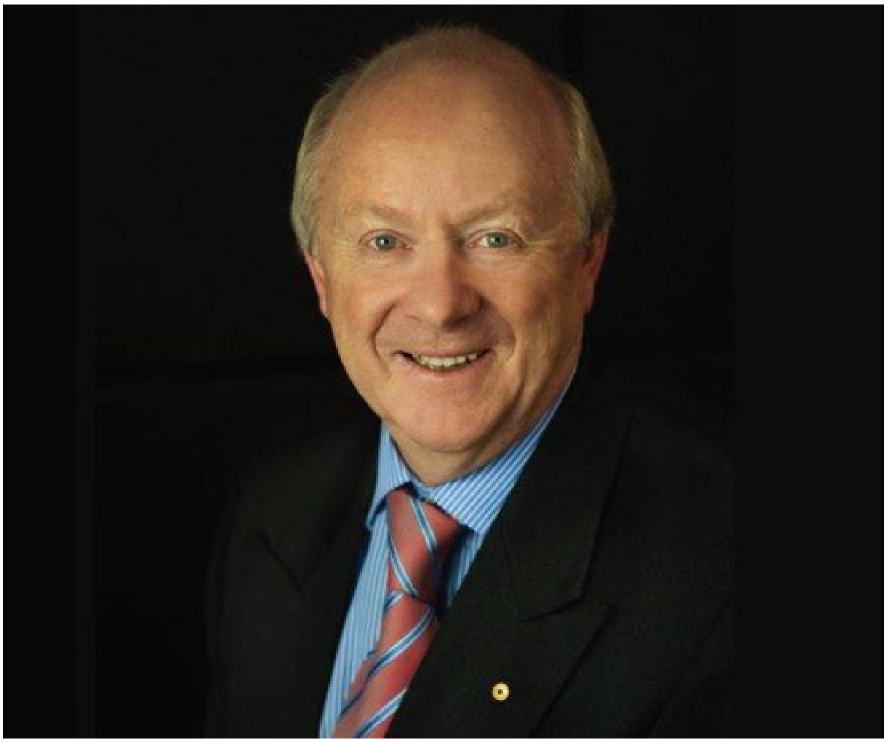
Interview — Dr John Laker AO — Rebuilding trust

by ZILLA EFRAT



The fundamental challenge in rebuilding the public's trust in the financial services industry is putting the best interests of customers at the centre of organisational culture, decision-making and remuneration arrangements.

So says Dr John Laker, the chair of the Board of The Banking and Finance Oath and former chair of the Australian Prudential Regulation Authority.

He says Australia is not alone in facing the challenge of rebuilding trust in financial institutions. 'The decline in trust has been a global phenomenon; other countries wracked by major banking failures and scandals have had to face the challenge earlier and although progress is being made, trust lost takes a long time to regain.

Laker notes that, up to a few years ago, the story of the Australian financial system was a very positive one. Strong capital footings, conservative risk management, and robust regulation and supervision all helped banks emerge from the crisis largely unscathed compared to other countries. As he told a recent global conference, that positive retrospective has turned instead into a cautionary tale.

He says the proven resilience of the financial system has helped reinforce the community's trust that banks will keep customers' money safe. Over the past few years, however, the level of trust that banks and other financial institutions have been acting in customers' best interests has been badly eroded.

He wonders whether the continued success of Australia's financial services industry could be a root cause of this loss of trust. Institutions that become used to a steady diet of sustained volume growth, high returns on equity and lucrative remuneration arrangements can easily fall prey to complacency and a loss of focus on customers.

Laker acknowledges that financial institutions are now committing substantial financial, management and consultant resources to strengthening their organisational cultures. They are focusing on key 'foundational' elements — the leadership of the institution and the tone set at the top, accountability, remuneration and behavioural norms, such as how bad news is treated and whether staff feel genuinely empowered to speak up.

'But if you step back from these elements, the crucial point is that an organisation must have a clear sense of its purpose,' he says.

One might think that's straight forward and obvious, but it isn't — as Commissioner Hayne's focus on the pursuit of short-term profits and greed in his royal commission report shows.

'Some institutions seem to have struggled with the simple but profound question 'What are we for?', and with what they have perceived as a choice between purpose and short-term profit. Surely, for a financial institution, the purpose is to improve the financial wellbeing of its customers, and the community more generally, by providing a range of financial products and services appropriate to its customers' needs. In turn, good customer outcomes drive sustainable profitability.

...achieving an appropriate balance of the interests of all relevant stakeholders and avoiding a fixation with short-term profitability gets to the heart of the trust issue.

'The choice between making customers happy and making profits is not a binary choice. The Group of 30, an authoritative international body of leading financiers and academics, has described the trade-off between customer outcomes and profitability as 'a false dilemma' — purpose and profit both need to be pursued together and be aligned. There should be no dilemma between good customer outcomes and sustainable profitability.'

Laker quotes noted *Financial Times* journalist Martin Wolff, who said recently: 'If a business substitutes making money for purpose, it will fail at both.'

'I think that achieving an appropriate balance of the interests of all relevant stakeholders and avoiding a fixation with short-term profitability gets to the heart of the trust issue. That should be the starting point for the rebuilding exercise'

Turning to culture, Laker acknowledges that this is an inherently complex force, which will necessarily differ from one institution to another and is difficult to observe. He thought William Dudley, then-Governor of the New York Federal Reserve, captured that difficulty when he observed: 'Culture reflects the prevailing attitudes and behaviours within a firm. It is how people react not only to black and white, but to all the shades of grey. Like a gentle breeze, culture may be hard to see, but you can feel it. Culture relates to 'what should I do' and 'not what can I do'.'

'In any large institution, there may well be sub-cultures where leadership does not aspire to the institution's values and where, for example, staff are discouraged from speaking up,' Laker says.

'These sub-cultures may be hard to identify from above, but they need to be weeded out. Directors sometimes say it is difficult for them to 'feel the breeze'. Perhaps so, but it is incumbent on boards, senior executives and management to understand how their staff behave and operate, and to affirm the institution's commitment to a sustainable and healthy culture. There is no substitute for boards getting out of the boardroom and walking the floors.'

Laker believes accountability is a key foundational element that supports a sound culture. 'We are seeing numerous examples from the royal commission and other reports of diffuse or uncertain accountability. A strong accountability framework provides for clarity of ownership of responsibilities and for proportionate consequences when adverse outcomes occur. The Banking Executive Accountability Regime (BEAR) will certainly stiffen up accountability frameworks, but institutions should be working hard to get these frameworks right in any event.'

Getting remuneration arrangements right is also critical.

'Remuneration outcomes are one of the best levers to reinforce individual accountability and the clearest signal of the behaviours that an institution values and celebrates,' says Laker.

'Remuneration arrangements are being addressed at the customer-facing level by the Sedgwick Report and, at the senior level, by BEAR. But given the critical role that remuneration and incentives play, there's a need to align these with ethical behaviour and good customer outcomes throughout the whole institution. And the remuneration consequences for inappropriate behaviour should be clear to all staff.'

Laker chairs The Banking and Finance Oath, an online initiative founded in August 2012.

'A few years ago, some senior people in the industry, sharing a common belief in the industry's inherent good, developed a set of simple but powerful tenets intended to underpin ethical behaviour' he says.

'The Oath is not a panacea, but an initiative to raise standards of honesty and integrity in Australia's financial services industry. It's a set of voluntary commitments freely entered into by individuals who choose to be accountable to each other for upholding the tenets of the Oath, and to call out behaviour that falls short.

‘Our intention in promoting the Oath is to keep conversations about ethics front and centre within institutions so that ethical considerations are taken into account — the ‘should we?’ question is raised and discussed openly — and individuals are more willing to be responsible for their behaviour.

‘The Oath is public for a very good reason. Signatories confident to ‘stand up and be counted’ are demonstrating their integrity and in turn their commitment to the industry. They can also identify like-minded individuals with whom they can share experiences and ethical challenges.

‘Within your workplace in particular, knowing that several of your colleagues are signatories to the Oath gives you confidence to raise issues.

‘There are surely lots of people who are committed to shaping a better future for the financial services industry. An organisation like the Banking and Finance Oath can help them find their voice.’

Around 2,900 people have signed the Oath since its introduction.

Laker believes the educational sector also has an important part to play in rebuilding community trust in the industry.

‘There should, in my view, be a specific ethics module in relevant university and professional courses in banking and finance. We know that some business schools and professional courses do have such modules, and others are considering this.

‘Students need to be exposed to ethical issues and challenged to think in terms of a broader set of personal and professional ambitions for themselves, beyond the salary they might earn. Individuals entering the industry should be proud of it and its value to the community.’

As a final point, Laker also believes that economics and business faculties should be challenging the long-taught view that acting in one’s self-interest ultimately helps to maximise the community’s welfare. ‘Adam Smith’s “invisible hand” does not seem to have guided us to an inherently moral marketplace in finance. But Adam Smith himself acknowledged that markets needed to be based on certain ethical norms — particularly trust and “sympathy” for others. And Milton Friedman, who famously argued that a corporate executive had a direct responsibility to make as much money as possible for shareholders, also added the caveat that corporate behaviour had to conform to the basic rules of the society, including those embodied in ethical custom.

‘When Commissioner Hayne bemoaned ‘ ... the pursuit of short-term profit at the expense of basic standards of honesty’, it is clear that ethical norms and the broader purpose of finance had been lost from view. Re-establishing those norms is the Commissioner’s call to action for all of us committed to a strong and responsive financial services industry that has the community’s full trust’, Laker says.

Dr John Laker AO is the keynote speaker at the Governance and Risk Management Forum in Melbourne on Thursday, 20 June 2019