# Hayne and The Future of the Australian Finance Sector*

Kevin Davis**

Department of Finance, The University of Melbourne

This Draft: 3 July 2019

The Hayne Royal Commission (RC)[1] was a major event for the Australian financial sector and may be expected to have significant implications for its future development. While the focus was on the conduct (or misconduct) of financial institutions, the consequences could be more wide reaching with implications for the sector's size, growth, structure, profitability and activities.

Such effects could occur through three broad channels. The first is the effect of the RC process on attitudes of end-users (those demanding and supplying funds) to dealing with the financial sector. This could reflect increased awareness of potential costs and risks from such interactions, perhaps offset by perceptions of beneficial changes in financial institution behaviour induced by the adverse publicity arising from the RC. The second broad channel is the consequences of the RC recommendations (and their eventual implementation by government) which could affect the costs and profitability of certain types of activities in the financial sector. The third broad channel is the effect of the RC experience on the perceptions of financial institution managers on the merits and worth of particular types of business structures and activities.

The objective of this paper is to examine the likely consequences of the RC on future Australian financial sector development. It poses a number of questions in that regard in the hope of prompting more analysis – rather than attempting to provide substantive answers.

A major problem in this regard is that any effects of the RC are likely to be swamped by other factors affecting financial sector development. Two are particularly relevant. One is the consequences of technological changes ("fintech"). This is changing the landscape of the financial sector via its implications for the significance of the financial frictions (information availability and real resource transactions costs) which influence the viability of alternative business models. The second is the ongoing agenda of financial regulation, independent of the Hayne RC, and aimed at prudential objectives, financial stability, economic efficiency, and financial consumer protection.

These other factors will make it exceedingly difficult to identify empirically the consequences of the RC for financial sector development. But this does not mean that such issues should not be examined. For the formulation of good financial policy it is important to understand the likely consequences of the RC for financial sector development.[2] The financial sector is a (possibly too)

---

* Prepared for the 24th Melbourne Money and Finance Conference, July 22-23, 2019, Brighton Victoria. I am grateful to Christine Brown, Rod Maddock and Matthew Wilson for comments on prior drafts.

** Contact Details: kevin.davis@unimelb.edu.au

[1] Hayne KM (2019) Royal Commission Into Misconduct In The Banking, Superannuation And Financial Services Industry. Final Report, Volume 1. Canberra: Commonwealth of Australia. https://financialservices.royalcommission.gov.au/Pages/default.aspx

[2] For example, to the extent the RC recommendations would increase costs of intermediation, the consequences need to be assessed on a cost-benefit basis against likely improvements in quality and risk characteristics of intermediation (as well as effects on the quantity of intermediation).

large part of the national economy and plays an important role in facilitating economic growth.[3] Its activities can also contribute to financial and economic instability. It employs around 3-4 per cent of the workforce, contributes around 9 per cent of value added, and has grown markedly (both in terms of that share of national output and other size measures such as balance sheet footings) over recent decades.

There are five main questions posed in the following sections of this paper:

- Will the RC affect the volume of financial intermediation and growth/size of the financial sector?
- Will the RC lead to changes in the pattern of flow of funds, including different access to finance for particular end-users; different types of intermediaries; different types of institutions?
- Will the RC affect the organisational structure of financial institutions?
- How has the RC affected the profit outlook and market valuation of major financial institutions?
- Will the RC lead to "better" provision of financial services and products to end-users?

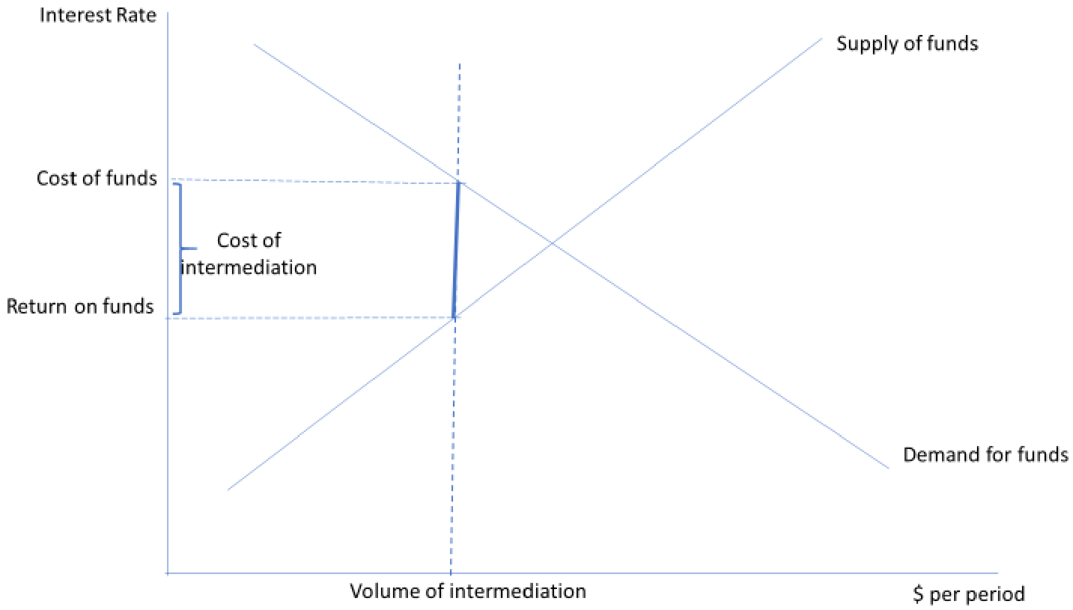
## 1. Financial Intermediation and Size and Growth of the Financial Sector

The financial sector intermediates between ultimate suppliers and demanders of funds (as well as providing a range of other functions including portfolio management). Ultimately the volume of financial intermediation is going to be determined by the "real" factors influencing the demand and supply of funds.[4] Figure 1 illustrates how the RC could influence the volume of financial intermediation using such a "loanable funds" approach.

[3] See for example Philippon, Thomas. "Has the US finance industry become less efficient? On the theory and measurement of financial intermediation." American Economic Review 105, no. 4 (2015): 1408-38.

[4] In adopting such a "loanable funds", the approach could be considered as equivalent to focusing on the IS curve in traditional macroeconomic IS-LM analysis rather than the shorter run determination of interest rates by macroeconomic balance sheet considerations of the LM curve.

## Figure 1:The Volume of Intermediation




As shown in Figure 1, the cost of intermediation (including intermediary profits) drives a wedge between borrowing and lending rates and has a negative effect on the volume of intermediation.[5] One way in which the RC could adversely affect the volume of intermediation is thus by increasing its cost.[6] An alternative channel is via effects on the demand for or supply of funds. The figure does not directly capture the risks (of product quality, default, costs of non-compliance with contract terms and conditions, remediation options etc) for end-users which will affect willingness to participate at any given interest rate.

The effects of the RC are unclear in these regards. While some financial entities will likely experience increased costs, others may not and may provide substitute channels for financial flows. Improved conduct of financial entities and/or improved regulation leading to lower risks/improved quality of financial products and services may encourage increased end-user participation (rightward shifts of the curves in Figure 1), thus offsetting, to some extent, a higher cost of intermediation. On the other hand, the RC experience may have alerted end-users to quality and risk issues, reducing incentives to participate (leftward shifts of the curves).

Overall, it is not possible to state with any certainty that any of these effects will dominate over the others. Thus, a cautious conclusion is that there is likely to be no noticeable consequences for the overall volume of intermediation (and thus any macroeconomic effects would arise from changes in the composition of financing).

The preceding discussion regarding the volume of intermediation focuses on the flow of valuable services from matching demand and supply of funds in primary markets. But there is also a flow of valuable services for owners of financial assets from portfolio (and risk management) services, secondary market trading, and payments services, for which fees charged and bid-ask margins cover

[5] There is so little in the way of direct dealings between end users without the use of an intermediary or broker/agent that this can be ignored.

[6] This could reflect direct costs of regulatory imposts or higher required returns of owners to compensate for increased risk of regulatory non-compliance. There could also be an opposing effect if increased scrutiny and competition led to lower remuneration and reduction in (any) excess profit levels.

profits and wages cost. This is reflected in the value added (contribution to GDP) of the financial sector. In addition, some significant part of financial sector value added comes in the form of "financial services" as defined separately from "financial products" in the Corporations Act. Provision of financial advice is the most obvious of these.

Similar difficulties (to those in assessing the RC impact on financial intermediation) also apply in assessing its impact on the volume (and price) of services provided to asset owners. Again a cautious conclusion is that, with the possible exception of financial advice services to retail customers, there will be little discernible effect on the size of the sector as measured by its contribution to GDP.

Finally, another commonly used metric in examining the significance of the financial sector is the size of balance sheet footings (intermediary deposits and liabilities, assets under management, etc). Such metrics have increased markedly in size over recent decades due partly to increased complexity and intra-sector transactions. Arguably, the RC could lead to a simplification of financial arrangements, such as fewer counterparty dealings and long intermediation chains, and thus a decline in the size of the sector based on asset and/or liability aggregates.

## 2. Changes in the pattern of the flow of funds

The RC could affect the flow of funds to or from particular end-users if the relative costs, returns and risks to financial entities change in dealing with different user groups. It could also affect the types of fund-flows (long-term versus short-term contracts, financial products involved, institution types involved).

The RC was primarily engaged in examining misconduct issues affecting retail customers of financial entities. It might thus be expected that proposed regulatory changes (and costs of improved internal control systems) would increase the costs of intermediation in dealing with retail customers relative to business customers. (SME lending, where the distinction with retail lending is often blurred due to proprietor loan guarantees or provision of collateral, was also a focus). In the absence of changes in interest rates or fees charged to customers, balance sheet composition of lending could be expected to tilt more towards business finance. Whether that would be offset by relative changes in interest rates or fees charged to customers depends on the extent of competition between affected intermediaries and others. Some relative decline in the allocation of funds to retail customers might be expected, although the emergence of fintech competitors in this space could disguise any such effect. It seems unlikely that there would be substantial changes in the relative flow of funds from different end-users, although the effects of a prolonged period of very low interest rates, domestic and international economic uncertainties, and government budgetary changes on savings will confound things.

## 3. Organisational Structure of Financial Firms

A trend emerging around the time of the RC has been the spinning-off by banks of wealth, advice, and insurance subsidiaries. Some have interpreted this as a response to, or pre-emptive move to the RC. Many of the issues of poor conduct have been related to those activities and substantial amounts of remediation costs paid to customers.

While the RC is no doubt relevant to these decisions, it is likely that it is other influences driving the decisions. Banks decided to diversify their financial product and services offerings over several decades following the deregulation of the early 1980s. Underpinning those decisions was the availability of large distribution networks of branches and staff, providing an opportunity to "cross-sell" products and benefit from scope economies. In hindsight, the conglomerate approach was a failed experiment. The ability to develop internal control and management processes dealing with such diversified service and product provision was clearly lacking. The organisational and staff culture (partly driven by profit and sales goals) and incentives (such as service quality, sales volume, profits) associated with the different activities were somewhat incompatible with each other and with good customer outcomes.

More significantly, recent divestment decisions can be interpreted as a response to the impact of technological change on the feasibility and profitability of alternative product/service distribution methods and business models. Reductions in the real resource transactions costs associated with internet dealings with customers has reduced benefits from branch and staff networks. Customers are able to access a greater range of (not always good) information about alternative products and suppliers via electronic means – and potential providers of services are now less handicapped by lack of physical (bricks and mortar) outlets and costs of marketing and advertising. One consequence of this is the increased importance of the strategic decision for large financial entities regarding the role of outsourcing of parts of the supply chain to third parties (such as mortgage brokers) as opposed to relying on in-house processes. Operational costs may be different, but so also are exposures to conduct risk.

A different aspect of financial entity organisational structure relates to firm objectives, governance and ownership. The RC noted in its Interim Report[7] that single-minded pursuit of profit was one of the drivers of the misconduct and poor behaviour observed. "Much if not all of the conduct identified in the first round of hearings can be traced to entities preferring pursuit of profit to pursuit of any other purpose." (p54). In this respect, it is not surprising that "for-profit" entities featured heavily among the misdemeanours observed relative to "not-for- profit" entities. In the superannuation space, retail (for-profit) funds were seen to involve significant conflicts of interest between interests of owners and the best interests of customers, while industry (not-for-profit) funds were judged to be significantly less conflicted. In the banking space, attention was focused on the "for-profit" banks and virtually no issues raised concerning behaviour of mutual and cooperative (not-for-profit) ADIs (which admittedly are only a small part of the total market).

It appears that the adverse reputational consequences of the RC for "for-profit" superannuation funds has had an effect on choices of customers. As Table 1 shows Industry funds have experienced substantially higher growth rates than retail funds since the commencement of, and issuance of the final report, of the RC. (Unfortunately data on changes in the number of accounts which would give a better indicator of member switching does not appear to be available).

### Table 1: Superannuation Funds: Relative Growth Rates

| | Growth in Total Assets: Superannuation Funds | |
|---|---|---|
| | March 2019 v Dec 2018 | March 2019 v March 2018 |
| Corporate | 5.5% | 4.8% |
| Industry | 7.6% | 13.1% |
| Public sector | 3.1% | 7.3% |
| Retail | 5.8% | 3.5% |

[7] Hayne KM (2018) Royal Commission Into Misconduct In The Banking, Superannuation And Financial Services Industry. Interim Report. Canberra: Commonwealth of Australia. https://financialservices.royalcommission.gov.au/Pages/default.aspx

Source: APRA: [Quarterly Superannuation Performance Statistics March 2019]

In the case of deposit taking institutions, any analysis is complicated by the lack of relevant statistics published by APRA. If there were to be any effect of the RC on consumer choices, it would relate primarily to decisions made by retail customers. Unfortunately no breakdown of deposits or loans between retail and other customers is publicly available. Examining figures for total loans and deposits (Table 2) it appears that over the period of the RC the major banks' growth has slowed relative to that of mutual ADIs, as well as compared with foreign banks. (Foreign branch banks can be ignored in this comparison given their restricted and limited dealings with retail customers. For foreign subsidiary banks, it is not possible to identify causes of the growth without access to further data). Given the variety of other factors affecting bank and ADI performance and the coarse nature of these statistics it is only possible to say that they are consistent with an hypothesis that the RC would have increased the attractiveness of mutual ADIs to the major banks.

Table 2:Bank and ADI Growth

| | **Growth in Total Assets** | |
|---|---|---|
| | March 2019 v Dec 2018 | March 2019 v March 2018 |
| Major banks | -0.4% | 2.4% |
| Other domestic banks | -2.7% | 2.0% |
| Foreign subsidiary banks | 3.3% | 11.9% |
| Foreign branch banks | 7.1% | 9.7% |
| Mutual ADIs | 1.6% | 6.8% |
| | **Growth in Deposits** | |
| Major banks | 0.2% | 2.3% |
| Other domestic banks | 2.0% | 6.3% |
| Foreign subsidiary banks | 3.0% | 11.9% |
| Foreign branch banks | 9.7% | 13.3% |
| Mutual ADIs | 1.3% | 6.5% |

Source: [Quarterly authorised deposit-taking institution performance statistics March 2019]

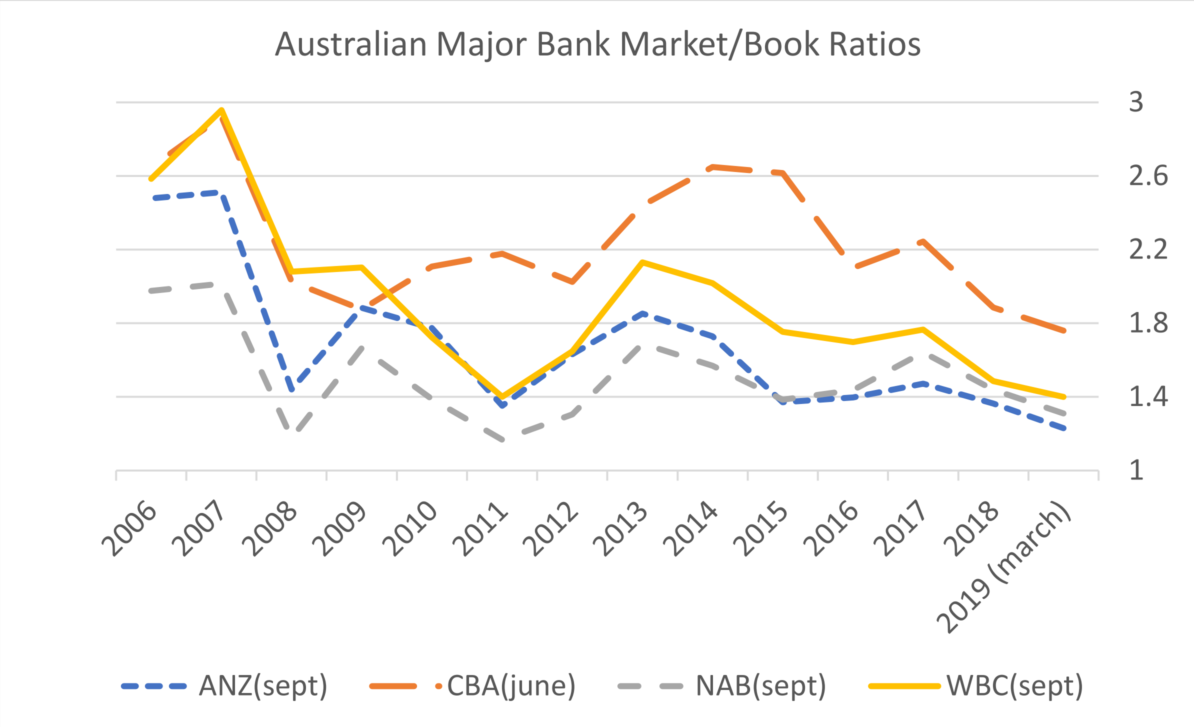
## 4. Major Bank Profitability and Valuation

It appears that the RC has had adverse effects on major bank profitability and the stock market valuation of bank equity. Regarding profitability the channels of effect can be divided into:

- Short term direct effects via customer remediation expenses and other costs
- Longer term costs of business process changes to ensure compliance with responsible lending, rebuilding customer trust etc
- Profits/losses on divestments of wealth/advice and other businesses and the consequences for future income flows

Expectations of lower future profitability are reflected in reductions in the market valuation of bank equity. Figure 2 illustrates how the market/book ratios for major banks' equity have declined over the course of the RC and after its report – although as the data for the earlier years indicates there are many other relevant factors involved. These include the consequences for profitability of higher regulatory capital ratios and market expectations of the potential impact of competition from "fintech" on bank profits.

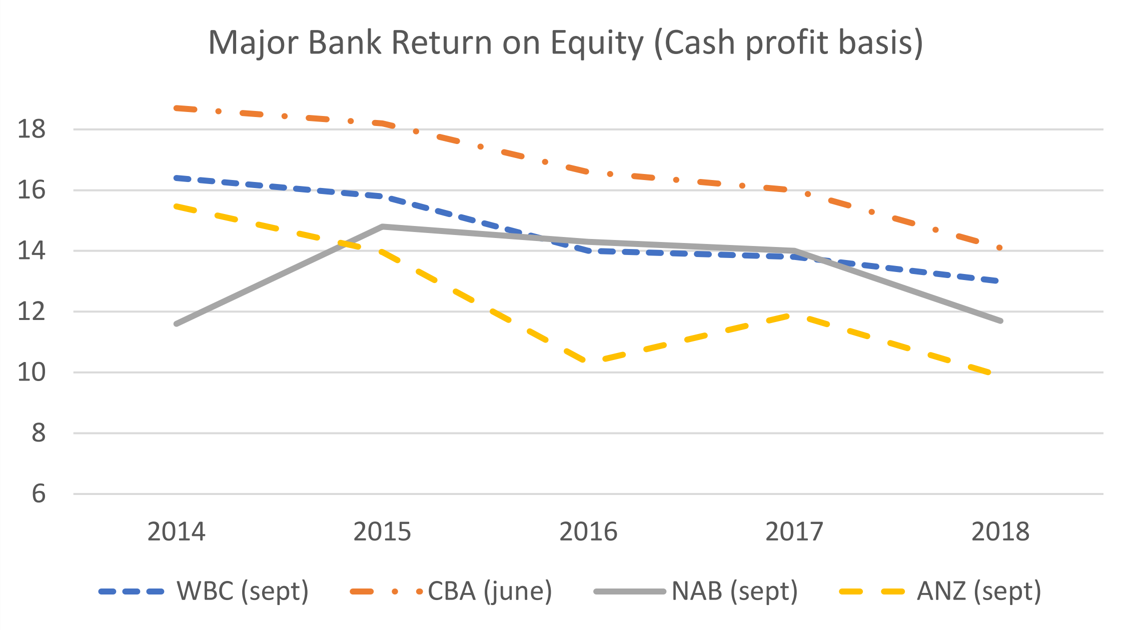
Figure 2: Major Banks - Market Value v Book Value of Equity*




** Market value calculated as stock market capitalisation of equity, Book value calculated as accounting value of shareholder equity. Source: Banks' Financial Statements*

These trends in market/book ratios are reflected in those in bank return on equity shown in Figure 3. The downward trend was evident well prior to the RC (with only the last observation encompassing the period after the announcement of the RC). Among factors explaining this downward trend is likely to be the effects of increased regulation, and the effect of the RC is unlikely to lead to a reversal of this trend.

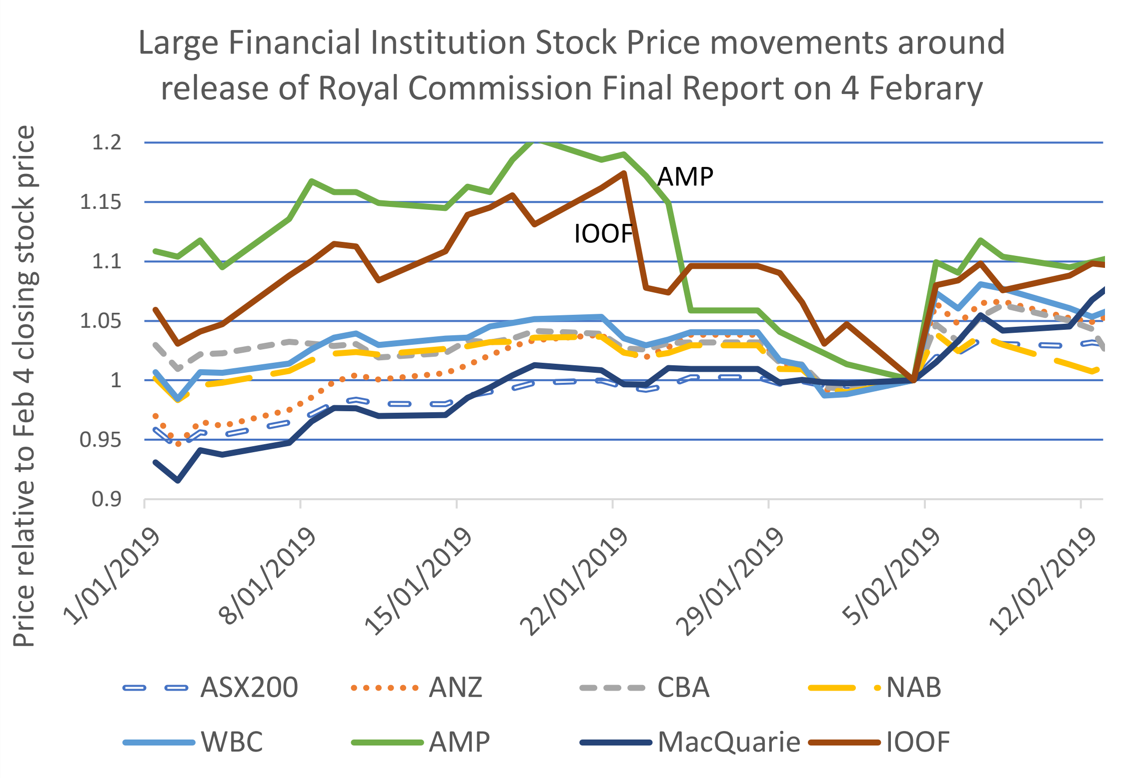
Figure 3: Major Bank Return on Equity*




**Source: Bank Annual Reports*

The RC process was generally seen as "bad news" for the major banks and other large financial institutions. However, the release of the Final Report appears to have been greeted with some relief (or as "no new bad news") by investors, as not imposing unexpectedly high costs or constraints on those institutions. Figure 4 shows how their stock prices responded on the day after the release of the Final Report, and it is noticeable that those institutions (AMP and IOOF) which had experienced the worst stock performance in the weeks prior to that date had the greatest recovery.

Figure 4: Stock price reactions to the Royal Commission Final Report*




- *Share prices are shown as value relative to February 4, 2019 closing price (the Final Report was released after trading finished on that day).*

## 5. Financial Product and Service Quality and Access

Will the RC lead to improved quality of financial products and services and treatment of customers?

In the short run, improved enforcement, increased accountability and penalties should drive improvements in internal control and incentive systems of financial institutions. These were clearly inadequate to avoid entering into (and inducing customers to enter into) financial transactions which were harmful to customers. But, as I have argued elsewhere[8] "the RC has done nothing to remove or moderate the 'pursuit of profit' objective on which most of the financial sector's behaviour is based and which can generate incentives for misconduct. Competition in such an environment of imperfect information and poorly informed financial consumers can lead to lowering of quality standards and poor customer outcomes from actions by agents which have adverse reputational consequences for the principals." In the absence of structural changes, on which the RC was silent (and realistically had inadequate time, resources, and mandate to investigate thoroughly) it is highly likely that the problems will re-emerge over time in perhaps different guises.

Interaction with the financial sector is a necessity in a modern economy. Unfortunately the level of financial literacy in the population is generally low. Gullibility and greed, or simply dire circumstances for some socio-economic classes, mean that there is a ready market for those willing to design and supply financial products which primarily benefit the supplier rather than, or at the expense of, the consumer. While those consumers who experienced or were aware (due to the RC

[8] Kevin Davis, "The Hayne Royal Commission and Financial Sector Misbehaviour: Lasting Change or Temporary Fix?" *The Economics and Labour Relations Review* 2019: 2, June, pp 200-221

process) of the past failings of financial sector conduct may be more cautious and less vulnerable, new inexperienced financial product consumers enter the market every day. The RC has not changed this.