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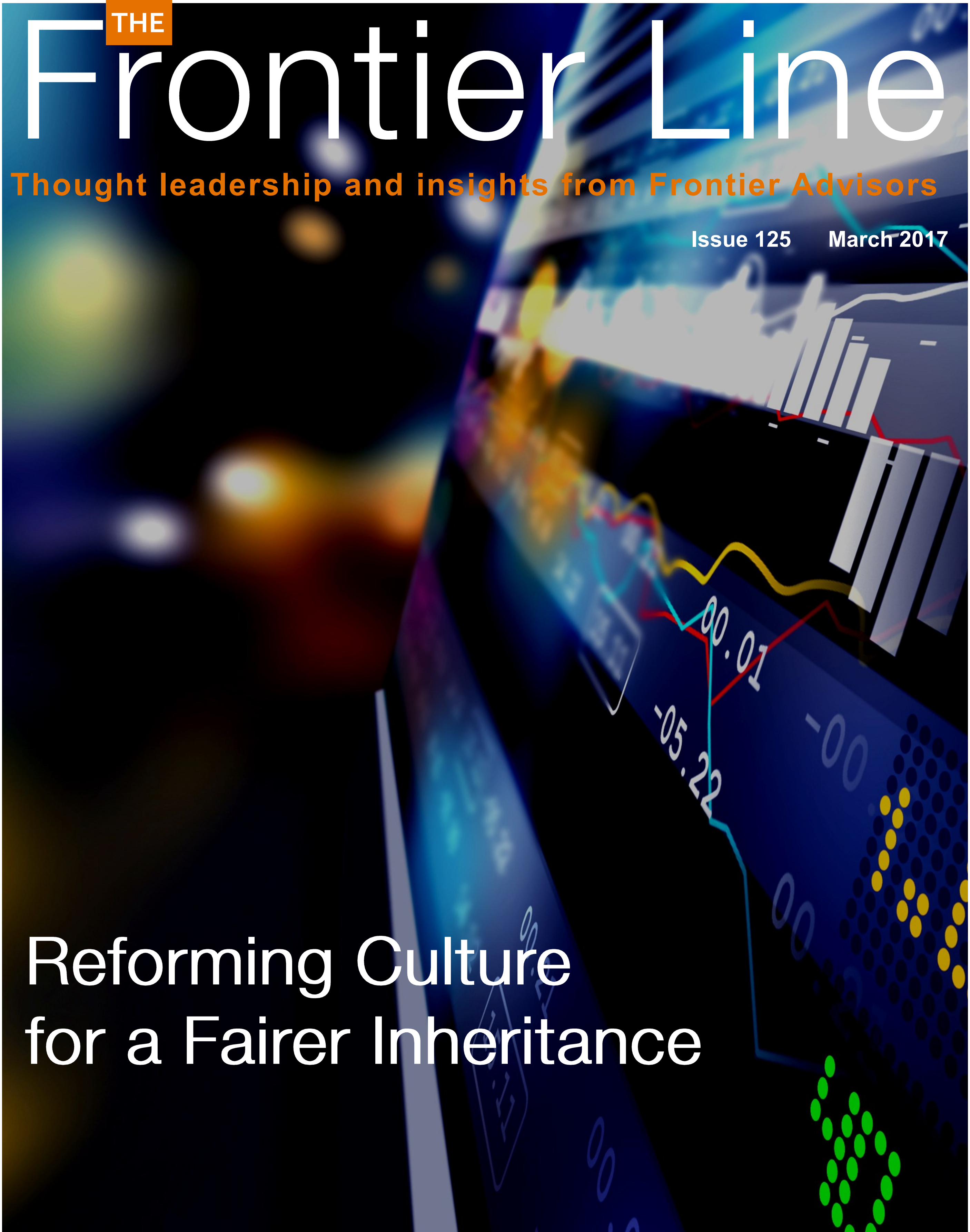

Reforming Culture for a Fairer Inheritance

FRONTIER ADVISORS

Frontier Director of Consulting Fiona Trafford-Walker was recently invited to speak on her view of the financial system at the Financial Institutions, Regulation & Corporate Governance Conference held at the Melbourne Business School on 30 January 2017.

Fiona is a highly acclaimed and internationally regarded investment consultant having featured in CIO Magazine's list of the world's most influential asset consultants for four consecutive years – the only Australian to achieve this honour. In 2016, Fiona was selected in the Australian Financial Review and Westpac 100 Women of Influence Awards in the Board/ management category.

This speech provides a perspective gleaned from more than two decades of working both with the nation's leading investors and with asset managers from around the globe.

AUTHOR

Fiona Trafford-Walker

As Director of Consulting, Fiona is responsible for overseeing the delivery of advice and research through our consulting team and provides advisory services to clients herself.

Fiona joined Industry Fund Services (IFS) in 1994 as a foundation staff member and in 1997 took responsibility for the management of IFS' asset consulting business which became Frontier in 2000 with Fiona as Managing Director. Prior experience includes working in asset consulting with Towers Perrin and completing econometric modelling for Queensland Treasury.

Introduction

My topic today is "reforming the culture of the financial services industry and creating a fairer inheritance for future generations".

I've worked in the finance sector in Australia since 1992. My main focus has been in investments and superannuation, specifically the provision of advice to institutional investors such as large super funds, endowments, charities, redundancy trusts and sovereign wealth funds. Twenty five years is a long time to do anything, and in that time, I have seen the roller coaster of the markets and the economy, including the worst financial crisis since the Great Depression, the Global Financial Crisis of 2008.

A quarter of a century of change

In twenty five years, I have seen the finance sector get larger and larger and within that, I've seen the superannuation sector get larger in funds under management but much, much smaller in terms of numbers of super funds. I've observed alignment of interest between those who own the capital and those who invest it get weaker and I've seen the massive tumble in trust of the finance sector by the general public.

I've also seen many positive developments – greater sophistication applied to solve some complex problems, the earning of some pretty decent returns overall for most members in super funds, the increase in super fund balances for everyday Australians helping to support more dignified retirements and I do have a general view that the financial system here works pretty well most of the time. We've had some scandals and some of those have had catastrophic impacts on individuals, but the system has remained intact and was one of the better performing systems during the Global Financial Crisis.

According to BCG, a financial system comprises six main components – payments, banking, wealth management, insurance, information services and infrastructure and price setting. It can also be divided into retail and commercial or institutional customers. My experience has largely been in the institutional wealth management area, specifically the institutional investment advisory space. So you'll forgive me if I focus a bit on super funds at times, although I have taken an overarching view of the financial services sector.

The role of the financial system

The job of any financial system is to support the real economy to work as well as possible. Its role in this respect is vital. A well-functioning financial system mobilises savings and allocates capital to its best use, allows payments to be made and received with confidence, helps promote sustainable growth and overall enables an economy to be more prosperous than it would otherwise be. A "good" financial system can therefore be described as efficient and effective, but increasingly words like stable and socially responsible are being used. That is, it should not dominate or drive the real economy. It should be the servant, not the master.

Along similar lines, I'd like to quote from a recent book that was written by Robert Shiller. Many of you have probably heard of him, but for those of you who haven't he is an extremely accomplished researcher and thought leader in economics and finance, the co-winner of the 2013 Nobel Prize in Economics and he is currently a Sterling Professor of Economics at Yale University.

His book is called Finance and the Good Society and the paragraph I'd like to read is as follows.

"The goals served by finance originate within us. They reflect our interests in careers, hopes for our families, ambitions for our businesses, aspirations for our culture, and ideals for our society; finance in and of itself does not tell us what the goals should be. Finance does not embody a goal. Finance is not about "making money" per se. It is a "functional" science in that it exists to support other goals – those of the society. The better aligned a society's financial institutions are with its goals and ideals, the stronger and more successful the society will be. If its mechanisms fail, finance has the power to subvert such goals, as it did in the subprime mortgage market of the past decade. But if it is functioning properly it has a unique potential to promote great levels of prosperity".

So notwithstanding that the financial system is broadly sound, there is room for change and for improvement.

Trust in the financial system

It's the combination of the lower levels of trust and the lack of alignment that worries me the most and that's what I'd like to focus on now. The finance sector, and the services it can and should provide to everyday people, is too important to be allowed to develop in the wrong way. We risk leaving a bloated, mistrusted, misaligned and overly complicated sector for our children to sort out if we don't make some changes now. And while I have great confidence in the next generation of kids coming through, I don't think it's fair to leave them such a mess to clean up. For one, my daughter will not be happy!

It's confronting to have spent your career in a sector trying to do good work when the overall sector is the least trusted generally. And not by a little bit.

A US-based firm called Edelman determines an annual trust barometer, via an online survey.

In 2014, the finance sector globally was the least trusted of the eight industries tested with a 48% trust level. In 2016, the news was better with an increase to 51%, but no change in ranking – staying at eighth of eight. In slightly better news, the trend from 2012 has been up from 43% at that time.[1]

Within the financial services sector, mobile banking is the most trusted, followed by credit cards and payments then banks, insurance and finally financial advisory and wealth management.

Just in case you are interested, the most trusted industry in 2016 was technology at 74% followed by food and beverage at 64%. So people trust the companies that sell them mobile phones and pizza and beer much, much more than they trust those who look after their money. There's definitely something wrong with that.

Rebuilding trust is therefore critical to the experience of anyone in the finance sector. Any one individual or organisation can be trustworthy but we need the system to be trustworthy.

We should not have to rely on regulators to make the system trustworthy and to protect the uninformed from the devious. We should not have to rely on codes of conduct and oaths to do the right thing. A position in the finance sector means you have the opportunity to influence someone's financial future – to me, that means that a high hurdle is needed for behaviour.

The list of things that have gone wrong is long and seems to be getting longer. There was of course bad behaviour in financial markets prior to the Global Financial Crisis. While not commonly talked about now, all we could talk about in the early 2000s were the corporate governance scandals including Enron, Tyco and WorldCom. Remember them? I remember reading that the CEO of Tyco, Dennis Kozlowski, allegedly had the company buy him a $30m apartment in New York including $6k shower curtains and $15k umbrella stands. He was ultimately found guilty of grand larceny (i.e. theft), securities fraud and conspiracy amongst other things and spent some time in jail.

But behaviour that we thought was pretty poor back then pales into insignificance when we talk about the corporate greed and bad behaviour that led to the GFC and sadly continues today.

While the US was the heart of the problem, Australian firms were not immune. In the US, Lehman Brothers was the poster child; a global financial services firm that filed for bankruptcy in 2008 and remains the largest bankruptcy filing in US history.

In Australia, we saw the failure of, amongst others, ABC Learning, Babcock and Brown, Allco and the emergence of a story about a small financial planning firm in Townsville in North Queensland called Storm Financial.

And these problems and challenges continue today but in new forms – ongoing financial planning scandals at the major banks, new ones around insurance at the same organisations, trading and market fixing scandals and so on.

1. The Edelman survey for 2017 was released after the date of this presentation and sadly the news is worse. Firstly, the report is called "Trust in Crisis", which pretty much sums it up. Secondly, 53% of those surveyed believe that the system is failing them and 32% are uncertain about it. Unfortunately data on the various sub-sectors has not yet been released but the overall picture is grim and trust in the four major institutions – NGOs, business, media and government – has all declined with media and government below the 50% threshold level and thereby "distrusted".

When things go wrong

And what happens when things go wrong? Surprisingly in some cases, the impacts vary from catastrophic to absolutely nothing.

You might be wondering why I specifically mentioned Storm Financial in amongst other failures. I grew up in Townsville in North Queensland. And there are people living there, and in other towns, who invested everything with Storm Financial and now have nothing. The impact on their lives, and on the retirement that they thought they would have, has been catastrophic. Storm had 13,000 clients in 2007 and around 3,000 of them had some form of gearing in their investments, that is, they had been advised by Storm Financial to borrow to invest in shares. Many were also advised to take out additional home loans to provide additional sources of funds to borrow against. Borrowing to invest is a fine strategy when markets go up, but it's potentially disastrous when they fall. And fall they did in 2008 – the Global Financial Crisis.

Now you might look at that and think that their clients need to take responsibility for their actions. But the advice they had from someone they trusted – their financial adviser – was bad, and it was not in their interests. They were often advised to borrow way too much money and were then unable to service the debt and the fees charged by Storm Financial were egregious.

A survey in 2009 of 400 Storm Financial clients indicated that two thirds expected to be unable to purchase a new home after the forced sale of their current homes. Around a quarter indicated they will need to rely on Centrelink to get by.

ASIC, the financial services regulator in Australia, began investigations into Storm Financial in December 2008 and Storm Financial was forced into administration in 2009. ASIC has a website dedicated to this if you are interested in reading more. The short version is that it is still ongoing, Directors have been disqualified and will probably pay some fines and some compensation has been paid to some clients.

For me, thinking about the very personal aspect of these failures in the financial markets – the people – makes them very, very real.

Where do the problems come from?

When we look at what causes this behaviour, it's mostly around poor alignment of interest, lack of customer-centricity and elements of a bad culture. Overlay that with lower levels of education about financial matters by the general public and you have the potential for some very adverse outcomes.

Alignment of interest in the financial services sector is all about how people get paid. It is a system that is heavily bonus based in some segments, and so people get more for doing more, and for doing specific things. I don't have a problem with the bonus model – in fact I think it can be used successfully to change behaviour and target outcomes, although it'd be nice if getting paid more didn't have a necessarily positive effect on behaviour. That is, you should just know how to behave appropriately in a work environment. But it fails when the potential outcomes are excessive or come at the expense of other people, who trust you or who need you. Can you imagine going to the doctor and saying you have a sore throat but they get paid by the number of things you have wrong with you (or they can suggest you have wrong with you) and the number of medications they prescribe? What if your doctor gets paid a bonus for seeing 20% more people in a day? What if they get paid if they can sell you specific medication because they've got too much of it in the cupboard and need to offload it? It's kind of ridiculous but that's the analogy for some parts of the financial services sector.

One of the common excuses used is that "it's just a few bad apples". I don't accept that. The difference between apples and people is that the good apples in the barrel can't call out the bad apples and get rid of them. But good people can. One of my favourite quotes that I so wish I had said first was that you accept the standards you walk past. So if someone now says to me that it is just a bad apple, I say do something about it. Community standards are increasingly demanding this, and quite simply, it's the right thing to do.

A lack of education is also a challenge. Australians deal with the financial sector every day and much of it is relatively straightforward – banking, shopping with credit or debit cards, getting a mortgage and so on. But much of it is not that simple. First time employees have to choose a super fund and an investment option within that super fund. There's no training for that at school. People can change the investment option over time. Many individuals make additional investments outside super e.g. buying shares or managed funds. That's mostly learn as you go or if you are interested.

As people approach retirement they have to make some pretty complex decisions about what to do – again no training for that. So people need to be able to rely on the quality of information and advice they can access to make good decisions for themselves. I don't think it's a big stretch to incorporate much more on financial literacy into the education system here in Australia and that is a big missed opportunity in my view. We teach kids all sorts of complicated things; we can definitely teach them about stock markets and compound interest and that high risk doesn't always mean high returns.

Big … and getting bigger

I just want to talk briefly now about the size of the financial services industry. It's actually quite hard to get reliable and comparable statistics on this. What we do know is that it is the largest industry in Australia, and that it has grown the second fastest of any industry in the last thirty years. Over time, growth has tended to be in profits. Industry Super Australia (ISA) reports that from 1990 to 2013, profits grew at 9.5% per annum compared with 6.3% for wages and salaries. Full time employment grew at 0.5% over the same period. The same numbers for the average of all other industries were 1.4% employment growth and 5.9% wage and salary growth.

ISA also reports that it has become less efficient over time. In the 1980s and 1990s, for every $1,000 of capital formation (i.e. tangible fixed capital such as manufacturing plants and intangible capital like R&D programs), the finance sector was paid $360. In 2013, that had risen to over $500. So the benefits of economies of scale are not flowing to consumers. We see this in a fairly pronounced manner in the superannuation space.

There has also been more work done recently on the correlation between size and performance. New research is showing that there is a negative correlation between financial sector growth and productivity growth, and also that the size of the banking and capital markets is non-linearly related to growth but that this becomes negative after a certain point.

ISA also reports that the Australian financial sector employed 375,000 people in 2013 on a full time equivalent basis (that's around 3.9% of total employment), paid around $6 billion in taxes, and contributed $124 billion in value added.
It was around 8.7% of GDP – around the same size as telecommunications and IT and mining. Over the ten years to 2013, the financial sector grew at 4.8% per annum – despite the GFC and the mining boom. It outpaced the mining industry, which grew at 4.5% per annum over the same period.

There are good reasons for growth in the sector such as increasing household wealth and the desire to invest more, the need for more insurance options, the increasing pool of superannuation, an increase generally in the size of the equity markets as businesses are brought to the public markets and governments privatise assets, financial liberalisation and increased willingness and ability to borrow, helped by a downward trend in interest rates over many years.

But it's also a sector full of complexity and agents (i.e. people who intermediate and receive income from doing so), one that is not as productive or efficient as it could be, one that suffers from being the least trusted globally and one that, due to alignment and cultural issues, can attract the wrong kind of people when we think about the higher fiduciary purpose of the sector as well as the need to support the real economy, and not dominate it.

Since 2009, I've been working on trying to develop ideas to restructure the way in which funds management firms are paid for the investment management services they provide to super funds. ***I think there are good reasons to pay a fair amount for what your super fund provides, and the focus needs to be on the net returns that you think you will receive, that is, the return after costs incurred. But there are limits on what is reasonable for the outcome you expect to receive and I think that there are opportunities to remodel fees so that the end user, i.e. the member of the superannuation fund, gets the best and fairest deal possible.***

I'd also like to make some observations on the role of the media, specifically the mainstream press. The papers that the average Australian picks up and sees "$30bn wiped off shares today", "market freefall", and "superannuation funds in the red", but where you don't as often see "$30bn added to market today", "market soars", and "superannuation funds in the black". I wonder how many people read these headlines and think twice about making new investments in shares, putting some extra money into their superannuation or even call their fund and change options. From a super fund perspective, I think we can argue today that most people are not very engaged with their superannuation but this does change as they get closer to retirement and their balances get larger.

It's at this point that some critical decisions can be made and the fact these get made with larger balances can have significant effects on any member's ability to retire when they choose.

The other issue is that people of any age can be influenced by what they read, and so some younger people are also going to be influenced by the mainstream media. So, who knows the impact that such emotive headlines will have on them when they do start that first job and need to tick a member investment choice option box. Maybe they will think that stock markets are just too risky – after all, who wants to invest in something that can lose $30 billion in a day? So maybe they pick the Cash Option – this is in fact likely to be the riskiest option of all for a person with forty years of work ahead of them.

So far I've spoken about the many challenges facing the financial services industry, but more importantly about the people who use and need the financial sector. But things are not all bad. There are lots of very positive developments – the levels of public reaction are rising and people are questioning organisations about behaviour.

This can only lead to greater accountability and hopefully better outcomes. And there are a lot of very good people who do work in the finance sector, working tirelessly to look after the fiduciary interests of others. It's just that these stories are not as interesting as the "bad apple" ones.

How can we make the financial sector better?

A lot of what I have spoken about today revolves around failures in culture at organisations that have resulted in catastrophic outcomes for individuals but with little impact on the organisation or senior management that allowed the behaviour to occur. You might be wondering what you can do – after all, isn't this an issue related to the organisations themselves? Shouldn't they fix them? That's true, but organisations respond to public pressure.

We've seen the pressure that the CEOs and Chairs of the major banks get put under from time to time. We see the same for similar people at other organisations such as investment banks. Holding senior people accountable for the behaviour of their staff is an important control mechanism and you can vote with your feet if you do business with these firms or perhaps own their shares. Choose financial services providers that have the same values as you do, for example.

In Australia, we've seen ASIC, the financial services regulator, mandate that the Board of listed companies in this specific case be specifically responsible for the organisation's culture. This is a big deal and I know has resulted in many conversations around Board tables about what this means and how Boards can discharge their duties. As well as being the Director of Consulting at a 55 person firm located here in Melbourne, I am also a Non-Executive Director at an ASX top 100 company that employs 4,500 people in eleven countries so this is something that I think about a lot from different angles.

One topic I have been reading about recently is that of having "centres of influence" especially inside large firms. These centres can be one person or a group of people who display the desired cultural values, and they can be used to encourage the right behaviour beyond the centre itself, that is, held out as key role models alongside the more traditional role models of the Board, the CEO and other key management staff. I think this is a great way to help the right culture permeate a firm. Anyone can be that centre or in a centre of influence.

Regulatory changes may also help, but as I said earlier, I don't think it's desirable to have to create laws and regulation in order to improve behaviour and culture; but the reality is that this can and will occur if some of these things don't change.

For example, in February 2015, the Netherlands introduced the Act on the Remuneration Policies of Financial Undertakings and this includes several rules for specific parties on bonus caps in the finance sector. There has also been similar discussion in the UK, but they are busy talking about BREXIT now and will be for a while by the looks of things. The finance sector can pre-empt some of these by reviewing its remuneration practices, although that seems unlikely based on past events.

Greater transparency around costs and cost management would also be to the advantage of consumers of financial services, enabling them to more clearly understand what they are buying; and should lead to improved trust levels. I acknowledge that sometimes costs can be difficult to be clear about including what levels need to be disclosed and how these might or might not be comparable, but that doesn't mean the industry can't make progress on this.

Responsible innovation and product development is also key – unfortunately the financial sector is well known for developing products that suit the seller and not the buyer. There are still too many that are complex and expensive, and full of financial engineering although this is not as much of a problem as prior to the GFC. ***Fit for purpose products that work for consumers and are for sale at a fair cost will help rebuild trust as well as deliver good financial outcomes for consumers.***

I've intentionally skewed my presentation today towards some of the challenges in the finance sector but as I said earlier, it functions pretty well most of the time and employs some amazing people doing great work. However, in my view, the sector overall could be better and in some very important ways around culture and behaviour. The good thing about these things is that they are not brain surgery. They do however require the good apples to kick the bad apples out of the barrel, they require consumers, like all of us in this room, to demand better and act when we don't get it, and the financial sector to listen.