CBA

Comment

16th August 2017

The CBA situation is worsening with legal, cultural and governance issues of great importance to the wider community, not just the issues in resolving the crisis at CBA. This is not a populist issue causing a problem but a problem giving rise to populist issues and will not fade as more and more people get involved.

In dealing with the Directors duties the issue of disclosure will be easier to deal with than forming a view about whether the duties of Directors can be expanded beyond the existing law to issues like culture and reputation. The recent case of Perpetual and Brickworks would indicate some difficulty. Whilst the pub and the reasonable man would believe that culture and reputation is crucial, a Court would have difficulty in defining these words and what kind of evidence was required to prove their failure. Even with definition and evidence the next problem would be the consequences that is the degree of failure and the remedies.

There is likely to be multiple litigation, including a class action, not only in Australia but overseas. The regulators will almost certainly take action.

The very nature of the litigation will make it extremely difficult for the Board and Management to operate normally. The CEO and direct reports will have considerable disruption to their ordinary activities quite apart from the issues of accountability.

It is hard to see how a CEO can operate with the jungle litigation when he has so many other issues on his plate. Not only does he have to continue to drive the strategy of

the bank in a time of great change and disruption in the Sector but has to deal with the need to drive the change in culture and attitudes within the bank from the Executive Team to the coalface and in all divisions. In addition there is the time that will be required of him in relation to the litigation and the Board Subcommittee. Presumably the Board Subcommittee will be hiring professionals, lawyers, accountants and consultants who are not currently dealing with the bank so that the public and shareholders can be assured that it is an independent process. The CEO will also have extra demands on dealing with Government on sector and CBA issues.

Driving strategy alone is a big enough challenge with the intense changes that are currently taking place in banking and the needs of the bank to meet the challenges and opportunities of digitisation and the emerging fintechs.

There is one important aspect of the CBA mess which goes to the heart of the culture and reputation issues that is the role of staff. It is extraordinary that the staff at the coalface in several branches became aware of the illegal activity and tried to get Management to deal with the issue. It is extraordinary that a CEO would not be aware of the staff issues. This shows how remote the bank head office is, not only from customers, but from its staff. So it is not only profit before customers but profit from staff. It is interesting to compare the bank's relationship with staff, with other sectors. For instance, in the retail sector, the CEOs of all our retail companies, Coles, Woolworths and many other retailers, are constantly relating to staff and understanding their issues and what is happening at the coal face with customers and their expectations.

Staff are a huge and valuable resource in any company as the famous Sam Walton has proven in America. Despite being a larger and much bigger company with many more employees than CBA he still spent a significant portion of his time talking with staff to learn from them. Walmart made many strategic moves as a result of this interchange. Clearly if this was happening at CBA some action would have been taken. It is also well-known at the moment that the staff in the banks, are under great

pressure as the banks drive hard for profit (ROE) and the continual reduction in expenses. It is not surprising that the banks have so many customer problems when they have an unhappy and committed staff. It is unlikely that you can have happy customers if you do not have happy staff.

Some might argue that this is not practical for a CEO of a bank to be as close to customers. John McFarlane at ANZ disproved this and took a close interest in staff issues at ANZ Retail and the consequence of which was that he managed to turn around ANZ Retail without any capital expenditure but basically undertaking a program of listening to staff.

Some would argue that given the size and complexity of a bank, how could you expect the CEO to be aware of such issues? To my mind that undermines the benefits that can be learned from being in close contact with the coalface through your employees. If CBA cannot handle it, then there is an argument that it should be broken up so that the parts can relate better to customers and staff, still get a very good return, and increase the choice and competition in the marketplace.

So with CBA, it appears not only is profit ahead of customer, but profit is also ahead of staff. In all the debate that is going on, one should shed a tear for the staff in the banks who have to bear the brunt of huge criticisms being made about the banks, and at the same time, are subject to a great deal of pressure from the their superiors. Staff are leaving the banks at the moment in great numbers.

How would a staff member feel about helplessly watching money-laundering from crime and terrorism being processed by a bank? It is not that much different to a distributor of drugs. To be handling the proceeds of crime, where the money has been earned on activities that has destroyed many lives is mind blowing. The pub test would clearly say that an employee would feel grubby about being involved in the process but does the bank care? No one wants to deal with grubby money.

The banks will say that their customer satisfaction surveys are high. The reality of this is that these are only surveys of existing customers not those that they have had dealings with but are not serving. A lot of the arguments today is about what the banks are doing inappropriately. There is also a huge area of what the banks are not supporting, where potential customers in the marketplace and customers who are not getting the kind of support they need to grow their enterprises.

The CBA issue goes to the heart of what should happen to the banking sector.

The reference by the Government to the Productivity Commission to examine competition issues only goes part of the way. A much broader inquiry is needed. This immediately brings up the argument that we have just had one inquiry why another? The fact is that the Murray Report was flawed. The Murray Report did not adequately deal with the structure of the banking sector, the competition issues and the cultural and reputation issues that have emerged. The Harper Review could not deal with the banking sector because its brief was to develop overall competition principles not to delve into any particular sector. There are other sectors that need attention and the Harper Commission could not justify getting involved with one sector no matter how needy that might be. Whilst there were many good features of the Murray Report in that it dealt with a lot of operational issues and pushed for the increased capital in the banks, its shortcomings have led to the need for another inquiry. This is an embarrassment for the Government but is that a fair criticism? The Murray Report did not attempt to deal with the economics of banks or the sector, either at the macro level or by division and the structural issues as did previous reviews – Wallis, Campbell.

Clearly we have structural problems with our banks that require examination. The analysts and commentators have been commentating for some time that the big four trading banks have too greater share of the ASX, are too concentrated and there is generally a lack of competition in many areas of banking.

The concerns are clearly right, we have by world standards undue concentration in Australia. We also have a supervisory structure which is exacerbating the problem. APRA defines and limits the ways in which our banks compete, with the result that we have a very cosy oligopoly. Not only does APRA encourage common behaviour but there is too much parallel behaviour in the sector, banks are all the same. It is noteworthy that the Boards of the banks are filled with retiring Senior Executives of the other banks. This is extraordinary, incestuous, notwithstanding that we are a smaller economy and even though there is probably not a huge pool of talent available. This leads to sameness and an unwillingness to break out though ANZ might be trying to. Ex bankers on Boards have with their superior knowledge greater influence but are likely to want the status quo and singing the hymn about the safety and stability of Australia's financial system.

The other issue is with our banks, as has been indicated by former bank CEO Don Argus, they are essentially large building societies where a huge portion of the funds are invested in residential housing. Unfortunately the capital allocation rules by APRA encourage this, so the banks in one area compete vigorously for mortgaged houses. The paradox is that whilst, on the one hand APRA is meant to spread and layoff risk, the very policies are causing a concentration of risk because in Australia the household debt is way too large. There are other factors that influence this but APRA could develop rules to minimise the problem.

At the moment you could say that the problems with the banks are reasonably well known, the more difficulty is the solution. A Royal Commission dominated by lawyers that further cross-examines the banks and their chief executives to discover more of the same is not helpful. The instrument to deal with this situation is one that is capable of developing solutions. A lawyers Royal Commission is not equipped to do that. Further, the present reference to the Productivity Commission is too narrowly conceived whilst any review is better housed in the Product Commission than in Treasury, the Government needs to widen the brief and appoint a panel of people who are able to put forward solutions for testing by the community. Such process can only

be done against the background of a good economic study of the banks, by divisions, understanding the profits, and understanding where the future of each division lies and what the competition issues are and the technology threats and opportunities.

What is needed more than anything else is greater competition. APRA inhibits competition and makes it more difficult for an entrant. APRA makes decisions not only that inhibits competition, but indirectly ensure that the banks go down the same path leading to a huge concentration risk. Information flows from one bank to another. Employee transfers and consultants also facilitate this. In one sense we have a very good bank system, thanks to earlier moves by the Reserve Bank and now by APRA but this is marred by the huge concentration risk that has resulted from their policies.

In terms of finding a solution we need a panel that would include first-class minds on the economics of banking, people who are very experienced at looking at business models and structure and the competition process itself. Clearly we need huge change which will revamp the way that APRA operates. It is for this reason that such a panel is best run out of the Productivity Commission, not Treasury. Treasury is too close to the banks and suffer the same problem as the Murray Panel; it was a bankers report, a report by bankers for bankers. A panel needs people that not only have an acute understanding of banks but are clever at restructuring but are not part of the bank. Ian Harper would be a good example of that and there are others.

Politics of the situation are interesting. At the moment the CBA issue just makes Labor's Royal Commission even more popular. Clearly the Coalition can gain the momentum on this issue by appointing a high-powered panel that would have the powers of a Royal Commission but would satisfy the community that the kind of issues that we are now facing are dealt with. At the moment the brief and its panel is too limited.

One very important issue in banking sector, is not so much what the banks are doing, but what the banks are not doing. In the Murray Report there was no attempt to deal with what I would call 'unsatisfied demand' for banks in the various sectors of the economy. One warning is very important in any inquiry and that is that the banks deliver products which are diverse, have different risk characteristics and very different competition issues so macro analysis will not be good enough, it needs to be done division by division and may be by major product groups.

It is clear that the fintech movement is rapidly growing and chipping at the edges of the banks. Fintechs will be more successful in some parts of banking and not others. It is important to understand that movement because fintechs can in some areas provide the competition that the banks need and fill the huge gaps where the banks have not served well. The recent Morrison initiative of restricted banking licences is good but is only at the edge of the problem. We need bigger entities.

The converse to the banks being great big huge building societies is that their mix of business over the years has changed where the mix or percentage is now much heavily weighted in favour of mortgages than it is on business banking where there are huge gaps and where the banks are simply not satisfying the demand. This is particularly in the case of Regional Australia where over the years the banks have withdrawn from bricks and mortar and with the centralisation of their activities and their risk policies have removed them even further from the customer.

Risk is a very important part of any kind of inquiry. It is clear that the risk silos in banking are growing more and becoming more powerful. The risk silos are driven by metrics and by big data. The banks as a consequence are becoming rule-based and box fillers in respect to their lending policy with little opportunity for exception. Within these silos there are so many checks and balances and capacity to overrule that it has become a game of the lowest denominator of risk. More and more people are added to the risk function and with more power the game of de-risking becomes an art form. The analysis of the upside is irrelevant and the weight of the upside and downside is

not considered. Over time, more and more risk factors are being placed on transactions with less concern about the probability of those risks occurring and the costs involved. The no exception lending means that there are lots of potential customers that are dissatisfied and lots of activities in the country are simply not being funded when there is little risk in doing so because the borrowers needs do not fit the banks products.

As banks develop more and more products in their various divisions accompanied by an appropriate risk framework there is a great temptation to standardise these as much as possible. The more standard the easier it is for the banks but the less customisation for prospective borrowers. There is not an appropriate balance between the top down production orientated development of product as against the individual needs of borrowers. Customisation incurs costs and is much easier undertaken by smaller banks than the larger ones. That is why we need many more smaller banks like Bendigo Bank and Suncorp who can move into the market gaps with banking products more suitable.

I have been critical of the Murray Report and said so at the time (see earlier material attached). The Report failed to look at the structure and economics of banking, division by division. Whilst the question of culture and reputation was raised, there was no serious study made. It is not surprising that we continue to have revelations about the problems in banking. Some of the problems are caused by the structure of the banking sector. At the time, numerous analysists and journalists talked about the huge concentration of the four trading banks in the sector, the sectors share of GDP, the ASX and the financial market. I added to the criticism the parallel behaviour that was taking place in banking. The four trading banks are all the same and there is a dangerous, incestuous level where retired Directors of one bank become Directors of the other. It worries me sometimes with the way the banks, with their massive power, threaten and challenge Governments.

More importantly is the role of APRA which defines and limits the ways in which the banks compete. One bank Chairman applauded the role of APRA; no wonder because APRA makes the sector very comfortable.

APRA is not mandated to deal with competition and is not making it easier for new entrants. With the huge regulation emerging out of APRA and other regulatory agencies means the sheer volume of regulation makes it near impossible for a new entrant. In a sense for APRA the fewer the banks the less problems caused by competition and the more banks are the same makes it easier for their supervision.

There is not enough debate and discussion in the community about the activities of APRA. Banks have little opportunity and are afraid to challenge APRA and there is little meaningful debate in the market place about APRA's regulatory activities. APRA makes limited information about its capital allocation rules and rarely explains them in a way that can be challenged.

Critical decisions are made about capital allocation by the banks which have a dramatic effect on where loans are made. One of the consequences of this is for instance is with residential mortgages. Because of the modest capital allocations for the mortgages for the four trading banks means the banks compete in the mortgage market with the consequence that a huge proportion of our lending is in residential market. Here is a paradox, on the one hand APRA is all about managing risk yet by its policies, it is given rise to a huge concentration in the Australian banking market, one of the highest in the world.

We are no longer one of the best financial systems in the world but one where there is material risk because of the huge borrowing by households. One former CEO, Dan Argus, complained that banks were simply giant sized building societies. The other side to this is that the mix of residential mortgages to business lending has changed dramatically with the banks lending a markedly less percentage into the business

sector. This is tragic because we now need companies to be able to grow and employ more people.

Another weakness in the Murray Report was that it failed to deal with unsatisfied demand for banking products in the market place. Bank satisfaction surveys concentrate on customer satisfaction not those who have been seeking but not getting funds. This requires a massive study. Banks seem to forget they have a licence to operate and as an oligopoly they have a greater obligation to look at the unsatisfied demand. For example, it is no excuse that it costs more to a bank to serve the smaller business requiring some customisation not the present process of one size fits all.

Murray's view was that it was not his role to deal with competition. This was for another inquiry. I asked Ian Harper about this issue and his response was that the Competition Inquiry had to focus on general principles of competition not those of a particular sector. Harper's problem would be that if he tackled one sector, he would be required to tackle another. So one of the key issues facing the banks is competition and that which has fallen between the stool of the two inquiries.

The big issue facing the Government is how to deal with these issues. Generally we know what the problems are and there is not much point of a Royal Commission digging in further or maybe expand the issues. The far more important issue is what is the solution? A Royal Commission dominated by the lawyers is not good at finding solutions. Solutions are best found by a mix of individuals with disparate capabilities. What is needed is an experienced competition economist and business men that could well come out of the consulting sector who are experienced in sector disruption and how sectors can be reshaped to deliver more value to the community. Clearly the problem with the Murray Report was that it was written by bankers for bankers and it was out of Treasury. Treasury is a very conservative institution with strong views and in my view, is too close to the banking sector. The review is best housed in the Productivity Commission which has over the years produced many reports resulting in material change in the economy. In my view it is possible to put up a panel within the

auspices of the Productivity Commission, give the public some comfort that solutions will be found. If properly structured and communicated it should satisfy those seeking a Royal Commission. This is a populist and inappropriate instrument although full marks to Labor for having a strong desire to find a solution.

Clearly the mandate and structure of APRA needs to be revisited:

- Competition in banking should be a key requirement of APRA's deliberations. It must understand the competitive effect of its decisions and should develop a lot of pro-competitive policies and actions. This means more than just a close relationship with ACCC, there needs to be a very experienced competition regulator involved in all decisions. APRA must do more to explain its policies and capital allocation roles. This should be accompanied by an economic impact statement. APRA should have a board, which would include non-executives and other regulators to whom the CEO of APRA relates.
- APRA before it imposes any regulation should do a cost benefit analysis of that regulation and every other existing regulation.
- We must have a much better idea of the cost that regulation imposes on the banks and be prepared to listen to the banks to streamline the process.
- From the banks point of view a huge amount of data is being produced at a great cost but never being acted upon.
- APRA must be more open to its policies being discussed and debated.

If something is not done fairly soon the anger and frustration of the community will continue and no doubt further revolutions about inappropriate bank behaviour. The problem cannot be left until the next election whenever that might be.

One important aspect of the inquiry will be the role of the credit approval process. To repeat, the credit process and protocol in banks have become very powerful silos, way more than existed years ago. Little is known in the market place about how the credit silos work. Customers rarely have contact with them and know little of their policies. The credit silos have layers of approval and checks and balances. Further the decision

making is heavily influenced by big data and metrics. There is little scope for exceptions and it looks like a box filing exercise with very little input from the relationship manager dealing with the customer. The relationship manager has lost power as has the local bank manager. They have little influence over the credit decision and that is well known in the market place. The result is that there are huge areas both geographically and by product of unsatisfied demand where a local would probably lend.

To repeat, our banks are too few, too concentrated and too much of the same to be concerned. We need a huge number of new entrants particularly as foreign banks have left the market following the GFC. New entrants as we are finding with the fintech movement, take a very different perspective on risk and so opens up new areas of lending. The new entrants are far more concerned with small data and not so much the big data and this is what is at the heart of CBA problems. They simply do not care about the unsatisfied demand or what their coalface people do. They are weighted more to production supply driven machines as opposed to demand market driven models. It is this structure that drives the strategy and behaviour of a lot of people in the organisation.

Incidently it is not enough for Ian Narev to retire but the Board needs to be reconstituted. Some Directors must accept responsibility and retire.

Narev's response to the crisis was unlike that of McKenzie at BHP who clearly and quickly showed deep concern for the dam disaster and result BHP has faced far few issues and questions than CBA.

See my earlier response to the Financial System Inquiry of 2014 (attached).

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