The importance of culture Lunchtime address to the ASIC Annual Forum 2016

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Thank you for the opportunity to speak to you today. I want to start by touching on some of the broad forces currently shaping our financial system – and why that makes the topic of culture in financial services such an important one for us to be collectively considering.

I'll also share with you some of my own views on culture and the interplay between individuals within firms, the broader system, regulators and government.

The Australian financial system is being subjected to some powerful global forces at present.

Most obviously, the global economy continues to sketch out a relatively weak and uneven post-financial crisis recovery path, in spite of extraordinary monetary policy support.

There has been an active debate about whether monetary policy has reached the limits of its effectiveness in the major advanced economies, particularly its ability to support growth.

We have been in this experimental stage with monetary policy for more than seven years now. A range of different interventions have been tried with, at least to date, mixed results.

Sadly we will have to await the passage of years before we can pass final judgment.

What is clear, however, is that unconventional monetary policies have had a pervasive and frankly quite worrying impact on the pricing of financial risk.

In this environment, companies that would historically have been viewed as having too much risk around their cash flows to support large amounts of debt on their balance sheets have been able to issue debt in large volume relatively cheaply, often without covenants.

And those that would historically have been limited to relatively short-term issuance have been able to raise funds at a very long tenor.

Part of the monetary policy rationale is to encourage private actors to take on more financial risk but there is evidence that some of the risk taking occurring could be considered concerning.

Markets are increasingly questioning whether global growth will be sufficient to drive corporate earnings and maintain the low default rates necessary to sustain current financial valuations.

Relatively weak and volatile global economic growth is also occurring against a backdrop of some fundamental structural economic transitions.

In many advanced economies, and in a number of important developing countries, demographic change is starting to work against growth and throw up challenging policy issues.

China is in the midst of transitioning its economy to one far more reliant on consumption and services as drivers of growth – and gradually freeing up its financial system and becoming more integrated into the global financial system.

China's transition is necessary and welcome – and will contribute to longer-term sustainability in economic growth.

They are cracking down on corruption with increasing intensity, which is also welcome. As someone who – in my previous life – had three joint ventures in China, I had first-hand experience of the frustrations of doing business in a less-than transparent operating environment.

However, for China, like other economies that have gone through similar transitions, the transition will not be smooth and seamless.

But the opportunities, not only with China but with other developing nations in Asia, are enormous. There are opportunities for continued growth in our trade and investment relationships, including in financial services.

At the same time, rapid growth in digital technology is transforming financial services delivery and challenging traditional business models.

The pressure to innovate to stay ahead, or to get a leg up on the competition, is more intense now than for some time.

The growth in digital services delivery has also given rise to a more empowered consumer, one that expects more of their financial services provider and that is more liable to switch if those expectations are not met.

We are entering a world where the cultivation and maintenance of a robust institutional culture will be a key determinant of implementing a successful business strategy.

Culture is critically important to the health of an institution and in turn the health of the whole financial system.

I am not afraid to say that I have worked for an institution that had a mixed record on culture in earlier times.

Indeed, I have even resigned over a matter of culture.

I am very glad to say that, having recognised that there were major governance and cultural problems, the institution undertook sweeping reforms that have restored their reputation and improved their performance.

Interestingly, following the financial crisis, the best and immediate career opportunities were, without doubt, in general compliance and risk. It was a real sea change in attitude.

The crisis brought home to every bank the importance of populating their compliance and risk teams with the very best of their people. The actions of regulators served to reinforce this.

Resources were multiplied and remuneration went through the roof. And yet, interestingly, it didn't prevent problems from emerging.

Partly this reflects the fact that more intensive scrutiny brought to light problems that institutions were not previously alive to.

But my own experience in financial services has underlined that any number of compliance and risk systems can be put in place but in the end it still comes down to the culture you embed as a leader and the importance of knowing your people.

Culture needs to be set from the top of an organisation.

There is no playbook. There are no rules to follow.

And it can be difficult in decentralised corporations with flat hierarchies and varying objectives in different parts of the organisation to establish and maintain a healthy culture.

But over the years I have observed some guiding principles that good leaders seem to use when they build a constructive culture. A good leader:

- sets the tone and provides the example for behaviour;
- applies a clear set of principles to decision-making;
- is honest;
- shows humility;
- treats all with respect and as you would want to be treated;
- approaches matters in an even-handed and sensible way; and
- appropriately balances the interests of clients, employees, shareholders and the broader community.

At the same time, creating a better culture can be difficult in an environment that focusses unduly on nearer term interests of shareholders alone.

We see the results of this play out every day.

And history has shown the potentially catastrophic consequences when the actions of self-interested private actors in financial institutions morph into pure selfishness and greed.

There is, of course, no shortage of examples on the historical record from which to draw.

The Arthur Andersen and Enron cases from the early 2000s remain important today.

Arthur Andersen was a traditional audit firm with a long history of high audit standards – many regarded it as a standard setter for the rest of the industry.

As the firm grew from a close-knit partnership to a large global player, the pressure to bring in profits from outside the audit practice became intense.

The company pitched to clients seeking not only the once-a-year external audit but also the "integrated audit" – mingling internal and external auditing as well as bundling in tax and corporate finance advisory services.

Enron was the laboratory for this new form of business.

To cut a long story short, Arthur Andersen auditors were found to be involved in signing off on Enron financial statements that failed to disclose significant financial risks and liabilities.

Enron's subsequent collapse ultimately brought down Arthur Andersen as well.

While there were many proximate causes, Arthur Andersen's demise essentially came down to one thing: a failure to embed within the organisation an overarching ethos or objective, including a clear sense of the firm's ethical obligations.

The case generated the inevitable calls for more regulation.

Some increased oversight of the profession did eventuate but it is ultimately very difficult to regulate against cultural failings.

Governments can create a regulatory architecture and regulators that can set the boundaries within which industry operates. They can articulate the community's expectations around the balance between customer protections and the need to innovate and transform.

But culture is fundamentally about individual behaviours, then expressed collectively.

And behaviours, in general, are not directly amenable to legislation or regulation.

Indeed, attempting to regulate individual behaviours can be very counterproductive.

It can create a narrow compliance culture, effectively absolving institutions of their ethical responsibilities – the "if something isn't explicitly forbidden, then it must be alright" mindset.

The focus becomes "how do we find ways to get around the rules", rather than on doing what is right and sustainable over time.

While specific rule-making has limits, active supervision and discussion has been shown to be an important catalyst for positive cultural change.

In assessing the ability of regulated entities to meet their financial promises, regulators have to consider whether the institution's culture and its appetite for risk will create dangers that could lead to insolvency or systemic instability.

If the institution is found to be lacking, the regulators can "encourage" the management to take remedial action.

This need not only rely on coercion – it can be a cooperative effort with the collective goal of enhancing the health of the institution and financial system.

On the whole this has been the Australian experience.

We escaped much of the excesses that led to the financial crisis of 2008, partly owing to the soundness of our principles-based regulatory framework.

This framework was strengthened in Australia, as in Canada, following the hard lessons learnt from our own internal financial crisis in the early 1990s.

The experience made us alive to the risks associated with the emerging financing channels outside of the regulated banking system – and allowed us to recalibrate our system where necessary away from the investment banking model.

The events surrounding the troubled state banks of South Australia and Victoria in the early 1990s were a real learning experience for me when I was a Deputy Secretary in Treasury at the time.

Our system also benefited from the lessons learnt from the Royal Commission into the collapse of HIH Insurance in the early 2000s, which was our largest ever corporate collapse.

But we have certainly not been immune from instances where an institution's culture has been found sorely wanting – there has been misbehaviour that has rightly needed addressing.

All of us involved in the financial sector have to realise that if community expectations are not being met, the result may well be more prescriptive rules, which may over time not be a good outcome for industry or the general public.

As I said at the outset, the world in which we find ourselves in is one in which the cultivation and maintenance of a robust institutional culture will be a key determinant of success.

Rules and regulations will adapt to these circumstances but one thing should be a constant – ethical and honest behaviour flowing from the right culture in all parts of the economy.

Thank you.