SUBMISSION ON POLICY ISSUES IDENTIFIED IN THE INTERIM REPORT

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Introduction

First, the Commission has an enormous task to identify the root causes of misconduct and conduct falling short of community standards and expectations within the financial sector and secondly identify how to ensure the behaviour is not repeated in the future. Having gained an interest trying to understand what happened during the GFC, ten years later feel I am still learning with every new perspective, a new insight can be gained. I do not envy your task within the timeframe set.

The Interim Report diagnosis greed as the problem at the heart of the financial system. I would put forward a different diagnosis; that at the heart of the financial system there are hazardly immoral, unprincipled agents that do not suffer the consequences of their bad decisions. Over three decades, institutional frameworks have been removed that had forced individuals to face up to the consequences of their decisions, and no amount of regulation can make up that lost accountability and responsibility.

Hopefully, I can contribute a little to you about what I have learnt as the underlying causes of this misconduct and over the very long term what steps can be taken to ensure reformed behaviour.

Case Study 1. Hazardly Immoral - The Global Financial Crisis (GFC)

The GFC occurred after January 2008, within the timeframe you sought episodes of misconduct from Australia's financial institutions. Do any banks admit to any misconduct during this period?

The GFC was caused by the banks not having enough equity. Not having enough equity while bad for business is not really conduct falling short of community standards. It is tough love, but it is expected that some business will thrive and some will fail in a dynamic economy. What conduct does fall short of community standards and expectations is passing the costs of the bankers bad decisions onto Australian citizens. The Australian people suffered the consequences of the bankers bad decisions to not have enough equity and had to be bailed out. I estimate that the cost to the Australian people of this bailout in the hundreds of billions of dollars, while for bailouts globally there are estimates in the multi-trillions of USD.

The board members and the executive teams did not resign because of incompetence. The board members and the executive teams were not fired by the owners. The board members and the executive teams were not fired by the government in exchange for a bailout.

If you did not suffer the consequences of your bad decisions, in fact, you were able to pass on the cost of your bad decisions on to unrelated, unsuspected people, what guides your moral compass for the next 10 years? What incentive is there for a banker to conduct themselves at their best? Are we not the fools for expecting conduct at community standards and expectations when we do not enforce these standards? If we do no enforce community standards and expectations, shouldn't misconduct be expected as a result?

Why did this happen?

Why did the banks receive a bailout?

They did not have enough equity

Why did the banks not have enough equity?

For the past 30 years, any big bank that got into trouble was bailed out, what incentive was there to be more prudent

Why did the government give out a bailout in 2008?

They thought (probably correctly) that without a bailout a financial collapse would lead to an economic collapse

Where were the owners (Shareholders)?

Owners care deeply when their company can go out of business. After 30 years of banks being bailed out repeatedly, there was an expectation that big banks could not fail. They were correct.

Case Study 2. Unprincipled Agent - The Commonwealth Bank of Australia (CBA) remunerates a new Chief Executive Officer (CEO)

As highlighted throughout the Commissions Interim report, remuneration is a key tool to reinforce institutional values. The culture of an organisation, the excepted behaviours can all be amplified or discouraged by how remuneration is set. Again in submissions by Treasury, ASIC, APRA to the Royal Commission, how somebody is remunerated is of utmost importance.

Throughout the economy, people are paid in many different ways depending on the roles they perform. In the world of startups where the risks of failure are high, and the causes of failure varied, it is common to issue equity to align incentives between employees and investors. It is not unheard of that that equity is locked up for longer periods than a decade.

In 2018 while the Royal Commission into Financial Services was underway, the CBA Board appointed a new CEO.

The yearly remuneration package of the CEO includes payment at various intervals, but for his role in Year 1, total remuneration is received by the end of Year 4. A large majority of the banks business in long term loans, in fact, some mortgages may last 30 years. Certainly, the loans may be on-sold, but some risks of that loan remain on the balance sheet for 30 years.

To pay someone millions of dollars prior to the knowing the success or failure of those long-term bets, I would posit is conduct that does fall short of community standards and expectations.

Questions for the Chair of the Board of the CBA

Is this the most prudent way to remunerate the CEO?

Would it not be reasonable to tie some compensation to the success or failure of long-term bets placed?

Are there barriers to using equity as remuneration?

Why not just have a standard 10 year vesting period for equity?

Would it be reasonable to have a policy that the CEO must resign in case of a government bailout?

You were a very successful entrepreneur in the past, entrepreneurs often use equity to align incentives, what are its limitations in aligning incentives in banking?

Questions for the CEO of the CBA

You have just recently agreed with APRA to undergo Remediation Initiatives. Tomorrow if you and the board agreed that you were to receive $100,000 of your remuneration in cash and the rest in equity and you never sold a dime of that equity. Wouldn't that send a message, not only to APRA but to the front line as well, that you are "all in", you now have Skin in the Game?

Questions for APRA

Why are 4 years chosen as long-term remuneration? Many risks that can be affected by a CEO last significantly longer than 4 years. Would it not be more prudent if long-term remuneration was greater than 4 years?

Recommendations

It is too costly to the economy and it is way too costly on democratic institutions norms and ways to ask 'How can we avoid a big bank failure?' The key question that now must be asked is "What is needed to ensure that a big bank can be unwound with as little instability in the credit system as possible?"

The main problem: **How to deal with bankers that do not suffer the consequences of their bad decisions?**

For most practical solutions to this problem, I recommend contacting Simon Johnson former Chief Economist of the IMF.

Big Bank Bankruptcy Resolution Plan

Behaviours in the financial industry will not change until the owners of these firms resume the traditional role of oversight of their business. Unfortunately, this will not occur until **AFTER** a big bank successfully goes through bankruptcy without tanking the economy.

In a normally functioning market, badly managed firms leave the market. Currently, this mechanism is cut off due to concerns that large systematic important banks leaving the market abruptly, which will then cause significant financial instability and damage to the economy. The business owners know their business will be rescued by the government, so, therefore, do not have the threat of going out of business. Ever. As a result, these shareholders have not been performing the traditional roles to ensure that their business has the right culture, behaviours, accountability and responsibilities.

Enable a successful bankruptcy of a big bank

This strategy ensures that over the long term horizon no matter how big an institution you are, that if you are badly managed and fail, you exit the market and the financial system can continue to function well. The current situation we face is a result of many decisions made over the last 30 years. This plan outlines over time we can reset new norms, behaviours and expectations. While it is not ideal to guarantee bank debt, (it will have unintended costs) I feel it is better to explicitly state when it will be available and how much it will cost.

Australia has 5 systematically important banks (Big 5)

- NAB
- ANZ
- Macquarie Bank
- CBA
- Westpac

The Big 5 banks currently do not face the threat of going out of business, no matter how badly they are run. This must now change.

The Plan

1. Big Bank Bankruptcy Resolution Review

What are the current capabilities of the courts and regulators for the unwinding of a Big 5 bank? What is needed by these institutions or others to ensure an orderly unwinding of a Big 5 bank? Any gaps in the system need to be addressed.

2. Big Bank Financial Incident One

Big Bank Financial Incident One will have said to occur once one of the Big 5 banks enters bankruptcy. To ensure contagion does not spread throughout the financial system and the economy, the remaining four banks of the Big 5 can immediately have new debt guaranteed by the government. The cost of this guarantee will be twice what Treasury charged during the GFC, so will be around 2%. The guarantee will be removed after 5 years.

3. Big Bank Bankruptcy Resolution Review Two

Five years after the first of the Big 5 banks enters bankruptcy it will be time for review. As this aims to be one of the first successful unwinding of a systematically important financial institution, without contagion to the rest of the financial system, there will no doubt be many important lessons to be learnt. What could be improved? How could the speed of the resolution improve? Are any additional resources needed? Any gaps in the system need to be addressed.

4. Big Bank Financial Incident Two

Big Bank Financial Incident Two will have said to occur when two of the remaining Big 5 banks go into bankruptcy within a one year time frame. To ensure contagion does not spread throughout the financial system and the economy, the remaining of the Big 5 can now have new debt guaranteed by the government. The cost of this guarantee will be twice what was charged during Big Bank Financial Incident One, so will be around 4%, the guarantee will be removed after 5 years.

5. Big Bank Bankruptcy Resolution Review Ongoing

Every 10 years this report must be done to ensure that Australia has the institutional arrangement that enables a financial institution of any size to be unwound without long term damage to the function of the financial system.

The Plan anticipates that by the end of Big Bank Incident Two a market norm has emerged that is different than what stands today. The expectation will be that firms that are badly managed can fail in the market place. The idea of a systemically important financial institution has died because of robust tools to successfully unwind any financial institutions no matter what the size.

High Commision on Human Responsibilities

Too much compliance. The is little evidence to show that ever-increasing rules lead to better outcomes for customers. It is time to try an alternative.

The Australian High Commission on Human Responsibilities will be set up to ensure the option of banking away from a prescriptive rules-based approach. The Australian High Commission on Human Responsibilities will issue ADI Licences.

Holders of an ADI form the Commission will be exempt from the following

- Basil III
- ASIC embedded employees
- APRA

To comply with Human Responsibility Commission ADI the following conditions must be met

- Top 100 earners remuneration: 30% cash 70% "I Will Suffer the Consequences of My Bad Decisions Equity"*
- All Non-independent Board directors to be paid 30% cash 70% "I Will Suffer the Consequences of My Bad Decisions Equity"
- no more than 1/3 of the board may be independent directors
- Independent directors to be paid in cash
- Provide a set of financial reports as laid out by Jonathan McMillan in "The End of Banking" (you will still have the ability to create money)

*"I Will Suffer the Consequences of My Bad Decisions Equity" once issued to the employee can only be sold after a period of 30 years. After 30 years all "I Will Suffer the Consequences of My Bad Decisions Equity" resorts to common stock.

There is a high chance that this option will not be taken up. At a minimum, it could play a role for current regulators to point to this option and say "You are welcome to an ADI from the Human Responsibilities Commission if you find our regulation burdensome, however currently you are under our regulation, so get into line buddy"

APRA

APRA has to balance many competing objectives. Sometimes these are opposing objectives. To prevent failure of entities within the system, this short-term aim comes into conflict with the long-term aim to prevent failure of the financial system. The RBA has a role in stabilising the overall economy and has the policy tools to deal with financial instability in the short term. It could be healthier for the APRA role to be to promote the long-term health of the financial system by ensuring that badly managed firms that fail can exit the market in an orderly way without significant disruption to the flow of credit throughout the economy.