RISK GOVERNANCE REVIEW

Section 95 Review of Westpac New Zealand Limited

23 November 2021

OliverWyman

INTRODUCTION

On 24 March 2021 the Reserve Bank of New Zealand – Te Pūtea Matua (‘RBNZ’) announced it had taken action on concerns raised regarding risk governance processes at Westpac New Zealand Limited (‘WNZL’, ‘the bank’).

The concerns centred on ongoing compliance breaches and technology issues including material failures to report liquidity correctly, capital models breaches and significant technology outages. The RBNZ considered these issues as indicative of weaknesses in the bank's risk governance.

Exercising powers given by Section 95 of the Reserve Bank of New Zealand Act 1989, the RBNZ instructed the bank to commission an independent report to assess its risk governance processes and practices, particularly focused on the role played by the Board.

Oliver Wyman was engaged to carry out this assessment and this document summarises the findings and recommendations of our resulting independent report.

Section 95 review objectives

The objective of the review was to assess the effectiveness of risk governance at the bank, with a particular focus on the role played by the Board. This included assessing:

- Current risk governance processes and practices, identifying any areas of weakness and the root causes of those weaknesses
- The bank’s efforts to proactively identify areas of weakness in risk governance practices and processes
- The effectiveness of the Board in setting an appropriate tone on risk management, and reviewing whether that guidance is adopted and applied across the organisation, and
- Any risks associated with the delivery of risk governance remediation programmes, why such risks had arisen and whether they were well managed

The review was to additionally consider the effectiveness of the Board in governing risk in the context of three case studies identified by the RBNZ.

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Assessment approach

To perform the Section 95 review, we carried out an extensive research and diligence exercise between June and September 2021.

This included:

- Interviewing over 50 current and former WNZL Board Directors and staff, as well as select Westpac Banking Corporation Board Directors and Executives
- Observing 10 Board, Board committee and Executive committee meetings over a period of three months
- Reviewing over 900 documents, including:
  - Board and Executive committee papers and minutes
  - Policies, processes, and frameworks
  - Documents relating to ongoing and completed remediation programmes
  - Prior independent Section 95 reviews and associated documents

We made our assessment of the state of risk governance at WNZL based on this research and considering regulatory expectations, international industry standards, and best practices.

The review was primarily a point in time assessment, but also considered past events to understand context and root causes. The Board and the Executive underwent changes in membership during and following the period of review. For this reason, it is important to state that references in this document to the Board and Executive reflect their composition as at the start of our review in June 2021.

The outcomes of this Section 95 review are presented here in two parts: First, our findings; and second, our recommendations to address these.

FINDINGS FROM THIS REVIEW

Westpac New Zealand Limited's risk governance processes and practices, in particular the role played by the Board, fell short of the standard we would expect of an organisation of the bank's scope and scale.

Findings relate both to the Board's capabilities, performance, and structure, as well as the broader risk governance structures, which affected the Board's ability to effectively govern risk. In some cases, issues had been acknowledged for several years but had not received due attention or effective remediation. Addressing the findings of this review will require both Board commitment and a strong focus on the effective execution of remediation activities. At the time of this report's publication, the bank has already made progress in implementing our recommendations and has demonstrated a strong commitment to the remediation of our findings.

We have classified our findings as follows:

- '*Material findings*' pose a material risk to effective risk governance
- '*Additional findings of concern'* reflect ineffective risk governance but are unlikely to pose a material risk in isolation

The major findings are summarised under three themes:

1. The Board and Board Committees
2. Communication, risk behaviours and mindsets
3. Risk governance structures

1. The Board and Board committees

Material findings

The WNZL Board Charter requires the Board to have a range of financial and other relevant skills, experience, and knowledge necessary to guide the business of the bank. The independent Non-Executive Directors collectively did not have sufficient expertise in the critical areas of banking, risk management, and banking technology to satisfy that requirement. As a result, the independent Non-Executive Directors were not able to engage with and provide robust challenge to the Executive on risk topics. The independent Non-Executive Directors also placed too much trust in the Executive without sufficient substantiation. Their relationship lacked the degree of transparency, respect, and constructive tension necessary to support effective risk governance.

The Board did not effectively use, consider, or engage with the bank's risk appetite framework; a critical tool for articulating the bank's tolerance for risk-taking, monitoring the bank's position against those tolerances, and guiding strategic decision-making. The independent Non-Executive Directors did not demonstrate the fluency and depth of understanding of risk appetite expected of a Director on a bank board that is necessary for effective risk governance. The Board tolerated risk measures that were out-of-appetite for sustained periods and did not consistently demonstrate the expected levels of urgency, challenge, or debate in response to these. Risk appetite was not sufficiently used in broader strategy setting and investment discussions, and was seldom discussed outside its formal annual review. This was not helped by insufficient commentary being provided on risk appetite and out-of-appetite measures in Board risk reports.

The mandate of the Board's primary risk committee, the Board Risk & Compliance Committee, focused on monitoring and providing oversight of risk exposures, and approving risk frameworks, but was not sufficiently comprehensive with respect to broader risk governance and risk management processes. For example, there was no stated responsibility for the Board Risk & Compliance Committee in ensuring the effective operation of risk management systems, in overseeing the bank's risk culture, or in ensuring that the second line of defence is robust.

The process of setting agendas and developing papers for the Board Risk & Compliance Committee lacked clear ownership. Agendas were lengthy, dominated by items 'for noting' and were not always aligned with priority risks and issues. This reduced the opportunity for sufficient discussion, debate, and reduced the Board's ability to focus and provide challenge on important key areas. Similarly, Board papers were voluminous and not adequately tailored to a Board audience. This inhibited the Board's ability to identify salient points quickly and garner an appropriate understanding of key issues.

Additional findings of concern

All four Board committees included all the Non-Executive Directors as committee members, which is not common practice. This had the impact of increasing Director workloads, diluting individual accountability, and reducing the opportunity for the full Board to scrutinise the recommendations of each committee.

Board and Board Committee meetings also had a significant number of non-Board member attendees, and non-Board members materially outnumbered Directors on most occasions. This created an environment of increased formality, reduced the opportunity for Director discussion, and led some Directors to feel uncomfortable challenging the Executive in the presence of their direct reports for fear of undermining them.

2. Communication, risk behaviours and mindsets

Material findings

The behaviours and mindsets of the Board and Executive with regards to risk were not yet fully aligned with an effective risk culture. Specific behaviours identified included inconsistencies in 'tone from the top' on risk, a pattern of tolerance for poor risk outcomes – for example, the long-standing out-of-appetite risk metrics – and a reactive approach to managing the bank's risk profile, particularly with respect to emerging risks and 'lessons learned' from overseas jurisdictions. Whilst the bank had plans in place to improve its risk culture, these plans require improvement to effectively deliver the cultural change required at the most senior levels.

Additional findings of concern

The relationship between the Board and the RBNZ had suffered from instances of miscommunication and misunderstanding.

The complex dynamic between the Executive, the Board and the bank's parent Westpac Banking Corporation ('WBC') hindered effective information flows, including on risk matters. The lack of WBC representatives on the Board for a period over 2020 and 2021 exacerbated this issue.

3. Risk governance structures

Material findings

There were a substantial number of risk and regulatory remediation programmes underway across the bank. The Board had a strong focus on these, however the underlying programmes had design weaknesses that resulted in delayed or ineffective delivery. Timelines appeared to have been set without full consideration of available capability, capacity, and priorities. Delivery was often approached in a siloed manner without effective consideration of synergies or interdependencies. This created broader efficiency and programme delivery issues, including over-stretched resources and recurring extensions of programme timelines. Regulatory remediation programmes, for example other Section 95 reviews to date, were an exception to this and had been delivered on time.

Additional findings of concern

There had been historic underinvestment in risk management capabilities at the bank. The Board had responsibility for approving the strategic direction of the bank and approving the annual budget but had not taken a strong position on directing investment into risk management until more recently. Prior investment appeared to have been made reactively rather than strategically.

The bank's risk resources appeared overstretched and struggled to deliver against their mandates. Whilst this review has not involved a detailed assessment of the bank's risk resources, the gap may be driven as much by skills and capabilities as by headcount challenges, and requires further investigation.

Risk reporting to the Board and management committees was significant in volume and its production was time-consuming. As a result, publication was often delayed which diminished the ability of the Executive and the Board to effectively oversee the risk-taking activities and overall risk profile of the bank.

Further observations

While the emphasis of the review was to identify areas of weakness in risk governance and the role played by the Board, we also acknowledge certain areas of strength as well as activities in-flight to make improvements. Recent changes in the Board and its committees' composition will go some way to addressing the gaps in experience and expertise identified in this report. Other notable areas include the bank's positive engagement with this independent review process; a clear focus from the Board and Executive on improving risk mindsets and behaviours across the bank; the establishment of a Transformation Office; and an improvement in Board engagement and challenge over the period of our review.

RECOMMENDATIONS TO ADDRESS FINDINGS

1. Equip the Board to effectively challenge the Executive on Risk topics

Augment the Board with independent Non-Executive Directors who have material executive experience in banking, financial services risk management, and banking technology as part of their broader portfolio of experiences and expertise. At the time of this report's publication, the bank has recently appointed three independent Non-Executive Directors who bring banking and technology expertise. Future Board appointments should ensure the independent Non-Executive Director group also has material risk experience within financial services. Concurrently, the Board should undergo a period of coaching to capitalise on the opportunities presented by a renewed Board and to support the deployment of best practices with regards to engaging with and challenging the Executive.

Enhance existing induction training for new Non-Executive Directors to include specific training on risk topics, including technical briefings on the bank's key risks and how these are measured, monitored, reported, and managed. All Non-Executive Directors should receive regular ongoing briefings and training on risk topics and emerging risks as part of their broader education calendar. Training should leverage a variety of formats and be delivered by a combination of senior executives and external subject matter experts. The training needs of each Non-Executive Director should be reviewed annually by the Chair.

Update the Board Risk and Compliance Committee mandate to broaden its remit, to include additional responsibilities with respect to oversight of the effectiveness of the broader risk management framework and ecosystem.

2. Strengthen the operating model of the Board and its committees

Improve the process, roles, and responsibilities for setting the Board Risk and Compliance Committee agendas to ensure that agendas are efficient, well-prioritised and there is sufficient time for debate and challenge for the most material issues. Design and apply clear standards for Board papers so that the content of papers is aligned to the needs of the agenda, key information and decisions required are clearly highlighted, and that executives are held to account for the quality of papers submitted.

Institute the regular discussion of risk appetite at all Board Risk and Compliance Committee and Board meetings, and ensure explicit consideration is given to risk appetite in strategic decision-making. Document and implement a process to address and mitigate potential and actual risk appetite measure breaches.

Revise the membership of each Board Committee to avoid any single Non-Executive Director sitting on every committee, whilst maintaining appropriate cross-membership. This should improve accountability and enable the full Board meeting to be a secondary opportunity for challenge. At the time of this report's publication, the bank has amended the membership of its Board committees such that there is different membership for each committee.

Reduce the number of non-Board members in attendance at each committee meeting to foster better discussion and challenge.

3. Improve communications, risk behaviours and mindsets

Establish operating principles that articulate the rules of engagement with regulators and with WBC to improve the quality, regularity, and outcomes of interactions. This could involve actions such as gathering feedback on engagements with the regulator, complementing existing formal channels with informal meetings, and setting expectations around the types of issues that are raised and escalated.

Augment the Board with WBC representatives to aid in the flow of information between the two entities. At the time of publication, two WBC representatives have been appointed to the Board.

Enhance and extend existing risk culture initiatives to ensure they target Board and Executive-level behaviours and mindsets regarding risk. Review firm-wide initiatives to ensure a strong behavioural focus.

4. Enhance the risk governance framework

Enhance the wider risk governance framework with a particular focus on remediation standards, risk reporting, investment, and risk resourcing.

Establish design and delivery standards for remediation programmes. Standards should include a definition of what constitutes a 'critical remediation programme' that requires Board oversight. Each programme should require clearly articulated problem statements, defined outcomes, and a target end-state. Programmes should not be funded or launched without these items being agreed. There should be a supporting set of standards and consequences to which the accountable owners of programmes are held in cases where successful programme outcomes are not achieved. At the time of this report's publication, the bank has established a Transformation Office and appointed an interim Chief Transformation Officer as one step to address these recommendations.

Improve risk reporting quality and timeliness. This will require streamlining current report production, associated governance processes and underlying infrastructure, as well as establishing guidelines and training staff to improve the quality of commentary and insights in risk reports.

Define consistent guidelines, roles, and responsibilities on investment prioritisation for management use in drafting strategic investment plans for Board approval. Increase the visibility of risk management-related considerations in those plans.

Conduct a risk resourcing analysis to review the allocation of risk resources and their capabilities against risk management priorities to identify and address any gaps or misalignment.

CONCLUSION

The recent changes to the composition of the Board provide a timely opportunity to strengthen the Board's role in risk governance.

Success will be contingent upon addressing the underlying issues with the Board's capabilities and operating model, while at the same time enhancing the broader organisation's risk management capabilities and supporting ecosystem.

At the time of this report's publication, WNZL has already made progress towards implementing these recommendations. There has also been a collective acknowledgment and acceptance of the findings and a strong commitment to their remediation. Together these are positive indications of an improving trajectory for the bank's risk governance.

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