Changing the Game

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Changing the Game

Today I want to recommend to you that we change the way we do things in the corporate world.

I do so, not merely because I think we can do things better, but because I think we must. What we are doing now will fail us badly in the future. Everywhere we look the landscape is changing, the ground is shifting: What brought success yesterday, we know, will not bring it tomorrow.

To Australia's prosperity and within it our corporate prosperity, we have to chart a new way. So I want to talk about some shadows looming in the corporate halls.

We can ignore them of course. We can look away, or persuade ourselves that they are the shadows of things leaving rather than arriving. But they will still be there in the morning and we'll have to make another excuse. Responding is optional, but only for now.

Forgive me if I talk about just a few of them, but please don't think there are not more things to worry about. It's just that I don't want to spoil your lunch.

Nor do I want to pretend that our problems are simple ones and have simple solutions – that we can go back this afternoon and fix them. Like everything in the modern corporate world they are complex and interconnected.

So, drawing on my experience over more than 8 years as Westpac's CEO and my earlier international and public sector experiences, I want to share with you my views on the need to change some of the rules of the game in:

- The structure of Australian banking;
- The workplace; and
- In the ever expanding realm of the regulator

Then I'll attempt to lay out briefly a more enlightened way to proceed.

Structure of Australian banking

Let me start with the rule that wraps Australia's big four banks in armour, protecting them from merger or takeover by each other: the so called four pillars policy – the word itself suggests the very opposite of what a modern corporation is supposed to be.

While everyone else is getting on with life in the market place the banks are commanded forever to be blocks of concrete or marble – or salt. It's the 'Lot's wife' banking policy.

Set against banking consolidation worldwide and the globalisation of services, the policy is an anachronism, a woolly mammoth dug from the Siberian tundra and shipped still frozen to Australia as a structure for banking.

It is not just a problem for the pillars.

The banks to a considerable extent are the arteries of the economy – and who wants pillars for arteries? It's a problem for the whole system. To put it bluntly, the Australian majors need scale to compete with global banks that are a growing presence here. But the four pillars policy materially constrains us, both domestically and offshore.

To put some perspective on it, if the ABN AMRO and Barclays merger was to go ahead, the merged entity would be around three times the size of all four Australian majors put together. Westpac often finds itself competing against organisations 10 times our size.

So no one should be too surprised when we do not feature in the "mega-deals". Size does matter when it comes to lead bank roles and taking on the exposures involved.

And the four pillars policy in effect shuts Australian banks out of lead roles in major Australian corporate transactions – transactions like BHP's acquisition of WMC, and the now shelved Qantas private equity financing.

One commentator summed it up well when he said that our big banks are being treated like bonsai trees. Yes we can perform well and last a long time, but the artificial constraints stop us from expanding to our potential.

The irony is that the four pillars policy offers no real protection against foreign ownership of the big four. In fact it may ultimately drive the majors into foreign ownership. And if ever there was justification for the policy on competition grounds, there is none today. Barriers to entry in Australian banking have tumbled down – and that's a good thing.

And the innovative business models used by the new entrants, many foreign owned, have had a dramatic impact in cards, mortgages, deposits, business loans, payments and so on.

On the face of it, we have a policy that is contributing to the 'offshoring' of Australian financial services and jobs. It is time for the Australian government to abolish the four pillars policy and let the market determine shape of the financial system - within the necessary constraints of prudential supervision and competition policy.

In fact it's past time. It's overdue. In the decade since the Wallis inquiry there has been widespread change, a superannuation revolution and sharp growth in the non-bank sector.

Whoever occupies the government benches next year might find a new review of the financial system a good way to enliven the relationship with business and a pleasing encore to abolition of the four pillars policy.

The workplace

Let me turn to a second theme – how a shift in the balance of power between employers and employees is changing the rules for management.

The workplace is changing rapidly. Not only are the supply / demand dynamics changing. With consequences equally profound a new generation of workers is forcing us to think anew about management.

New generations are taking us into new territory, in employee participation and democracy for example. We have learned that many of the old commands and controls simply don't work any more. Much of this seems to have by-passed the current industrial relations debate.

I wouldn't give advice on politics, but in modern business I know you can't succeed if your values come up short of the social norm, or worse, threaten some regression. There can be no trust unless our standards at least match the community's.

That said, we should always remember where there is trust between employers and employees, there is typically little room – or need - for third parties. Critical labour shortages in key industries and sectors like banking have forced upon us an escalating war for skills and talent.

And the situation is only going to get worse. Much, much worse if you look at the demographics of an aging population. Today the working age population grows by around 190,000 a year[1]. On current population trends, the Australian Bureau of Statistics estimates that in the 2020s it will grow on average by just 12,500 a year. That's a drop of more than 90 per cent.

These are not figures that business can ignore. And yet we seem to. Even at our peril. The new rule for companies is that they can no longer be managed as *product* companies. They need to be managed as *human* companies selling products. Which means strategic success now rests increasingly on the discretionary effort of employees.

To get that effort, we have to tap their emotional commitment. But the real rub is that this commitment can't be demanded or bought. You have to inspire it. You have to fight for their hearts and minds.

The key to managing people today is not managing them - because most people will resist it. They won't let you tell them how to think.

[1] The number of people aged 15-64 years (working age population) increased by 1.4% (or 195,100 persons) in the year ended June 2006. (Source: ABS)

Maybe there are some businesses where you can still micro-manage people, but not in the businesses I know anything about. Certainly not in banks – or any other place employing large numbers of enterprising and intelligent career-oriented young people.

The task is to create the environment in which people know enough and care enough to do their best and to live the company values without being managed - working jointly if you like.

When our employees come to work they do not leave their character or their standards at the door. Rather, they expect to find that our norms approximate their own. Today in our companies we run an economic machine and a social system.

Values bind these two parts of the company together, they make the culture jell. I think we are just coming to realise that the most important values for a company – if not the only ones – are those aligned with social values. Contemporary corporate leaders will need to consider what those values are.

In doing this they should follow the example of Einstein and suspend the assumption that the answers lie in the past and that rationality should always reign supreme. They will need to get inside a few heads other than their own – and younger than their own – and they will have to think anew.

They might have to forget some of the management textbooks for a while. Above all they will have to think about the foundations of trust.

The regulatory world

Which takes me to my third theme – regulation and how to have less of it.

At present business and the community are both wearing more regulation than they need and more costs than are reasonable. This is not solely the fault of governments and naturally risk-averse bureaucrats. Regulations don't drop from the sky – though it is true some seem to. And some appear to bubble up through the crust of the bureaucratic brain. But regulation is necessary - to protect rights, to protect people from harm, to govern society, including the corporate part of it.

Where the community's reasonable expectations are not met, the community looks to government to rectify the problem, and that in general means to regulate affairs.

So it's not good enough simply to exhort governments to wind back regulations. Corporations need to be good citizens.

Nevertheless, even allowing for the few bad citizens of the Australian corporate world, the legal and regulatory burden upon business has grown mountainous. The volume of business red tape has been growing in Australia at three times the rate of economic growth.

In just one year - 2003 - Commonwealth and State governments together produced 33,000 pages of new laws, rules and regulations. Astonishingly, half of all legislation passed by the Commonwealth parliament since federation has been passed in just the past 16 years. No wonder that the Commonwealth spends in excess of $5 billion a year administering business regulation.

When Westpac writes a simple mortgage it must refer to multiple separate pieces of Commonwealth and State legislation. And something is seriously awry when the Financial Services Reform Act, established to protect the consumer against fraudulent or misleading financial products and advice inflates the cost of selling investments and superannuation to people, but fails to protect people from unscrupulous providers – as we have seen with the collapse of several mortgage investment schemes.

While the intent here is sound – to maintain the quality of financial advice and products provided to consumers and protect them from people who are little more than surrogates for companies paying them commission – the unintended consequences are dire.

Welcome progress in some areas of FSR has been made, but we arguably still have a regime that sets such high standards for compliance, that the cost to serve has made it too expensive to provide advice to lower income earners – probably those who need it most.

In a flawed regulatory environment, businesses lose money and opportunities, consumers pay higher prices, and taxpayers pay the higher costs of inefficient public administration.

Governments can have little excuse for failing to review and reform, or to remove inefficient or unnecessary existing regulation. It's an opportunity too important to be neglected.

I think it is now widely accepted that the federalist model designed more than a hundred years ago requires a dramatic overhaul. The system was established to delegate responsibility for funding and managing certain tasks in times when travel and communication was relatively primitive.

Today, overlaps, gaps and massive inefficiencies are legion and well-documented in everything from education to health to infrastructure development.

One simple but bizarre example is first aid. Some of you may not know that the regulatory guidelines for the contents of first aid kits in Westpac branches differ depending on which state they are in.

A first aid kit in New South Wales has to have dressing tape 2½ centimetres wide, in west Australia it has to be 1¼ centimetres. In Victoria, a non-specified amount of eye wash is required; in Queensland there must be 250 mls or an unspecified number of 30ml ampoules. In South Australia, where one would think the need is as great if not

greater, there is no requirement for eyewash at all. It's a puzzle – as regulatory requirements so often are.

And the actual dollar expense of regulation can be very material. US Anti-Money Laundering legislation has imposed millions of dollars in systems and compliance costs on businesses around the world. We are happy to play our part – but governments must remember that we are to some extent solving their public policy problem at our shareholders' expense. And application of this extra-territorial legislation delivers little benefit for our customers or shareholders.

We can see the same problems in hundreds of pages of prospectuses that do absolutely nothing to avert the collapse of companies like Fincorp and Australian Capital Reserve.

There is perhaps some comfort in knowing that we are not alone. Consider Sarbanes-Oxley. The response of the US congress to the Enron and Worldcom scandals shows what governments in our most 'open market' economies can get wrong. While the underlying problems the act sought to address were real and important, the act was not limited to remedying the problems it was created to address.

The Sarbanes-Oxley act (SOX) was (in the words of the *economist*) 'designed in a panic and rushed through in a blinding fervour of moral indignation'. The result was one of the most demanding compliance changes in many years. SOX hit shareholders with the labour costs of implementation and spiralling audit fees, an effect the act did not intend.

Cumulatively, compliance costs across the world have run into billions of dollars. And despite this massive impost, to a certain extent SOX has over looked the substance of the reforms in favour of the process. It is a classic example of legislation that while failing to properly serve its intended purpose has far reaching and damaging unexpected consequences.

I have to say that the report of the taskforce on reducing the regulatory burden on business (the banks taskforce) has drawn a very positive response from the Australian government and we have been assured that the reforms and rigorous attention to their implementation will stem the consuming tide of regulation.

In this respect we welcomed the creation of the office of best practice regulation within the productivity commission. So far so good, but the proof of the pudding will be in how much of a regulatory burden we will still have to swallow. The jury as they say is still out.

As much as anything else, we need a sensible debate about risk in public policy making and regulation. Most importantly, we need to remove the pressures on policy-makers to eliminate risk in a way that is out of all proportion to the potential damages.

And, we need to re-engineer whatever it is in the character of regulatory bodies that drives them to acquire their own particular interests and pursue them at almost any cost

– to others of course. It could be the bureaucrat in them of course. ‘for the bureaucrat, the world is a mere object to be manipulated by him’, Karl Marx said.

Substitute ‘regulate’ for ‘manipulate’ and you have the problem pretty well summed up. And you have the solution too: if you don’t want your world manipulated by a regulator, regulate yourself. Practise self-regulation.

We also need to somehow deal with the fear, of litigation, among other things, that forces regulators to act in highly risk-averse and peculiar ways. We cannot eliminate risk. We can’t guarantee people risk free futures. We have to live with risk, and manage it rather than trying to guarantee ever more tiny margins of safety. You can’t guarantee good behaviour through regulation. History has shown time and time again that people they will find a way around the law no matter how good the law is.

It’s going to take massive political energy to follow through on the response to the banks regulatory task force, but I think the Australian community will overwhelmingly support the agenda.

Corporate responsibility

Let me try to bring this all together into the broader corporate context.

The corporate sector fought for and achieved a massive transfer of power from the public to the private sector over the past 25 years. No one any longer doubts that this has produced a more efficient economy and higher growth rates. However, the victory has not been won definitively.

We need to prove we understand that in accepting the additional power we also accepted additional responsibility; specifically to use that power responsibly and in the interests of the entire community who grant us our licence to operate.

We also need to remember that capitalism is far from a perfect system – it is undeniably the most creative economic system ever invented, but it does not of itself create a perfect society or a perfect democracy.

And with trust in corporations at an all time low and cynicism at an all time high, the sustainability of the free market system is coming under renewed scrutiny.

Bill Emmott, the former editor of the *economist* magazine, for example, believes that whether "capitalism will survive" is one of the two most crucial questions for the 21st century. Emmott identified four flaws threatening its survival: capitalism is "unpopular," "unstable," "unequal" and "unclean".

Capitalism makes no claim to providing an equitable distribution of income and wealth. Nor, of itself, does it care much for the environment: its basic impulse, as Joseph Schumpeter said, is ‘creative destruction.’

We know from behavioural economics that when pushed, people care mightily about equity and fairness – and the environment - and are prepared to trade efficiency for it. And indeed, there remain plenty of critics of the Washington consensus.

In any functioning, transparent democracy, the community 'licence to operate' is up for continual renewal.

So the way forward is to move beyond the notion of corporate responsibility to the notion of enlightened self interest by adopting business practices that are responsive to stakeholder concerns.

The links between stakeholder-responsive practices and shareholder value are pretty obvious and are particularly evident through:

- Improved reputational capital, with both employees and customers;
- Enhanced social licence to operate;
- Reduced regulatory and other operational risk;
- Greater operational efficiency; and
- More rapid responsiveness to changing societal trends.

All of which go to maximising shareholder value.

But if we in the corporate world do not take control of this agenda and widely adopt stakeholder-responsive practices, we are likely to see new legislative requirements on directors to take account of the interests of stakeholders beyond shareholders.

I say this from a relatively unique vantage point, having served in both public and private sectors. In any functioning democracy, the legitimate needs of the community are ultimately met. The only question is how they are met.

This can be by corporations taking an intelligent long-term view of stakeholder interests and managing the externalities of business activities; or by legislation.

In my experience legislation is almost invariably less efficient and less effective. And if you think I am being overly critical and an alarmist about the need for corporations to act, you need look no further than the regulators' response to the business world's ostrich-like reaction to corporate excesses and governance failures.

Community outrage at corporate inaction was inevitably followed by highly prescriptive governance and costly disclosure requirements.

In contrast to this, the recent political response to climate change encourages faith in the capacity of business to play a leading role in driving the public policy debate.

In April 2006, together with the five other companies, we released the Australian Business Roundtable report calling for a national market-based carbon pricing mechanism to deliver cost-effective emission reductions. This was pretty lonely space

at the time. By June 2007, this had become bipartisan policy. Business can do all sorts of things when it tries. That's the point.

It can anticipate and adapt to change, which means it can work with new generations of employees. It can be not only a good member of the community, but a leader in it.

It can be the solution much more readily than the problem – and prosper from it. It is clever enough to regulate itself, and clever enough, one would hope, to see its interests in doing so.

And it can be a pillar of the community, but that's as much of a pillar as any company needs to be.

Thank you.