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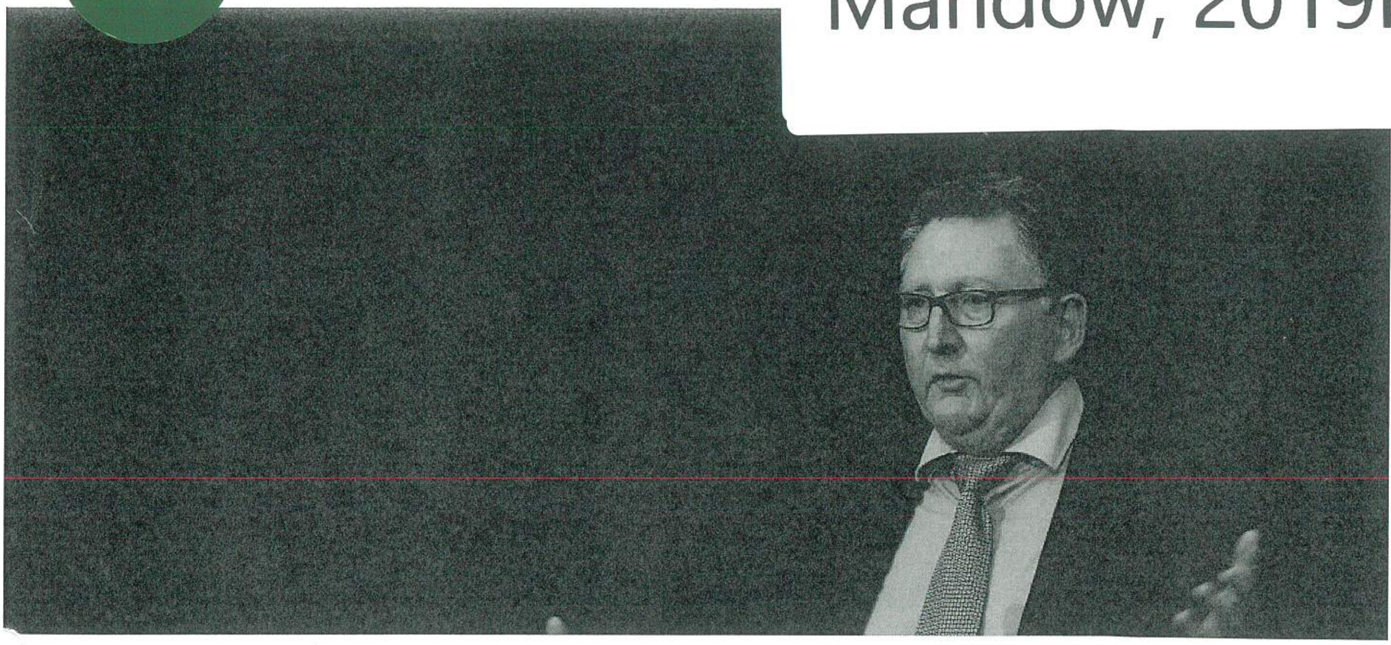

Adrian Orr is concerned about potential conflict when bank executives and directors sit on parent-subsidiary boards both sides of the Tasman. Photo: Lynn Grieveson.

Nikki Mandow

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BUSINESS

Of chocolate biscuits and conflicted bank directors

Could New Zealanders be short-changed by a conflicted relationship between New Zealand bank leaders and their Aussie parent companies?

Imagine a chocolate biscuit. The last one in the packet. You have two takers. A parent and a child.

Both hungry.

Who gets the biscuit? They can't decide.

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Each appoints an advocate to argue their case.

"The parent should get the biscuit because the sustenance of the family depends on the wellbeing of the parent."

"The child should get the biscuit because the parent is big enough to go and get its own biscuit."

Both arguments are sound, and the solution will decide on the strengths of each case and the persuasiveness of each champion.

But what if the advocate for the parent and the child is the same person? Suddenly there's a conflict of interest. Let's say the advocate role is paid. The parent has more money, so the advocate may feel he or she is more likely to get future work from throwing their weight behind the parent rather than the child?

And there's a power imbalance. The parent has better powers of persuasion. They are bigger and stronger. Suddenly, in a tussle over a biscuit, the parent is more likely to come out with chocolate on their lips.

It's a frivolous argument when it's about a biscuit.

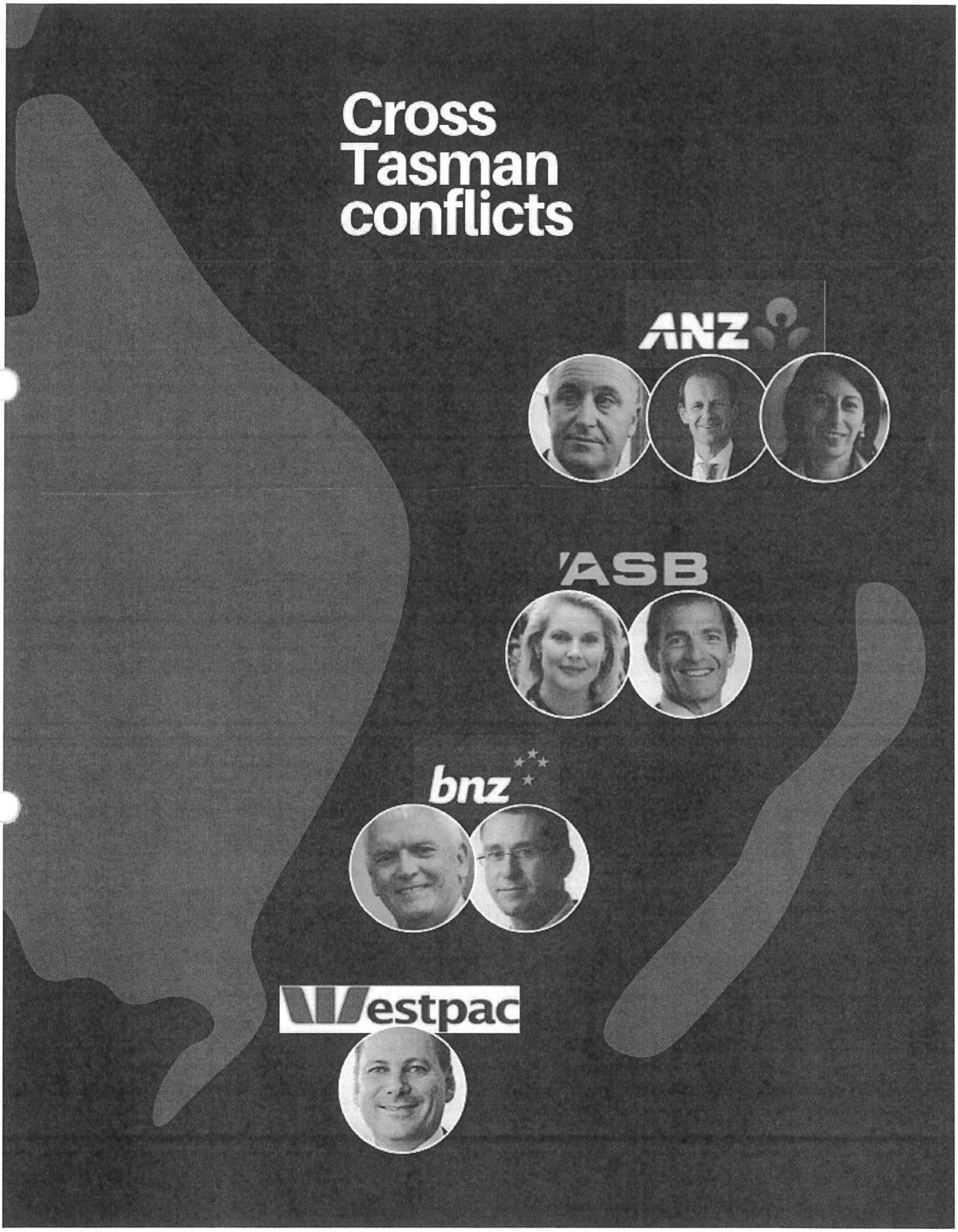
But what about a bank? All of our big four banks - ANZ, BNZ, ASB and Westpac - are Australian-owned, and there are a number of crossovers where directors and senior executives hold positions on both sides of the Tasman. To whit:

- At ANZ, New Zealand board chairman John Key, Australian group CEO Shayne Elliott sit on both boards. Australian chief financial officer Michelle Jablko sits on the New Zealand board.

- BNZ chairman Doug McKay is chair of the New Zealand board and also on the board of BNZ parent NAB. Gary Lennon is the CFO of NAB and also on the BNZ board.

- ASB chief executive Vittoria Shortt is on the ASB board and is part of the leadership team at Australian parent CBA. David Cohen, CBA deputy chief executive also sits on the ASB board.

- Westpac has the least crossover. Peter King, chief financial officer of Westpac Banking Corporation in Australia is also on the Westpac New Zealand board.



It's a complex web, and that creates the possibility for conflicts of interest that might not be in the best interests of customers.

Take just one example: the amount of money that gets invested in upgrading a bank's IT systems. Sounds boring and technical, but actually, customer-focused regulators in New Zealand are pretty keen on banks improving the way they use their data, because it's those improved systems that are going to help banks identify when a customer isn't getting a good deal on their mortgage or credit card, for example. Also, more streamlined processes should bring fees can come down, and should allow banks to find out who their vulnerable customers are.

And New Zealand banks should have lots of money to invest in their IT systems. Our banks are insanely profitable - some of the most profitable banks in the world for the size of the population.

X New Zealand's 'big four' made more than $5 billion profit between them last year.

But it's a totally different situation for the Aussie-owned parent companies, which are facing massive financial hits following last year's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Just this month, ANZ Australia announced a $A650 million hit to its full-year profit to cover the costs of remediating over-charging and mis-selling products to its customers.

This takes ANZ's total remediation bill over the past two financial years to $A1.1 billion. Some estimates suggest the big four Australian banks (each with a big four subsidiary here) could end up paying a total of $A10 billion to atone for their bad conduct.

With that hanging over them, chances are the Aussie banks will be keen to keep as much of those New Zealand profits as they can.

Which is a difficult choice for a director or a CFO with a foot on both sides of the Tasman. Should profits earned here be spent on customer-
X enhancing technology in New Zealand (as the Kiwi regulators want)? Or

should it stay to help the Australian parent.

The power imbalance makes it a risk that Australia will win out over New Zealand.

The Governor of the Reserve Bank of New Zealand, Adrian Orr, has said he's concerned. Earlier this month he told *RNZ* investigative reporter Guyon Espiner he wasn't comfortable with the situation where bank directors could sit on the boards of both an Australian parent bank and a New Zealand subsidiary.

And he was looking at whether to do something about it.

If times got tough for a bank, a board member (or potentially a senior executive) could be conflicted trying to serve two masters, one on either side of the Tasman, at the same time, Orr told Espiner.

"My biggest concerns with boards is in whose interests are they working? Are they working for the parent shareholder, or the subsidiary shareholder ... that's a real critical challenge.

"For example, if the Australian parent is getting into trouble and you're sitting on the Australian board and the New Zealand board, and the Australian board says, "We need to bring capital back home from New Zealand to bolster the Australian side," what does the New Zealand director who is sitting on that board say?"

Capital adequacy

Another potential area for conflict for trans-Tasman directors is with the Reserve Bank capital proposals.

RBNZ wants our banks to hold more capital. But that means less money for the Aussie parent. And the Australian regulator APRA wants the same stability for the Aussie banking system, so it doesn't want more money in New Zealand.

The New Zealand banks are fighting tooth and nail against the Reserve Bank's capital adequacy proposals. That's partly understandable from a short-term profit perspective, but more so if you take the Australian parent's financial needs into account.

It's certainly not in the best interests of New Zealand bank customers, who could lose their savings if a bank collapsed because it didn't have enough capital. And it's not in the best interests of the New Zealand economy if the Government had to pick up the pieces in the event of a bank collapse.

How does a director or senior executive weigh up the interests of New Zealand banks and their customers, and those of the Australian parent, if they are involved at a governance or high executive level on both sides?

At the very least, it's a difficult balancing act.

Legally, a subsidiary company cannot be seen as an extension of the parent company. Even if it's wholly owned, it is still a separate legal entity. And although directors of the subsidiary can consider the interests of the parent company or the group as a whole, they still have a duty to act in the best interests of the subsidiary.

There are benefits

Actually, crossover directorships are pretty common in New Zealand, a country of small- and medium-sized companies, which are often family-owned, argues Professor David Lont, head accountancy and finance at Otago University.

And mostly it's a good thing, even with big companies, he says, as it fosters good communication between parent and subsidiary.

"An unintended consequence of banning a member of a board of a New Zealand subsidiary from going on the parent board [and vice versa] would be that the Australian board would be less informed and the New Zealand subsidiary would have less of a voice."

He gives the example of rogue Barings Bank trader Nick Leeson, who managed to hide dodgy trading out of the Singapore office he ran. His losses eventually brought down the UK's oldest merchant bank.

"These things are not black and white. If you 100 percent own this company, want to know what's going on. Imagine a world where the parents don't know what their subsidiaries are doing."

Kirsten Patterson, chief executive of the Institute of Directors, agrees there are benefits for New Zealand companies having good communication flows with their parent company.

"New Zealanders might like a Kiwi voice on an Australian board, making sure New Zealand is being heard and being represented, that it's not just the Australian board making all the decisions."

Safeguards already exist

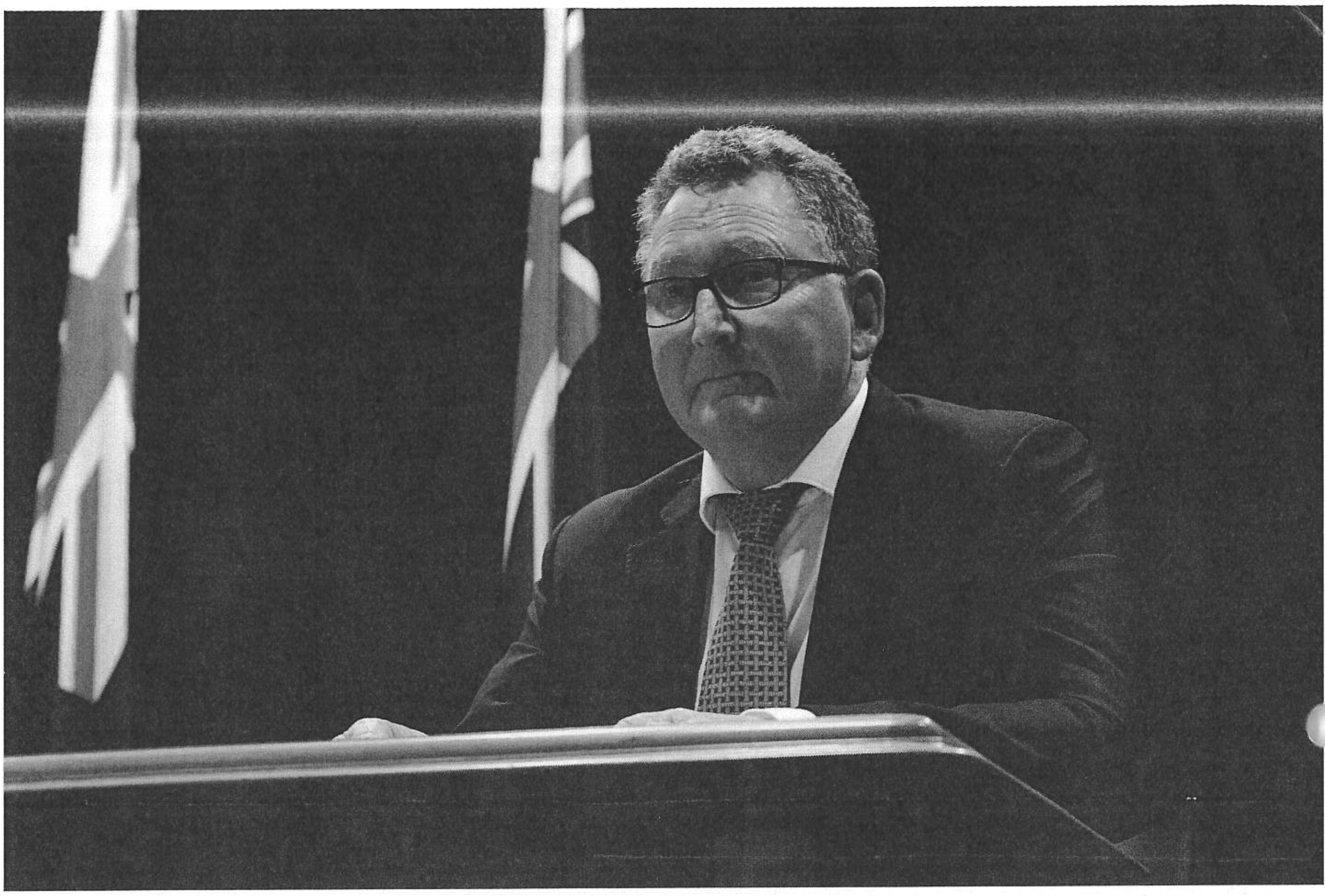
Patterson says there are already legal protections in place to force directors of a wholly-owned subsidiary bank to always act in the best interests of the subsidiary, not the parent. +

In particular, a Reserve Bank rule specifically overrides a provision in the 1993 Companies Act allowing a director of a wholly-owned subsidiary to "act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company" if "expressly permitted to do so by the constitution of the company".

Not if you are on a bank board, the Reserve Bank says.

"This condition of registration prohibits the registered bank's constitution from allowing a director to act other than in the bank's best interests."

The Reserve Bank's registration criteria also stipulates that the majority of directors on a NZ bank board are non-executive, that at least half are independent, and that at least half of the independent directors live in New Zealand.



Adrian Orr.

Meanwhile, the chairperson of a New Zealand bank can only sit on the board of a parent bank if they get permission from the Reserve Bank. ANZ and BNZ's respective chairs Sir John Key and Doug McKay, got this RBNZ tick of approval to be on the boards of parent companies in Australia.

Still the wording of the relevant provision of RBNZ bank registration recognises the potential for conflict is there.

"The Reserve Bank will also need to be satisfied that the chairperson's experience and background is such that they could be expected, when acting as a director of the holding company, to adequately contribute the subsidiary's perspective to the way that the group as a whole is run (within the constraint that their legal duty is to act in the best interests of the holding company itself)."

It's a tightrope.

A quick glance at the constitution of one of the New Zealand banks picked at random, Westpac, shows the potential for conflict - and the fact the Reserve Bank has a critical role.

Westpac New Zealand Ltd is owned, in turn, by Westpac NZ Group Ltd, Westpac Overseas Holdings No. 2 Pty Ltd, and then Westpac Banking Corporation. Any of those three parent bodies has the right to directly or indirectly appoint 100 percent of Westpac NZ's directors.

The only thing standing in the way is the Reserve Bank's veto power.

Patterson says there is already regulation to ensure board conflicts are managed and the regulator's job is to enforce existing rules. She says the Institute of Directors recognises the potential problems but isn't overly concerned.

"Directors need to be skilled to understand which hat they are wearing when. They need to be really clear who their duty is to."

Lont agrees. "It is naive to think directors aren't conflicted all the time. So they should be recognising the conflict and looking at the risk and what they are going to do."

Meanwhile the Reserve Bank is keeping its powder dry. A spokesperson told Newsroom: "We have not announced any policies regarding dual directorships and there are no imminent plans to do so. Rather [in the interview with Guyon Espiner], the Governor noted that he was considering whether it made sense for directors to be able to sit on both the board of the New Zealand subsidiary bank and that of the Australian parent."

Chocolate biscuit anyone?

New terrorism law raises concerns

Sometimes you can win when you lose