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FSI is no shift back to regulation: Davis

The Murray inquiry didn't set out to move the financial system to a state of perfection but rather use research and experience to make it better without smothering it in blanket regulation.

One of the members of the government's financial system inquiry (FSI), the University of Melbourne's Professor Kevin Davis, was in Sydney last week speaking at conferences.

His formal role as a panel member finished in December when the FSI final report was handed to Federal treasurer Joe Hockey but Davis is now keeping himself busy trying to convince people of the merits of the report.

He'd like the report to be remembered as setting out some principles and big picture issues around how the financial sector best benefits the end-users, reflecting what has been learnt from both research and experience.

For example, "the GFC has shifted people's views on the stability of the financial sector if left to its own devices.

There is also the general recognition that people aren't economically rational as assumed in economic textbooks, and highlighted in the problems of reliance on disclosure to achieve good outcomes when financial products are being sold."

Ball dropped on vertical integration?

Davis is concerned that people will see the FSI's report as a shift back to regulation when in fact "one of the things we were trying to achieve was reducing the extent to which regulation affects those who don't require it."

Given all the issues around poor financial advice from businesses owned by a number of banks, some people have criticised the FSI as having dropped the ball on vertical integration.

Davis pointed to the recommendations in the report concerning requirements around having processes to ensure product suitability in product manufacture and distribution and avoiding conflicted remuneration.

He hopes the adoption of these two recommendations will result "in good products to the people who want them without conflicts of interest."

He noted that regulation is usually directed at wrongdoers or particular problems "but unless you design it well, it affects everyone else and other institutions."

In the case of the two recommendations around remuneration and product manufacture, they shouldn't have any impact on reputable institutions and avoid the need for more intrusive regulation that would affect the good guys.

"It is minimising the regulatory intrusion to get the outcomes you want," explained Davis.

While breaking up vertical integration, as advocated by some, would be a tremendous shock and disruption to the financial system, "we thought we would achieve the same thing" with the two recommendations.

Role of ASIC

Likewise, the FSI's recommendation that the Australian Securities and Investments Commission be given product intervention powers may seem like an increase in regulation but it is intended to be rarely used, and for specific occasions.

Again, reputable institutions doing the right thing by their customers shouldn't be worried about it."Specific regulation is better than blanket regulations that wouldn't be appreciated by everyone."

Vertical integration notwithstanding, there is clearly as issue around the culture in the financial services industry, with Davis noting literature indicates that people who handle money seem to be unduly influenced by it.

"How do you change that culture," he asked. "You can't regulate for culture" other than try to ensure the right incentives are in place.

In Davis' opinion, it is up to CEOs and boards to instil the right ethos in financial organisations.

He also gave the example of mutuals like credit unions and building societies.

"It does seem to me that one of the good things about the mutual structure is the owners are the customers."

"You hope the boards and management are working for their customers and you lose the agency problem of owner/customer conflicts," said Davis.

"You like to think there are less problems of culture."

BANKING | **Tags:** Kevin David, FSI, David Murray, regulation, vertical integration, ASIC
Author: Marion Williams, mwilliams@financialpublications.com.au March 16, 2015
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