be with Board approval). Then have a zero tolerance policy for actions that conflict with the culture wanted. In the end, the Board is very reliant on what is in the reports, what the CEO says and any other intel they can get through their own means (e.g. separate meetings with other staff, site visits, independent reports etc).

**Boards need to measure and monitor culture on an ongoing basis**. This can be achieved through engagement surveys as well as culture surveys. These provide lag indicators so we recommend combining these with more regular surveys (which can provide more current data and more often), focus groups, interviews with current staff as well as interviews with staff who have left. A recent study by the Australian Institute of Company Directors (AICD) found that the top five ways for not-for-profit organisations to measure culture are through staff survey results; staff turnover and dismissals; client survey results; occupational health and safety reports; and client complaints (these are relevant for all organisations, not just not-for-profit).

**Boards need to be thinking about remuneration.** More importantly, they need to think about how they can align financial rewards with the organisation's core values and the behaviours they want for their organisation, thinking about any unintended consequences of remuneration models.

However, it is not just Boards that should be thinking about their culture. It is important that all parts of an organisation, from the Investment Committee Directors, CIOs, internal teams, etc, support the organisation's culture. Employee education is paramount so everyone in the organisation understands the role they play in risk awareness and management. Such a culture begins with clear policies and procedures in place which includes providing the necessary resources, outlining the philosophy, the beliefs and risk appetite as well as ensuring full and open dialogue across internal teams within the organisation. The structure of the organisation should be such that employees have the confidence to speak out if they believe actions are inconsistent with their culture.

*"The Board should lead by example by demonstrating conduct that supports the firm's values, and take action where they see the wrong thing occurring — what you walk past is what you accept."*

*- John Price, Commissioner, Australian Securities & Investment Commission*

# Aligning incentives and culture

One aspect of a strong culture which is often overlooked, is staff attraction, staff retention, and alignment of interest. Alignment of interest in the financial services sector is all about how people get paid. It really comes down to why people come to work every day and why they do their best. People want to work for (and stay at) an organisation with a good culture. Therefore, we see a clear overlap between culture and incentive structures.

Surveys into what makes a company a great place to work have found that employees value the non-financial aspects over the financial aspects. As can be seen in Figure 3, employees considered their company to be the "best" place to work due to things such as work/life balance, having flexibility, and opportunities to learn. A recent study by Deloitte[4] of Generation Z[5], found that Generation Z's greatest concern is in regard to the environment and for them, of upmost importance, is working for an organisation which makes an impact. This shows that non-financial benefits can be an equally strong motivator. Further, these play their part in entrenching a strong positive culture, maintaining high morale and encouraging teamwork, collaboration and company loyalty.

Incentives based only on financial outcomes may create a culture where employees are driven to do anything in order to achieve their bonus (which perhaps is what happened in the case of the NAB foreign exchange traders).

Successful incentive programs typically comprise both financial and non-financial incentives to motivate employees. The nature and scale of the incentives is commonly driven by the job categories but what is important to understand is the behaviours you may be implicitly encouraging through the company's incentive structure. Empirical evidence highlights a positive relationship between non-financial incentives and job performance and job satisfaction. US company, Goodyear Tyre & Rubber[6], tested this theory by rewarding one group of its employees with cash and one group of its employees with non-financial incentives. What it uncovered was that the employees who were rewarded with non-cash incentives produced almost 50% better sales results than those motivated by cash only. Tom Gravalos, who devised this idea for Goodyear, suggests the reason for this is that "cash has no trophy value or lasting effect, and cash has poor perceived value".

Figure 3: Non-financial incentives


[4]The Deloitte Global Millennials Survey 2019

[6]Those born between 1995 and 2010, which means that the oldest are about 22 and are just entering the workforce.

[6]GC Incentives, White Paper, "Why Non-cash Awards Are More Effective Than Cash", https://www.giftcertificates.com/

# Aligning incentives and culture

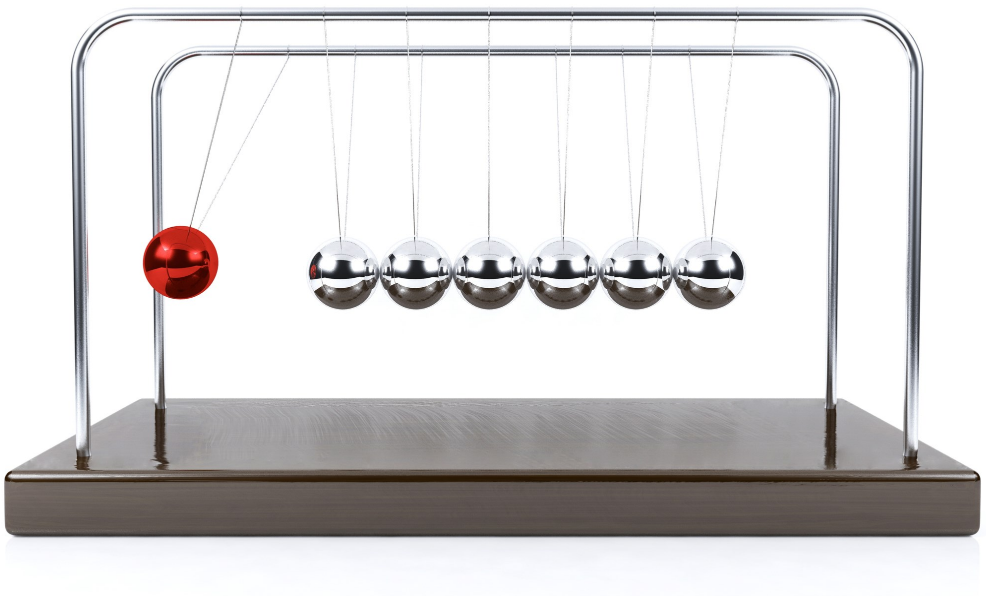
Effective employee incentive schemes can provide institutions with a competitive advantage by being able to align the employees' interests with those of the organisation and to reward and retain staff in the longer-term. We believe incentive structures should be thought of from a total reward perspective. Financial and non-financial rewards are both important in creating a compelling Employee Value Proposition (EVP). We have observed a range of different remuneration structures, a critical feature is that they are fit for purpose, therefore there is no one "right" framework. Ultimately, we think consideration should be given to what kind of incentives should be included, how success is measured, the timeframe and who should be eligible for the incentive program.

It is important for compensation structures to be transparent and to align with governance structures in order to reduce excessive risk taking and keep individuals accountable for their behaviour, both good and bad.

Getting the balance right, whatever that may be, enables employees to have stronger alignment to the organisation's outcomes. This has the potential to be very powerful. In reviewing investment managers as part of our manager research program, we consider the investment team's alignment in regard to their remuneration structures and culture.

Alignment to investment outcomes is critical for investment organisations, be it asset owners or fund managers. In undertaking fund manager research, alignment to investment outcomes and organisational culture are key areas of assessment in gaining conviction in a fund manager offering. For asset owners such as superannuation funds, alignment of variable remuneration to total portfolio outcomes and overall investment objectives is beneficial in avoiding siloed or too short term investment decision making.

In the listed space, companies are increasingly looking at behavioural gates i.e. employees need to pass through one to be eligible for their incentives.



# Maintaining organisational culture

*"Culture can – and must – be assessed by financial services entities themselves. …It is a requirement of APRA's prudential standards (at least in relation to "risk culture"). It is also common sense."*

*– Commissioner Kenneth Hayne*

Culture can be considered a tool to help an organisation achieve its strategic goals and it also highlights the important interplay between the leadership group and the organisation's culture. Culture needs to be nurtured and constantly (and consistently) applied.

Commissioner Hayne dedicates a whole section to culture in his final report and makes three general points.

First, the culture of each entity is unique, and may vary widely within different parts of the entity. We think this is a really important point, it also needs to resonate with the entity and its employees.

Second, there is no single "best practice" for creating or maintaining a desirable culture, but one necessary aspect of a desirable culture is adherence to the basic norms of behaviour that are described in the Report:

- obey the law;
- do not mislead or deceive;
- act fairly;
- provide services that are fit for purpose;
- deliver services with reasonable care and skill; and
- when acting for another, act in the best interests of that other.

Third, culture cannot be prescribed or legislated. Proper governance, a healthy culture, and accountability are desired outcomes, but they cannot be imposed by rules that say, "You must … or you may not … Culture is about behaviours. Behaviours in general are not amenable to legislation or regulation … Sustainable cultures need to arise from and be embedded in banks' [and other entities'] DNA".

We think it is important for initial and ongoing commitment to culture from all levels within the organisation. Hayne's comments also highlight that an internal policy is unlikely to, in isolation, have any real impact on achieving the desired goal without the right behaviours supporting its ongoing implementation and function.

# The final word...

The right culture for any organisation is bespoke and there is no one size fits all approach. Academic research suggests that a good culture can sustain competitive advantages beyond shorter term advantages. We firmly believe culture can be a key determinant of long term success.

Each person within the organisation plays a role in the evolution and maintenance of the culture. Staff from all levels should be both accountable and empowered to call out behaviours that do not align with the culture.

The examples of cultural failings outlined highlight that governance is much more than a box ticking exercise and all organisations need to be constantly thinking about their culture.

Culture needs to resonate with all staff, the organisation and its goals. It is important to bring staff of all levels along on the journey – a more inclusive process fosters more united outcomes. We believe initial and ongoing commitment to culture is required from all levels, however the Board and leadership team within the organisation will play a pivotal role in driving the culture. The alignment of incentive structures and culture are also closely linked and play a pivotal role in the values and behaviours desired at an organisation.

The Royal Commission highlighted the need for the financial services industry to assess its culture. Commissioner Hayne suggests regular self-assessment of culture; seeking to identify and deal with any problems; and assessing whether changes have been effective.

Culture has long been an area of focus in our assessment of fund managers, as our experience has shown it is critical to both long-term investment success and maintaining alignment to asset owner clients. It also needs to be a focus for asset owners themselves, be it within investment teams, the broader organisation, or in the role of the Investment Committee or Board, particularly as investment functions grow or change over time. We are increasingly supporting clients to review their own culture and alignment to outcomes as part of investment governance and internalisation reviews.

Culture needs to be an ongoing focus for the organisation. Like an objective to stay fit – you can't just work on it for a few weeks/months and expect that to be sufficient or sustainable over the long term; it takes effort; determination; a robust plan; and constant refinement. Culture is really like a living thing, a bit like a plant, that we all need to take care of and nurture.

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