FINANCIAL REVIEW

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Banks dangerously complacent on risk culture

By James Eyers

The Australian banking sector came through the global financial crisis relatively unscathed but its resilience also had a downside: it has left banks dangerously complacent about assessing shortcomings in their risk cultures.
Complacency can be defined as "a mixture of laziness and self-delusion", Harrison Young told *The Australian Financial Review*'s Banking & Wealth Summit last week.
The chair of the Commonwealth Bank of Australia board's risk committee said an example would be a dentist's patient who thinks going for a check-up would be a waste of money as his teeth are fine – but also because he doesn't really want to know if he has a cavity.
With culture inside Australia's banks a topic of national conversation in the wake of the *Financial Review*'s summit, it's become clear the banks haven't wanted to go to the dentist on culture. But now their neglect has created a hole that requires a filling, and the procedure could be painful.
The Australian Securities and Investment Commission's cases against Westpac Banking Corp and ANZ Banking Group for allegedly manipulating the key benchmark interest rate, and revelations by *The Sydney Morning Herald* and *The Age* that Commonwealth Bank of Australia mistreated its financial planning and life insurance customers, has provided the burning platform that will lead to a prolonged period of introspection across the banking sector.

But Australia's banks are eight years behind the rest of the world when it comes to examining an inherent conflict at the heart of banking: the fair treatment of customers and the maximisation of profit.
As various speakers to last week's summit made clear, banks are struggling to define what culture is. As Young pointed out, there are multiple conversations going on here – involving risk culture, fiduciary culture, conduct risk, ethics and compliance – which tend to get conflated. Boards are struggling to work out their role as stewards of culture and to determine what action is needed to make improvements.
While he served as secretary-general of the Basel Committee on Banking Supervision from 2011 to 2014, Wayne Byres watched many global banks grapple with the challenge of defining and improving culture. Arriving back at the Australian

Prudential Regulation Authority as chairman in 2014, one of the first pieces of policy reform Byres pushed through was a new prudential standard known as CPS 220, which requires boards to "form a view of the risk culture in the institution". This put directors on notice that APRA wanted them to assess and improve risk culture as a matter of priority. Byres also created a new internal APRA unit last year to drive its supervisory efforts on culture, governance and remuneration.

REGULATORS KEEN TO SEE INDUSTRY LEAD

Wayne Byres said APRA wants banks to take the lead to enhance culture. "

Byres' international experience taught him that regulators cannot be overly prescriptive on stipulating what culture needs to be. "Regulators have variously been accused of being on a culture crusade, and wanting to be the culture police. That's not the case: indeed, regulators are really keen to see the industry lead the running on this issue," Byres told the summit last week. "We need the financial sector to take up the challenge to put in place better incentives for prudent behaviour, so as to prevent problems emerging in the first place. That is likely to be far more productive than spending our time removing so-called 'bad apples' after the fact."
National Australia Bank chairman Ken Henry's speech to the summit illustrates the extent to which Byres' signalling is filtering into the big-bank boardrooms. "The fact that our regulators are taking such a keen interest in banking culture, right now, means that they are not satisfied that the Australian banks are always sufficiently customer-centred," Henry observed.

He then delivered what can only be described as some radical words given the lofty Australian banking profits and ongoing desire to cross-sell products in order to maintain them. "In a successful business, the customer drives product design and the suite of products offered. No customer is encouraged to buy something they don't need or charged more than they need to be charged to cover the cost of providing the product. No customer of a successful business buys something that they don't understand well enough to have a high degree of confidence that the product will deliver what they want, when they want it."
Where the rubber will hit the road on this will be shifting from platitude to resolving the multifarious occasions in banking when serving a customer and the profit motive conflict with one another.
In his speech to the summit, Henry pointed to NAB's adoption of the "net promoter score", which rates customer satisfaction with the bank, to assess part of senior executive remuneration. But the NPS only comprises one-third of the bonus; the

majority relates to achieving strong return on equity and cash earnings.

As boards formulate their assessments of risk culture for APRA and seek to lift standards to avoid the types of scandals that have plagued the sector in recent times, directors should be considering how remuneration policies incentivise bankers in the trenches to ensure particular products are suitable for each customer.

This will require establishing a culture that supports ongoing discussion about ethical dilemmas, difficulties and challenges, and an openness to talking about whether the bank is managing the competing priorities of different stakeholders in the right way.

If a culture is strong, that's a discussion that will happen naturally. In a weak culture, it's a conversation that doesn't happen at all, opening the door for the sort of bad advice dished out by CBA, NAB, ANZ and Macquarie in recent times.

SELLING A LOWER-MARGIN PRODUCT

One question that should be considered is how can bankers be encouraged to sell a lower-margin product if that happens to be the one which best suits the customer, despite that sale pulling in less profit for the bank?

Mark Lawrence, a former chief risk officer of ANZ and now a risk management and regulation consultant and adjunct associate professor at UNSW, provided the summit last week with a roadmap for identifying risk culture weakness in banks. Among the killers are complacency and overconfidence; staff not challenging each other's attitudes and actions on risk and fear of bad news, where staff feel inhibited about communicating bad news upwards. "The biggest challenge is usually to create an environment which empowers all employees – and especially junior employees – to routinely question and challenge and escalate things they don't understand," he said.

Based on this template, CBA's decision to sack staff who attempted to blow the whistle on its financial planning and CommInsure failures is anathema to creating the sort of culture necessary to reduce risk.

With banks now political footballs ahead of the federal election and as calls for a royal commission into the industry grow louder, boards understand there is an urgency to improve culture, but there is no quick fix.

A royal commission, though, would be counterproductive because it will turn banks on the defensive; inevitably, a phalanx of lawyers will be hired to defend interests in adversarial proceedings. This could prevent the frank and transparent assessment of risk culture that banks need to have.

Henry suggested last week that more leaders in banking should look to the Banking and Finance Oath as they work out strategies for conversations on culture that will take place across the industry over the coming months. Henry and the senior management team at NAB have signed the oath. None of the CEOs of the other big banks have. But they should.

The oath reads as follows: "Trust is the foundation of my profession. I will serve all interests in good faith. I will compete with honour. I will pursue my ends with ethical restraint. I will create a sustainable future. I will help create a more just society. I will speak out against wrongdoing and support others who do the same. I will accept responsibility for my actions. In these and all other matters; My word is my bond."