Lessons from a retired banker

One of Australia’s best-known bankers, Tony Berg, made a dramatic career change recently when he took the reins of a major industrial company. The change gave him an opportunity to reflect on the lessons learned in 24 years of investment banking and to pass them on to others — although he admits they are lessons more often learned by experience than by example.

I hope that the lessons that I have learned (and in some cases relearned many times) during 24 years of investment banking are still relevant for the 1990s and beyond. The lessons I wish to discuss revolve around the five areas of people, customers, strategy, statistics and risk management.

People

People are more valuable than capital. Westpac, even at its most critical period, could raise a substantial amount of capital — $1.3 billion. What Bob Joss has been demonstrating during the past year is that rebuilding an effective team is more difficult and takes much more time. The key to having a highly performing bank starts with hiring policies. Each year you have to hire the best graduates you can find. This is what Macquarie Bank, Bankers Trust and others have done. By attracting the best people, training them (mainly by doing rather than in formal training programs) and retaining them — that is, creating a climate which is attractive, remuneration policies that reward success, and promotion policies based on merit rather than seniority — you can, over five to ten years, build really effective executives. This much is understood, although not necessarily practised, by most in the industry. But, when it come to people, there are many contradictions, many lessons to be learned.

First, profit may not be a good measure of talent or expertise. The most obvious way that this arises is when a particular market is having a run. Equities is a good example at present. It would be surprising if any broker was not making considerable profits. Their profitability will indicate that they deserve bonuses and promotions, but do they really? When the market quiets again you will find out how good they are and you will find many over-remunerated and over-promoted.

This is not only true of the equities market and other financial markets such as foreign exchange, bullion and fixed interest, but also traditional banking areas such as lending — the lending to the property market up to 1990 would be a good example. How many executives, who earned huge bonuses in the property area, were subsequently fired for incompetence?

This example raises my second contradiction — your best sales person can be your worst enemy. What do good sales people do? They persuade customers to accept loans from your bank. They do it by emphasising the advantages of borrowing from your bank and ignoring or playing down the disadvantages. So far so good — your bank gets loans on the book, hopefully at better mar-

Tony Berg, ASLA is managing director elect of Boral Limited and the former managing director of Macquarie Bank. This is an edited version of his introductory address in the Optus Lecture Series sponsored by Optus and Australian Banking and Finance.
gins than would result from an inferior salesperson.

But there is a catch. That brilliant sales technique might not be as beneficial internally as it is externally. The salesperson will put a loan proposal to the bank, emphasising the advantages and ignoring or playing down the disadvantages. I learned a number of times (always too late) that the real situation did not conform with the proposition summary. On one occasion our brilliant salesman sold us on a secured shipping loan substantially on the basis of the valuation of the ship. Our loan was a fraction of that valuation. What he didn’t tell us was that the valuation was an insurance value, and that the market value was a fraction of the insurance value. The salesman lost his job, we lost $1 million.

This neatly leads to the third contradiction. The bank’s risk/reward ratios and those of its executives can differ dangerously. This time, I learned the lesson from a friend working with a large North American bank and not at the expense of Macquarie. My friend had secured the role of lead manager for a major resource financing which, at the time, had a number of identifiable risks for the lenders. The lending margin was 1 3/8 per cent over LIBOR. I said that I could not understand why he would make a loan at that margin when there was a more than 1 per cent risk that the loan would go bad.

“I agree with you,” my friend responded. “But look at it from my point of view. While there is more than a 1 per cent chance of the loan going bad, the overwhelming probability is that the loan will be seen to be a great milestone in project financing. I will be a hero, I’ll get a very good bonus and I will get promoted. In the unlikely event that the loan goes bad, the worst that can happen to me is that I get fired.”

In the event my friend got promoted. But if the bank let my friend make too many loans or if it had many lenders like him, this was a recipe for disaster. The problem is that the personal risks and the business risks are not aligned.

This lack of alignment of risk between the bank and its executives is exacerbated if rewards are based on direct individual profit results. Not to do so is the fourth lesson. If people get a direct percentage of the profit they make for the bank, you give them a free option at the expense of the bank. The executive is encouraged to go for big profits, to take large risks, to do things that are not in the interests of the bank.

I found one of the most difficult tasks in investment banking was finding a just and fair compensation system which rewarded executives for success but at the same time encouraged teamwork, longer-term thinking and prudent risk-taking, and which encouraged the people to stay.

My fifth lesson is that some people never learn — they are committed to making the same mistakes over and over. At one time, when we were searching for a new corporate lending executive, we came up with a person who had a long record of lending with considerable success. He was a very good salesman and sold himself to us very well. At the final interview, we asked about the only blemish in his career — he had lost money on a shipping loan. What had he learned from the experience? Quick as a whip, he responded: “Don’t make shipping loans.”

If that is the lesson from a failed loan, the banking industry would stop making property loans, loans to large, middle and small corporates, personal loans and housing loans, not to speak of shipping loans. Clearly, that could not have been the lesson. It might have been: check your security, check your borrower, ask what happens to cashflow if there is a glut of shipping capacity.

The answer worried us and we did not hire him. He later became the managing director of an overseas-owned merchant bank which lost hundreds of millions on property loans, corporate loans, leasing and loans to so-called entrepreneurs. But there were no losses on shipping loans. This person represents the category of those who are committed to make mistakes over and over — always in a slightly different way.

The sixth lesson in relation to the people aspect of banking is fundamental to all business. Staff appreciate the need for standards and prefer working for an organisation with high ethical standards. Each organisation needs to work out carefully its ethical approach and then clearly explain it to its people. The bank needs to ensure that its actions reinforce the approach. It is very easy for the reward systems of the bank to deliver contradictory messages.

The final lesson in relation to people is that banking should be fun. Banking can be an intense business and it requires enormous commitment. We spend a lot of time in this business. We ought to enjoy it and our people are more likely to stay committed if they, too, enjoy it.

Customers

A discussion of any business is incomplete if it does not deal with customers. They are the lifeblood of business. There is no viable business without customers.

While this may seem obvious, there are many aspects of banking where it is sometimes felt that customers are not needed and, in fact, that we may be better off without them. Sometimes, to hear dealers in foreign exchange, futures and commodities, swaps, options, fixed interest and equities talk, you could gain an impression that they make the money by brilliant dealing and that customers, if anything, tend to get in the way.

But even in dealing activities, customers are very important. Dealers might not tell you about the spreads they make on customer business. Dealers may also ignore the information they obtain from their client trade. For example, are exporters starting to cover their exchange risks? Are institutions starting to sell their bond positions? Also, the information picked up from customers about your competitors is important. The more customers you have, the better the information.
In the early-to-mid-1970s, most companies had a “one bank” relationship. Some banks did not repay this customer loyalty during the difficult times of the mid-1970s and the beginnings of deregulation of the financial markets in the early 1980s changed this situation. The proliferation of banks of all types meant that finance directors and treasurers were besieged by bankers offering increasingly competitive terms and an increasing array of financial products. The customer became a child in a financial lolly shop.

The customers were guilty of promiscuity and bankers started to engage in rape-and-pillage-style banking. Which, when you think about it, is worse. In any event, there was no loyalty on either side and both sides were greedy. The lesson is that customers are important to the business of banking and you have to look after them if you want to build a bank which is successful over the long term.

Strategy

The third category of lessons revolves around strategy. There is no single formula for success but successful banks normally have a clear strategic direction. For example, regional banks have done well by concentrating on branch banking for large numbers of individual customers. Those that have strayed from that formula have had problems.

Macquarie Bank and Bankers Trust Australia both realised what they were good at and stuck to it. The same is true of SBC Dominguez Barry in various dealing activities, and Rothschild in bullion and investment management. Of the majors, National Australia Bank and the Commonwealth Bank stayed relatively narrowly focused while Westpac and ANZ tried to be all things to all people in all lands. The state banks got into trouble when they strayed from what they were good at.

There is frequently an early mover advantage. If you are first with a new product, or a close second, you can more easily maintain a leadership position. A good example is Macquarie’s cash management trust. It was first into the market in 1980 and in recent years it has never been less than double the size of the next largest operator. Macquarie was able to retain leadership positions in bullion banking and options, among other businesses, as a result of being first into the market. Also, innovation is exciting, and contributes to the people “having fun”.

A further strategic lesson I have learned is that short-term profits are not a good indicator of strategic success. Just as profitability does not necessarily indicate expertise in your people, it does not necessarily demonstrate that the business is well positioned. Market share is probably a better indicator.

Another lesson applies to foreign banks operating here and to Australian banks venturing abroad. There is home ground advantage in banking even more powerful than on the football field. Most of the foreign banks have not done very well in Australia. Foreign bankers don’t understand the local conditions well, they do not stay long enough to build close relationships with clients, they are unable to attract the best people and they are slow to innovate because of long lines of communication and so they lack the early mover advantages. It is not surprising they have not done so well, and it is not surprising that Australian banks have not done so well when they have expanded overseas.

Finally, in relation to strategy, all of this demonstrates the need for a longer-term approach in an industry which is characterised by short-term thinking — particularly in investment banking. Typically, the focus on the annual profit and the reward system reinforces this. Building new products and businesses often takes much longer and the people who do this provide a more lasting benefit. It is important that the incentive system recognises this vital contribution.

Statistics

A thorough knowledge of probability and statistics generally can be a banker’s best friend. Successfully managing all the credit, trading and liquidity risks in banking rests on a thorough knowledge and deep understanding of the use and abuse of statistics.

The first lesson in this category is to track statistical trends relevant to your business. Statistics on land subdivision would have indicated that far too much residential land was being developed in the mid-1970s, leading to loan losses. Similarly, statistics on property lending in the late 1980s would have signalled an increasingly risky market. Banks should track bank lending statistics to find indicators of too much credit chasing too few genuine opportunities.

A knowledge of probability also helps. It is amazing how politicians, customers and even bankers fail to understand the basics of loan pricing. If a loan has as little as one in 100 chance of going into major default in a year, then you need to have at least a one per cent margin to cover this risk alone. You obviously need extra margin to cover marketing and loan administration costs, and cost of capital. My experience has been that most loans are sold too cheaply.

With the growth of derivatives trading, management needs to understand the mathematics, statistics and probability theory that underlie valuation issues and risk management. For example, when your options dealer says that he can state with a 95 per cent level of confidence that the worst-case loss from a position is $1 million, you would be excused for thinking that the position, even if it goes bad, will not break the bank. If so, you would be severely deluded for two reasons.

First, your dealer is really saying...
that a statistical analysis of events over a defined period (and it would be interesting to know what period was analysed) indicates 95 per cent of the events fell within a range leading to an outcome of a profit or loss not greater than $1 million. What we are talking about is the famous bell curve, and we know that bell curves have tails, sometimes long ones. The fact is, even based on your dealer's analysis, there is a two-and-a-half per cent chance, or a one-in-forty chance, that a worst-case outcome will be greater than a $1 million loss. Moreover, if your dealer plays this game often enough, and you have other divisions playing games also, that outcome is almost certain to occur.

Second, your dealer's analysis is based on observed history. How far back was the analysis taken? Some particularly volatile periods may have been missed. In financial markets, as well as in sport, we have a habit of breaking new records.

At Macquarie Bank, we did an analysis in mid-1987 of the stockmarket. We were concerned about the boom and wanted to know what could be the worst one-day fall. Our analyst went back to the 1929 crash and found that the worst one-day fall was of 11 per cent. We felt justified in using 10 per cent as a worst case. After all, nothing was going to equal the crash of 1929 and the probability of such a fall was statistically insignificant. We all know now that on Tuesday 20 October 1987 the All Ordinaries fell by 25 per cent.

The lesson is: while the mathematics and statistics are important, it is even more important to apply an overlay of common sense and “what if?” analysis.

**Risk management**

If risk management is not handled successfully, daily, monthly, annually, you can be very quickly out of business as financial institutions demonstrate time and again.

My first recommendation is to **disband the credit committee**. A collective cannot take responsibility — only individuals can. The dynamics of a committee are to reach consensus. A tough-line, “negative” personality is not appreciated and will not last long. The alternative is to have individuals sign off on credits, requiring more senior sign-offs for larger credits or smaller credits outside guidelines. Each individual signing knows that he or she will be held responsible if anything goes wrong.

My second recommendation is that **all risks should be supervised by an independent prudential control division**. Many banks have their credit departments within the lending division, they are therefore subject to the pressures for meeting loan targets and profit budgets. Also, the credit people report to the head of lending who will not tolerate people saying “no” to business he would like to do.

My final lesson is that **it is easier to turn the tap on than to turn it off**. As soon as you have agreed to do one deal, you have set a precedent. Why not do another, and another? You may judge that, at the present time, it is not too risky to lend money to a particular sector. But who blows the whistle when it’s time to move out? You have committed people to the activity who are doing very well and for financial and emotional reasons they will not want to wind down. So when you turn on the tap, give some consideration to whether you will want to turn it off, and if so, how you will do so.

**Conclusion**

I have tried to share the major lessons I have learned in my career in banking. But maybe there is one final lesson: that is that lessons are rarely taught, usually they have to be learned from experience.

The sharemarket gives some good illustrations. With another share boom in progress, those of us who have participated in previous booms and busts can preach the wisdom of not holding on to share positions, because you will inevitably hold a pile of rubbish when the market break occurs. But preach as we might, the new generation is certain to learn the lesson as we did — by experience. The same is true of underwriting. Underwriters are taking more and more risk and inevitably some are going to be stuck with big losses.

Finally, I would like to say that I will miss investment banking very much. It is an exciting industry. It is an industry that has very bright people and it lives on their wits. Nevertheless, for me, it is also exciting to be crossing the fence and I look forward to being a customer.