Royal Commission into Misconduct in the Banking,
Superannuation and Financial Services Industry

Written Submission by Anthony Asher in response to issues raised in the INTERIM REPORT

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1 Introduction and summary of recommendations

This submission addresses the cultural questions raised in item (d) of the RC’s Letters Patent and the questions on culture, business structure and remuneration in the Interim Report.

My views on virtues and culture in the finance industry have been shaped by work on risk culture with Tracy Wilcox.\(^1\) We have developed Figure 1 below to suggest that virtue within an organization is supported, or not, by three elements: culture, practices within the organization and regulation.

![Figure 1 Structures supporting the virtues](image)

**Figure 1 Structures supporting the virtues**

Our paper does not address regulation in much detail, but I am in almost total agreement with the views on regulation expressed in *Integrity, Risk and Accountability in Capital markets: Regulating culture*, particularly the last chapter by John Braithwaite.\(^2\) To the recommendations in that book, I think it is helpful for regulation to explicitly address the culture of greed, which is the main subject of Part 2 of this submission\(^3\) and the organizational structures that encourage hubris, which is the focus of the third part of this submission.

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\(^4\) And also addressed in my submissions to module 5, where I suggest that temptations should be addressed by a greater regulatory focus on rent seeking and potential regulatory capture, by enhancing accounting and accountability and by the strict enforcement of the general law proscription of conflicts of interests.
submission. These two temptations to greed and hubris undermine the virtues of justice and prudence that ethical theory suggests should be developed to address the social and economic purpose of the industry. An understanding and commitment to a productive purpose provides the intrinsic motivation that be stronger than the selfishness of hubris and greed.

The RC has already had a significant and positive impact on the culture of financial institutions as it has exposed and denounced misconduct within industry, the culture of greed and the remuneration practices that have fostered it, and the timidity of the regulators. I believe that it would have a further impact if it could also see fit to denounce:

- worldviews that valorise greed and hubris, while deprecating fairness and regulation, and the economic and finance theories that have fostered them;
- a failure to distinguish between profits that arise from socially beneficial entrepreneurial activity and rent seeking in its various forms, and the timidity of politicians; and
- the levels of remuneration and hubris amongst senior executives, and the timidity of directors.

Such denunciations are however likely to be short lived on their own. There would be an increased likelihood of longer lasting impact if they provided the momentum for regulatory changes to organizational structures particularly. In potentially making recommendations as to changes in the regulatory regime:

- the introduction of compound boards where directors’ election is entirely independent of that of the CEO;
- cumulative voting for directors to give minority shareholders a greater role in appointing strong directors;
- greater power to shareholders in AGMs to approve remuneration of directors and the CEO;
- there is a need for some expert body with independent expertise to provide a check on rent seeking and regulatory capture in financial markets, partly modelled perhaps on the abolished CAMAC.

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2 Culture

We take culture to be a collection of norms, narratives and purpose by which people explain their behaviour. It is widely thought that the finance sector displays:

... a combination of hubris, myopia and the decoupling of ethical considerations from core business. Taken together, the failure to articulate and integrate purpose, values and principles within the functioning ethical framework has created toxic and socially harmful corporate cultures.\(^7\)

This part traces and attempts to rebut the narratives that valorise selfishness, and shows how companies in the sector have failed to identify and commit to the purposes of the sector and misunderstood their own purposes and metrics of success. Part 3 then explores the role of hubris as an explanation of the culture of the organizations and how regulatory changes might address this.

In addressing the cultural questions in its terms of reference, the RC has already denounced greed, and thus implicitly taken a stand on some of the differences of opinion that are identified in this. It is recommended that the final report address these differences explicitly, condemning greed and hubris, and affirming the need to individuals, companies and regulators to address themselves to the social purpose of the sector.

2.1 Norms

The norms valued by many in the sector are those articulated by Ayn Rand as “reason, self-interest, capitalism, and the trader principle” – effectively replacing the traditional cardinal virtues of wisdom, self-control and justice.\(^8\)

The centrality of self-interest to economic life is strongly argued by many. Even in Regulating Culture, Campbell and Loughrey argue that it should not be “other regarding” and informed by “humanity, justice, generosity and public spirit” but only by “respecting the autonomy of the other party to an exchange”, and that the legitimacy of regulation “inheres in its being a system of self-interest and mutual recognition.”\(^9\) Given that they argue from Adam Smith’s Wealth of Nations, it would seem apt to rebut from the same:

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\(^7\) O'Brien, J. and Gilligan, G. (2013) Regulating Culture: Problems and Perspectives, in Regulating Culture See n 2, xviii


\(^9\) Campbell, D. and Loughrey, J., 2013. The regulation of self-interest in financial markets. in Regulating Culture See n 2, 89
According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understanding:

1. The duty of protecting the society from the violence and invasion of other independent societies;

2. The duty of protecting, as far as possible, every member of society from the injustice and oppression of every other member of it, or the duty of establishing an exact administration of justice; and

3. The duty of erecting and maintaining certain public works and certain public institutions which it can never be in for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.

Regulation must be consistent with humanity and justice, and may well recognise greed only to the extent that it attempts to constrain it. One might also ask how the public infrastructure so clearly approved by Smith can be constructed without some element of public spiritedness by someone in the private or public sector?

Generosity and public spiritedness by entrepreneurs cannot perhaps be legislated but we surely honour those entrepreneurs whose products are designed to improve the common lot, and who are public benefactors with their wealth.

2.2 Narrative: Free markets

The valorisation of self-interest and greed arises from the belief that it is at the root of economic prosperity, dependent on the free rein of greed in competitive markets. This narrative however fails in two respects. Firstly, it does not distinguish between entrepreneurial profits and economic rents: the former being socially productive, the latter destructive – see Box 11.

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10 By requiring accountability and prohibiting conflicts of interest particularly – as argued in my submission to Module 5.

Entrepreneurial Rules of the Game

Baumol\(^{13}\) explores the differences between profit seeking activities that are genuinely entrepreneurial (that is are creative) and those that largely involve rent seeking. "If entrepreneurs are defined, simply, as persons who are ingenious and creative in finding ways to add to their wealth, power, and prestige, then it is to be expected that not all of them will be overly concerned with whether an activity that achieves these goals adds much or little to the social product or, for that matter, even whether it is an actual impediment to production."

Based on some historical data, he goes on to make three propositions - which on his numbering are:

"Proposition 2.1: The rules of the game that determine relative payoffs of different entrepreneurial activities do change dramatically from one time and place to another."

"Proposition 2.2: Entrepreneurial behaviour changes direction from one economy to another in a manner that corresponds to the variations in the rules of the game. (e.g. In ancient Rome, wealth from land, lending or political office was valued - and yielded more - than income from industry or commerce.)"

"Proposition 2.3: The allocation of entrepreneurship between productive and unproductive activities, though by no means the only pertinent influence, can have a profound effect on the innovativeness of the economy and the degree of dissemination of its technological discoveries."

...a distinction between the creative and the rent seeking. The former is worthy of praise, the latter is degenerate and reprehensible. Some obvious points of difference are set out below:

**Table 2**

<table>
<thead>
<tr>
<th>Partial Behaviour</th>
<th>Monopolist</th>
<th>Entrepreneur</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The objective is to maximise</strong></td>
<td>Market share</td>
<td>Turnover</td>
</tr>
<tr>
<td></td>
<td>Cost Savings</td>
<td>Efficiency</td>
</tr>
<tr>
<td><strong>Particular Behaviour</strong></td>
<td>Lobbying</td>
<td>Research</td>
</tr>
<tr>
<td></td>
<td>Restrictive practices</td>
<td>Innovation</td>
</tr>
</tbody>
</table>


This is not to hold that cost savings or market share are unimportant, but rather that efficiency and turnover reflect greater aspirations - both for the financial success of the firm and the prosperity of all.

Secondly it fails to take account of intrinsic motivations that can be more powerful motivators particularly in complex situations.\textsuperscript{14}

The strength of the narrative of profit maximization and the exclusion of rent seeking can be explained by the power of vested interests. This is manifest in the polarization of many current political debates. If Adam Smith is to be the authority, then:

\begin{quote}
The capricious ambition of kings and ministers has not, during the present and preceding century, been more fatal to the repose of Europe, than the impertinent jealousy of merchant and manufacturers. The violence and injustice of the rulers of mankind is an ancient evil, for which, I am afraid, the nature of human affairs can scarce admit of a remedy. But the mean rapacity, the monopolizing spirit of merchants and manufacturers, who neither are, nor ought to be, the rulers of mankind, though it cannot perhaps be corrected, may very easily be prevented from disturbing the tranquillity of anyone but themselves.\textsuperscript{15}
\end{quote}

Politicians of both sides need the courage to repudiate rent seekers and to reframe the debate into one around productivity and welfare.

\section{2.3 Narrative: Purpose of the financial sector}

Community expectations are surely that the financial sector and its regulators should be concerned to meet its key functions. Greenwood and Scharfstein\textsuperscript{16} capture the social purpose neatly with “the key functions of a financial system are to facilitate household and corporate saving, to allocate those funds to their most productive use, to manage and distribute risk, and to facilitate payments.”

They also identify three areas where the financial sector currently fails:

\begin{quote}
"Limiting the extent to which financial firms can fund long-term assets with short-term liabilities—thereby decreasing the risk of bank runs—would also help protect the system." ...
\end{quote}


\textsuperscript{15} From \textit{Wealth of Nations}

“The long-term goal of housing finance reform should be to promote financial stability and the proper allocation of capital.” ...

“High investment fees affect U.S. competitiveness chiefly by distorting the allocation of talent. Among employed 2008 graduates of Harvard College, 28% went into financial services, compared with about 6% from 1969 to 1973. ... The channeling of talent to finance can be justified if the high wages and profits reflect value added to the rest of the economy. But if investment fees are too high, then finance is inefficiently draining talent from other industries, hampering overall productivity growth.”

Section 5.5 (page 37) of my submission on Module 5 describes the first and third of these problems within the superannuation sector, where I suggest that trustees need to be democratically elected so as to free them from their current bondage to liquidity in investment markets, and to ensure that they get better value from investment managers.

2.3.1 Limiting the mismatch of terms

The first area also affects the banking sector in that it leads to an overestimate of its relevance in the allocation of resources and leads to excessive and inappropriate lending. While the macroprudential consequences are specifically excluded from the remit of the RC, the problem speaks directly to the questions of responsible lending and failures to do so.

The most popular way of describing the problem was developed by Hyman Minsky:

Minsky distinguished between three kinds of financing. The first, which he called “hedge financing”, is the safest: firms rely on their future cashflow to repay all their borrowings. For this to work, they need to have very limited borrowings and healthy profits. The second, speculative financing, is a bit riskier: firms rely on their cashflow to repay the interest on their borrowings but must roll over their debt to repay the principal. This should be manageable as long as the economy functions smoothly, but a downturn could cause distress. The third, Ponzi financing, is the most dangerous. Cashflow covers neither principal nor interest; firms are betting only that the underlying asset will appreciate by enough to cover their liabilities. If that fails to happen, they will be left exposed. 17

Minsky’s hedge financing is responsible; the others are speculative, and banks should not engage in them. While they have reduced their exposure to such risks since the GFC, the problem I see is that bankers are convinced that they can engage in “maturity transformation” (borrow short and lend long). I have yet to meet a banker who would not agree with the current governor of the RBA that “Without such transformation, it is difficult to see how

17 https://www.economist.com/economics-brief/2016/07/30/minskys-moment
modern economies would work." With respect, I am not convinced that his concerns with the model of maturity transformation go far enough. Certainly, speculative financing creates ongoing banking crises, as indicated in Figure 1.

![Banking crises](https://www.imf.org/~/media/IMF/external/np/exr/wp/2012/_wp12163.pdf)

**Figure 1 Banking crises**

The issues of responsible lending are most clearly visible in Chapter 5 of the Interim Report. On the other hand, all Australian banks required government guarantees of their liquidity during the GFC. When banks rely on debts being rolled over (Minsky’s speculative finance), they are engaging in irresponsible lending.

2.3.2 Aside:

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2.3.3 Housing finance

It has been recognised that interest only loans – speculative finance in Minsky’s terms – do represent a greater risk and are now being discouraged by APRA. Not yet in their sights are

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long term loans to older workers that can perhaps be repaid from superannuation balances, but are only secured by deposit on a house. 30-year mortgages are routinely offered to those in their fifties.

2.4 Narrative: Purpose of the company

There is a robust argument about the purpose of a company – see Box 2 for a summary – which leads on directly to a valorisation or otherwise of greed.

Box 2

Value for the Customer

You will know that there is an ongoing debate as to whether the sole purpose of business is to make a profit, or whether it has a social purpose in meeting people’s material needs — with profit being one measure of how well it is doing so. Milton Friedman (1970)25 is perhaps the best-known expression of the former view, Peter Drucker well known for the latter. ...

If Friedman is right, there would be nothing much to say about working in the finance or any other sector — as long as you were making a living. I think, however, Drucker’s critique is unanswerable. He says:

Profit is not the explanation, cause, or rationale of business behavior and business decisions, but rather the test of their validity. If archangels instead of businessmen sat in directors’ chairs, they would still have to be concerned with profitability, despite their total lack of personal interest in making profits. 26

I am attempting here to refute an idea for which Adam Smith is famous:

It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.27

Smith was over-pessimistic about human nature in some respects. He was convinced that corporations would always fail because of the agency problem: managers could not be prevented from looking after their own interests to the exclusion of everyone else’s. … To return to Drucker’s argument:

*It is irrelevant for an understanding of business behavior, profit, and profitability, whether there is a profit motive or not. … We do not learn anything about the work of a heart specialist by being told that he is trying to make a livelihood, or even that he is trying to benefit humanity. The profit motive and its offspring maximisation of profits are just as irrelevant to the function of a business.* … 28

### 2.4.1 Vagueness of purpose undermines innovation

Companies that have not resolved this debate will be vague on their purpose. Drucker goes on to address the core strategic task of any business:

> If we want to know what a business is, we have to start with its **purpose**. And the purpose must lie outside the business itself. In fact, it must lie in society, since a business enterprise is an organ of society. There is only one valid definition of business purpose: **to create a customer**. The customer is a foundation of a business and keeps it in existence. The customer alone gives employment. And it is to supply the customer that society entrusts wealth-producing resources to the business enterprise.

> Because it is the purpose to create a customer, any business enterprise has two – and only two – basic functions: marketing and innovation. These are the entrepreneurial functions. Marketing is the distinguishing, the unique function of the business. 29

It is important to note that his understanding of marketing as ‘providing for the needs of clients at a profit’. This is contrasted a product or sales orientation, which confuse the means (being the product or sales process) with the ends (the needs of the customer) – most famously captured in Theodore Levitt’s classic Marketing Myopia,30 still making the top 25 Harvard Business Review articles.31 This “marketing concept” is not readily grasped as it requires considerable effort to get to grips with the real underlying need of clients – as against preconceived ideas. It is however necessary for innovation which must go beyond what is already available.

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28 See note 26, p60

29 See note 26, p61


31 [http://mgmtblog.com/?p=232](http://mgmtblog.com/?p=232). In might be thought that theory and practice have moved on since 1960, but two of the current top three articles deal with ethical concerns and the third can easily be seen as a refinement of importance of meeting customer needs.
In this context, it is instructive to consider the purposes expressed in the annual reports of the large banks and AMP.

- ANZ: “Our purpose is to help shape a world in which people and communities thrive. That means striving to create a balanced, sustainable society in which everyone can take part and build a better life.”
- CBA: “We will advance our purpose to improve the financial wellbeing of our customers and communities.”
- NAB: “It will enable the Group to continue to deliver for all its stakeholders, live its purpose to 'back the bold who move Australia forward' and achieve the Group’s vision to be Australia and New Zealand’s most respected bank.”
- Westpac: “our core purpose is to help customers achieve what’s important to them.”
- AMP: “Our purpose is to help people own tomorrow, helping them take control of their money and achieve their financial goals.”

Without making detailed criticisms, there is vagueness and an absence of any mention of the purposes of the sector as identified above. There seems to be an assumption that customers are interested primarily in making money. At least it can be said that they have not explicitly stated the purpose is to maximise profits.

It does appear that these companies have not done the difficult intellectual work of understanding their purpose in serving customer needs. They have therefore failed to innovate and frequently moved away from serving customers. It is not that there are no needs. My book\(^{32}\) gives examples of some of the possibilities of innovation in financial services if one adopts the marketing concept. International consulting firm NMG has noted the success of South African companies’ innovations and say:

> By contrast, the major Australian insurers have in general acted (or failed to act) in concert, and as a result ended up focusing on the same target markets, the same products, the same operating model, with the same cost and capital structures, and with little or no basis for non-price differentiation.\(^{33}\)

A notable exception is Challenger, which has achieved standout profitability possibly because of its market innovations in the life annuity business, which other companies have avoided despite its obvious social value and profitability. Their purpose statement – to provide financial security to retiree – stands out for its focus.

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2.4.2 Mistaken metrics constrict services

Several the problems and misconduct in the financial sector cannot be ascribed only to a reductionist focus on profits per se, but to an even more reductionist focus on two utterly inappropriate measures of profitability: return on equity (ROE) and the cost to income ratio (CIR)\textsuperscript{34}. Both metrics reduce involvement in otherwise profitable investments with a comparatively low ROE or high CIR\textsuperscript{35}.

Although the problems with ROE are taught in first year economic and finance courses, my experience with final year and graduate students shows that these too require intellectual effort. An example may therefore be helpful at this point. CIR's are easier to understand. Ignoring all other considerations, including returns on capital, which is more profitable:

a) a customer who gives rise to costs of $70 and pays you $100, or
b) a customer who gives rise to costs of $30 and pays you $50?

The answer is clearly (a) as you make a profit of $30 against only $20 for (b). But (a) has a CIR of 70\% as against 60\% for (b).

Of course, it is possible that these metrics are used merely as indicators and the companies are really trying to maximise the real measure of profit such as economic value added (EVA)\textsuperscript{36}. There are however suggestions that this is not the case.

- The larger banks have closed branches in rural areas that sometimes have been replaced by community banks\textsuperscript{37}. Such community banks are obviously economical despite not having the advantages of scale of the larger banks and the same ability to diversify risks from the local area. Given the significant disruption to the local communities, branch closures with no economic justification except they fail to meet arbitrary economic indicators, surely fall below community expectations.

\textsuperscript{34} These have been included in the financial objectives of the banks for some years. The worst current offender is NAB, for which ROC and CIR account for two of four main objectives. See p4 of their 2018 Half Year Results Summary https://yourir.info/e4600e4db4d0c89-nab.asx-3A492724/NAB_2018_Half_Year_Results_Summary.pdf


\textsuperscript{36} See ibid EVA.

It may well be that some of these branches are not profitable unless the banks take additional measures to charge their rural customers more, or reduce some services, but they surely owe it to the community to be a little innovative if necessary.

- The Australian financial sector is noticeably absent from Asian markets, despite our locality advantage and the presence of many Asian immigrants with knowledge of the foreign markets. It is not that these markets have not offered opportunities – as evidenced by the success of European and American companies. The explanation may well be a high degree of complacency, but inappropriate metrics are likely to have played a role.

2.5 Role of universities

There is a widespread belief and some evidence that economics students learn to be more selfish. Frank et al (1996) finds evidence of this at some US universities, but Frey (2005) finds that while his Swiss business economics students are more selfish they do not become more so over the period of his study. Ahmed (2008) also finds no tendency to selfishness in his sample of Swedish students, but finds that students in the police academy become more willing to collaborate over the course of their studies. Box 3 gives some further evidence.

Box 3

Many believe that community standards of ethics have declined, and that some of the failure of moral formation results from the intellectual content of positive economics. Khurana\(^{38}\) traces the academic philosophies that have most influenced business schools over the past century and driven out ideas of professionalism and responsibility. Ghoshal\(^{39}\) argues that the consequences are:

> *that by propagating ideologically inspired amoral theories, business schools have actively freed their students from any sense of moral responsibility. As has been extensively documented in the literature over the last 50 years business school research has increasingly adopted the scientific model—an approach ... that Friedrich A. Von Hayek described as the pretence of knowledge.* (75)

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Mearman et al. 40 provide some confirmation of this opinion by reporting beneficial effects on students’ ethical development from going beyond positive economics and teaching alternative economic theories. …

It should be noted that Bok 41 was critical of attempts to “weave moral issues” into other courses and suggested the development of:

> problem-oriented courses in ethics. These classes are built around a series of contemporary moral dilemmas... Prospective lawyers, doctors, or businessmen may set higher ethical standards for themselves if they first encounter the moral problems of their calling in the classroom instead of waiting to confront them at a point in their careers when they are short of time and feel great pressure to act in morally questionable ways. (28)

George 42 reports that Bok’s article was the precursor to a significant increase in ethics courses in US business schools... There appears, however, to be no evidence to date that this approach has led to more ethical graduates, which suggests that it is not enough. This paper suggests that there is a prior need for an agreed ethical framework, and explicit induction into a professional community of virtue by ... teachers and mentors who identify with the profession, as argued by Bennis and O’Toole 43 in their analysis of the failure of business education.

The evidence is that business, economics and finance departments at Universities have played a role in the development of the selfish narrative, and that many of my colleagues believe in it. Formal interest in ethics and social responsibility is limited. As one example, the Society of Business Ethics and the Academy of Management held conferences simultaneously in Chicago in August 2018. Attendance at the former was 2% of the latter. On the other hand, the business schools affiliate to international bodies such as the Association to Advance Collegiate Schools of Business, which are concerned with developing ethical standards. 44


44 See for instance, https://www.aacsb.edu~/media/AACSB/Publications/research-reports/ethics-education.ashx
This involvement of the universities provides perhaps arguments for an outside review of the teaching of economics and finance – both at school and in the tertiary sector. There are a few issues that might be covered:

- I think it would be useful for the Department of Education and Training to find ways of measuring the impact on the ethics of students of teaching business subjects both at school and universities.
- The syllabuses of the undergraduate courses have ossified in a format that privileges the role of selfish incentives and fails to mention rent seeking. I find it necessary to define rent seeking to senior students, and am outraged that they have not heard of the “Minsky Moment” as an explanation the GFC, after three years of finance or economics.
- It has become standard practice in the universities to use revenue from the teaching of business and economics to subsidise other areas of the university (and higher administrative salaries). Some of this is because higher paying foreign students are more profitable to teach. There appears however been a reduction in staff student ratios which has meant that students have a more distant relationship with their teachers. The teachers themselves are more focussed on research metrics – with “global pressures for conformity with a mythical US style economic research ideal,” Box 4 makes the point that these factors are not helpful to the entire educational process – let alone the development of ethics.

It would be helpful if the RC were to denounce the unexamined teaching of the primacy of the profit motive, and call for the universities to address the question.

Box 4

**Ethical teachers**

Induction into the community is personal, and needs personal connections: teachers and mentors. Their role is more than intellectual. Traditional education in ethics places relatively little importance on teaching philosophical theories. It is rather aimed at “educo”, Latin for “leading out” students’ best aspirations and understanding.

This section reaffirms the traditional approach to teachers and teaching, suggesting that induction into the professional community falls to teachers and mentors who identify with the

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45 See note 17.


47 Webster’ Third New International Dictionary, where education implies “expansion of knowledge, wisdom, desirable qualities of mind or character”.

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profession, as argued by Bennis and O’Toole in their analysis of the failure of business education. Blakemore and Frith, from the perspective of educational neuroscience, suggest: “The teacher’s values, beliefs and attitude to learning could be as important in the learning process as the material being taught.” Palmer emphasises “good teaching comes from the identity and integrity of the teacher.” Carr and Skinner write “the most effective teachers are not those who simply regard the acquisition of knowledge and understanding as worthwhile for others, but those who have first and foremost grasped its value for their own personal, moral and spiritual development.”

One conclusion from this is that students should be exposed to a variety of teachers and mentors over the period of their training. If all are required to address ethical issues then students will be exposed to a variety of views and approaches, and be challenged to develop a personal ethical framework and commitment to professional judgement. Exposure in a single course is unlikely to be enough. There is also a need for more conscious management of the recruitment and direction of an appropriate range of committed teachers and mentors.

The other conclusion is that teachers (or material in distance learning) must explicitly raise ethical and practical issues in their teaching – even of the apparently technical subjects, and in a manner that emphasises the personal and affective. One critical area to change is identified by Dean and Beggs’ survey of what business-school teachers believe about ethics education. Rather surprisingly they find: “Major results indicate that faculty generally do not believe that they can change students’ ethical behaviors, and that faculty’s conceptualization of ethics do not match their classroom approaches. (15) … Most faculty believe that ethics is a value-driven and internal construct but teach using compliance-driven and external methods. (40)”

3 Organization

This part builds the case that the culture of greed will take root in organizations that tolerate and even encourage selfishness, and that culture cannot be changed without addressing greed and hubris at the top. Central to this question is the issue of the level of executive remuneration. Figure 3 suggests some of the causes and connections between excessive

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remuneration, the unfettering of power and poor decisions that can lead to recklessness. The smugness demonstrated in the previous section could be explained by hubris.

A personal view: Hubris creates recklessness

A considerable body of recent academic research confirms ancient wisdom that overconfident leaders with too much power make reckless decisions - and pay structures can contribute to overconfidence and excessive concentration of power.

Figure 3 Pay, hubris and recklessness

3.1 Hubris

Hubris has been recognised by numerous enquiries as a major contributor to the failures of many recent and significant failures: the Equitable, HIH, HBOS just some recent examples. While much has been written by the regulators on the structure of bonuses and their impact on misconduct and recklessness, it is extraordinary that the regulators have not made the


54 Asher and Wilcox, n1 p5/6.
connection between excessive remuneration and reckless and greedy behaviour. If hubris has led to the failure of many organizations, is it not likely that it lurks in many others that have been lucky enough not yet to have failed?

### 3.1.1 Hubris leads to selfishness

A variety of research shows that “CEO compensation and resulting power” is expressed not just in purchasing power and political lobbying but inevitably “makes itself known in the work domain”. “[P]ay differentials provide information regarding the relative power of managers”, and provide signals both inside and outside the organization. To the extent that they are believed, they give rise to real power. “[S]ystematic research has also found power to be related to a variety of negative effects such as selfish and corrupt behaviour … reduced empathy … tendency to objectify and stereotype others.”

> A meta-analysis of 25 studies focused on the relation between power and superiors’ evaluation of subordinates and found that as power levels increased, evaluations of subordinates become increasingly negative and self-evaluations grow increasingly positive. All in all, the experience of power metamorphoses power holder into meaner people.

And their example of greed is likely to be emulated: “if the boss is chiselling, everyone else will feel they have a right to chisel.”

### 3.1.2 Motivated blindness

In their selfishness, they lead others to be dishonest. A review of 60 papers found “overconfident executives to be embroiled more often in accounting manipulation (p56)” See also Box 5. If the RC asks, I would be surprised to find that companies have not massaging at least some of their results.

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55 As an example, take APRA’s Information Paper: Remuneration practices at large financial institutions April 2018.


My observation of those in practice is that they are very often blind to the ethical considerations involved here. This phenomenon should be well known:

*Psychologists have known for some time that individuals who have a vested self-interest in a situation have difficulty approaching the situation without bias, even if they view themselves to be honest.*

Box 5

**Accounting and earnings management**

A classic joke on company reporting goes:

* A company is going through the interview process in order to hire a chief financial officer. In the last interview session, each of three finalists is given the company’s financial data and asked, ‘What are the net earnings?’ Two applicants diligently compute the net earnings. Neither of them gets the job. The candidate who lands the position answers the question by replying, ‘What do you want them to be?’*

I thought this was funny when I first heard it, but now I see it as the single most powerful corruptor of young accountants, actuaries and other financial professionals—and warn my students as they go into their first jobs. Unless alerted to this possibility, they may be blissfully unaware of the underlying motivation for the instructions they are receiving, and find themselves compromised later.

In many companies, they will be asked to provide a variety of results so that the CFO and CEO can decide what the profits will be. In writing this, I can hear some acquaintances of mine objecting that this is nothing remarkable: the CEO has a duty to ensure that the reported profits are fully reflective of the business. There is a problem however to the extent that the concerning is with impressions and not reality—attempting to give the right message to shareholders to inflate the share price. Subjecting your customers to puffery is one thing—they expect it and the law requires them to take care. Attempting to fool the shareholders, to whom you owe a fiduciary responsibility, is fundamentally dishonest.

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60 Taken from Asher (2015) n24, p93.

Such blindness leads not just to overconfidence, but to a mistaken belief that leaders should display confidence to be effective, and that passion and ambition are prerequisites of success. (see Box 6.)

Box 6

While there is much to learn from anecdotes and more expansive stories of success (and failure), we need a deeper analysis. The research suggests that optimism in business is more likely to end in failure than success. Donald Duchesneau and William Gartner find that, when compared with less successful start-ups, successful entrepreneurs were more aware of the risks beyond their control and so worked harder and more carefully. When the optimism leads to hubris (pride), then the likelihood and consequences of failure are likely to rise. Enron, the Equitable, HIH in Australia are all recent examples.

A final example of motivated blindness is to link executive bonuses to share prices on the apparently convincing grounds that this addresses the agency problem by aligning interests. It suffers from two problems. Firstly, most share price movements are related to the overall level of the market. CEOs have very limited power as individuals to move the market so deserve no credit at all for most of the movement. Secondly, while shareholders have an interest in the long-term growth in the share price, short term overvaluations merely benefit sellers at the expense of buyers, and will distort decision making if CEOs are sellers at the time.

This is only one of the many inconsistencies in determining CEO remuneration. Michael Jensen, the father of agency theory, finds over three dozen errors that are commonly made in their design – in Jensen et al.

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3.2 Excessive remuneration

Box 7 gives a short summary of the view that executive remuneration has risen to excessive levels and the theories why this has occurred.

Excessive executive remuneration is another species of overcharging. The three standard arguments for the size of current levels of remuneration do not stand up to scrutiny. The first, the argument that they deserve it does not apply in a free and efficient market. Companies only have to pay executives enough to encourage enough competent people to offer their services. This is the logic of the market—the matching of supply and demand.

Second is the view that money is the strongest motivator. There is ample psychological and economic evidence\(^67\) that people are better motivated by intrinsic rewards when faced with complex tasks where it is difficult to measure success. The idea that managers should have ‘meaningful equity stakes’ to align their incentives with shareholders is not only theoretically suspect, but it has always been obvious that the enormous share options that they have been given depend more on the overall increase in the share market than on any effect that they have on the company’s results. When I have been told that leaders and companies need to focus on a single objective, I wonder if they could cook a meal without burning the vegetables!

The final explanation – that of the tournament effect, which suggests that junior people will work harder to be promoted – is more plausible. The problem however, is that this focusses people more on winning the promotions tournament than on the job, and is more likely to create office politics than productivity. The current level cannot be justified by desert, equality, need or liberty, and the efficiency impacts are at best debatable\(^68\).

Although excessive remuneration is not new, extreme levels and poor economic performance in recent times have led to greater public opposition if not outrage. The ratio between the highest and the lowest wage within a company in the United States apparently rose from 20 in the 60s to almost 400 in 2000, but was still almost 300 in 2013.\(^69\)In comparison, Drucker\(^70\) suggested that this ratio should normally be limited to some 25 to 1 – with each company publishing the ratio, and each person earning about 40 percent more than their subordinates.


\(^{67}\) The best known is perhaps Frederick Herzberg (1987) n14.


\(^{69}\) https://www.epi.org/publication-ceo-pay-continues-to-rise/


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My friend, Nick Hudson, who works in venture capital, responded to the first draft of the previous paragraph with:

In our closely held private companies we set salaries that are much lower than your proposed ratios suggest. The executives must expose their capital to risk, and earn economic profits on it only when the firm earns long-term economic profits on its capital, which it can only sustainably do by treating all key stakeholders fairly. I consider it a sign of poor character (lack of virtue) when a CEO is unwilling to share or share in the economic outcomes he creates. Then you should not trust him.

The problem exists across the economy and is perhaps worst within the finance sector. Proximate responsibility (that is the most guilt) lies with the CEOs who request and indeed argue for such pay and their board directors who vote for it. The CEOs are being greedy. The directors are failing in their duty to their shareholders and other stakeholders in the company, and displaying a lack of courage.

Courage needs forethought: it has to be appropriately armed. I used occasionally to have lunch with a director of my life insurance employer, who had worked his way up from selling policies. In semi-retirement, he was helping a management remuneration consultant sell reports to companies. He told me it was the easiest job he had ever had: in about half the cases, the report said the CEO was earning less than the average of his or her peers and the sale was guaranteed. Directors need to know that the comparative reports put before them may have been selected, and clear that some people must be paid less than average. They need to be free of the notion that the level of pay is a measure of respect for the person concerned.

As a manager and non-executive director, I have had to turn down requests for higher pay. It is relatively easy as a manager. You are normally operating with budget constraints and can refer to higher powers. At board level, there is no one else to whom you can shift blame. The arguments become heated, and you have to back what is a subjective judgement. If you are being fair, you will be relatively sure that you can replace the person concerned at the package that you are offering. Only when my preparation has allowed me to get to that point, have I found the confidence to take an effective stand and say: I do not want to lose you, but the board will not be paying you what you are asking for.

3.3 Historical explanations.

The recent increases in executive remuneration need an explanation if it is to be addressed. In a balanced consideration, Bank et al. 71 discount the role of lower marginal tax rates and the declining union power, suggesting rather a cultural explanation for the recent increases in CEO income:

The market for managerial talent and norms within public companies do more to explain the mid-20th century executive pay compression. While by the end of the 20th century CEOs were widely thought of as being genuine “difference makers” who

would be worth paying generously and even poaching if they were the right person for the job, from the 1940s through the 1970s top executives were perceived of as mere bureaucrats with largely fungible talents and were paid accordingly. Also, a “team first” ethos and a fear of being pilloried as greedy stemming from the crisis conditions of the Depression and World War II fostered the development of strong norms within companies against the awarding of highly lucrative executive pay.

They are however unable to suggest how these changes might be addressed, going on to say: “There probably is little appetite for a return to the orderly but potentially demoralizing uniformity of mid-20th century corporate life, which likely precludes norm-driven reform of executive pay.”

There are counter-arguments to the suggestion that pay is excessive. Conyon et al\textsuperscript{72} express a common view (in some business circles at least) that the use of the term excessive might “reflect one of the least attractive aspects of human beings: jealousy and envy.” They show that “US CEOs are paid only modestly more than their European counterparts after controlling for firm, ownership, and board characteristics.” That everyone is doing it is scarcely a justification, but their identification of these characteristics does provide a clue as to how excessive remuneration can be addressed. They find that executive remuneration is higher where there is greater leverage, greater stock returns, more institutional but less inside ownership, and where there are more directors of whom a greater proportion are independent and busier (have more board appointments). Their ownership and board characteristics would be consistent with the hypothesis that weak directors allow executives to command greater income. They also confirm that institutional investors and independent directors are less active in monitoring pay.

### 3.4 Possible remedies

“Public outrage” at excesses has been expressed for at least two decades\textsuperscript{73}, but the RC may well offer an opportunity to address the problem more effectively than heretofore. This section suggests how changes to regulation could effect changes in the structure of organizations that would be more likely to lead more effective and ethical behaviour.


3.4.1 Addressing CEO dominance

Recommendation 13 from Jensen et al\(^74\) addresses issues of power and culture: “Change the structural, social and psychological environment of the board so that the directors (even those who fulfil the requirements of independence) no longer see themselves as effectively the employees of the CEO.”

While there are many ways in which boards can be organized in terms of structure and process, and competent and courageous directors should be able to control CEOs in all of them. It seems likely that the main issue is that of power, where the relative strength or board and CEO fluctuates with the CEO’s influence rising with tenure and success.\(^75\)

One solution would be to increase the power of directors by giving them a base other than as nominees of the existing board, which often means indirectly by a long-serving CEO. Turnbull\(^76\) provides a detailed argument why “compound boards”, which include a “senate” nominated by stakeholders other than shareholders can more effectively monitor the CEO. An alternative is given by Branson\(^77\), who referred to cumulative voting systems that give minorities the right to elect a proportional share of the board. Share prices are apparently reduced when this right was removed.

A second approach would be to empower shareholders by allowing them to propose motions that set restrictions on remuneration when in general meeting. Shareholders have now been given a “say on pay” and can surely be trusted not to destroy value by voting for packages that will undermine corporate value.

3.4.2 Breaking up the banks

The US Glass-Steagall Act forced US banks to divide their commercial and investment arms and has been credited with reducing the power of the financial sector in the thirties, and its repeal blamed as contributing to the GFC.\(^78\) Both are disputed, but – as with anthropomorphic global warming – the potential harms are so great that the debate does not have to be settled for the policy imperatives to be clear.

\(^74\) See n65.


In addition, more focused institutions may well have more reason to define their purpose and be more innovative; be less influential in corrupting our political process; and be less likely to feed the hubris of their directors and management. In the current Australian sector, one can consider a four-way split.

- Investment banking should focus on the long-term capital market and investment management. As discussed in my submission to Module 5, superannuation trustees need to be empowered to ensure they obtain value for money from these banks.
- Commercial banks need to focus on the payment system and provision of short-term savings and loans – cash flow management for businesses. They should therefore not be distracted by housing finance.
- Housing banks are also traditionally a different business. The risks of default are much easier to evaluate than business loans. Housing loans should be less likely to give rise to losses as the value of the collateral is not directly related bank to the borrower’s income as it is in business loans.
- For reasons that have been widely canvassed, superannuation trustees should be independent of other financial institutions.

3.4.3 Taxation

Even if it is not an explanation for excessive executive remuneration, higher rates of marginal tax for the wealthy should not be entirely discounted. Box 8 points out that it has frequently been applied to prune the temptation to arrogance.

Box 8

The final argument for taxation of the wealthy, in order to reduce inequality, is to bring down the tall poppies. It has long been recognised that all power tends to corrupt, and wealth is power that corrupts. Most countries with democratic constitutions limit the terms of presidents; it is good practice in corporate governance to limit the terms of directors and managers. Both ancient and modern literature identifies hubris as destructive of politicians, while powerful CEOs increase firm risks and exploit shareholders. Democracies tend to

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have a more equal distribution of income and are apparently more resilient to economic crises.\textsuperscript{82}

### 3.4.4 Empower research

Zingales\textsuperscript{83} suggests that academics could function better as whistle-blowers in the system if regulators were more active in making their data more widely available. At very least company accounts should be digitally available at minimal cost.

### 4 Other matters

This part deals with other matters raised by the Interim Report, and some that I had expected to be considered but were not.

#### 4.1 Default interest and charges

This issue was raised in the Interim Report in the context of agricultural loans, but applies more broadly and can include "normal" credit card interest, which is set at a level that is clearly penal. My view is that it is a question of justice or fairness, and would apply the model of justice described in Box 9. This leads to the following:

- **Just deserts.** Charging penalties to those who are behind in their payments offends desert if they have fallen into arrears because of a financial shock beyond their control. It might be further argued that those behind in their debts were more likely to default and cause loss to the bank and so on the ground of actuarial equity, those in arrears bear more of the cost of default. This, however, takes too short a perspective. \textit{Ex ante}, before the loan is initiated, the losses that arise from unexpected and uncontrollable financial shocks should be shared between all borrowers to achieve actuarial equity. Lenders may not be able to easily distinguish those at fault from those not, but if borrowers are able to show that their arrears were a consequence of them having suffered a financial shock, then it would be unfair to penalise them. This is the intuition behind not charging penalty interest to farmers suffering from drought, and should apply to all unexpected and uncontrollable financial shocks. Applying desert to credit card interest, high rates would be justified only to the extent that "revolvers" are responsible for the lenders' credit losses and cost of funds – both of which could be seen as proportional to the amounts borrowed.

- **Efficiency.** It might be argued that the threat and act of changing penalty rates is useful in that it encourages borrowers to keep up to date and so reduces credit losses. This is probably true – except again in the case of those who have suffered financial

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\textsuperscript{82} While they fail to find a causal connection between democracy and equality, the correlation is found in Acemoglu, D., Johnson, S., Robinson, J. A., & Yared, P. (2008). Income and Democracy. \textit{American Economic Review}, 98(3), 808-842.

\textsuperscript{83} Zingales, L., 2015. See n 10; 1352.
shocks. On the other hand, charging penalty rates will in some cases increase the likelihood that the costs of default are incurred, so one would want to err on the side of leniency when determining whether the defaults were deserved.

- Need. Very clearly, those who have suffered a financial shock are in greater need.
- Equality. All borrowers in the same position should be charged the same rate. The question here is whether discrimination between borrowers who are up-to-date and those who are not can be justified. The rate of penalty should be proportionate to the differences in circumstances.
- Liberty. Regulation should be applied only where necessary, but the failure of lenders to routinely take the circumstances of the borrowers into account suggests that there is a need to protect the vulnerable from abuse.
- The other question is whether penalty interest rates unfairly interfere in the lives of the borrowers, but I think this is probably unavoidable.

On balance, I suggest that lenders should not be permitted to charge penalty interest and other charges when the borrowers can show that they have suffered unexpected financial shocks. If this were the case, then lenders would be entitled to require borrowers to take out appropriate insurance to cover shocks before they take out their loans.

Box 9

The Art of Balancing

2.2.1.2 It might be thought that differences between people are too wide to allow agreement on social and ethical issues. This section, however, attempts to outline the traditional view - held by philosophers and political writers from the earliest times - that the principal social and ethical virtue is justice. (Justice is used here as having wider applications than equity or fairness - but the words are often interchangeable.)

2.2.1.3 The claim that justice is the primary social criterion is not made lightly, nor in an attempt to squeeze a complex problem into a simple answer. It is rather because societies require a balance between the needs, actions and values of different individuals - and justice is the name given to the art of finding this balance. Justice, therefore, rules over other social objectives - such as liberty, prosperity, equality or peace - because it functions to balance them against each other.

2.2.1.4 Its key characteristic is a recognition of the dignity and individuality of each member of a society. This is the basis of its concern for a reasonable balance between the particular interests of each individual. It is, as a result, also concerned with desert: with appropriate rewards and punishments. It is also particularly concerned with the protection and dignity of the poor and otherwise defenceless. This personal aspect of justice perhaps explains the anger felt - often on someone else's behalf - when people are faced with injustice.

2.2.1.5 Because it is justice that ought to rule the relationships people have with each other, it

84 Taken from Asher (1998) n12.
can provide a basis for compulsion. This partly explains the many conflicting definitions of justice. Redefining justice in order to favour one’s own values and interests not only makes for satisfying, if not constructive, argument, but also provides a justification for overruling the interests of others. There may be differing, but legitimate, interpretations of what constitutes a just balance of interests. Indeed, individuals in different societies do come to different answers as shown in a summary of empirical work by Le Grand.\(^85\)

2.2.1.6 A discussion of justice could not be complete without mentioning Rawls.\(^86\) His theory of justice rates liberty highest, and then balances equality, prosperity and need - by a rule that requires the interests of the worst off to be maximised. The Rawlsian approach is widely used but seems eccentric in ignoring desert - which Lucas\(^87\) would not be alone in considering pre-eminent in distributive justice. It does not rule out alternative rules of distribution - and is thus compatible with this paper’s definition of justice.

Justice can also be spoken of in terms of rights - which can be seen as defining the boundaries of just behaviour. Rights are not absolute; even rights to life and liberty must sometimes be balanced with the rights of others (especially to life and liberty). Claiming a right does not establish its validity. It is regrettable that calls for greater rights are often rhetorical and simplistic. Millennia of legal development have shown that rules that work, and are fair to all, are often complex and require trade-offs.

4.2 Asset management

The investment management industry appears to have escaped much scrutiny in the Interim Report. As the allocation of capital figures prominently in the purpose of the industry, and excessive incomes are identified as a major issue in section 2.3 above, some consideration could be justified. Some areas where these markets could be considered to fall short of community standards are:

- Lehman Brothers’ was found to be “financially liable for misleading clients including Church and Not-For-Profit Groups to purchase complex financial products.”\(^88\) Not-For-Profit Groups and local governments are vulnerable against unscrupulous investment banks. Some thought could perhaps be given to include them as retail clients as they will frequently not have the expertise to resist the unscrupulous.

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• It appears that high frequency trading (HFT) is a form of front running and rent extraction, in which I have been told the stock exchanges connive as it is a source of income. It is difficult otherwise to explain the profitability of the most notorious of the participants, Renaissance Technologies.

• There seems to be no mention of insider trading even though research consistently shows that “Australian regulation is less precise and appears to have been less rigorously enforced than in the United States, where legal action against directors is much more common.” This was also the finding of the Senate Economics References Committee on the performance of ASIC.

• Concerns about the short-term nature of equity markets and the failure of institutional investors to focus on long term wealth creation have long been a concern in the UK. The Kay Review of UK Equity Markets and Long-Term Decision Making was critical of regulation:

> Regulatory policy has given little attention to issues of market structure and the nature and effectiveness of competition, instead developing detailed and often prescriptive rules governing market conduct, with substantial cost and limited success. Regulation should focus on the establishment of market structures which provide appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives. We look forward to a future of less intrusive and more effective regulation, the product of a new emphasis on the incentives market participants face, and to the creation of trust relationships which can give savers and companies confidence that the equity investment chain meets their needs and serves their interests.

All these issues fall under ASIC’s remit and its failure to address them is further indication of regulatory capture. The power of the lobbying is perhaps illustrated by the delight of the

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90 The company is described thus: https://en.wikipedia.org/wiki/Renaissance_Technologies. It is obviously heavily involved in HFT, as described in this discussion of their patent application: https://nexchange.com/article/10534


92 EXHIBIT-5.318.67.pdf

Financial Services Council at the abolition of the Corporations and Markets Advisory Committee (CAMAC) in 2014.

FSC advocated for the abolition of CAMAC after a series of reviews which lacked a proper evidence base and significant concerns on the integrity of the process used by CAMAC. CAMAC had been undertaking inappropriate structural reviews into trustee companies and managed investments. Its abolition now permits the FSI to focus on any structural issues in the industry under its broad terms of reference.94

CAMAC “was set up in 1989 to provide a source of independent advice to the Australian Government on issues that arise in corporations and financial markets law and practice.”95

Whatever the failures of CAMAC – and opinions differed – it does seem to be a necessary body as Freehills said at the time of its abolition:

Despite its merits, the Australian Law Reform Commission is no substitute for CAMAC: it lacks the specialist and practitioner expertise. If CAMAC did not exist, we would have had to invent it. If it ceases to exist, we will have to reinvent it. 96

It seems likely that the RC will be making recommendations to the structure and remit of ASIC. In doing so, I suggest that it add an expert body with independent expertise to provide a check on rent seeking and regulatory capture.

26 October 2018

94 FSC’s Year in Review for 2013/2014, EXHIBIT-6.409.11.pdf


96 https://www.herbertsmithfreehills.com/latest-thinking/camac-to-be-abolished