

Comments on the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry

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1. The following remarks are informed by discussions during a by-invitation-only roundtable on October 19 that was organized by the UNSW Business School research networks on *Cyber Security and Data Governance* and *Behavioural Insights for Business and Policy*. It was attended by a judicious mix of 14 legal academics and (behavioural, experimental, and financial) economists as well as representatives of behavioural insights units from government and firms in the banking industry. The roundtable took part under the Chatham House Rule and was meant to facilitate an open discourse about the issues identified in the Royal Commission's Interim Report, especially its chapter 10 and therein pages 327 – 342 and pages 345 – 7, as well as other chapters (namely 1, 8 and 9).
2. While my comments draw on those discussions, the following comments reflect my opinion only. Importantly, my opinion below does not necessarily reflect my employer's view.
3. Kudos first to Commissioner Hayne and the senior counsels assisting (namely Rowena Orr and Michael Hodge) for a job well-done in uncovering plenty of misconduct when, in the run-up, representatives of the government du jour repeatedly argued, and strenuously so, that there was nothing to see here, that the call for a Royal Commission (RC) was a populist whinge, and that an RC would endanger economic growth by undermining trust in the banks, superannuation providers, and the financial services industry more generally. It seems obvious now that these claims were made despite better knowledge. It seems important to recall this fact, as the implementation of effective solutions – even if evidence-based – is likely to encounter considerable opposition and attempts to water them down. Strategic dishonesty is a thing and it is at the heart of the problems so competently ferreted out by the RC.
4. Kudos also to ASIC – much maligned these days – since it clearly has provided a considerable portion of the relevant systematic evidence under not always favourable conditions (e.g., the substantial reduction in its resources announced in the 2014 budget; the fact that some of these resources were restored in 2016 cannot distract from the fact that any such disruption is counterproductive).
5. For an economist who knows the empirical (including the experimental) evidence on the effects of market power, incentives (especially those in social dilemma situations), and on human actors' frequent failure to be ethical (honest) and in violations of existing norms of conduct, there is nothing surprising in the Interim

Report. Likewise, the failure of the regulators to interfere effectively was hardly surprising, although the discussion of effective remedies among economists is likely to be more robust than on the other topics.

5.1. We know for example that market power begets socially suboptimal outcomes (e.g., Huck et al. JEBO 2004, or any textbook on Industrial Organization worth its cost).

5.2. We know, for example, that incentives, especially when in conflict with organizational or societal welfare, lead to undesirable outcomes (e.g., the huge literature on trust games reviewed in Ortmann et al. EE 2000, or more systematically in Johnson & Mislin JoEP 2011)

5.3. We know, for example, that, even for low stakes, there is a considerable amount of people that will always be unethical, with many more people being easily tempted by dishonest behaviour as the stakes increase (e.g., Rosenbaum et al. JoEP 2014; Abeler et al. JPubE 2014; Kajackaite & Gneezy GEB 2017; Capraro JDM 2018; Heck et al. JDM; Abeler et al. ECMTA forthcoming). People's susceptibility to norm violations has been documented since Adam Smith wrote his *The Theory of Moral Sentiments*. For more recent evidence, see some of the evidence from psychology and related behavioural sciences in Gentilin (2016; for a critique of that evidence see Ortmann CE 2016 and references therein).

5.4. The question of effective remedies is a more complicated one. It touches on numerous mechanism design issues, although even there one can tap into a considerable empirical (and experimental) literature that addresses questions such as the relative efficacy of self-regulation (possibly under the threat of government intervention; see Van Koten & Ortmann 2017), certification, and other institutions such as independent standards boards that administer ethical culture surveys and whistle-blower protection, and provide pools of principal integrity officers, as suggested in [REDACTED] submission. More on these issues below under 7.

6. That breaches were so many and so widespread will, especially in light of the significantly larger stakes at stake, not surprise any economist who knows the literature on the negative effects of market power, poorly designed and calibrated incentives, and many human actors' tendency to be economical with the truth, and in violation of norms (especially if the chance that they are found out is minimal – see Dana et al. ET 2007)). Pages 268 – 270 of the Interim Report get it exactly right: “There being little threat of failure of the enterprise, and there being little competitive pressure, pursuit of profit has trumped consideration of how the profit is made. The banks have gone to the edge of what is permitted, and too often beyond that limit, ... because they can; and because they profit from the misconduct that is described in this report.” (p. 269)

7. So what needs to be done to prevent the conduct from happening again?
- 7.1. It seems obvious that extant law be applied to lay charges for unconscionable acts such as charging customers fees for advice they did not receive. (While it is laudable that ASIC has secured hundreds of millions in refunds for affected customers, it has come through enforceable undertakings which let the perpetrators of criminal actions off the hook.) Other potentially criminal offences have been committed and they should be pursued under current law wherever possible. Unfortunately, the current state of affairs has considerable reputational spill-over effects and contributes to the wide-spread decline of trust in key institutions.

7.2. It seems clear that the light-touch approach of ASIC, and APRA, has not served the community well although it is hard to tell from the outside whether tough cops – such as Allan Fels and Graeme Samuel – alone can do the trick (Irvine *SMH* September 22, 2018).

7.3. It also seems abundantly clear that Commissioner Hayne's assessment of the sorry state of internal compliance assessment and reporting within [REDACTED] justifies immediate action.

7.4. I do agree with Fels that structural separation of banks from their financial advisory arms is the way to go (Irvine *SMH* September 22, 2018). The same applies in my view for superannuation providers. The conflicts of interest are just too obvious to ignore and some proposed remedies (such as disclosure of conflicts of interests) seem to have counterproductive effects (e.g., Taguchi & Kamijo 2018, for a recent review of the literature).

7.5. Relatedly, the whole commission business has to be reconsidered. See also the relevant discussion on the broken model of broker remuneration in the Productivity Commission's June 29 report on *Competition in the Australian Financial System* (pp. 21- 23) Financial advisors are effectively glorified salespeople and incentivizing them through commissions is a recipe for disaster under the best of circumstances.

7.6. Relatedly, the variable-remuneration provisions for accountable persons according to BEAR have to be rethought. I endorse fully *Recommendation One* and *Two* in [REDACTED] submission on the RC's Interim Report.

7.7. I also endorse fully *Recommendations Four through Eight* of [REDACTED] submission on the RC's Interim Report and the rationale they are based on. What exactly the relation of an Independent Standards Board would be to Treasury, APRA, ASIC, and possibly ACCC, is as worthy of a good discussion as is a discussion of appointment procedures to that Board. See also the discussion of "a competition champion" in the Productivity Commission's June 29 report on *Competition in the Australian Financial System* (pp. 15 – 19). [REDACTED]

[REDACTED] I believe that [REDACTED] *Recommendation Six* – to have the proposed Independent Standards Board oversee the recruitment and appointment of Principal Integrity Officers to designated ADIs -- is a brilliant one that will be key in guaranteeing the independence of Principal Integrity Officers. With [REDACTED] (specifically *Recommendation Eight* and its rationale), I believe that the establishment of a Whistleblowing Protection Authority is an indispensable and complementary step if indeed reducing misconduct in the banking, superannuation, and financial services industry is a serious concern and not just public posturing.

7.8. Last but not least, I would urge the Royal Commission to explore ways – rather than adding more regulation that then is likely not enforced – to let reputational feedback systems (e.g., Bolton et al MS 2013; see also systems such as *TripAdvisor* or *Serviceseeking.com.au*) do their magic. Considerably more transparency, and data, should be provided to the public to let interested researchers identify anomalies and developments that might be otherwise go unnoticed too long. Take the fascinating Figure 3 in the Productivity Commission's April 2018 draft report on *Superannuation: Assessing Efficiency and Competitiveness*. Making that data available in a timely fashion would do wonders for the alignment of incentives. No traditional regulatory action I can think of would have the same effect.

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