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ENSURING SEAWORTHINESS TO CHARTING A COURSE

How Australian Banking Can Survive the Perfect Storm

Australia's banking industry—and the country's financial services industry more broadly—has faced a perfect storm over the past year:

- The Royal Commission on the banking industry released its final report[1] in early February, with a series of 76 recommendations designed to rein in the excesses of the financial services industry.
- The Banking Code of Practice (BCoP) comes into effect in July, and requires that banks focus far more on the customer by designing for a service culture and behaving ethically.
- Expanding on the above two regulatory demands, the Big Four face an estimated additional A$2.4 billion in regulatory and compliance costs over the next three years.[2]
- Less publicly, but no less of a challenge, the business environment for the Big Four banks[3] has deteriorated for a number of reasons, many of which are likely to continue.

This is without considering the growing threat of digital disruption. The advent of open banking, for example, will see the implementation of the Consumer Data Right system this year, which will require banks to provide customer data to clients and to accredited third parties. Additionally, the spread of digital banking means customers can more easily switch providers—whether to other banks or to fintech providers.

To survive the storm and chart a course forward, banks must repair their ships to make them seaworthy—which, broadly speaking, requires appropriately adhering to the new and existing regulatory requirements—and then chart a course out, primarily by improving the customer experience. Specifically, they should consider to:

- Switch from a sales culture—which, the Royal Commission found, was broadly behind the industry's excesses—to a service culture across all channels.
- Ensure that regulatory spend improves both the customer experience and banks' digital channels.

Understand that poor conduct lies at the centre of the storm, and that fixing this will kill two birds with one stone: both improve the customer experience and address the BCoP's compliance requirements and the findings of the Royal Commission.

Taking these actions may allow banks not only to survive this storm, but to chart a new course that may assist them to thrive in an industry that is undergoing profound change.

THE PERFECT STORM

WAVE 1
THE ROYAL COMMISSION

The Royal Commission pulled no punches in determining that the cause of misconduct was corporate and individual greed; that "providing a service to customers was relegated to second place"; that "sales became all important"; and that the primary responsibility for what went wrong lay with boards and senior management.[4] The prevailing undercurrent was that shareholders' needs trumped all others—especially those of customers. The sector's culture, governance and remuneration policies came under the spotlight.

The leaders in Australian Government have indicated that they will take action on all 76 recommendations and may introduce further measures.[5] Briefly, the outcome will see few changes to responsible lending. But banks must report on conduct and culture; regulators have been granted additional powers; there is a strong focus on remediation and commissions; and the Banking Executive Accountability Regime (BEAR), which came into effect in 2018, has been extended to other financial services institutions.

The Royal Commission's key recommendations include:

- The remit of the Australian Prudential Regulatory Authority (APRA), which supervises financial services institutions, and which administers BEAR, will be broadened beyond the management of financial risk to include misconduct, compliance and other non-financial risks.
- APRA will establish limits on the use of financial metrics for long-term variable remuneration. Additionally, employee remuneration systems must focus on non-financial risks and misconduct.
- Lenders will be banned from paying commissions to mortgage brokers and aggregators—this will be phased in over three years. Trailing commissions will be banned from July 2020.
- Mortgage brokers will be subject to the same laws that apply to financial advisers, including a best-interests duty.
- The Banking Code of Practice will be extended to cover loans to small businesses of less than A$5 million.

WAVE 2
THE BANKING CODE OF PRACTICE (BCOP)

The BCoP was introduced by the Australian Banking Association (ABA), partly in an unsuccessful bid to head off the threat of a Royal Commission into allegations of misconduct in the financial sector.

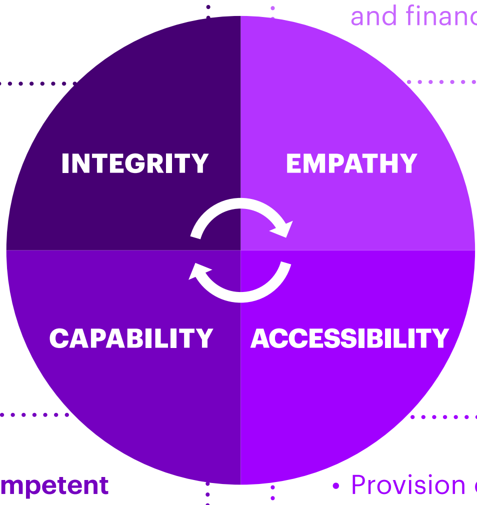
The Code, which is scheduled to take effect in July, will ensure that banking products are both easier to understand and more focused on what personal and small business customers need.

It also commits banks to behaving ethically, lending responsibly, and being more transparent, and will pressure them to ensure good employee conduct.

Key clauses (see diagram) focus on culture drivers—integrity, empathy, capability and accessibility—areas that, if addressed, could see across-the-board improvements in compliance and the customer experience. Changes announced to the Code in late February will further protect customers, the ABA has said.[6]

- **Fair**, **Ethical**, **Reasonable** Conduct
- Data protection and **Confidentiality**
- Adequate **notice** and **warnings**

- Culture of **inclusivity** and integrity
- **Sensitivity**, **respect** and **compassion** for diverse/vulnerable customers
- **Customer Advocate** roles
- **Support** customers facing hardship and financial difficulty



- All **Staff Trained** and **Competent**
- **Diligent** and **Prudent** bankers

- Provision of **timely**, clear and information in 'plain English'
- **Clear** terms and conditions
- **Accessible** banking for remote customers
- Access to **Complaints Handling**

WAVE 3
A CHALLENGING BUSINESS ENVIRONMENT

The business environment for the Big Four has deteriorated for a number of reasons: from lower property prices to increased competition; tighter margins and diminished incomes in areas such as trading and wealth management; and a stagnated share of deposits (for three of those banks) combined with the fact that banks now source a larger share of funding from the US.

Take that final point: according to the Reserve Bank of Australia, the share of domestic short-term funding declined from about 8 percent in 2000 to about 5 percent in 2017, while the proportion of short-term offshore funding climbed from about 5 percent to about 8 percent over the same period.[7] Given higher US interest rates, that will further squeeze margins.

In addition, term rates on deposits of A$10,000 more than halved from about 5 percent in 2012 to about 2 percent in 2017. Over the same period, household term deposit growth declined from nearly 20 percent to about 5 percent.[8] The consequence of this shift in interest rates has been that term deposits, which in the five years after the global financial crisis were the fastest-growing deposit product, were outstripped by transaction and savings deposits.

On the earnings side, the share of interest-only loans—which provide the highest margins—as a proportion of total housing loan approvals dropped from about 40 percent in 2000 to about 19 percent in 2017.[9] At the same time property values have fallen, leading to a decline in the value of banks' property books. And lastly, the mortgage rate trend has been downwards, with the average lending rate for major banks declining from about 6 percent in 2000 to about 4 percent in 2017.[10]

There have been two positives for banks: net interest margin improved due to the repricing of certain mortgage types, and improved deposit spreads. But bank levies and the higher wholesale funding costs have offset some of that, and matters are unlikely to improve much in the near future: banks will face costs reskilling employees and assigning them to new customer-focused roles as they pivot towards a more customer-centric model.

Additionally, the remediation program—whose goal is to identify and make good all customers that received poor financial advice, and which is being overseen by ASIC—will also hit the bottom line.

At the same time, banks face an unprecedented threat to their dominance from fintech companies that are hungry to take market share from them—and that have the skills to do so.

WHAT SHOULD BANKS DO? REPAIRING THE SHIP AND CHARTING A COURSE

Banks, then, are not only facing a future in which they must contend with greater scrutiny and far more rigorous expectations of ethical conduct; they must also improve the customer experience or risk losing business to new, more nimble competitors.

1. IMPROVING THE CUSTOMER EXPERIENCE

Achieving this requires action in three key areas:

- Shifting from a sales-driven culture to a service culture;
- Ensuring that this shift happens across all channels;
- Prioritising regulatory spend that also improves the customer experience and digital channels.

Designing for a service culture that focuses on customer-related outcomes rather than on a sales culture will meet the Royal Commission's and BCoP's requirements, putting the customer front and centre. It is also an essential step to success in the digital world. Banks in other countries have already trodden this path, introducing blended measures that limit sales as a factor in remuneration, and that incorporate elements like customer satisfaction, risk management and team-based goals.

It will take time to implement, but it is vital as the banking landscape undergoes a seismic shift with fintechs and GAAFA competitors (i.e. Google, Apple, Amazon, Facebook and Alibaba—tech firms offering financial services) competing for banks' business, and wholly altering customers' expectations for the sector. Success will also require a change in management culture, along with reassurances for employees that customer satisfaction trumps sales.

Banks must also avoid the mistakes made in the UK a decade ago: there, the sector focused its spending on meeting control and risk needs, and failed to improve the customer experience, leading to the rise of nimble, customer-focused challengers. Banks must maintain spending on the customer experience and digital channels and do so with a focus on human-centred design (HCD)—which means considering problems from a human perspective, and relying on collaboration, empathy and experimentation to create innovative solutions that people love.

It is this approach that GAAFA firms have used to build global behemoths, and banks need to design their response to regulatory requirements using HCD.

2. REBUILDING TRUST

The Royal Commission revealed three elements at the heart of the crisis: a lack of accountability, flawed incentives and unethical behaviour.

The BCoP provides part of the solution and is central to efforts to lower conduct risk and improve the customer experience. It puts more emphasis on ethical behaviour by bank staff, provides increased transparency of banking products and services for personal and small business customers, and outlines a range of rights and protections for customers.[11]

However, banks must also win back trust, ensure accountability and proper alignment of employee incentives, and build an effective Conduct and Culture Model. This requires a customer-centric approach where sales practices are ethical, controls over conduct are in place, and corporate culture changes for the better.

It also means:

- Identifying proactive and predictive insights so banks can monitor and manage business conduct and culture risk.
- Expanding their historical approach to reporting (focusing on incidents), and generating proactive, forward-looking insights.
- Integrating multiple data sources, systems and processes to ensure fluid engagement of new digital systems.

Banks need to show they are complying with their BCoP obligations, and that senior management are doing the same under BEAR. In part, that requires knowing what is working and what is not– and success in this arena means using technology and data analytics to fix data failings.

3. PUTTING THEORY INTO PRACTICE

Accenture suggests a three-step process to action.

Step one: conduct a gap analysis to understand where regulatory initiatives like the BCoP will have the greatest impact, and to discern the changes needed to ensure that systems, policies, processes, controls and bank collateral comply with them in time.

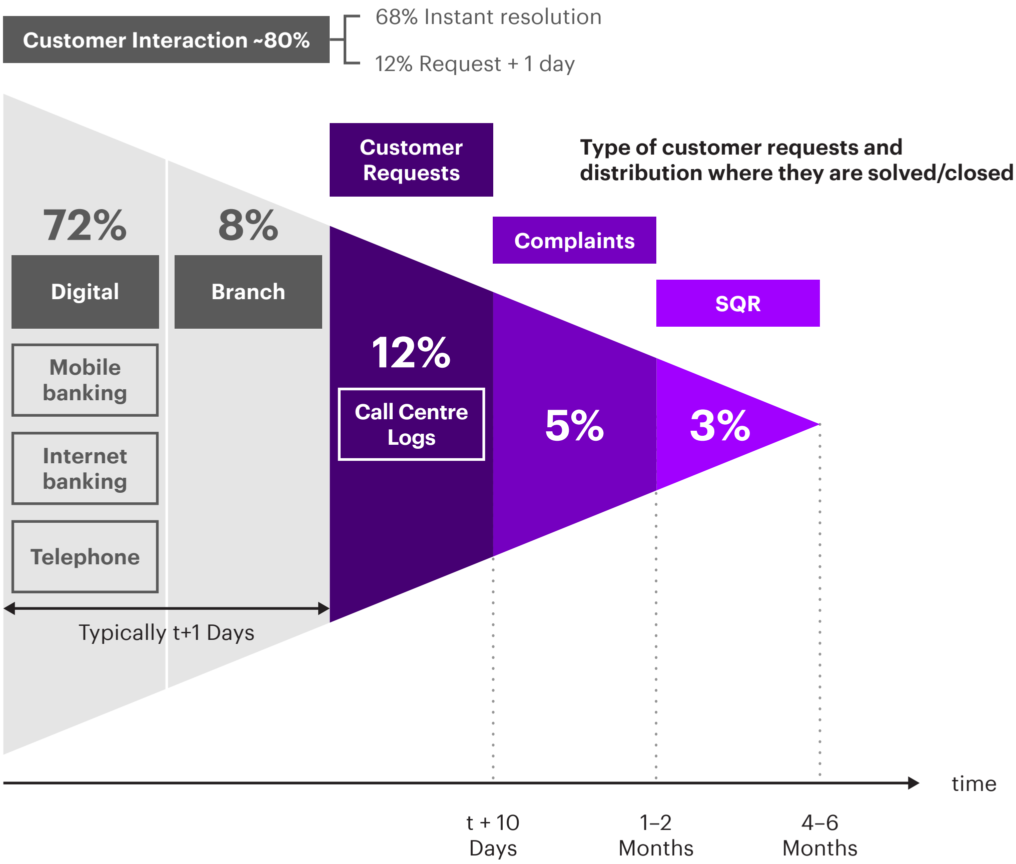
The graph below includes a timeline of resolved complaints/requests. The percentages and resolution times depend are subject to various factors.

The BCoP module of Accenture's Risk & Insights Platform (RCIP) maps controls, risks and obligations to the bank's value chains. Conduct and compliance cut across all operational aspects, and moving from a business-unit view to a value-chain approach makes understanding the environment, actions and accountabilities easier.

Banks must also clean up data-points in their systems of record (SOR) to ensure better analytical insight.

Step two: maximise control by introducing systems to improve understanding of the compliance environment and generate deep insights from internal data. This proactive approach means insights are viewed vertically and horizontally, creating greater accountability and allowing evaluation of compliance with regulatory requirements.

Step three: link to the customer experience and make regulatory-driven investments a win-win. That requires insight into customer journeys and understanding where the BCoP and the customer experience intersect. Banks can then add a BCoP or customer experience element to investments that are underway. The RCIP Customer Journey module can provide this understanding by visualising, tracking and drilling down into customer journeys.



In conclusion, a holistic, data-driven and proactive approach is the only way to get out in front of today's commercial and regulatory challenges. Increased competition, greater regulatory scrutiny and a crisis of trust means banks have little choice but to reinforce controls, conduct and compliance, and improve the customer experience. The innovative modules on Accenture's Risk and Compliance Insights Platform mean banks can do both at once.[12]

Looking ahead, we expect the environment will remain challenging, and that is why banks must act now. After all, in a storm it doesn't pay to sit tight and hope for the best—what's needed is to fix what's broken, ensure the vessel is seaworthy, and chart a course out. In that way, when the storm passes, the ship is still afloat and in the best possible shape to keep sailing.

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