5. Bank Structure, Ownership and Governance Issues

Contents

5.1 Introduction 1
5.2 Bank Ownership 2
Some History regarding Bank Ownership Structures 2
Mutuals 4
The EEC and Cooperative Banks 5
Bank Ownership and Non-Banking Activity Restrictions 7
5.3 Australian Major Bank Business Structures 9
5.4 Banking Conglomerates 11
Conglomerates, Risk and Regulation 15
Diversification and Performance 15
5.5 Branching, Franchising and Banking Service Delivery 16
Trends in Australian Bank Branching 16
Community Banking 18
Outsourcing via Mortgage Brokers 19
Franchising 20
Australia Post – Bank@Post 21
"White-labelling" of banking products (BaaS) 21
5.6 Bank Governance 22
5.7 Banker Remuneration and Accountability 24
Banker remuneration: what do we know? 24
Recent Developments 25
APRA's remuneration standards 26
The BEAR (and FAR) 26

5.1 Introduction

Financial institutions can be organised in a variety of different forms, involving different methods of allocating risk and control rights. Because of imperfect information and the impossibility of complete contracting, these lead to different forms of agency problems and risks for stakeholders and society. The form chosen will reflect the perceived most efficient form given the objectives of the founders (or controllers) of the organisation and the various constraints they face. Taxation and regulation also

affect the viability or suitability of particular types of organisational structures. An historical perspective is important, since current institutional structures will reflect past social and economic circumstances relevant to their origins and evolution through time.

The structure of the organisation also gives rise to internal governance issues. Particularly in large organisations, delegation of decision-making authority becomes necessary and requires control mechanisms to ensure that decisions are consistent with the goals of the organization. Sticks and carrots are both needed. Accountability is required, limits on the scope of decision-making delegated are required, rewards for superior performance are warranted. Senior executives and Boards need to receive adequate information to enable them to assess overall performance against goals. As the Hayne Royal Commission showed, these have not always worked well in Australian Banks (nor those in foreign jurisdictions).

The following sections examine types of ownership arrangements, the role of banks as (part of) conglomerate structures, Australian banks and methods of delivery of banking services, governance and accountability in banks, and bank remuneration arrangements.

5.2 Bank Ownership

Organisational forms and ownership structures in the financial services industry vary widely and include unincorporated enterprises, partnership (including limited partnerships), unit trust/managed investment schemes (MIS) and mutual/cooperative structures and joint-stock companies. The last of these, where equity holders are the residual risk bearers, but with limited liability, and have control (voting) rights, is the most common nowadays, but history demonstrates a wide variety of alternative structures can exist. Since joint-stock companies (such as limited-liability companies listed on the stock exchange) are well known, they are not discussed in detail here.

Some History regarding Bank Ownership Structures

A feature of banking before the 20th century in many countries, including Australia, was the existence of *unlimited liability or double liability* of bank owners.[1] With minimal regulation, this was a way of owners convincing depositors or holders of the bank's notes that they would have strong incentives to manage the bank in a way which avoided failure. Likewise, Lloyds of London insurance was historically characterised by unlimited liability of the individual members (high net-worth individuals referred to "names") providing insurance cover. That has changed in recent decades such that

[1] Until 1963 many of the Australian Trading Banks had uncalled shareholder funds which could be demanded from shareholders if needed. In the early post-WW2 years these were around a quarter of shareholders' funds. (Source: RBA, Occasional Paper 4B, Table 10)

members typically have a corporate form, or other structure, which limits liability, and no new individual memberships are allowed.

Partnerships also involve unlimited liability and were the only structure allowed in stockbroking in Australia prior to the mid 1980s. Most investment banks before the 1970s were partnerships, but in the 1970s and 1980s the large US investment banks converted to public firms. Morrison and Wilhelm (JF, 2008) explain this phenomenon by reference to the relevance of human versus physical capital in investment banking. Prior to the technological revolution of the 1970s onward, the partnership form was suited for ensuring mentoring within the partnership (to achieve the maintenance of "reputational capital") and development of, and retention of future partners with, "tacit" human capital skills. The partnership model allowed profit sharing and provided incentives for effort by those with such not easily codified or measured "soft" (as opposed to technical) skills. Once technology provided scope for new efficiencies requiring large investments in physical capital, the public firm model was a better organizational form. Not only was it better able to provide the required funds for large scale investments, but within larger organisations the free-rider problem becomes more relevant – to the detriment of the partnership model. It also increased the relevance of technical skills relative to "tacit" skills.

There are very few unlimited liability firms found in financial services today, although limited liability (or master limited) partnerships (LLPs) involve a general partner having unlimited liability and management responsibility, while limited partners (investors) enjoy limited liability. Many hedge funds adopt such a structure in other countries, but Australian tax laws have stifled growth of this form of organisation, by not allowing a "tax flow through" approach (except for some venture capital funds). (A flow-through approach means that if all realised income is distributed to investors, to be taxed in their hands, there is no tax paid at the LLP level).

Governments have also often been owners of banks, including historically promoting "trustee banks" run in the public interest by trustees appointed by the government. Tasmania had several Trustee banks (eventually privatised in the 1990s). The Victorian and South Australian governments each owned banks (SBV and SBSA), with a significant share of the local banking market, until the banking crisis of the early 1990s led to their demise and takeover by the private sector. SBV was sold to the Commonwealth Bank in 1991 and the SBSA was sold to Advance Bank in 1995. The NSW Government sold the State Bank of NSW to Colonial Mutual in 1994.The Australian government-owned Commonwealth Bank was privatised in the 1990s as was the WA government owned R&I (subsequently BankWest) bank. The Commonwealth sold the Housing Loans Insurance Corporation to the private sector in 1997

Mutuals

In Australia, the mutual form once dominated the life insurance business, and mutual life offices have been common elsewhere. While customer/members are the legal owners (with one vote each), control generally lies in the hands of management due to limited member participation in voting. Credit Unions and (many) Building societies were established as mutuals in Australia and similar structures for deposit taking/lending institutions can be found in other countries such as the USA and UK. In Europe, cooperative banks have been particularly important. Many stock exchanges around the world were originally established as mutual entities with market participants (stockbrokers in Australia) being the owners, but demutualisation has been widespread.

The RBA provides some historical information on demutualisations in the Australian financial sector prior to 1980 here and Davis provides an analysis of credit union demutualization in Australia here and here, and internationally here.

What are the advantages and disadvantages of the mutual form relative to others such as joint-stock companies, and why has there been the observed decline of the mutual form in the financial sector? One explanation lies in the nature of agency problems associated with each ownership structure. Joint stock companies involve an agency problem between owners and creditors (including depositors in the case of banks) which can lead to excessive risk-taking (owners getting the upside benefits, with creditors incurring the downside costs of failure). Mutuals do not have that agency problem arising from separate groups of owners and depositors (or policy-holders etc). And while in mutual ADIs, borrower and depositor members have conflicting preferences over interest rates, traditional limits on membership to those sharing a common bond (location, religious affiliation, employment etc) tended to reduce the significance of that conflict.

But mutuals may face a more severe owner-manager agency problem because their one-member one-vote structure can lead to managerial entrenchment. Paradoxically, manager preferences for avoiding loss of perks of their office may lead them to be more risk-averse, increasing the safety of member deposits. More generally, capital market discipline, associated with having tradeable shares priced in the market, is missing for mutuals (although product market discipline has similar effects for financial mutuals).

Why have mutuals declined in importance? There are two main conflicting (but not incompatible) views. One is an *expropriation* hypothesis. As mutuals have accumulated communally owned financial reserves, incentives increase for some to convert that into private wealth via demutualization, even if the mutual is a more efficient ownership structure. The alternative is an *efficiency* hypothesis, which argues that the benefits of the mutual form may have diminished with changes in competition,

technology, regulation etc. Small mutual institutions may find the costs of regulatory compliance high, while growth may involve more heterogeneous membership with different, competing, preferences – less suitable for the mutual model. Government financial consumer protection schemes (such as deposit insurance) may reduce the perceived safety benefits for customers of the mutual form. Information and monitoring benefits of mutuals dealing with a limited, socially connected, group of members may have declined as membership widened. Growth ambitions of professional managers who are needed for a more complex financial environment may be thwarted by the inability of a mutual to raise external capital.

What does the evidence say on the expropriation versus efficiency hypotheses? Overall, it is somewhat mixed. A number of studies (reviewed in Davis) provide evidence supportive of increased efficiency following demutualisation, but this event typically involves other possible confounding changes such as shifts into different activities and risk-taking. Others point to the demise of demutualized institutions as stand-alone entities (via take-overs etc) as suggestive of conversion leading to loss of some benefits of mutuality. Arguably both expropriation and efficiency considerations are both relevant.

The EEC and Cooperative Banks

In Europe, the creation of the European Economic Community has created many issues regarding banking structure and supervision. Whereas previously banks from another European country would have been classified as "foreign banks", there is no longer such a distinction. Since the GFC the EU has embarked on a banking union applying common laws and regulations across all EU states and creating a single market for financial services.

Europe is characterised by a range of ownership structures in banking. **Error! Reference source not found.** provides an overview of bank ownership structures in Europe.

TABLE 1: BANK OWNERSHIP STRUCTURES IN EUROPE

In Europe, government and cooperative banks are as significant as shareholder owned banks.		
Schoenmaker et al[2] provide a useful list of significant Euro-area banks as at 2015, which is summarised (excluding branches and subsidiaries of banks from elsewhere) in the Table below.		
Type, Size (Assets), Number		
G-SIBs, >EUR 800bill, (8)	6 – joint stock	Listed - dispersed ownership
	2 - cooperative	1 listed – controlled by mutuals 1 unlisted – owned by mutuals
E-SIBs, >EUR 150 bill, (22)	8 - joint stock	Listed – dispersed ownership
	4 – cooperative	3 unlisted - owned by mutuals 1 listed – controlled by foundation
	10 – government	2 listed – nationalised 1 unlisted – nationalised

		1 in resolution 4 local government owned 1 Post Office owned 1 Policy bank
Other significant institutions, >EUR 3bill,(70)	27 – joint stock	16 listed – dispersed ownership 4 unlisted – major owner 7 unlisted private owner
	21 – cooperative	10 unlisted – mutual or owned by mutuals 6 populares (listed, one vote per owner) 3 Unlisted – controlled by foundations 2 other
	22 – government	6 nationalised 7 policy banks 4 central government 3 local government 2 other
[1] Source: Schoenmaker et al (Bruegel.org, 2016)		

The cooperative banks in Europe generally have a structure along the lines of that shown in Figure 1 (although some may have only two tiers rather than the three shown in the figure). Members/customers own the local bank which in turn has an ownership stake in a regional bank, and which in turn is a part owner of the group's "central bank", which provides liquidity and other services and access to Central Bank facilities for the lower level banks. This is in distinct contrast to the multiple bank-holding company model seen in the USA where shareholders own the holding company which owns several bank subsidiaries and provides equity capital (and debt funds raised by the parent to them).

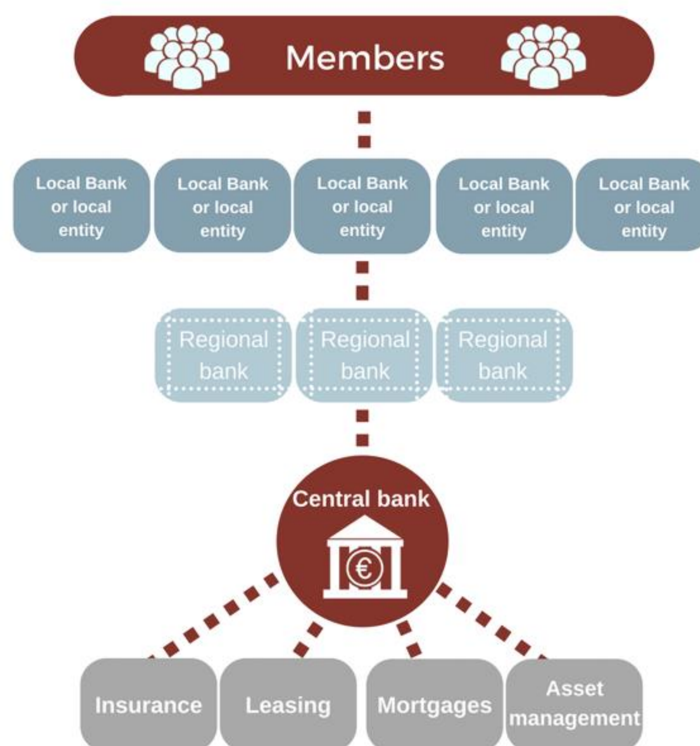

FIGURE 1: COOPERATIVE BANK STRUCTURE (SOURCE: GLOBALCUBE.NET, 2017))

Bank Ownership and Non-Banking Activity Restrictions

The appropriate nature of relationships between banks and industry, as well as that of ownership and control of banks, has long been debated. Different regulatory arrangements and models have emerged globally, and changed over time, reflecting historical experiences, dominant political ideologies, and roles of special interest groups.

The ownership of banks has been a subject of considerable controversy and regulatory arrangements. At one level there is the question of the extent to which commercial companies should be allowed to own or control banks. At another level there are debates over government versus private ownership structures, choices between joint-stock, partnership, or mutual ownership forms, foreign ownership, limits on maximum ownership share, banks as parent companies or subsidiaries of some other holding (parent) company.

Regarding ownership of banks, Australia requires that there be a diversified ownership structure, reflecting concerns that concentrated ownership could lead to activities which benefit controlling shareholders at the expense of depositors and bank safety. That is reflected in the Financial Sector (Shareholdings) Act of 1988, which limits shareholding in a financial sector company (which includes banks) to no more than 20 per cent, unless otherwise approved by the Treasurer.

Regarding activities, in some jurisdictions, at some times, there have been severe limitations on the ability of banks to engage in "commerce", either directly or via significant equity investments in companies engaged in non-financial activities (manufacturing etc). There have also been restrictions on commercial banks engaging in certain types of financial activities, such as securities business, real estate, insurance, with the since repealed Glass-Steagall Act, involving separation of "commercial" and "investment" banking in the USA being the most well-known example. Where non-banking business is allowed, it may be permissible if conducted in a subsidiary of the bank, or in a separate part of a conglomerate structure of which the bank is a part.[3] Ford provides a recent review of the "banking/commerce separation doctrine" as it is known in the USA, and how it applies in a number of countries.

In Australia, there is no formal, legal, restriction on banks undertaking non-financial activities, but it has not been an area of major activity nor concern. Prudential regulation, which applies relatively high risk weights to equity investments can discourage such activity. While the Australian banks have recently retreated from a range of non-banking financial activities (insurance, wealth management, financial advice) the growth of fintech may operate to encourage more involvement in non-financial activities. Banks possess large amounts of data about their customers which is a valuable resource for the development of "apps" across a wide range of activities. With "Open Banking" allowing customers to approve sharing of that data with third parties, banks may have incentives to partner with fintechs to engage in non-financial activities using that data.

Such restrictions have reflected concerns, not necessarily supported by strong evidence, that mixing banking and commerce could aggravate financial instability, lead to concentrations of economic power, or allow self-interested bankers to direct financing inappropriately to associated parties for their own gain.

Understanding why different activity and ownership regulations on banks apply around the globe requires a deep understanding of the history of financial and economic development, and political pressures of the countries concerned. Often the differences are summarised as being whether a "universal banking" model (in which a full range of financial activities is allowed) applies or whether a segregated banking model applies. The USA during the period in which the Glass-Steagall Act applied was an example of the latter, while European banks tended more toward the former. In some countries, such as Japan and Korea, the integration of banking and commerce was even more pronounced with the Keiretsu and Chaebol conglomerates involving a "main bank" which serviced a plethora of associated industrial companies.

[3] For an overview of US history in this regard see Haubrich, Joseph G., and Joao AC Santos (FMII, 2003).

5.3 Australian Major Bank Business Structures

Large banks are complex organisations divided into a number of Business Units (BUs) each comprising various divisions or sub-units and undertaking a number of activities. The complexity extends across a range of business activities as well as geography – including in different jurisdictions. Managers of those BUs (and of divisions) have delegated authority for decision making - subject to limits imposed on such delegation, reporting requirements, performance targets, etc. Ensuring consistency of decision making with bank objectives across BUs and management of resulting risks for the bank are complex problems.

Within a large complex banking conglomerate or BHC, it is possible to categorise the possible range of activities into the following:

- Traditional Banking – deposit taking, lending, payments services etc
- Investment Banking/Dealing – securities activities
- Insurance – Life Assurance and General Insurance,
- Mutual Fund and Pension Fund provision and management
- Wealth Management, Financial Advice
- Trust & Custody Services – managing and holding assets on behalf of others
- Other financial – portfolio managers, broker dealers, other intermediaries
- Nonfinancial Management firms – real estate, housing, utilities, management,
- Other Non Financial – technology, accounting services, subsidiaries etc

Many of the non-financial subsidiaries may be providing services for the organisation and/or for external clients. For the US Goldberg and Meehl (FRBNY, 2020) show that the largest Bank Holding Companies controlled over 1,000 legal entities operating across most of these types of activities. There was some evidence of reduced complexity (in terms of number of legal entities) and less international dispersion of activities since the GFC, but less so in terms of range of business activities.

The four major banks in Australia all have group structures such as shown in Figure 2 in which the Australian banking activities and those of offshore branches are classified by regulators as “Level 1”. Those banking type activities operated outside the bank itself (in subsidiaries) are included in the “Level 2” classification, and other financial services activities are included in the “Level 3” classification. The Banking Group, the firm listed on the stock exchange, is the consolidation of all those activities, such that most of the level 2 and level 3 activities are conducted within subsidiaries or associates of the “Bank”. Banking prudential regulation focuses upon the safety (and financial stability implications) of the Level 1 and Level 2 activities, although exposures to the bank arising from Level 3 activities conducted by subsidiaries is also taken into account. Moreover, some of those Level

3 activities (such as insurance, provision of superannuation funds) will also come under the purview of the prudential regulator.

Macquarie Bank has a quite different structure (as do AMP and Suncorp) involving the bank being a subsidiary of a Non-Operating Holding Company which is the ASX-listed company. This reflects the relative importance of non-banking activities for those groups.

Information on the number of subsidiaries and affiliates of the major Australian banks is not readily available, although their annual reports do indicate major entities included in the consolidated group. Interests in some structured entities (such as SPVs used for securitisations) may be included, as well as insurance and funds management subsidiaries and overseas bank subsidiaries (such as in NZ).

FIGURE 2: MAJOR BANK STRUCTURES

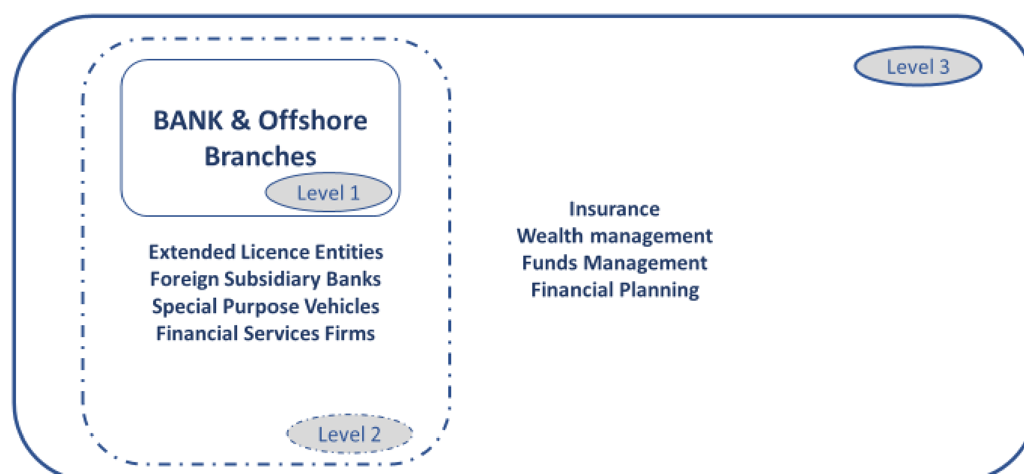

Figure 3 provides an overview of the business unit structures of the four major banks plus Macquarie Bank. Each of the customer facing units will have sub-units with responsibility for different types of financial products and services. An example of how various activities are arranged within particular business units for NAB can be found here.

Treasury which is depicted as being part of Head Office plays a major coordination role for the bank in dealing with consequences of BU activities. Net imbalances of funds received and provided to customers will be managed in that entity through raising or placing of funds in wholesale markets, and

from the equity funding of the bank. Some level of funds will be invested in a portfolio of liquid assets to meet regulatory requirements and manage liquidity risk. Interest rate risk arising from the different transactions undertaken by the customer facing units will be managed at this central level. That will generally involve the head office unit undertaking an internal hedging transaction with the "trading desk" which may be located organisationally within the Institutional Division, and which will separately determine what hedging position, on behalf of the bank, it will take via transactions with third parties.

To achieve this coordination role, involving management of funding, liquidity and interest rate risk, and to provide appropriate pricing signals to BUs consistent with market conditions and the bank's objectives, the *Funds Transfer Pricing* system (Chapter 15) plays a crucial role.

FIGURE 3:MAJOR BANK BUSINESS UNIT STRUCTURES

Major Bank Business Unit Structures (contribution to Profit 2017)

	ANZ	CBA	NAB	WBC	MacQuarie[a]
Head Office	Corporate Centre, Digital Banking, Group Operations & Services, Technology (-1%)	Group Strategy, Marketing, Corporate Affairs, Treasury (-4%)	Technology & Operations, Risk, People, Customer products & services, People, Finance(-4%)	Treasury, Technology, Core Support (-2%)	Macquarie Group - Macquarie Banks
Customer Facing	Australia (Retail, Corporate and Commercial) (53%)	Retail Banking Services (50%)	Consumer Banking and Wealth (25%)	Consumer (39%)	Banking & Financial Services (Personal Banking)
	Institutional (26%)	Institutional Banking and Markets (13%)	Business and Private Banking (43%)	Business (26%)	Corporate and Asset Finance
	New Zealand (20%)	Wealth Management (6%)	Corporate and Institutional Banking (23%)	BT Financial (10%)	Macquarie Asset Management[a]
	Wealth Australia (3%)	New Zealand (10%)	NZ Banking(13%)	Institutional (16%)	Commodities and Global Markets[a]
	Asia Retail & Pacific (-2%)	Bankwest (7%))		New Zealand (11%)	
		IFS (overseas retail /business banking) (1%)			

Macquarie Bank is a subsidiary of the Non Operating Holding Company, Macquarie Group, with other financial activities undertaken by other subsidiaries. For the other banks the parent company is the bank, such that some types of activities undertaken in the non-bank part of Macquarie Group would be undertaken in the bank itself or its subsidiaries. (a) these business units and Macquarie Capital are primarily part of the non-banking group business.

As can be seen from Figure 3, the Head Offices of the banks generally run at a loss, even though many services provided by the head office may be charged to the customer facing divisions through the banks' costing systems. Within the customer facing divisions, two main points stand out. One is the heavy reliance of the banks on consumer business – particularly home-mortgage lending. The second is the significance of New Zealand operations (contributing in excess of 10 per cent of profits) and which are also heavily dependent on consumer business.

5.4 Banking Conglomerates

The major Australian banks diversified into a range of non-banking financial activities following the financial deregulation of the 1980s. To some extent this reflected a view that their large customer bases gave them the opportunity to efficiently cross-sell non-banking products to their customers as

part of a "whole of wallet" strategy. In recent years the trend has been in the opposite direction for reasons explained below.

One aspect of Australian bank diversification has been expansion (at least until recent years) into wealth management activities (see Golat, 2016) with the four major banks having around 20 per cent of total Assets Under Management (AUM) in 2016. Growth at the turn of the century partly reflected acquisitions of: Colonial Group by CBA; BT by Westpac; and MLC by NAB, which were generally operated as subsidiaries of the parent bank. These wealth management activities include financial advice, product distribution and funds management and (in some cases life insurance).

Partly prompted by opportunities arising from the growth of superannuation (as well as possibilities for cross-selling of products to their large customer bases), the banks' income growth from wealth management disappointed and this has been an area which has created reputational problems and remediation costs for the banks following the Hayne Royal Commission. Large complex, conglomerate, financial institutions create the potential for adverse outcomes in one part of the organisation to spill-over into other parts, while governance can be made more complex (as discussed by Golat, RBA 2016). APRA has a range of prudential standards which aim to deal with such issues.

The Productivity Commission in its Report on Competition in the Financial Sector provides an informative (if already dated due to bank exits from wealth and insurance) graphic showing the involvement of the four majors in various parts of the financial markets. It is reproduced below.

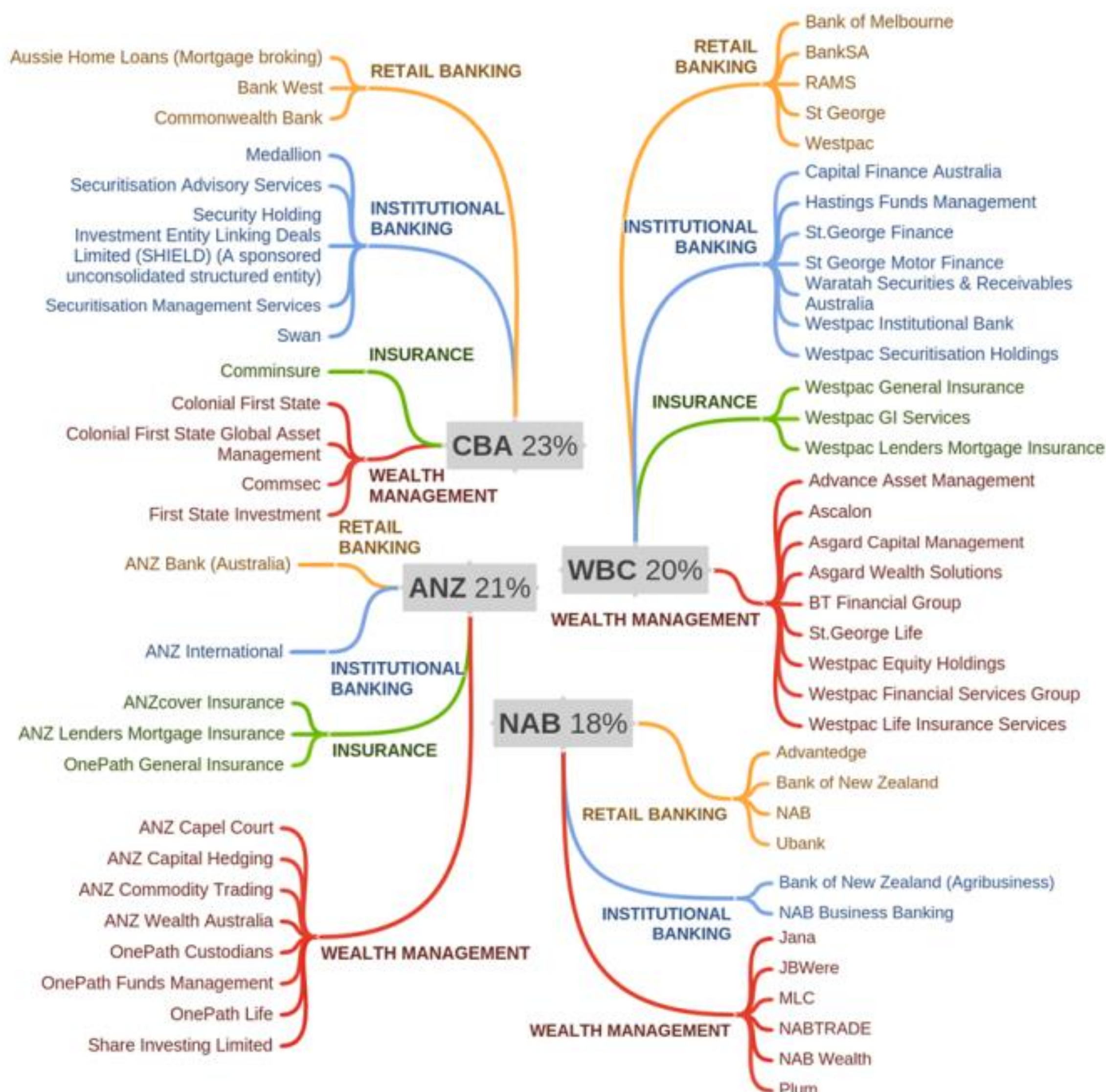

FIGURE 4: MAJOR BANK ACTIVITIES (SOURCE: [PRODUCTIVITY COMMISSION])

At the time of the Hayne Royal Commission and since, there have been (or commenced) substantial disinvestments of wealth management subsidiaries by the major banks as shown in Table 2.

TABLE 2: AUSTRALIAN BANK DIVESTMENTS

Year	Bank	Divestment	Activity	Acquirer
2018	ANZ	OnePath Life (NZ)	Life Insurance	Cigna
2019	ANZ	PNG Retail, Commercial, SME Businesses	Prior sales of retail and wealth in Singapore, HK, China, Taiwan, Indonesia, Vietnam, joint venture stakes in Cambodia and Philippines	Kina Securities
2020	ANZ	OnePath (Aust)	Life Insurance	IOOF (initiated discussions 2017)
2020	ANZ	UDC (New Zealand	Asset based finance	Shinsei Bank
	ANZ	Merchant Acquiring Services	Provision of merchant terminals	(Joint venture with) Worldline
	ANZ	Offsite ATMs	ATMs	Armaguard
2019	CBA	Colonial First State GAM	Asset Management	Mitsubishi (MUTB)
	CBA	CommInsure Life	Life Insurance	AIA
	CBA	Count Financial	Financial Advice/Planning	CountPlus
	CBA	Colonial First State	Superannuation & Investment	KKR (55% stake)
	CBA	Commsec Adviser Services	Wholesale Broking Services	Nomura
2021	CBA	CommInsure General Insurance	General insurance	Hollard
2016	NAB	MLC Life	Life Insurance	Nippon Life
2019	NAB	Ausmaq	Managed Funds Services	ClearStream
2020	NAB	MLC (Wealth Business)	Financial Advice and Funds Management	IOOF
2020	NAB	PLAN Australia, Choice, Fast	Broker aggregation business	Loan Market Group
2021	NAB	BNZ Life	Life Insurance	Partners Life
2019	Westpac	BT (financial advice component)	Financial advice	Viridian Advisory
2020	Westpac	Pendal (formerly BT Investment Management)	Funds Management	Took control of the fund manager in 2002. IPO in 2007 Gradual sell off of holdings from 2015
2021	Westpac	Vendor Finance (part of subsidiary Capital Finance Australia Ltd) CFAL	Funding small equipment loans	Angle Finance
2018	Westpac	Hastings Funds Management (100% owned from 2005)	Portfolio management of infrastructure debt and equity assets	Northill Capital acquired international activities, loss of mandate to manage Infrastructure

				Trust Australia in 2017 led to closure of domestic activities.
2020	Westpac	Westpac general insurance	General Insurance	Allianz
2020	Westpac	Westpac Fiji, Westpac Pacific PNG	Fiji and PNG businesses	Kina Securities
2021	Westpac	BT super fund management	Super fund management	In progress
2021	Westpac	Auto dealer financing and novated leasing	Auto dealer financing and novated leasing	Cerberus Capital
2021	Suncorp	Suncorp Portfolio Services Limited (SPSL),	Superannuation business	LGIAsuper
2015	Suncorp	Guardian Advice	Wealth Management/Advice	
2015	Suncorp	Suncorp Financial Planning	Wealth Management/advice	

Conglomerates, Risk and Regulation

Correa and Goldberg (JBF,2021) examine the effects of greater bank complexity (geographic, number of business lines, organisational structure) on risk and performance, based on analysis of large US BHCs over the period 1996-2018). They find that "organizational complexity and geographic scope tend to provide diversification gains and reduce idiosyncratic and liquidity risks while also increasing BHCs' exposure to systematic and systemic risks."

Regulators world wide have been concerned since the GFC to reduce complexity in ways that enable dealing with distressed organisations. Requirements for "Living Wills" (documented plans for recovery and resolution arrangements, see Chapter 18) have been one component of that.

Diversification and Performance

A long standing question in finance is the extent to which diversification improves the performance and/or valuation of a firm and that has also been a topic of research in banking. Diversification can reduce overall risk, but often it involves entry into higher risk activities than traditional intermediation. In general, there is no strong evidence that diversification of activities within a bank brings benefits, with most studies using a higher role for non-interest income as a proxy for diversification, and either stock market valuation or income metrics as performance measures. Geographical diversification has also been studied, such as involving entry into foreign markets, but there is little evidence of significant benefits (and the Australian experience points to that). Likewise diversification into non-banking financial activities such as insurance and wealth management has not proven value adding for Australian banks.

There is an enormous academic literature investigating the effects of different types of diversification in different countries and at different times. As well as considering effects on bank valuation and performance, some studies also focus on the implications for bank risk and regulation. The literature generates varying results, but does not appear to suggest that diversification has substantial benefits. And whether the results from any study focusing on a particular country, time period, or type of diversification are generalizable is very much open to question. Perhaps not surprisingly, the answer to whether diversification is worth pursuing is: it depends!

5.5 Branching, Franchising and Banking Service Delivery

Historically, the delivery of banking services relied upon physical "bricks and mortar" premises where customers could interact with bank staff to deposit and withdraw funds, obtain information, apply for loans etc. Proliferation of branches, by reducing travel and time costs incurred by customers in doing banking business, was an important form of competition.

However, over time, the need for physical branches (and associated staff and face-to-face interactions) has been reduced by the progress of technology. Phone banking and subsequently internet access to accounts, ATMs, EFTPOS, electronic wallets have all played a role in leading to the decline in number of bank branches.

But also important has been the "outsourcing" of parts of the "front office" activities of banking– such as the growth in the role of independent mortgage brokers. In 2020, around half of residential mortgage loan applications were originated by mortgage brokers – and even many of the direct applications to banks could be done largely on-line. Outsourcing of "middle and back office" processing activities, including use of third-party provided banking software and hardware systems, has been relatively common for many years. For smaller ADIs such as Credit Unions, banking platforms, payment services, and applications have been provided by several specialist providers such as Data Action, Indue, Cuscal, with some such companies owned by the credit unions themselves.

Trends in Australian Bank Branching

The number of bank branches in Australia peaked in 1993 and has fallen significantly since that time. Between 1970 and 1993, total bank branches increased by around 15 percent, although much of this increase was a statistical artifact caused by the conversion of building societies to banks. (The branch networks of the four major banks changed little in number over that period). Between June 1993 and June 2001, the number of bank branches fell from 7064 to 4712 and the number of bank agencies fell from 6288 to 5043 (most of this fall occurring in the last year).[4] The number of credit unions declined

[4]These and the following numbers on credit unions and building societies were extracted from Reserve Bank of Australia documents and statistical tables.

from over 600 in 1981 to under 200 in 2002 (and is well below 100 in 2021). The number of building societies declined from 66 in 1985 to 17 in 2001, to low single digit numbers in 2021. Many of the credit unions and building societies had more than one branch or agency (and many now use the term "mutual banks").

Since that time, there has been a continued decline in "points of presence" of ADIs.[5] At June 2020, branch level service was available at 5173 locations and "other" (agency) type service at 4,193 locations. Partly offsetting this decline was a growth in ATMs and EFTPOS terminals. At June 2020 there were 9621 ATMs (albeit down by around 25 per cent from a peak in 2016) and 780861 EFTPOS terminals. There has thus been a massive growth in locations at which customers can access their bank/ADI accounts to withdraw or deposit (via ATM) cash and make payments, but a significant decline in availability of "face to face" customer service for information exchange. However on-line (phone/internet) banking has become ubiquitous.

Several factors can be identified which may have contributed to these trends. First, takeovers/mergers in the banking/ADI sector (of previously state-owned banks and regional banks – including former building societies) prompted some branch rationalisation. Second, deregulation of the banking sector led to more price competition and less "service" competition in the form of excessive branching. Third, advances in telecommunications have made the need for physical branch presence less relevant to the delivery of certain banking services such as access to payments services.

The decline in bank branches led to significant public concern about access to banking services, particularly in rural areas, reflected in the establishment in 2002 of a Parliamentary Inquiry into Banking & Financial Services in Rural Regional & Remote Areas of Australia. The Inquiry made a number of specific recommendations regarding, *inter alia*, bank treatment of customers when services were withdrawn from an area. The Inquiry noted the potential role of agency arrangements, including via Australia Post and Rural Transaction Centres[6], and also raised the issue of banking as an essential service and suggestion of Community Service Obligations (CSOs)[7] arising from the privilege of having a banking licence.

[5] Data from APRA. Earlier data from RBA

[6] Rural Transactions Centres, operated largely by volunteers, were established in the early 2000's in a number of small regional towns under a government program to enable access to basic government and private sector services.

[7] CSOs are a requirement for a provider of some essential service to make it available in all locations even if it is not profitable to do so in some areas.

Community Banking[8]

The exit of the major banks from various communities, leaving them "unbanked", created an opportunity for another entrant with a business model able to capitalize on the willingness of those communities to contribute to establishing a local bank

Between June 1998 and December 2002, eighty-seven "Community Banks" were established in Australia under a franchising type arrangement promoted by Bendigo Bank. The number has since grown to 324 community banks in mid 2020. Four former credit unions also became community bank branches of Bendigo as members of an "Alliance Bank Group".

Although the community banks are linked to Bendigo Bank, their organisational structure involves some participation at the community level in the decision making process.

The Bendigo Community Bank model operates as follows. Community members are invited to subscribe "equity capital" to the organisation which is established as a company and operates under a franchise arrangement from Bendigo Bank. Typically $500,000 or more was required as equity capital. Some proportion (eg half) of any profits of the Community Bank would be used for community projects and the remainder available for distribution as dividends to shareholders.

Banking products provided by the community bank are those of Bendigo Bank, and provided at prices determined by Bendigo Bank under its Funds Transfer Pricing model. For regulatory purposes, the community bank is viewed as a branch of Bendigo Bank, such that separate regulatory reporting and supervision is not involved. This is a significant advantage, since regulatory compliance is quite costly for a small ADI. The Board of the community bank is responsible for operational decisions of the bank.

Bendigo Bank operates a Funds Transfer Pricing model with the Community Banks as described in Figure 5 from the 2019 Annual Report of Inverloch & District Financial Enterprises Limited. Deposits by customers of the Community Bank are transferred to Bendigo Bank's balance sheet, with the difference between the transfer pricing rate and the rate paid to the customer being a source of income for the community bank. Similarly the difference between loan rates charged to customers and the cost of funding those loans from Bendigo's Treasury is a source of income. The community bank's profit is derived by subtracting operating costs such as the cost of office rental and staff expenses etc.

[8] See also Thomson and Abbott (Agenda, 2000).

Margin is arrived at through the following calculation:

- Interest paid by customers on loans less interest paid to customers on deposits
- *plus* any deposit returns i.e. interest return applied by Bendigo and Adelaide Bank Limited for a deposit,
- *minus* any costs of funds i.e. interest applied by Bendigo and Adelaide Bank Limited to fund a loan.

Margin is paid on all core banking products. A funds transfer pricing model is used for the method of calculation of the cost of funds, deposit return and margin.

FIGURE 5: COMMUNITY BANK FTP MARGIN (SOURCE: INVERLOCH & DISTRICT FINANCIAL ENTERPRISES LTD)

Many of the earlier community banks established were listed on the Bendigo (now National) stock exchange, but a lack of trading of the shares has since seen most delist. Exempt markets are operated by the Community Banks matching interested buyers and sellers of shares in the bank. While some banks have proved financially successful, others have made losses, thus requiring some form of financial support from Bendigo.

Outsourcing via Mortgage Brokers

Branching is one mode of product and service delivery to bank customers. But not all steps in the delivery system need to be provided by the bank using its own resources. Mortgage loan applications are a good example. Mortgage Brokers, independent from banks, originate around 50 per cent of mortgage loans – helping intending borrowers to complete applications, advising on most suitable loan products and providers, and submitting applications to the chosen bank.

Some mortgage brokers may be sole traders or members of a quite small group, but the majority are employees of a large firm such as Aussie Home Loans, Mortgage Choice, and Loan Market Group. These three firms had 970, 517 and 503 brokers respectively in 2020 and accounted for over 75 per cent of loans arranged by mortgage brokers in that year.

Mortgage brokers rely on the services of companies known as “aggregators” who provide platforms (systems and software) enabling brokers to obtain information about bank loan products from banks on their panel, create and send loan applications from customers to banks, and maintain ongoing liaison with borrowers. There are a large number of aggregators (the industry association MFAA provides a list on its website) and the industry is relatively concentrated. Despite this, but reflecting the role of the “direct channel” of intending borrowers dealing directly with banks, the ACCC did not oppose a planned merger announced in 2020 between the two largest aggregators, Australian Finance Group (AFC) and Connective, which had 39 per cent of the market. The ACCC report on the planned merger provides a large amount of information about the market and the activities of aggregators. A planned merger between Aussie Home Loans (owned by CBA) and Lendi was announced in December 2020 with CBA to own 45 per cent of the merged group.

Outsourcing via brokers may generate cost savings for the bank, and may increase the demand for its loans. However, it is not without risks, since mortgage brokers may operate in their own best interests and not in those of the bank nor the customer. This issue was one considered by the Hayne Royal Commission, which argued that the remuneration model for brokers – involving up-front and trailing commissions paid by banks to brokers on the loans they had originated – was not compatible with broker responsibility to act in the best interest of their client. As well as an incentive for brokers to direct clients to banks offering higher commissions and encourage clients to take out larger loans, there was also an incentive to "churn" (encouraging customers to switch from existing loans to a new loan with a different provider). The government rejected the RC recommendation to move away from this conflicted remuneration structure, opting instead for an upgraded "best interests" duty (with guidance on achieving that contained in ASIC Regulatory Guide 273 published in June 2020).

There is no definitive evidence that loans originated by mortgage brokers have different default rates than those originated by the banks directly. However, the RC heard evidence that broker originated loans were generally larger and more likely to be interest only, which together with concerns about the accuracy of information about applicant income incorporated into applications, indicates a potential for higher default risk (and/or non-compliance with responsible lending rules) from such loans.

Another possible concern is the ownership of a number of mortgage broker groups by some of the Australian banks. (CBA owns Aussie Home Loans, Westpac owns RAMS). The competitive concern is that smaller mortgage lenders may not get equal prominence on the loan platforms.

Franchising

Another possibility for banking services delivery is via franchising, where an independent business owner (the franchisee) is given the right (for a fee, and with specific constraints on product/service quality) to deliver products and services branded with the franchiser's name. Many fast-food and convenience store chains operate on such a model. The franchiser may (depending on the specific model) avoid investment of its capital in the physical premises, and may generate better outcomes from the independent owner/manager of the franchise effecting better operating economies resulting from better incentives than an employee/manager model.

The Bank of Queensland advertises branch franchising opportunities and the "single site operators" are responsible for operational management decisions at that branch level. Final responsibility for loan approvals remains with the bank credit department, such that the franchisee appears to have responsibility akin to a mortgage broker (but without flexibility regarding choice of lender). The model has experienced difficulties. The number of franchisees fell from fell from 198 in August 2012 to 159

in February 2015 and the bank successfully defended a court action from some franchisees alleging misleading and deceptive conduct. The financial advice and remuneration issues arising from the Hayne Royal Commission and other developments has created complications for the model, requiring some readjustment in 2020.

ANZ operates a mobile lending franchising operation in which franchisees "sell" loans on a commission basis with customers within their allotted territory.

Australia Post – Bank@Post

The 2002 Parliamentary Inquiry suggested that the banking sector could provide banking services and choice of bank to regional communities through the use of shared services, but recognized the competition and commercial impediments to doing so. Australia Post, however, has developed such a model with its Bank@Post services. Through linkages with over 80 ADIs (including CBA, NAB, Westpac – but not ANZ!), customers are able to deposit and withdraw funds from their bank accounts at Australia Post Offices around the country. Bank@Post also provides Money Transfer Orders (MTOs) enabling a purchaser of an MTO to make funds available at a convenient post office to the recipient.

These facilities have value for individuals living in locations where there are no bank branches and who need to access or deposit cash. However, the ongoing decline in the use of cash, even for small value payments, and ability to make transactions on bank accounts via the internet must raise questions over the future growth of this service. Also relevant in that regard is the availability of third-party provided ATM machines and "cash out" EFTPOS facilities in various business premises.

"White-labelling" of banking products (BaaS)

White-labelling refers to the practice of a third party (the *brand owner*) providing a product or service which is labelled with their brand, but where it is in fact provided by some other entity (the *white-labeller)*. It is fairly common in grocery retailing where large chains market products labelled with their brand, but which have been produced by some third party. Some mortgage broking firms (or aggregators) offer white-labelled mortgages. The customer may be attracted to a mortgage labelled with the name of the broker (or aggregator) with whom they have a relationship. While they will deal with the broker, the mortgage will be a contract with a bank provider of the mortgage.

White-labelling has been widespread in the credit card business. A bank (Citi has been prominent in this area) will allow other business entities (such as airline companies) to market credit cards branded with the name of that business. But the credit card (and associated credit) is provided by the bank and transactions flow through the bank's system. The bank is also the entity that makes decisions about the card arrangements.

Similarly, deposits can be white-labelled. In late 2020, Westpac announced an arrangement with the BNPL operator AfterPay whereby, AfterPay could offer deposit facilities to its customers. While branded as AfterPay deposits, they would be legally recorded as deposits with Westpac. Financial technology enables a non-bank entity (called say NB) to accept funds as a deposit with NB via its operating platform with those funds being automatically transferred as a deposit of NB on behalf of the customer to the bank involved. While there will be a number of regulatory and compliance obligations involved in this process for NB (and the bank), NB will avoid those, very substantial, obligations associated with being a bank. Indeed, there is no reason that other banking services such as payments facilities cannot also be offered by NB

For the bank involved, the attraction of white-labelling is that the relationship can enable it to obtain business from a group of customers it may not other interact with. If white-labelling is a cheaper way of obtaining that business than directly, there can be benefits to the bank.

White-labelling of banking products is often referred to as Banking as a Service (BaaS). The non bank entity (NB), generally a fintech with "apps" available to its customers via digital technology perceives an opportunity to provide additional, new, banking services to its potential customer base and grow its business.

One way to think of BaaS might be that the app is the modern equivalent of the bank branch. Historically, an individual would access banking services of ABC bank through, say, its Brunswick branch. The customer would think of themselves as having an account at the Brunswick branch, but that was just the interface between the bank ABC (with which any deposit was held). The "app" of the fintech NB achieves the same outcome. The difference, of course, other than the technology involved, is that the owner of the provider of the app is NB rather than the bank (which historically owned the branch).

But in practice BaaS is potentially much more. Whereas the bank branch only transacted in the bank's products (although often providing access to other services such as insurance on an agency basis) the app provider will aim to provide access to a wide range of financial and other non-financial services through the app.

BaaS is not without its complications. NB might facilitate a range of services including financial advice via its app, and this could create risks for ABC bank.

5.6 Bank Governance

Governance problems are particularly severe in financial institutions. Processes of financial reform and financial system design have until recently paid inadequate attention to governance considerations. Now, spurred on by clear governance failings, it is a major focus of attention.

Governance issues can be divided into external and internal governance. The former refers to the control mechanisms exerted over bank boards and senior managers by: shareholder voting, "exit", or "voice"; the takeover market; capital markets etc. Matters such as disclosure, prudential regulation, industry codes of conduct, ownership limitations are relevant in this regard (and discussed elsewhere in this book). Internal governance refers to management control, risk management, performance, and accountability systems in place to ensure that delegation of decision making power leads to actions consistent with the bank's objectives.

Following the exposures by the Hayne Royal Commission there can be little doubt that internal governance structures were severely inadequate in many Australian banks and financial institutions. Skill sets of Boards were not necessarily adequate for effectively performing the required role, even after APRA introduced prudential standard (now CPS 510) on ADI Governance in 2005. That standard focuses primarily upon requirements for: Board size and composition; independence of the Chair; policies for board renewal and assessing board performance; and remuneration, audit and risk committees. Arguably these are, at best, necessary conditions for good governance, but not sufficient. But they do, together with a requirement (para 110) which essentially prohibits prevention of "whistleblowing" to APRA, provide APRA with scope to intervene if unsatisfied with a bank's governance.

APRA used these powers to implement an independent Prudential Inquiry into governance, culture and accountability in CBA which reported in May 2018. CBA was required to implement a program of reform and hit with an increased capital requirement. It then required the largest financial institutions to undertake a similar analysis, leading it to require extra capital requirements for ANZ, NAB and Westpac, and ultimately leading it to agree in December 2020 to an Enforceable Undertaking from Westpac to improve the pace of rectifying risk governance deficiencies.

Internal governance issues such as remuneration and accountability are discussed in the following section, while problems with incentive structures for customer-facing staff which focused on sales targets led to numerous instances of miss-selling of unsuitable products are considered in Chapter 7.

5.7 Banker Remuneration and Accountability

Bank CEOs and other "C-Suite" executives get paid large salaries. So too do many at lower levels of management. The bank's traders can also make large money – although a larger proportion of their income is likely to come from performance-related bonuses.

The relationship between remuneration, performance, and accountability in banks has become an increasingly important topic. Important questions include:

- How should remuneration be structured to induce appropriate performance by staff?
- Are very large salaries necessary to attract suitably skilled individuals to "C-Suite" positions?
- Can risk management and institutional performance failures be attributed to particular individuals and, if so, what should be the consequences?

Banker remuneration: what do we know?

Unfortunately, we know very little in detail about the structure of remuneration within banks. It wasn't always quite so bad. Up until 2003, banks were required under Australian Accounting Standards to include in Annual Reports the numbers of staff earning amounts above $100,000 within specified bands. From those reports we could identify, for example, that in 2003 the National Australia Bank (NAB) had 32 staff earning between $100,000 and $400,000, 43 earning between $400,000 and $1 million, and 9 earning in excess of $1 million. (Between 2003 and 2021 the Consumer Price Index has increased by about 50 per cent, so to convert those into equivalent 2021 dollars, multiply by 1.5).

Those reports weren't necessarily all that informative. They might exclude staff offshore (some of whom were among the very big earners). They didn't include a "fair" value of option-based remuneration, which could also be substantial. They didn't provide any information about the responsibilities of the individuals involved.

But they were probably more useful than the current remuneration disclosures which came into effect with changes to section 300A of the *Corporations Act* in 2003 as part of CLERP 9. Much more data (but not necessarily useful information) was required to be disclosed about remuneration of Directors and Key Management Personnel (KMPs), with the latter numbering maybe up to a dozen for each of the large banks. The reports (part of the Annual Report) are in the order of 30 pages with a range of arcane details about the nature of remuneration, which even skilled analysts would have difficulty interpreting – and assessing the likely consequences for behaviour.

Taking NAB again as an example, in 2016 there were only six KMPs identified who were employed for the full year (with a number of others employed for part of the year). The lowest level of remuneration reported was in excess of $2 million. In 2020, there were 11 KMPs identified with remuneration for those employed for the whole year all above $0.9 million.

But we have no information on how many NAB (or other bank) executives and managers earned in excess of, say, $1 million or $500,000. Probably quite a lot! Traders on the FX or Interest Rate desk would not be classified as KMPs, but can get very high remuneration. At those levels of pay, significant decision-making responsibility and accountability should be characteristics of the role.

Recent Developments

With the fallout from the Hayne Royal Commission and the large penalties imposed by AUSTRAC on CBA and Westpac, there has been some significant executive turnover and realignment of salaries, making it difficult to summarize levels and underlying determinants of executive salaries across the sector. Voluminous remuneration reports provided as part of bank annual reports do provide lots of information, but in a form which is hard to digest.

But to illustrate, journalist Charis Chang reported the following. CBA's former CEO Ian Narev was on a package of $10 million p.a. (and agreed to forgo long term bonus of $13.9 million when he resigned following the AUSTRAC penalties and Hayne Royal Commission exposures of governance and operational failings at the bank. Then Westpac CEO Brian Hartzer earned $4.9 million in 2018. NAB's then CEO Andrew Thorburn received $6.4 million in 2017 but only $4.3 million in 2018. ANZ CEO Shayne Elliot received $5.25 million in 2018. (Of those CEOs, only ANZ's Elliot remained in the role in 2021, Hartzer leaving Westpac following their AUSTRAC penalties and Thorburn after criticism from the Hayne Royal Commission).

Since then, there has been some moderation in banker salaries and adjustments to the mix of fixed salary remuneration, versus long term and short term incentive bonuses, and grants of options and shares. But salaries are high, and the questions often posed are whether they are too high, what incentives they give to executives and managers regarding risk-taking versus prudence, and what accountability executives and managers have when things go wrong?

At less senior levels of the organisations, there are issues about the incentives which remuneration packages give to sales and advisory staff. The Hayne Royal Commission generated much concern about sales linked remuneration and targets generating behavior which was not in the best interests of, and often detrimental to, bank customers.

Regulators worry about these things. APRA has produced a guide (CPG 511), which is being revised (as a standard (CPS 511)) in 2021, setting out guidelines on how remuneration should be structured. The Federal Government introduced the BEAR (Bank Executive Accountability Regime) in 2018 legislation which is proposed to be extended to other institutions as the FAR (Financial Accountability Regime), with legislation expected in 2021. Apparently calling it the FEAR (Financial Executive Accountability Regime) wasn't seen as desirable!

APRA's remuneration standards

APRA's initial guide specified a 50 per cent cap on using financial measures for variable remuneration. Underpinning this cap was the concern that incentives based on financial measures (profit, sales, etc) could lead decision-makers to engage in higher risk activities. The reason is that linking some part of pay to such financial measures creates an "option-like" structure for pay. Undertaking higher risk activities can generate both greater gains and losses for the bank. But self interest on the part of the decision-maker will create a bias towards higher risk activities, since the upside outcomes will be reflected in remuneration, but the fixed component of remuneration limits the downside risk (unless sacking or demotion is likely).

In addition to *financial risk,* financial institutions are also exposed to *non-financial risk*, such as operational risk, conduct risk, regulatory and compliance risk. While these risks have financial consequences, the links are less direct. The planned revision in the standard is intended to be more *principles-based* rather than *prescriptive*, and requires (for significant financial institutions) that "material weight be assigned to non-financial measures, combined with a risk and conduct modifier that can potentially reduce variable remuneration to zero" (APRA, 2020)

Other concerns are that incentive-based (variable) remuneration can lead to a short-term focus, and that the consequences of decisions by senior managers may take several years to become apparent. Consequently, requiring that variable remuneration be deferred for several years has some merit and the proposed standard requires "a reduction in the minimum deferral periods for variable remuneration from seven to six years for CEOs, from six to five years for senior managers and from six to four years for highly paid material risk takers". (APRA, 2020)

The BEAR (and FAR)

While there have been a number of well-publicised examples of bank executives and board members being shown the door in response to major risk management failings within banks, that has not always been the case. And there are, no doubt, many examples of lower-level staff being assigned the blame for events, which should rightly have been attributed to their superiors. So, identifying accountability is an important issue, which is reflected in the introduction of the Bank Executive Accountability Regime (BEAR) in legislation in 2018. This gives APRA increased regulatory power to induce improved governance, risk culture, remuneration and accountability (GCRA) in banks (and other financial institutions which will be affected by the subsequent Financial accountability regime (FAF)).

The BEAR applies to directors and senior executives of organisations and designates relevant individuals with management or control responsibilities over significant areas of activity as an "accountable person". As set out in the Explanatory Memorandum accompanying the bill It applies where that individual's behaviour or conduct could pose risks to customers or the ADI. (For small

institutions the only staff member affected might be the CEO. For large institutions it could apply to heads of business units or risk management/compliance/audit/ human reosources/information technology/AML functions). Institutions to which the BEAR applies are required to have an "accountability map". Accountable persons who breach the roles and responsibilities set out in the accountability map may face disqualification or lose part of variable remuneration (which is required to be deferred for up to four years). Meeting the BEAR requirements essentially involves acting with honesty, diligence, integrity, due skill, and being open, constructive, and cooperative.

As at mid 2021, there have been no prosecutions under the BEAR regime. But the main objective is ultimately one of deterrence against bad individual behaviour and lack of institutional attention to internal governance arrangements. In December 2020, APRA released an information paper on the implementation of the BEAR regime at ANZ, CBA and NAB, which provides detailed information on the substantial issues involved in implementing the regime.