The Hayne Royal Commission and Financial Sector Misbehaviour: Lasting Change or Temporary Fix?

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ABSTRACT

The Hayne Royal Commission into Australian financial sector misbehaviour reported in February 2019. It is, however, unlikely to provide a lasting solution to problems of financial sector misbehaviour. It has identified a number of types of misbehaviour, their 'proximate causes', and recommended solutions to those. But, reflecting its limited mandate and limited time, it was unable to investigate the complex question of whether there are more deep-seated, fundamental issues driving financial sector misconduct, both in Australia and globally. This paper argues that there are, and that consequently the benefits from the Royal Commission will relatively short lived, with misconduct likely to resurface, albeit in different guises.

KEYWORDS

Royal Commission, Financial Sector Misconduct, Financial Regulation

JEL Codes:

G20, G28, K40

Introduction

The Final Report of the Royal Commission (RC) into Misconduct in the Banking, Superannuation and Financial Services Industry, chaired by Justice K. Hayne (Hayne, 2019) was released at the start of February 2019.[1] The year-long proceedings of the Commission, highlighting numerous cases of financial sector misconduct and 'naming and shaming' wrongdoers, were a journalist's delight. The public focus induced (at least temporarily) significant changes in conduct, behaviour, and business models by many Australian financial institutions. The 76 recommendations of the Commission, most of which have bipartisan political support, may cause some structural change in the financial sector, although less than many may have expected (or wished for). Financial institutions have already begun making changes to business models and practices to conform to the recommendations. Commitments have been made by major financial institutions to instil better cultures (hopefully) less likely to lead to misconduct.

Will the effect on financial sector misconduct of the RC process and its recommendations be long lasting? Or will it be more of a temporary fix to the problems of misconduct and 'behaviour falling short of community expectations' which led to the Government (and industry) ultimately acquiescing to public demands for such an Inquiry?[2] A central argument of this paper is that the latter outcome (a temporary fix) is more likely. The Commission identified many 'proximate' causes of the problems, which were characteristics of the Australian financial sector, and proposed solutions in response to these. Those proximate causes reflected gaps in legislative and regulatory arrangements, deficiencies in regulatory enforcement, and a range of unsuitable industry practices (including unwarranted fees, mistreatment of consumers, remuneration arrangements, conflicts of interest, and inadequate internal control systems).

International experience with financial sector misconduct suggests that the problems lie deeper than the proximate (Australian) causes. (See, for example, Cherednychenko and Meinderstma (2018), Reurink (2018), Zingales (2015)). The RC did not really consider in detail whether there were more fundamental issues at play, such that the proximate causes were actually symptoms of underlying structural problems that have not been fully addressed in the report or its recommendation.

The RC's mandate also limited its focus. A flip side of financial entity misconduct and poor behaviour is harm imposed on financial consumers and retail investors. A mandate focused on that flip side of financial consumer protection would have broadened (an already broad) inquiry. But it may also have led to more consideration of other types of financial sector exploitation of unwary financial consumers, including sales of unsuitable investment products such as structured financial products, derivatives and complex managed investment schemes. As the global financial crisis (GFC) demonstrated, these can be designed to extract wealth from unwary consumers who are also exposed to further risk of loss if the business structures involved fail due to inherent structural problems or fraud. Whether it would have led to an alternative recommendation to [R6-1] to maintain the 'dual peaks' regulatory structure or instead transfer financial consumer protection to the ACCC or establish a separate financial consumer protection bureau is an open question.

Among the gaps in the RC's recommendations are the following:

- despite highlighting the role of an excessive focus on profit-seeking resulting (via various channels) in poor conduct, there is nothing in the recommendations to obviate this. Lip service by financial entities to balancing a range of goals is common, but that is no guarantee of actual behaviour. Receiving a valuable 'social licence' to operate financial businesses under advantageous institutional structures (such as highly leveraged, limited liability structures, including using deposit funding in the case of banks, with (arguably) implicit government support) should potentially bring other enforceable obligations beyond profit-making.

- While recognising that organisational culture is critical in shaping behaviour, the RC did not recommend any changes giving greater weight to stakeholders, other than shareholders, in governance arrangements and a say in shaping culture. While shareholders are the residual risk-bearers in the corporate form, in modern financial institutions they provide a relatively small share of the overall funds at risk.
- Because of its mandate and consequent focus on misbehaviour by suppliers of financial products and services, the RC did not really consider problems in the demand side of the market for financial services and products. Misconduct by suppliers requires financial consumers to enter into explicit or implicit contracts which give scope for exploitation. The RC provides little guidance on how to prevent poorly informed, unaware, financial consumers exposing themselves to becoming victims of misconduct. This is a complex area as Lusardi and Mitchell (2014: 34) indicate:

  > researchers have demonstrated that low levels of financial knowledge are pervasive, suggesting that it will be quite challenging to provide the tools to help people function more effectively in complex financial and credit markets requiring sophisticated financial decision making.

- While exhorting financial institutions to develop better internal control systems to prevent misconduct, the RC does not recommend any changes to institutional complexity which might reduce the risks of deficiencies in such control systems. (Its recommendations do, however, impose greater individual accountability and penalties when such deficiencies are exposed, which may indirectly result in changes in institutional structure).

- A significant part of financial sector activity, that of trading and position taking is redistributional in nature, aiming to profit at the expense of the counterparty. That can permeate and influence behaviour in other parts of a financial institution where it is not desirable. The RC proposes nothing in terms of structurally separating incompatible activities.

These comments should not be interpreted as a criticism of the RC which was operating to a restricted mandate and with limited time. Rather, they reflect a concern that misconduct problems reflect deeper issues inherent in all modern financial sectors which the RC was unable to consider. If that view is correct, it will likely be only a matter of time before the problems of misconduct re-emerge in possibly different guises.

Another question of interest, not considered here given space limitations, is the likely effect of the RC for the future growth, profitability and structure of the financial sector and income and employment in the sector. The finance sector is large, profitable, and pays high remuneration. Some would argue that market power enables large financial institutions to extract 'rents', at a cost to customers, which are shared with (predominantly more senior) staff.[3] Some authors (eg Bolton et al., 2016) have argued that the opaque nature of the financial sector enables significant extraction of rents and attracts an excessive amount of young talent. This reflects a concern expressed 35 years ago by Nobel Laureate James Tobin 'that we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity.' Tobin (1984: 14).

The RC's focus on fee and remuneration arrangements for agents and employees may have short-run impacts on employment and incomes. But these are likely to be swamped by changes emerging via the ‘fintech’ revolution. Whether increased risk-sensitivity of remuneration and increased agent/employee/managerial accountability and exposure to penalties, as recommended by the RC, will be effective or affect the supply of expertise to the sector remains to be seen.

Some structural effects may result from the RC’s recommendations, but, as argued above, these involve ‘tinkering around the edges’ of an existing structure, rather than advocating fundamental change. That is hardly surprising. The RC’s mandate and the short timetable allowed the RC limited scope for more wide-ranging analysis. Moreover any such inquiry, regardless of its ‘independence’, must also recognise that recommendations ultimately require political support for their implementation. Advocating substantial fundamental change is impeded by the desirability of adhering to ‘evidence based policy’ and likely ‘pushback’ by those directly affected. The burden of proof of net benefits is arguably less onerous for marginal changes to an existing structure, whereas evidence about likely effects of major changes is less readily available and support more dependent upon ideological perspectives. The ability of a RC to find or develop such evidence for radical change in its short time span is limited. Moreover, as recognised by the Commission, ‘fintech’ and the impact of recommendations of prior inquiries, recently or currently being implemented, will also change the shape of the financial sector in ways not yet fully discernible.

An outline of the paper is as follows. First, the background to and environment within which the RC was established are presented, including an overview of its mandate. Then, in Section 2 the way in which the RC interpreted the key, but subjective, metric in its mandate (‘community expectations’) is considered. Section 3 provides a brief overview of the process followed by the RC and issues arising from adopting such an approach. That leads into a brief overview of the systemic causes of problems identified by the RC in Section 4, and an overview of the recommendations in Section 5. These provide a background for considering some of the key areas which are addressed by the recommendations and their likely implications. Section 6 considers the issue of governance. Section 7 considers recommendations which could affect the profitability of certain types of business models and induce structural changes. Section 8 examines key features of recommendations for regulatory change and regulatory practices. Section 9 returns to the question of whether Australian experience with financial misconduct is worse than elsewhere, such that more fundamental issues beyond the 'proximate causes' remain to be considered. Section 10 concludes.

1. Background to the Royal Commission

The RC was established after a long, drawn out, political battle over its necessity or desirability, with the coalition Government ultimately bowing to Labor party demands for such an inquiry and continuing revelations of financial sector misconduct. The banking industry, in an 11th hour turnaround, supported the establishment of the RC in the hope that this would be a cathartic exercise, ultimately put an end to ongoing public criticism of the financial sector, and avoid other less desirable inquiries and reviews (Bligh, 2017).

It was not as if there had been a lack of recent inquiries into financial sector behaviour and practices. The Australian Banking Association (Bligh, 2017) listed 51 substantive inquiries in which it had been involved between 2007 and November 2017 (12 of which were still ongoing). Those prior inquires, including the Australian Financial System Inquiry (AFSI) which reported in November 2014, (Murray et al., 2014), had made many recommendations for changes to financial sector regulation and practices. Many of these, aimed at achieving better outcomes for financial consumers, were in various stages of implementation, or had not been in operation for long enough to assess their overall consequences for the financial sector and its participants.

In making its recommendations, the RC was thus faced with the problem of whether the financial regulation reform agenda already under way would prevent repetition of at least some of the misconduct problems which it examined, and how its recommendations would mesh with that agenda. Also relevant is the growth of 'fintech' which has significantly lowered the resource/transaction costs associated with financial product distribution and increased the availability of information (and potential for misinformation). Recommendations would need to take into account the likely emergence of new types of financial entities and changes to business models of established entities. As one illustration of these challenges, the RC was firmly of the view that there should be no 'hawking' of financial products [eg R3-4, R-4-1]. But it did not appear to address whether internet search engine tailoring of adverts for financial products, based on information previously acquired about the viewer, would fall under this category, and how to deal with this.

The RC was given a specific mandate, and its findings and recommendations need to be considered within that context.[4] In brief, the RC was charged with investigating the extent of misconduct and behaviour falling short of 'community standards and expectations' by financial services entities, and the effectiveness of redress mechanisms for affected consumers. It was asked to investigate possible causes, with a focus on culture, governance, risk management, remuneration and recruitment. It was charged with recommending prosecutions where relevant and making recommendations for changes to prevent future recurrence. Recommendations could relate to laws and regulations, regulatory practices, or financial entity and industry practices.

The task of identifying cases of misconduct involving violation of laws and regulations, and making referrals for prosecution, is suited to a legal approach such as a RC, and 24 such referrals were made.[5] However, the other aspects of the RC's mandate were more nuanced, and these are taken up in the following sections.

2. Community Standards and Expectations and Competition

An initial consideration for the RC given its mandate was to determine a benchmark for judging that behaviour does not meet 'community standards and expectations'? The RC did not explicitly provide such a benchmark. On the first day of hearings Justice Hayne instead referred to the argument of the Australian Financial System Inquiry (Murray et al. 2014) and suggested that:

> fundamental to fair treatment is the concept that financial products and services should perform in the way that consumers expect or are led to believe. Fairness, understood in this way, may lie at, or at least close to, the heart of community standards and expectations about dealings with consumers (Royal Commission Hearings, Transcript February 12, 2018, para 35).

That premise helps to explain the RC emphasis on matters such as unsuitable products, misleading advice, fees for no service, etc but it is far from a definitive benchmark. It implies that behaviour leading to customers entering into financial contracts, which involve an expected transfer of value from them to the counterparty, would be unfair (since entry into such contracts might not occur with well-informed consumers).

The literature on fairness (see, for example, Fehr and Gächter, 2000) provides some insights here. Customers who perceive such unfair treatment (actual or intended) may reciprocate by 'punishing' the counterparty – for example by taking their business elsewhere. However, one of the features of many financial products and services is that they have features of 'credence' goods (Dulleck and Kerschbamer, 2006). The less than perfectly informed consumer is unable to properly assess the worth of various alternatives. S/he thus relies on the advice of an 'expert' or 'certified' supplier in making a decision whether or not to consume or in choosing between alternatives available. Even more problematic is the fact that such customers may not be able to assess whether the financial service was appropriately performed or the financial contract was worth the price involved *ex post*.

Akerlof and Shiller (2015) provide a number of illustrations of the way in which competitive markets with imperfect information and some unscrupulous suppliers can lead to a 'phishing for phools' equilibria involving contracts which expropriate value from at least some consumers. In his American Finance Association presidential address, Zingales (2015) highlights the need to focus on, and rectify, causes of financial sector failings, arguing that (justified) trust in the sector is necessary to achieve the benefits for economic growth and welfare that the financial sector can bring.

However, the RC approach does not categorise as unfair those situations in which a trade benefits both parties but in which a disproportionate share of the gains from trade accrues to one party as a result of superior information and/or market power. It thus is unable to deal with situations in which, for example, financial enterprises make abnormal profits from the pricing of financial products and services provided. It does not therefore consider the extent to which the oligopolistic structure of Australian banking and financial markets facilitates such outcomes. Publicised cases of misconduct have led to much of the community antagonism towards large banks and other financial entities, but so also have sustained levels of high (possibly excessive) profits.

An important issue here is the role of financial sector competition, with a recent Productivity Commission Report (Productivity Commission 2018) making recommendations for ways to improve competition. Competition amongst suppliers might be expected to preclude pricing which exploits market power and generates abnormal profits, by giving consumers a range of choices. The Royal Commission observes: 'Competition in parts of the

Australian financial services industry is not always strong and has not prevented the misconduct considered by this Commission.' (Hayne, 2019: 422).

However, it is far from obvious that competition inhibits misconduct. In an imperfect information environment with imperfect verifiability of causes of outcomes, a 'race to the bottom' in terms of quality may prevail. Akerlof (1978) provides the seminal exposition of this possibility in his analysis of a 'market for lemons'. In the context of financial markets, suppliers of financial products could either underinvest in ensuring quality products or over-price the products they sell to trusting customers in the quest for higher current profits. Such a 'race to the bottom' could occur in terms of lower service quality, not apparent to the customer, or in lowering of ethical standards. Shleifer (2004) provides a number of examples of this across a range of industries, while Egan et al. (2019) and Rud et al. (2018) are among recent papers examining the effect of competition on moral standards in the financial sector. Di Maggio et al. (2016) find evidence of a 'race to the bottom' in terms of predatory lending upon the relaxation of regulation in the USA, which is more pronounced in areas where higher competition prevailed.

There is a long literature which examines whether concerns over reputation (and thus future profit opportunities) will prevent such adverse outcomes. Arguably the answer is 'it depends' on the likelihood of exposure, the resulting costs of reduced reputation, and the cost of restoring reputation. This provides support for some types of regulation to protect consumers and impose regulatory penalties and facilitate consumer compensation. The RC recommendations accept a need for increased regulation relative to reliance on institutional reputation maintenance.

3. The RC Process

The RC adopted primarily a 'case-study' approach, presenting in its public hearings specific cases of misconduct and poor conduct from amongst the vast number of submissions made to it. Areas covered in the seven rounds of hearings were: Consumer Lending; Financial Advice; SME [Small and Medial Enterprise] Lending; Financial Services and Regional and Remote Communities; Superannuation; Insurance; Causes of Misconduct and Regulatory Considerations.

Notably absent from this list (other than indirectly through the financial advice focus) is creation and sale of unsuitable investment products, such as structured products, derivatives and certain types of managed investment schemes. This was rife prior to the Global Financial Crisis [GFC], and the limitation of the RC's mandate to the period after the GFC meant that purveyors of such products, including investment banks and fund managers, largely escaped scrutiny of these activities by the RC. The growth of self-managed super funds (SMSFs), a sector not considered by the RC[6], has created a large, obvious, target market for sales of such unsuitable products to once again thrive. Whether the RC support of financial advice reforms and the adoption of product suitability obligations and ASIC product banning powers recommended by the AFSI will be sufficient to prevent this, remains to be seen.[7]

While case-specific, the issues identified in the case-studies were argued to be representative of more widespread failings – and provided good cannon-fodder for the media. Whether these were the 'tip of the iceberg' or atypical failings of otherwise sound practices in the financial sector is an obvious question. The RC had little doubt that the former interpretation was appropriate based on the volume of submissions (over 10,000) it received and issues with business practices and conduct exposed in its hearings.[8] However, by focusing on specific types of misbehaviour the risk arises that recommendations will deal with specific causes of those, but not be of sufficient generality for dealing with other types of misbehaviour. The RC's recommendations [R7-3, R7-4] to eliminate exceptions in legislation and to link legislation to fundamental norms are general in nature, but by that very feature are easy for government to agree with but difficult to implement effectively.

One risk of the RC approach of focusing on 'bad' outcomes of the financial system, is that it may lead to disregard for its 'good' outcomes. Recommendations focused primarily on dealing with the former may adversely affect the ability of the financial system to deliver the latter. Opposition by various interest groups to particular RC recommendations typically argue this way, often relying on (generally unsubstantiated) claims about adverse consequences for such things as the supply and cost of credit, access to financial advice, and financial market competition.

A further shortcoming of the RC case study process lies in assessing whether the misconduct and undesirable behaviour observed is peculiarly an Australian problem, or one common in most financial systems. If the latter, then, either way, it suggests some fundamental problems warranting rectification, which ultimately go beyond the scope of the RC.

Another shortcoming from the RC process (albeit reflecting its mandate) is that the search for solutions lies primarily in examining behaviour of one side of the participants in financial contracts. Misconduct and unfair behaviour can only prosper if there are potential counterparties (customers) who are inadequately informed and unable to identify contracts which are to their disadvantage. Campbell (2016) stresses the tendency of financial consumers to make mistakes in financial decisions, reflecting low financial literacy, behavioural biases, increasing financial product complexity, and various developments which have made lifecycle financial management more complex. The RC, reflecting its mandate, does not look at this side of the equation (other than via its analysis of the 'intermediaries' who provide advice, and via the role for compensation schemes). It thus has little in its recommendations to reduce the size of the 'market for misbehaviour' via improving financial consumer decision-making.

4. Problems Identified and their Perceived Causes

> 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 (Hayne. 2018: 54).

Of course, pursuit of profit is not necessarily a bad thing. Ever since Adam Smith discussed the benefits of the 'invisible hand' of the market, economists have advocated the merits of self-interested, profit-seeking, behaviour for economic efficiency. But that benefit is (or should be) tempered by recognition of the situations in which problems can arise. Zingales (2015) provides a recent perspective on the extent of financial sector misconduct globally, the need to be aware of both the benefits and costs of finance sector activity, and whether growth of the finance sector has added value for society.

In a world of imperfect information and where transactions costs can be important, individuals will often seek advice from and delegate decision-making authority to others who act as their 'agents'. But self interest on the part of the agent can lead to conflicts of interest and outcomes not in the best interests of the principal (the well-known principal-agent problem), while the skills and competence of agents may vary markedly but be non-verifiable to the principal. This problem is aggravated by the complexity of financial products and services and also by the complexity of laws and regulations. These problems arise both at the individual level and also within large financial entities where internal control structures are needed to align interest and behaviour of employees with those of the entity and its owners. Failures of corporate governance arrangements to achieve such alignment are thus a potential cause for concern, and invite the question of why such failings should occur and persist. Garicano and Rayo (2016) examine the role of agent's incentives and bounded rationality in organisational structures which help answer this question). Regulatory scrutiny and enforcement are meant to prevent such behaviour inconsistent with community norms and expectations.

The RC found failings in all of these areas. Competency standards were not always adequate and business remuneration models gave rise to conflicts of interest which were not necessarily disclosed to the customer. Governance arrangements were inadequate to ensure that ethical standards and behavioural objectives professed by company leaders were maintained throughout the organisation. Legal and regulatory complexity allowed for unscrupulous actors to find loopholes for personal enrichment at the expense of customers. Regulatory enforcement practices did not appear to provide adequate punishment nor general deterrence to inhibit unacceptable behaviour. Self-regulation by industry and professional associations failed to prevent misconduct and poor behaviour (at least partly attributable to self-interest of decision-makers in those bodies).

The Commission's analysis of issues and potential solutions is based on a number of underlying norms of good behaviour. These are:

- obey the law;
- do not mislead or deceive;
- act fairly;
- provide services that are fit for purpose;
- deliver services with reasonable care and skill; and
- when acting for another, act in the best interests of that other. (Hayne, 2019: 8-9).

These are hardly controversial and reflected in laws and regulations (and their enforcement) designed to prevent non-compliance by criminals and ensure compliance by otherwise honest citizens.

This raises the question of why employees in financial entities who would generally subscribe to such principles may be induced, perhaps unwittingly, into non-compliance, as exposed in the RC case-studies. Some part of the reason may lie in the fact that only the first principle (obey the law) is black and white in nature. All the rest are open to subjective interpretation of whether actions are compliant. If a counterparty doesn't really understand the potential consequences of a financial product which have been set out in some detail, is it misleading or deceptive behaviour to enter into the contract (particularly given difficulties in assessing the degree of counterparty understanding)? What division of the expected gains from trade between the counterparties is fair? If a range of services or quality of service levels exist, what should be chosen as being 'fit for purpose' and what price can/should be charged? How can 'best interests' of a principal be clearly identified when financial contracts have multiple dimensions (such as risk and return) over which the principal's preferences may be ill-defined and hard to elicit?

In the pursuit of profit, it is easy for individuals and organisations to slide into behaviours and practices which can be justified as meeting these principles, even though the outcomes are primarily to their benefit (profit) rather than that of the other party in a transaction. There can be little doubt that high rates of profit in banking and other parts of the financial sector, and high remuneration levels, are part of the cause of community concerns about financial sector behaviour. Those concerns may be rationalised in the context of 'fairness', such that behaviour exploiting market power to capture most of the gains from trade and generating such high profits and remuneration are inconsistent with 'community standards and expectations'. But the RC approach unfortunately does not lend itself to a direct focus on such cases.

It must also be noted that some (possibly a major) part of financial sector activity is redistributional in nature, rather than directly creating social value by way of production of valuable goods and services. In financial market trading participants aim to benefit at the expense of counterparties by use of private information or superior interpretation of market developments. The conventional economics argument is that such activities do add social value by incorporating valuable information into financial prices and consequently leading to decisions involving better allocation of economic resources. That may well be the case, but the pervasive influence in financial entities of activities involving trading for private profit, at the expense of the counterparty, may lead to acceptance of such an approach in other parts of the organisation. Pre-GFC examples of complex structured products being designed and sold to ill-informed customers which are likely to transfer value from the customer to the seller are a case in point.

5. The Recommendations: An Overview

The 76 recommendations focus primarily upon issues specific to the four sectors of banking, financial advice, superannuation, insurance, as well as upon more general culture/governance/remuneration issues and the activities and oversight of financial regulators.

Given the range of poor behaviours by large financial institutions exposed by the RC process, the final report was likely a relief for those institutions – although not for various individuals who were on the receiving end of some harsh criticism.[9] Indeed, the stock market response to the release of the report (after trading closed on 4 February) was positive for the major banks and wealth managers. In the following days and weeks, the share prices of those institutions kept pace with or exceeded the market generally.

Of course, that may have been as much a relief that the recommendations could have been much worse for the organisations. Over the life of the RC, uncertainty about the process and its outcomes arguably weighed upon financial sector stock prices. Over that period, the banking and financial sector stock indices slightly lagged the general stock index, after significantly outperforming in prior years.

The Commission helpfully cross-references the recommendations to the key issues which it has sought to address (Hayne, 2019: 43-50). These are:

- Simplifying laws and removing exceptions (such as grandfathering) in current legislation/regulation
- Removing conflicts of interest
- Improving the implementation of, and compliance with, regulation
- Improving culture, governance and remuneration practices in financial entities
- Increasing financial consumer protection

It is neither possible nor desirable to examine individually each of the recommendations in the space available here. Many require marginal (but potentially significant) changes to law, regulations and industry practices. But several themes emerge related to the objectives listed above. They reflect a more interventionist philosophy than has prevailed since the early 1980s.

One is the willingness of the RC to recommend direct controls on, or regulatory oversight of fee and commission structures and levels, and remuneration arrangements within the financial sector. [R1-3, R2-5, R4-4, R5-1]. A second is greater application of *caveat vendor* rather than *caveat emptor* regarding the suitability of financial contracts. [R1-2, R1-17, R4-5]. A third, related theme is the demise of the free market policy approach of relying on disclosure, education and advice for achieving good financial consumer outcomes.. [R4-5]. Fourth, the RC has illustrated the failings of reliance on self-regulation by industry and professional associations, implying increased need for formal regulation (and enforceability of industry codes). [R1-15, R1-16, R2-10, R4-9]. Fifth, simplification of law and regulations suggests a shift towards greater reliance on 'black letter law' rather than a 'principles based' approach. Sixth, the RC closes some loopholes in what is regarded as a financial product or service (eg funeral bonds [R4-2], add-on insurance [r4-4], insurance claims payout practices [R4-6, R4-8]). It does not, however, attempt to provide an improved overall definition (nor remove the arbitrary legislative distinction between credit products versus financial products and services). Seventh, increased penalties for breaches of law, regulations, and industry codes are recommended along with more robust regulatory approaches to identify such breaches, and obligations for self-reporting [R1-2, R1-6, R2-8, R2-10, R3-7, R4-9]. Eighth, the recent government initiative for a compensation scheme of last resort for financial consumers suffering loss is supported [R7-1]. While making provisions of industry codes of conduct enforceable [R1-15] and increases in regulatory powers should assist in improving dispute resolution, retail financial consumers arguably still face a non-level playing field when dealing with large financial institutions.

Rather than attempting to analyse the merits of each of the specific recommendations, in the following sections, several of the major topics are considered.

6. Corporate Governance

Although the RC was highly critical of governance standards in financial institutions, its recommendations largely ignore potential changes to 'external governance' arrangements and focus on 'internal governance'. Figure 1 provides a simple schematic outline of relationships relevant to governance issues both within the firm and involving external stakeholders to illustrate the issues.

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Internal governance refers to the processes and practices within the entity, which aim to ensure that objectives set by board and senior management are achieved, and relates to the area shaded in grey in Figure 1. It can be referred to as the ‘control system’, which the RC found wanting in most large financial entities. It incorporates remuneration structures, risk-management processes, setting of performance indicators, individual and collective accountability, etc.

By ‘external governance’ I refer broadly to the ownership-control relationship. In principle, ultimate owners (shareholders) can exert influence on firm performance and behaviour either through ‘voice’ (choosing board members and engaging in discussion with the firm’s principal decision-makers) or ‘exit’ (by way of sales of shareholding). Other financial stakeholders (depositors, bond-holders, investors, policy-holders, etc.) can also use the ‘exit’ mechanisms but have limit ‘voice’ opportunities.

In its background paper for the RC, Treasury (2018) noted a number of ‘direct regulation’ approaches to corporate governance arrangements (some finding favour in other jurisdictions), which fall under the heading of external governance. These included limits on director external activities or tenure, but could go significantly further to encompass inclusion of other stakeholder representation in governance (such as in the European model of dual boards)[10], or mandating specific objectives of boards. For example, while boards of life insurance companies are required to give priority to policy holder interests over shareholders, and superannuation trustees and Responsible Entities have legal ‘best interest’ obligations to their beneficiaries/members, no such obligations exist for ADIs or general insurers.[11] Mutual and cooperative financial institutions (where the RC did not expose any issues of poor behaviour) have an objective of providing benefits for member/customers.

The RC did not pursue any such options, instead appearing to rely on the legal requirement that '[d]irectors must exercise their powers and discharge their duties in good faith in the best interests of the corporation, and for a proper purpose.' (Hayne, 2019: 402), and the assertion that '[i]n the longer term, the interests of all stakeholders associated with the entity converge.' (Hayne, 2019: 403). Even if that is true, it could be asked whether other external governance arrangements might achieve a better outcome more rapidly. As Keynes (1923: 80) observed 'in the long run we are all dead'. In complex organisations, some agents may have short-term incentives that can lead to actions which risk diminution of the firm's reputation and are thus against the interest of at least some stakeholders.

Indeed, the RC appears to pay little attention to the ownership – control nexus which underpins external governance structures of firms. There are two relevant considerations here. One is that while equity holders are at risk of loss of their investments (although protected against further loss via limited liability structures), in non-financial firms their potential losses generally dwarf those of other stakeholders (creditors, employees, government etc) who have lower investment stakes. But in the financial sector, equity holders or principals, typically have much less skin in the game than other providers of finance or stakeholders due to the very high degrees of leverage employed. In modern banks shareholders contribute generally less than 10 per cent of total bank funding.[12] In non-financial firms, creditors will endeavour to exert governance influence via use of covenants, but this is not so common in banks or other financial firms, reflecting the impediments such covenants would impose to efficient banking practice. Arguably, some form of governance by 'voice' (representation in some type of board structure) could be provided to depositors, governments (reflecting implicit guarantees) or employees. Whether such greater diversity of representation in governance would lead to improved outcomes (culturally, financially, or socially) is unclear, but the argument warrants examination. While the RC could not be expected to provide a specific recommendation to adopt some such change, it could have recommended further investigation.

The second consideration is that the ownership structures of listed firms in the modern economy has now evolved to a situation where institutional investors such as superannuation funds hold significant shares in most financial entities. The corporate governance role of such investors, involving demand for short-term profit while often playing a limited role in exercising voting power is relevant. Given the emphasis placed on the effect of 'pursuit of profit' on financial entity behaviour in the RC, it is perhaps surprising that the RC had nothing to say on this topic. This is a problematic area for superannuation funds charged with promoting members' financial interests while also being major shareholders in other financial institutions.

The only real focus on external governance arrangements was in the area of superannuation. To the extent that the inclusion of a reference to superfund governance in the RC mandate by the coalition Government was an attempt to expose failings in the industry fund model, and limit union influence, it misfired dramatically. Significant governance shortcomings were exposed in the for-profit retail funds sector due to conflicts of interest, with limited shortcomings discovered in the industry fund sector.

The RC briefly considered the question of whether 'for-profit' entities should be precluded from operating institutional superannuation funds, but did not pursue this option. 'Not-for-profit' funds have generally achieved better performance for members in the recent past. But the RC considered that this would not necessarily occur in the future if it could be ensured that conflicts of interest could be removed (such as by requiring a single purpose role for the trustee of a registrable superannuation entity [R3-1]). Likewise, despite pointing to the role of pursuit of profit as a cause of misbehaviour, the RC made no comment on the absence of cases of misconduct found in the not-for-profit mutual and cooperative ADIs [Authorised Deposit-Taking Institutions].

The RC's main focus was on the 'internal governance' arrangements, including remuneration structures [R5-1, R5-3, R5-4, R5-5], management of 'non-financial' risks [R5-2, R5-3], increased executive accountability such as via the Bank Executive Accountability Regime (BEAR), ([R1-17, R3-9, R4-12]), and regular in-house and regulatory assessments of governance and culture [R5-6, R5-7]. An important question here is the nature of the 'market failure' that leads to owners not ensuring 'optimal governance' structures such that a possible case exists for regulatory intervention in such internal governance arrangements. One argument simply may be that in complex organisations internal control structures arising from delegation of decision-making to agents are imperfect and the deficiencies not observable to the principals. At the higher levels of the organisation, boards may be 'captured' by management and fail to implement structures which protect owners from loss due to erosion of firm reputation, brought about by management actions in search of personal rents. More generally, the ownership structure may affect incentives for design of internal control mechanisms and reputation management (Noe et al., 2015). That may suggest a case for different/improved external governance mechanisms. However, while it may be possible to draw a link between prudential regulation and non-financial risks associated with firm culture and governance, it is by no means obvious that APRA [the Australian Prudential Regulation Authority] rather than the corporate conduct regulator ASIC [the Australian Securities and Investments Commission] is best suited to act as a 'governance/culture' regulator as implied by recommendations [R5-2, R5-3]

7. Structural Change and the Boundaries of the Financial Firm

There is a long literature on the boundaries of the firm, beginning with Coase (1937) addressing questions such as the reasons for organisation of production and marketing activities within a hierarchical control structure rather than via use of market contracts. Within the context of the RC there are (at least) three main issues considered which are related to this question.

The first is the role of what the RC calls ‘intermediaries’ in providing information and connecting together potential consumers with producers of financial products and services. The focus here has been particularly on the use of ‘independent’ financial advisors, mortgage brokers, insurance brokers/agents, and product sellers, as complements to ‘in-house’ staff performing similar roles.

The second issue is the role of vertical integration within financial firms, particularly the role of banks and other financial entities in producing financial products, and distributing those via financial advisers using software ‘platforms’ provided by the banks.

The third issue is the role of horizontal integration within the financial sector. In particular, banks having expanded beyond ‘traditional banking’ activities of deposit taking, lending and provision of payments services into wealth management, insurance, financial advice etc. Regulation of this expanded model of ‘financial conglomerates’ is often referred to as a ‘bank assurance’ model.

Horizontal and Financial Integration

Horizontal and vertical integration took off in earnest following the financial deregulation of the late 1970s – early 1980s, and expanded through the 1990s and early 2000’s. During the course of the RC a number of banks began the process of disposing of some such ‘non-banking’ (wealth management, insurance, financial advice, etc) activities. While the RC considered the possibility of limiting integration, in the absence of convincing evidence on potential effects, it did not go down this path. Instead, it supported a Productivity Commission recommendation for regular market studies on the effect of vertical and horizontal integration in the financial system (Hayne, 2019: 196) and noted the AFSI recommendations aimed at reducing risks to customers from vertical integration.[13]

Why then are the divestments occurring? One explanation is that these ancillary activities have proven to be somewhat unsuccessful for the banks. The profits obtained have been a relatively small part of overall profit, and many of the problems exposed during the RC and compensation payments being made by the banks have resulted from those areas. Given the control problems exposed, the game has not been worth the candle.

Another explanation, not inconsistent with the first, and influencing the RC approach, is that the advent of 'fintech' is changing the economics of financial product distribution. The banks' expansion into other areas, reflected partly the fact that they had well established distribution networks for financial products and services in the form of branch networks and staff. These, it was felt, could be used to sell a greater range of products and services to obtain a 'greater share of wallet' and achieve cost economies. The advent of the internet has changed the economics of financial product and service distribution. Customers could obtain information remotely and (generally) undertake transactions such as purchase of insurance remotely. The competitive benefit which the banks thought they had under old technology for product distribution no longer applies.

Commission and Fee Structures – Mortgage Broking

While the RC did not recommend forcing structural separation, a number of its recommendations could, by changing the viability of particular business models, impact on financial sector structure. Particularly relevant here are recommendations to prevent commission and fee structures which are viewed as creating conflicts of interest [R1-3, R2-1, R2-4, R2-5, R3-2, R4-3, R4-4]. Intermediaries such as mortgage brokers, insurance brokers, and financial advisers undertake a ‘multi-activity’ role involving both provision of advice to financial consumers and selling to them financial products from product manufacturers. Remuneration structures can create or aggravate conflicts of interest involved and thus consumer outcomes. Inderst and Ottaviani (2012) provide an analysis of why commission structures have evolved as a common form of remuneration, which depend in part on the mix of wary versus uninformed consumers, illustrating how an optimal regulatory intervention is likely to depend on that mix. The RC recommendations appear most suited to the case in which most consumers are uninformed, which, given the complexity of product choices available, does not seem an unrealistic assumption.

Possibly the most controversial recommendation of the RC, lacking political support at the time of writing following industry lobbying, has been the proposal that the commission-based remuneration structure for mortgage brokers be replaced by an up-front customer fee model. This reflects the RC’s view that commissions paid by product suppliers lead to a conflict of interest for the intermediary (the broker) which presents itself as acting in the interest of the potential borrower. These conflicts manifested themselves in such outcomes as larger loan sizes and more interest-only loans, which generate increased broker commission revenue, and were not necessarily in the borrower’s best interests. A prior study by ASIC (2017) had reached similar conclusions, including finding no evidence of loans via brokers being cheaper for the borrower, and recommended changes to the remuneration model, but none as radical as that of the RC.

While changing to such an up-front fee model would be very disruptive to current industry business models, there is economic logic behind it. Better alignment of incentives would occur with competition for customer business occurring via setting of fee levels and demonstrable ability to negotiate better loan terms for borrowers. Because brokers reduce operating costs otherwise incurred by lenders, they should be able to negotiate lower interest rates than if the borrower dealt directly with the bank.[14] If value is added by the broker's activities (lower operating cost, better advice and selection of loan type and provider, interest rate negotiation skill, etc) the borrower should be a net beneficiary from using the broker's services.

At the time of writing, intense industry lobbying seems likely to prevent ultimate political implementation of this recommendation, but the industry will be affected by other RC recommendations and regulator reactions to misconduct publicised during the RC. Applying similar enhanced standards as required for financial advisers [R1-5, R1-6] should prevent some of the misconduct observed. And it can be expected that APRA will increase its focus on operational risk requirements associated with such outsourcing of activities – although that only applies to ADIs and not to other mortgage lenders.

Financial Advice

Attempts to reform the financial advice industry have been in train for some years, with Future of Financial Advice (FOFA) legislation and the subsequent establishment of FASEA [the Financial Advice Standards and Ethics Authority] to oversee professional standards' key developments. However, as the RC proceedings demonstrated, progress has not been rapid, and the RC recommendations highlight past political unwillingness to tackle key recognised deficiencies in the face of industry opposition. Some of the RC recommendations essentially reinstate some of the proposed reforms dropped from the original FOFA legislation (such as annual fee renewal, [R2-1]), or remove concessions made by way of 'grandfathering' prior arrangements [R2-4]. They, and others, aim to remove conflicts of interest [R2-6,], prevent charging of unwarranted fees, and improve the level of professional standards and discipline [R2-3, R2-7, R2-8, R2-9, R2-10]. But the RC was unwilling to go to the extent of recommending structural separation of advice provision from financial product manufacture and distribution.

8. Regulation

The RC was particularly critical of the performance of regulators, in effect attributing some of the blame for financial sector misconduct to inadequacies in the approaches and activities of ASIC and (to a lesser extent) APRA. While recognising that some of those inadequacies reflected resourcing issues and powers available to the regulators, the main focus of attention was with the methods of enforcement applied when wrongdoings were identified. Specifically, the low level of prosecution actions via the courts, and an apparent preference for use of enforceable undertakings and negotiated settlements were criticised. Indeed the RC argued that the starting point for the regulator in cases of misconduct should be the contemplation of court action [R6-2], and ASIC (2019) has accepted that a 'why not litigate?' approach will be the starting point for its future enforcement work.

While regulators have acknowledged past under-use of prosecution in determining penalties for wrongdoing and as a deterrent, the assertion that prosecution should be the first option warrants more consideration. The nature of much of the misconduct unearthed has two significant features. First, senior management of organisations involved generally expressed surprise at the discovery of such activity by their firms. To the extent that such responses are to be believed, it is difficult to imagine how an external regulator could be expected to unearth misconduct when it was not apparent to internal managers of the organisation. Second, and reflecting the 'credence good' nature of financial products and services, in many cases the 'victims' were unaware that they were indeed victims.

The problem this gives rise to is the following. In situations where the commission of a crime or breach of regulation is readily apparent, prosecution makes sense. But when it is not readily apparent, there is a need for mechanisms to bring the misconduct to light. Fear of court prosecution, rather than some alternative form of settlement, may inhibit managers of firms from bringing such matters when discovered to the attention of the regulator. This can be particularly significant if the misconduct practice is widespread in the industry. Early notification of misconduct involving lesser penalty cost to the firm may bring wider issues to the attention of the regulator. Some balance between enforcement options is required.

To improve the performance of regulators, the RC made a number of recommendations. These included regular capability reviews of the regulators [R6-13], and requirements for increased inter-regulator cooperation and information sharing [R6-3, R6-4, R6-9, R6-10]. Among these, the proposal [R6-14] for a new oversight authority for APRA and ASIC reiterates one of the recommendations of the AFSI for a Financial Regulator Assessment Board, which had been rejected by the Government. Both major political parties have agreed to this RC recommendation.

9. Is Australian experience worse than elsewhere?

The Hayne RC brought to light many instances of misconduct in the Australian financial sector. Is the Australian experience worse than elsewhere? That is an important question. A positive answer might suggest there are primarily domestic organisational, cultural, and regulatory factors at play. Alternatively, there may be more deep-seated factors driving financial sector misbehaviour globally. If the latter is the case, then by focusing primarily on the former, the Hayne RC's recommendations and impact may be at best a 'temporary fix'. More fundamental changes may be required to prevent re-emergence of misconduct – possibly in different guises by different actors.

There are no ready, simple, metrics which can be used to compare the degree of financial sector misconduct between jurisdictions. The range of activities involved is broad and there are many different types, and degrees, of misconduct. Nevertheless I would argue that, despite the spotlight shone by the RC on Australian financial sector misconduct, it is by no means obviously worse than elsewhere.

Zingales (2015) observes that ‘throughout history finance has been perceived as a rent-seeking activity’, and provides numerous examples of fraudulent behaviour. (See also Reurink (2018).

The G30 [Group of 30] (2015) presents information from a number of global surveys which show that trust in banking has declined and that the sector ranks very poorly in terms of trust. The European Union, noting that ‘[r]etail financial markets across the EU have been upset by large-scale mis-selling of financial products to consumers’ (Cherednychenko and Meinderstma 2018: 1) undertook a series of studies of such mis-selling. EFIFSU (2017, p2) argued that ‘ “Retail” financial services are still ranked as the worst consumer markets in the entire European Union according to the European Commission’s Consumer Scoreboard’. [15]

In the UK, the financial sector has been plagued by misconduct with very heavy penalties imposed on banks and other financial institutions. Treanor (2016) argues that misconduct had cost UK banks £53bn over the previous 15 years.

The preceding information is only a small sample of research and evidence that, I believe, points to there being common problems of endemic misbehaviour in the financial sector globally, arguably greater than in other sectors of the economy, and as not being an idiosyncratic Australian problem. Arguably some characteristics of financial sector business are conducive to the emergence of a culture permitting or inducing poor behaviour, both at the individual and the organisational level. By focusing on specific Australian examples of misconduct, the RC has not ventured into solutions for draining this broader swamp.

10. Conclusion

It will be difficult to separate the impact of the RC from that of recommendations and industry responses to a number of other inquiries and regulatory changes not directly aimed at conduct (such as prudential policy, competition policy), but likely having some effects on conduct. Reflecting the fact that most of the recommendations are logically derived from the core norms of behaviour set out by the RC, there has been relatively little opposition to many of them. For example, the National Australia Bank (NAB, 2019) indicated that it agreed with 72 of the 76 recommendations, with its disagreement on the others more associated with precise specification and implementation procedures.

In that regard, the RC process can be seen to have been a success by overcoming political reluctance to make (in the face of industry opposition) regulatory changes which generally make economic sense. Of course, implementation of such changes takes time, and it remains to be seen how many of the recommendations get watered down or not implemented as push-back from vested interests occurs. That has already happened in the one case where the RC tried to effect a significant change in business models which it viewed as creating conflicts of interest and poor outcomes – that of mortgage broker remuneration. Similar concerns exist over the ultimate implementation of other recommendations relating to remuneration for intermediaries (such as brokers, advisers).

But because the RC made relatively few recommendations regarding significant structural changes which ultimately drive behaviour, it must be asked whether it will have lasting effects. It essentially argued that internal control systems in large organisations had deficiencies, that business models created conflicts of interest, that there was a lack of accountability for poor conduct resulting from these, and inadequate enforcement and penalties when poor conduct was identified (if indeed it was identified at all). Increasing accountability, enforcement, and potential penalties could be expected to ensure increased attention is paid to ensuring control systems work. One effect of this could be to cause management to elect to adjust business activities to achieve that. Likewise, enforced removal of conflicts of interest could lead to adjustments to business models. In this way some structural change could be effected.

But ultimately, 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.

The RC is thus best viewed as a small step towards reducing financial sector misconduct, by ‘naming and shaming’ and providing ‘fixes’ to deficiencies in the existing structure. It has enabled sensible changes to laws and industry practices which have previously been inhibited by political lobbying and industry resistance to changing established practices. But in the absence of recommendations for fundamental change, which arguably were not feasible given the RC’s brief and timescale, these are likely to be at best a temporary fix for preventing financial sector misconduct.

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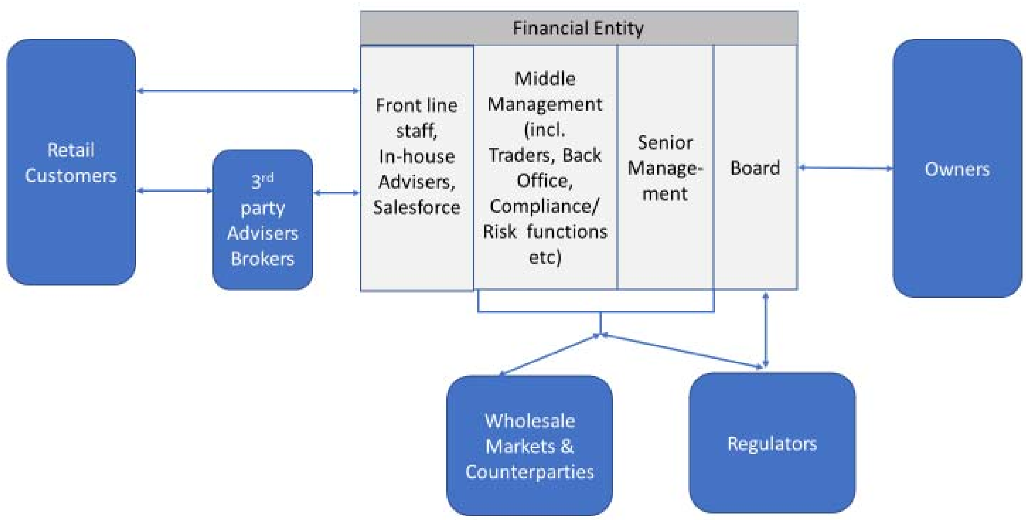

Figure 1:Governance and Agency Relationships in Financial Entities - A Schematic Outline

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[1] For brevity, it will hereafter be referred to as the RC or the Commission. Where individual recommendations such as Recommendation x-y are referred to they will be denoted by [Rx-y].
[2] The opposition Labor party had been calling for such an inquiry for several years and in early 2016 promised to hold a Royal Commission if the party won the next election (due in 2019).
[3] Denk O. (2015) presents data from Europe indicating 'wage premia' in financial sector pay, which is more concentrated at higher levels.
[4] The mandate can be found at https://financialservices.royalcommission.gov.au/Documents/Signed-Letters-Patent-Financial-Services-Royal-Commission.pdf.
[5] The RC did not comment on a number of legal cases relating to misconduct already in process.

[6] Although the RC's mandate did not mention nor specifically exclude examination of the SMSF sector, the announcement of its creation did so (see Turnbull and Morrison, 2017)).
[7] The Corporations Amendment (Design and Distribution Obligations and Product Intervention Powers) Regulations Bill 2018 was passed by Parliament at the start of April 2019 (Treasury Laws (Design and Distribution Obligations and Product Intervention Powers) Amendment Act).
[8] The RC also produced and commissioned a number of background papers on aspects of the financial sector from regulators, the public sector, academics and others. These are available at https://financialservices.royalcommission.gov.au/publications/Pages/default.aspx. In addition there were thousands of exhibits made public, including internal documents and other information, from financial entities and others participating in the public hearings. These are available at https://financialservices.royalcommission.gov.au/public-hearings/Pages/Exhibits.aspx
[9] There are undoubtedly many former executives and directors of large financial entities who were thankful that their tenure finished before the commencement of the Royal Commission.
[10] IFC (2015) provides an overview of the range of alternative governance models.
[11] See Mathieson and Levy (2014).
[12] For example, the ANZ Bank Annual Report for 2018 shows shareholders' equity of $54 billion and total assets of $841 billion.
[13] These included recommendations for product issuer and distributor product suitability obligations, a product intervention power for ASIC, improved disclosure, improved alignment of consumer and financial firm interests.
[14] To illustrate consider a highly simplified example where the broker's costs for intermediating a $500,000 loan were $10,000 and this saved the bank the same amount of costs. Competitive loan pricing would see the bank price a $500,000 brokered loan at a lower interest rate involving $10,000 lower present value of repayments than if done in-house. Thus, the borrower could instead take out a slightly larger loan, using some part to pay the broker's up-front fee, with the same repayments required as if instead a $500,000 loan was obtained directly from the bank.
[15] The latest such survey (European Commission, 2018) does indicate that these markets (although still ranking below the average) have shown the greatest improvement between 2013 and 2017.