IA Investment Analytics Research

26 October 2018

Mr Kenneth Haynes, Chair
Royal Commission
Canberra ACT 2600

Dear Mr Haynes

Re: Submission on Interim Report: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

I am Dr Wilson Sy. I worked for three years as Research Analyst at ASIC on projects such as licensing under the *Financial Services Reform Act 2001*. I was also a Principal Researcher at APRA for six years, until 2010.

My submission consists of brief answers to various questions posed in the Interim Report (IR). These brief answers are supported by references to published papers and other submissions to the Australian Parliament on related issues.

The main conclusions from our answers to the IR questions are:

- The global financial crisis (GFC) and findings of the royal commission have provided ample evidence that our financial system needs radical reform,
- Our financial system has been created based on false premises,
- The concentrated and integrated financial institutions have not served the community as expected due to lack of transparency, and widespread and systemic misconduct,
- The regulatory system is inappropriately structured, being weak and ineffective in protecting consumers,
- The financial system should be structurally separated to simplify regulation, increase competition and innovation, and better serve the community.

I would be happy to answer any questions you have.

Kind Regards,

Dr Wilson Sy
Investment Analytics Research

Responses to Questions
Posed by the Interim Report

In our responses, we refer to the sections and their headings of the Interim Report (IR). For ease of reading, the IR questions are repeated in normal type and our answers are given in ***bold italics***.

5.1 The present regulatory regime

- Is the law governing financial services entities and their conduct too complicated?

  The law can only address effectively known problems of well-established entities and conduct. Some parts of financial services are constantly changing due to innovation. Attempts to regulate innovation lead to unmanageable complexity. The regulatory system has not been designed to protect consumers (see below).

  – Does it impede effective conduct risk management?

  – Does it impede effective regulatory enforcement?

  Inappropriate regulation is merely "red tape", which is ineffective and unenforceable.

5.2 Accountability of the regulators

- Should there be annual reviews of the regulators' performance against their mandates?

  Yes. Annual reviews, if conducted seriously, may provide early warning of failing regulation. The government's regulator performance framework has six key performance indicators[1] (KPIs) which are entirely related to the industry, with no explicit reference to protecting consumers or the community.

5.2.1 ASIC

- Is ASIC's remit too large?

  – If it were to be reduced, who would take over those parts of the remit that are detached?

  – Why would detachment be better?

  Yes. ASIC tries to do too many things it is incapable of doing. For example, ASIC gives the impression that it listens to consumer complaints, but there is no objective evidence it even knows what are in those complaints. ASIC does not have an explicit remit to protect consumers. Consumer complaints are seen as feedbacks to help corporations to better comply with the laws such as product disclosure requirements.

[1] For ASIC's metrics and self-assessment see: https://download.asic.gov.au/media/4516892/regulator-performance-framework-evidence-metrics-published-20-october-2017.pdf; For APRA's metrics and self-assessment see: https://www.apra.gov.au/sites/default/files/RPF-self-assessment-report-2016_17.pdf

- Is the regulatory regime too complex? Should there be radical simplification of the regulatory regime?

  Yes. ASIC should not be expected to understand complex products. ASIC is dominated by lawyers with little depth of understanding of finance, particularly complex products such as derivatives. Hence ASIC often cannot enforce[2] product disclosure laws.

- Should industry codes relating to the provision of financial services, such as the 2019 Banking Code of Practice, be recognised and applied by legislation like Part IVB of the *Competition and Consumer Act 2010* (Cth)?
- Are ASIC's enforcement practices satisfactory? If not, how should they be changed?

  No. ASIC enforcement practices are unsatisfactory. Regulation should be such that the need for enforcement is limited. There are too many loopholes in the regulation of complex products for enforcement to be certain of success and it is therefore a waste of resources.

- If the recommendations of the Enforcement Review are implemented, will ASIC have enough and appropriate regulatory tools?

  No. ASIC will never have enough tools, because enforcement of complex regulation is not a good use of resources.

- Should ASIC's enforcement priorities change? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that it is in the public interest not to do so?

  No. The problem is the wrong approach to regulation, not necessarily a problem of ASIC's enforcement priorities. Enforcement is expensive and often ineffective.

5.2.2 APRA

- Are APRA's regulatory practices satisfactory? If not, how should they be changed?

  No. APRA's regulatory practices are unsatisfactory, because it gives no regards to consumers or the community at large. APRA's six key performance indicators[3] (KPIs) favour the industry over consumers.

- Are APRA's enforcement practices satisfactory? If not, how should they be changed?

  No. APRA sees no reason for enforcement, because its regulations are directed at ensuring the soundness of institutions. Therefore, a breach of regulation is assumed by APRA to be accidental, because an institution does not knowingly damage its own interests. APRA relies on self-reporting of any breaches of the law.

- Does the conduct identified and criticised in this report call for reconsideration of APRA's prudential standards on governance?

  No. APRA does not see itself as a conduct regulator. APRA sees misconduct which affects consumers, to be in ASIC's remit. APRA's prudential standards on

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[2] For example ASIC considered that contingent convertible bonds or "bail in" bonds are against the interest of consumers, but it could not stop them from being sold to retail investors.

[3] See the first footnote on APRA's regulatory performance framework.

governance are concerned with the risk management of institutions, not their conduct in relation to consumers. APRA has no obligation to stop institutions from issuing toxic products because it has no competence to rule that they are in fact toxic – toxicity is to be tested in the markets.

- Having examined the governance, culture and accountability within the CBA group, what steps (if any) can APRA take in relation to those issues in other financial services entities?

  None. APRA had failed to do its job in the first place which was to oversee and supervise the operations of its regulated institutions. APRA knew about money laundering [redacted] because there was a memorandum of understand[4] with [redacted] APRA is more concerned with protecting the system and its institutions, than with protecting the community.

7.5 Business structures

- Do the events that have happened raise any issue about business structures?

  Yes. The highly integrated structures of major banks and other financial conglomerates have led to a loss of transparency and accountability, which form the foundation of misconduct.

- Do the events that have happened invite consideration of whether structural changes should now be made?

  Yes. The financial system needs to be structurally separated. Financial conglomerates should be discouraged. The mixing of potentially toxic products with traditional financial products by integrated banks is confusing to regulators and consumers, making the whole system unsafe.

- Do the events that have happened suggest that manufacturers of **financial products** should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures?

  Yes. The manufacture and distribute model is not appropriate for financial products, because toxic products could be manufactured and distributed to buyers who are unaware and not fully informed. There are inherent conflicts of interest in the "originate and distribute" model as we have learned from the role of subprime mortgage securities in the US in the GFC.

- More particularly, do they provoke examination of how and to what extent conflicts of interest and duty arising from the structure of the business can be managed?

  No. Conflicts of interest and duty should be eliminated or minimized because they should not be expected to be well managed. Reliance on management of conflicts of interest leads to complex regulation and ineffective or expensive enforcement.

[4] The MOU was signed on 20 February 2007 by APRA chair John Laker and AUSTRAC CEO Neil James Jensen which includes: "6.1 Full and timely exchange of information is a crucial element of co-operation between the agencies".

pp. 346-347

- Are changes in law necessary?

  Yes. The law, the financial system and the regulatory system all need to change, because they were built on false premises which have been socially and economically damaging to Australia. For example, since financialization, improvement in the standard of living has been in steady decline from a trend rate of nearly 2 percent per annum in 2000 to just above 1 percent recently.

  – Should the financial services law be simplified?

    Yes. The financial service law must be simplified because it is based on the false assumptions that consumers do not really need protection and that it is sufficient to pretend to regulate complex financial products. The financial services law need to acknowledge that complex financial products cannot be regulated in detail. They need to be isolated from doing harm. The idea that one has to go to court to decide whether a product sold by an agent has broken the law is frankly unsatisfactory. The system and the law need to be simplified to minimize enforcement and litigation.

- Should the regulatory architecture change?

  Yes. The regulatory architect needs to change because it largely protects a bad complex system rather than protects consumers who are wrongly assumed to be fully informed in an "efficient market". Consumers cannot be assumed to understand products which the regulators themselves do not understand.

  – Are some tasks better detached from ASIC?

  – Are some tasks better detached from APRA?

  – What authority should take up any detached task?

  – Should either or both of ASIC and APRA be subject to external review?

    The regulatory architecture should not be based on tasks, but on total responsibility for both product and conduct regulation in different areas of financial services. There should be no ambiguity about who is responsible for what. APRA should take full responsibility for traditional commercial banking, while ASIC should take full responsibility for investment banking.

- Is structural change in the industry necessary?

  Yes. The financial services industry should be structurally separated into traditional commercial banking and investment banking[5]. Traditional commercial banking should protect the normal functions of the economy with simple products and activities: payments, deposits, home and business lending. Investment banking should provide services for financial innovation, venture capital formation, trading of securities and other complex products and activities. ASIC and APRA would then be regulating different sets of financial institutions for distinctly different economic purposes.

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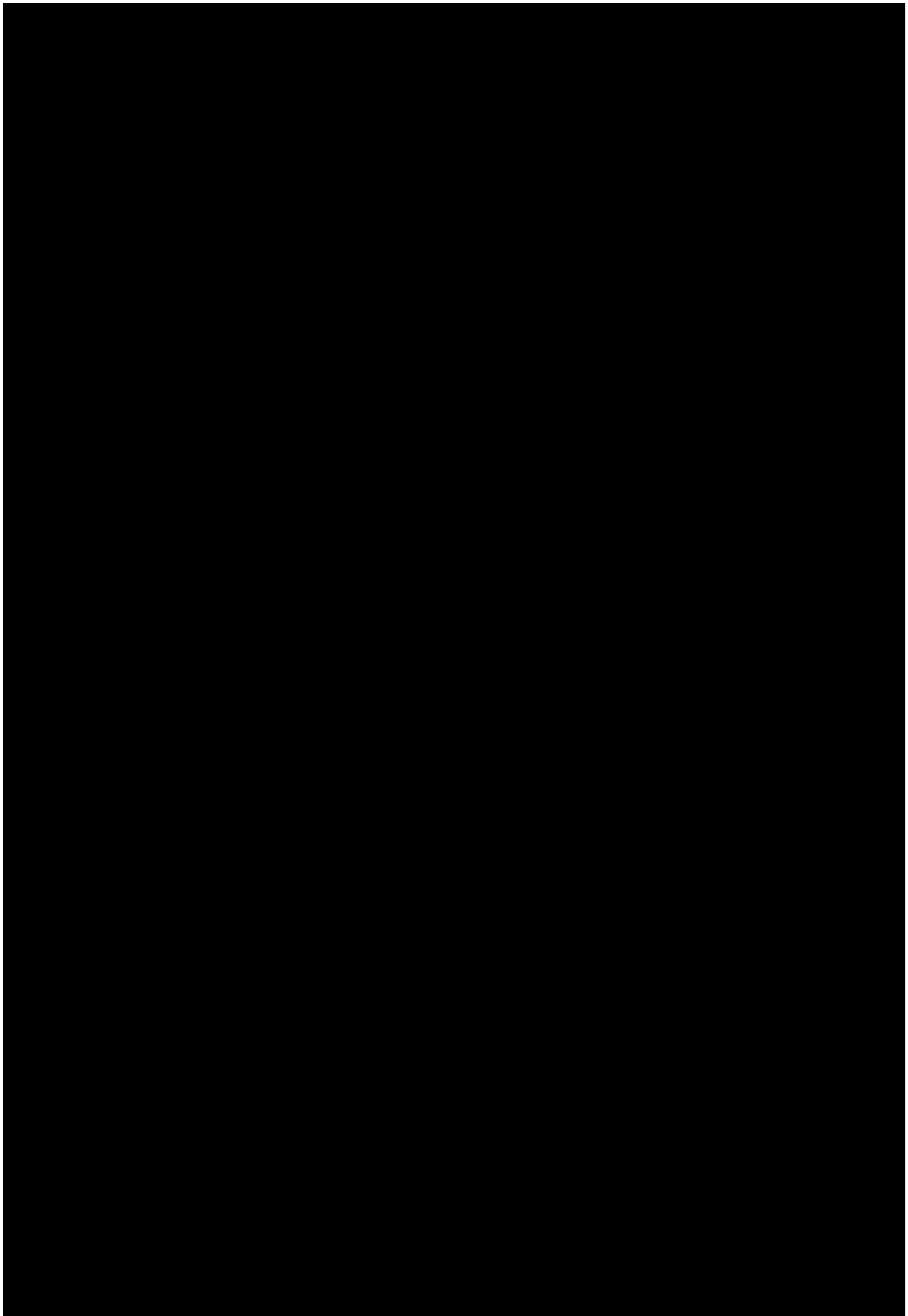
[5] A response to the Australian Treasury's false claim that the Australian financial system is already structurally separated is appended below.



The Treasury response includes the following false and misleading statements:

- ***Our financial system already exhibits a high degree of structural separation***,
- ***Foreign bank branches play a major role in investment banking,***
- ***Australia's major banks… do not have large investment banking businesses,***
- ***Structural separation of retail and commercial banking from investment banking, including Glass-Steagall legislation in the US, was considered by the FSI in 2014,***
- ***the unlikely event a bank or insurer fails, a risk that exists regardless of whether structural separation is in place,***
- ***Government's approach focuses on strong prudential supervision across each institution's business.***

It is false to say "***Our financial system already exhibits a high degree of structural separation".*** The four major banks with over 76 percent of total assets of the financial system have highly integrated businesses which are not structurally separated (see Appendix). They have major presence in nearly every aspect of finance: commercial banking including deposit taking, household and business lending, and investment banking including corporate finance, capital raising, stockbroking, market making, proprietary trading, derivatives trading, financial advice, estate planning, insurance, superannuation, custody, asset consulting and so on.

The only sense in which "***our financial system already exhibits a high degree of structural separation*"** is our regulatory structure, with separate roles for the Treasury, the Council of Financial Regulators, RBA, APRA, ASIC and ACCC. This highly separated regulatory structure is inappropriate for our highly integrated major banks.

The Hayne Royal Commission (HRC) has begun to expose that the **lack of structural separation** within major banks has caused many problems which have "fallen between the crack", with "finger pointing" and "buck passing" between the regulators. The "***Government's approach focuses on strong prudential supervision across each institution's business"* has failed** because the HRC evidence suggests the regulators are incapable of strong prudential supervision, particularly in mortgage lending and superannuation operations.

Outside traditional lending of commercial banks, the domestic banks have 80 percent while foreign banks have 20 percent of the investment bank market (see Appendix). It is false to say "***Foreign bank branches play a major role in investment banking".*** It is also false to say ***"Australia's major banks… do not have large investment banking businesses".***

Foreign banks have $103 billion in "liquids and securities" assets out of a system total of $910 billion or 11 percent of the total. Foreign banks have $299 billion in non-loan assets out of a system total of $1,469 billion or 20 percent of the total (see Appendix). While most foreign banks' activities (more than 50 percent) not being related to traditional lending may be considered mostly investment banking, foreign banks' share of investment banking (11 to 20 percent) is still minor in Australia.

The Financial System Inquiry (FSI) was chaired by the former CEO of the Commonwealth Bank (1992-2005), David Murray, whose main claim to fame was that he "*oversaw the transformation of the Commonwealth Bank from a partly privatised bank to an integrated financial services company*" (FSI report, p. x). It is therefore highly unlikely that he would have made any serious attempt to investigate the structural separation of banks.

In the FSI final report, there was no mention of ***Glass-Steagall legislation in the US*** and there were only a few passing mentions of structural reforms (e.g. ring-fencing), but "separation" was mentioned only once in relation to operations. It is misleading to say "***Structural separation of retail and commercial banking from investment banking, including Glass-Steagall legislation in the US, was considered by the FSI in 2014".***

Indeed, structural reforms were only mentioned as unnecessary because the FSI recommended crisis management, rather than crisis prevention, as a solution to any structural weakness in the Australian financial system. In February this year, the Government passed the ***Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*** to give APRA crisis management powers to reorganize secretly insolvent institutions, including the conversion or confiscation of bank deposits.

It is misleading to assert that a bank or insurer failure is ***"a risk that exists regardless of whether structural separation is in place"***. Under structural separation, for several decades of Glass-Steagall legislation, the risk and consequence of a bank or insurer failure were so much smaller that there was no need for any special crisis resolution powers. Instead of preventing crisis, the unsound policy now is to allow every crisis to provide an opportunity for the banks to loot the wealth of ordinary tax-paying citizens through "bail-outs" and "bail-ins".

Neither the Treasury nor the regulators acknowledge the cancer of our financial system – the $40 trillion worth of over-the-counter derivatives, which are growing and could potentially hide substantial losses off the balance sheets of Australian banks. At current levels, one percent loss on this derivative exposure from investment banking will wipe out the entire equity of the system, potentially hurting many innocent bank depositors – banking separation is urgently needed to avoid crisis for the safety and stability of our financial system.

Appendix

As at March 2018, the nominal GDP measured by the ABS, for the size of the Australian economy is $1,728 billion. The structure of the Australian banking system is seen by the balance sheets of the main sectors given by APRA statistics (Quarterly ADI Performance, issued 21 June 2018) in Table 1, where all figures are in AUD billions except where stated as percentages. Authorized Deposit-taking Institutions (ADI) are regulated by APRA under *Banking Act 1959*.

Table 1: Balance Sheets of main banking sectors (Mar 2018)

	ADIs	Majors	Foreign	Foreign (%)
Housing	1,958	1,622	72	4
Liquids and securities	910	702	103	11
Total loans	3,198	2,547	290	9
Non-loan assets	1,469	1,023	299	20
Total assets	4,667	3,570	589	13
Deposits	2,761	2,170	267	10
Total liabilities	4,368	3,330	567	13
Equity	299	240	22	7
Capital Ratio (%)	6.4	6.7	3.7	