SUBMISSION TO ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY[1]

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This submission raises some broad preliminary points for consideration. The submitter will develop these further in further research and submissions.

The points raised will be under three headings

1) How did we get to where we are?
2) Solutions?
3) A caveat

A. HOW DID WE GET TO WHERE WE ARE?

Principal developments over the last 30 years

Financial services and financial products were hived off into a new area of responsibility administered by ASIC and APRA following the Wallis Report of the late 1990s. They were removed from the purview of the ACCC, Insurance and Superannuation Commission and various other regulators.

The current prolix regulation

Financial Services Regulation

There followed a large quantity of legislation on Financial Services Regulation (FSR) mainly enacted as Chapter 7 of the Corporations Act in a number of pieces of legislation (including the various pieces of Corporate Law Economic Reform Program (CLERP) legislation and Future of Financial Advice (FOFA) reforms).

Much of this FSR material appears in the now highly detailed Chapter 7 of the *Corporations Act 2001* (Cth) (currently some 379 pages encompassing some 800 sections and several thousand subsections). There are also nearly 900 separate regulations and thousands of many more sub-regulations enacted in the relevant Corporations Regulations made pursuant to Chapter 7.

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It is often unclear whether the legislative and regulatory interventions are enacted with knowledge of and having regard to the existing principles of law (such as, for instance, the interplay of the Part 7.5 financial market compensation regime with existing general law causes of action against market operators or market participants) and so create uncertainty as to whether they add to, derogate from or modify such principles. Needless to say this adds to uncertainty in the law.

Superannuation

Meanwhile, there appear to be at least thirty current consolidated acts dealing with superannuation in one form or another including the lengthy *Superannuation Industry (Supervision) Act 1993* (Cth) and the lengthy regulations thereto. This is in addition to the significant body of well settled case law on the duties of trustees in equity.

It is often unclear whether the legislative and regulatory interventions are enacted with knowledge of and having regard to the existing principles of equity, and so create uncertainty as to whether they add to, derogate from or modify such principles. Needless to say this adds to uncertainty in the law.

Conclusion

There is no lack of regulation. Quite the opposite. If anything, regulation is in fact too long, complicated and detailed and needs to be simpler and more principles based.

Problems of prolix regulation

The sheer volume of law in a discrete area also has problems in that the area inevitably becomes an area of extreme specialisation. Practitioners may then become increasingly immersed in their area of specialisation and decoupled from general legal principles that may be longstanding and of considerable value, yet may be ignored (or in other cases reinvented in other guises[3]). This makes the law more messy and inconsistent overall. Further, practitioners are only human and therefore limited in their ability to maintain ongoing familiarity with increasing volumes of law across numerous areas.

Some of the problems of prolixity (i.e. needlessly long, detailed and complex provisions) and resulting overt specialisation by practitioners include:

1. Compliance costs including the need to find lawyers and/or compliance professionals familiar with the lengthy detail of such regulation.
2. More possibility of provisions that are not consistent with each other.
3. Lack of clarity as to whether common law and equitable principles are supplemented, derogated from or modified.
4. Lack of legislative memory – where new provisions are enacted without having regard to existing principles or in ignorance of existing principles causing duplication and/or inconsistency.

[3] Thus, for instance, we have the s912A Corporations Act obligation of efficiently, honestly and fairly which may or may not overlap with possible fiduciary duties of advisers, apparent fiduciary obligations of trustees, general tortious duties of care, numerous statutory duties not to mislead and deceive and the statutory duty of utmost good faith of insurers (s 13 *Insurance Contacts Act 1984* (Cth)).

5. Lack of consistency between laws and/or consistency with fundamental principles of the general law.[4]

Developments in the banking and insurance sector over the last 30 years

Notable developments in the banking and insurance sectors in the last 30 years or so in Australia include the following:

1. Privatisation of the major government owned banks – e.g. Commonwealth Bank and State Bank of Victoria.
2. Conversion of many mutually owned (customer owned) building societies into private stockholder owned banks (which I will refer to as 'PSHO Banks"). These have often then been acquired by shareholder owned banks – e.g RESI Statewide Building Society became Bank of Melbourne in 1989 and was acquired by Westpac PSHO Bank in 1997 as was St George Co-operative Building Society in 2008, New South Wales Building Society became Advance Bank in 1985, Perth and Hotham Building Societies became Challenge Bank in 1987, Cooperative Building Society of South Australia became Adelaide Bank in 1994, United Permanent Building Society became National Mutual Royal Savings Bank in 1986, Metropolitan Permanent Building Society became Metway bank in 1988 and was later merged with Suncorp Insurance and privatised as Suncorp-Metway in 1998.[5]
3. Demutualisation of customer owned friendly societies (Australian friendly societies usually incorporating both building society and some insurance functions) with the Over 50s Mutual Friendly Society demutualising in 2001 to form the OFM Investment Group Limited and the Independent Order of Odd Fellows (IOOF) demutualising in 2002.
4. Demutualisation of customer owned insurers or societies such as Australian Mutual Provident (AMP), Colonial Mutual, National Mutual, Mutual Life and Citizens Assurance Company (MLC) and NRMA Insurance, some of which were then acquired by PSHO Banks (e.g. Colonial acquired by Commonwealth Bank, MLC acquired by NAB).
5. Reduction in the number of small building societies and credit unions – in some cases due to mergers and consolidation of these into larger entities (e.g Credit Union Australia)

Ownership changes as increasing conflict of interests and reducing effective competition

A major effect of these developments has been a reduction in the number of banks/building societies/credit unions and insurance companies that are owned by their members or by

[4] Such fundamental principles across the law, to name a few, include enforceability of contract, the importance of notice, due process and procedural fairness, identification and disclosure and avoidance of conflicts of interest, establishing causation of loss and proving quantum thereof, consistency and certainty of law, separation of executive, legislative and judicial governmental activity and prohibition on acquisition of property other than on just terms.

[5] Demutualisation in Australia, *Reserve Bank of Australia Bulletin* January 1999, 7-8.

government and a tip towards such entities being more commonly owned and run by outside equity (and run in the interests of such outside equity).[6]

Another development was an attempt to expand competition in the banking sector by the granting of banking licences to 16 foreign banks by the Hawke Keating government in 1984-85.

The latter development was symptomatic of the general faith in ***competition policy*** to improve customer service in the sector.

The former developments that saw greater outside equity ownership and less customer (sometimes also referred to as 'stakeholder'[7]) and government ownership were generally accompanied by governmental and regulatory acquiescence (and or in some cases outright support[8]). This stance may have been symptomatic of little policy understanding of or faith in ***ownership policy*** and ***interest alignment policy*** as another means of increasing customer service and satisfaction (the latter seeks to achieve its objectives by aligning the interests of owners and customers given that customers are the owners[9]).

This development is notable given that the Royal Commission appears to have identified a real tension in financial services where the interests of customers appear to have been sacrificed in some cases to the interests of the owners – shareholders. That is, the pursuit of profit for shareholders has overridden customer interests and competition policy has not been adequate to protect the latter.

In relation to customer ownership (and even the old policy of government ownership of some competitive players in a mixed economy), it might be commented that competition is actually likely to be most effective when some of the competitors have the ability to undercut their competitors due to a comparative advantage. The ability to offer better value service to customers through having no competing pressure to transfer wealth from customers to shareholders is clearly such a comparative advantage. Yet the above events mean there are many less players in the field now able to do so.

Another problem for competition policy in the area of financial services is the complexity of financial services and the ability to compare products. This problem – sometimes referred to as asymmetrical information – makes competition policy a less effective tool of consumer protection.

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[6] There are occasional exceptions to this general trend with occasional new entrants having somewhat alternative ownership structures such as the industry superannuation fund owned Members Equity Bank.
[7] See e.g. Morey W McDaniel, "Stockholders and Stakeholders", 21 *Stetson Law Review* 121 (1991) 161-2.
[8] Such as the government sale of the Commonwealth Bank which had originally been set up to provide competition to the other PSHO banks.
[9] The efficacy of such policy has been noted in long standing relational contracting such as life insurance (see Clifford W Smith, "On the Convergence of Insurance Finance Research", *Journal of Risk and Insurance* 53: (1986) 708) and is the basic philosophy of customer owned credit co-operatives. The policy is also a manifestation of the efficacy of the law's traditional critique conflicts of interest and the desire to remove or minimise these – and at a minimum to recognise and disclose them. Another more fashionable manifestation of policy to align interests is the application to remuneration of corporate managers where it has been used to justify large share option packages as incentives to align management's interests with shareholders' interests. See generally Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics* 3:305 360 (October 1976).

It is notable that many of the more egregious problems that have been exposed by the Royal Commission have the common theme of conflict of interest and lack of alignment of interest that has been noted. In particular:

1. Pressure on PSO Banks to achieve shareholder returns which may be at the expense of customers;
2. Pressure on PSO Banks and PSO wealth management companies (many of which were formally mutuals) to achieve shareholder returns at the expense of customers/policy holders.

Conclusion: Stockholders' and customers' interests will not always be in outright conflict. A win/win can be achieved if better customer services means more customers use the company. There is however a perennial tension between the owner interest and the customer interest. The decline in availability of and competition from customer owned banks and insurers (and even government owned banks) has generally not been a positive development for customers and consumers of financial products and services.

Other conflict of interest problems in financial advice

Similar structural problems exists where 'advisors' purport to give objective advice about competing products while receiving payment from product issuers to do the exact opposite by actually spruiking the particular products of the commission payers.

In relation to financial advice, the simple expedient of imposing a fiduciary duty on financial advisors appears to have been vigorously resisted, and appears to have had the ear of government. Instead reliance has been placed on long, complex and prescriptive regulation intended to somehow deal with the conflict of interest inherent in pretending to give objective advice about competing products while receiving payment to do the exact opposite.

B. SOLUTIONS

It follows that the thrust of this submission is that better regulation is likely to flow from simpler principles based regulation that seeks, as much as possible, to reduce or avoid conflicts of interest. This noble aim is of course easier said than done.

Principles based regulation

S912A – duty of honesty, efficiency and fairness

The obligation or duty to provide financial services efficiently, honestly and fairly under s912A may have merit as a form of principles based regulation – as opposed to the lengthy and unduly prescriptive regulation discussed above. Principles based regulation based on such general obligations – the statutory duty not to mislead and deceive is another – can be helpful and can be reliant on the wealth of common law that has developed in these areas rather than on attempts at a 'Napoleonic Code' of statutory regulation, delegated legislation

and ASIC regulatory guides. This may require regulators such as ASIC or APRA to focus more on the vast common law in these areas.

One proviso to this is, however, a question of whether the s912A obligation is sufficient. The obligation or duty had its origins in the *Securities Industry Act 1980* (Cth) and was initially somewhat bound up with concepts of whether a securities dealer was a fit and proper person. The function is expressed in sub-headings as both an 'obligation' and a 'duty'. A breach of the obligation provides a basis for revocation by the ASIC of the FS licence so that the nature of the obligation as a 'duty' to and enforceable by the client' is not completely clear. In *Story v National Companies and Securities Commission* [10], Young J (dealing with earlier legislation) reviewed the history of this concept and stated (at pages 570 and 571):

> I agree with the Commission that the word "duties" does not refer merely to the statutory obligations of a licence holder under sections such as 51 and 52 of the Code. In my view it is close to the mark to define "duties" as meaning "functions" which is a meaning that the word often has, see e.g. *Canadian Pacific Tobacco Co. Ltd v. Stapleton* [1952] HCA 32; (1952) 86 CLR 1, especially at p. 6 and *A.-G v Cooper* (1974) 2 NZLR 713 at p 720. Accordingly, I do not think it is necessary to analyse any of the tasks performed by licensees to see whether they can be classed as statutory duties, fiduciary duties, duties under the common law of negligence or otherwise.

One possible amendment then may be to clarify the nature of s912A as a duty owed to and enforceable by a client rather than just something had regard to by ASIC. This might also bring in a greater role for private enforcement. Whether this should be a fiduciary duty is a complex problem – it may be that it should be a general duty that becomes fiduciary where someone purports to give personal independent or objective advice (see below).

<u>Conflicts of interest, interest alignment, ownership policy</u>

Consideration should be given to a fiduciary duty being applied whenever a FS business advertises 'advice' to clients (particularly where the advice purports to be independent or objective). This may also require a better focus by regulators such as ASIC or APRA on the non-statutory requirements of equity. The regulators are well versed in the Corporations Act, ASIC Act and SIS Act and regulations thereto but possibly less so of the *general law*, *common law* and *principles* of *fiduciary law* and *equity* and the implications thereof. Yet ASIC, for instance, appear to have power to enforce many such general law duties under s50 of the ASIC Act.

It is obviously beyond the scope or role of government to encourage re-mutualisation of insurance companies and building societies though there does need to be more sophisticated consideration of the merits of *ownership policy* as a complement to *competition policy*. This might include mandating better information to members/owners/customers about the pros and cons when demutualisation and privatisation are proposed. The lack of understanding, appreciation or proper disclosure of such issues was somewhat exemplified in the litigation over the demutualisation of NRMA and the suggestion that policy holders were getting 'free shares' when in fact they were surrendering valuable existing ownership rights in return for such shares.[11]

[10] (1988) 6 ACLC 560
[11] See e.g. *Fraser v NRMA Holdings* (1995) 13 ACLC 132

A friendly environment to the creation of new mutuals and customer owned bankers and insurers businesses needs to be facilitated as well.[12] This again may involve a better appreciation by ASIC and APRA of the somewhat complicated issues involved and care to ensure that a desire for regulatory conformity (e.g. the standard ASIC regulated stock corporation) does not discourage stakeholder owned structures nor unduly privilege external equity ownership over such stakeholder ownership structures (the same issues can arise in relation to agricultural producer and customer co-operative companies where the introduction of outside equity and resulting increased conflicts of interest have created similar problems[13]).

C. ONE CAVEAT

It may follow from what has been said and observed that banks and some insurance providers have increasingly operated philosophically more as investment vehicles in our economy than as customer service providers. This is probably a retrograde development insofar as average Australians are probably more likely to be customers of these organisations than large shareholders of such bodies.

Nevertheless and in fairness, there should be a caveat added to the generally critical tone adopted in nearly all quarters when the banks and insurers are discussed. Not all bank shareholders are 'fat cats'. Indeed, given that the big five banks make up some 32 per cent of the market capitalisation of the ASX Top 50,[14] we can be sure that a lot of the superannuation of ordinary Australian 'battlers' is indirectly held in bank shares and will be affected by measures that penalise the Australian big five banks.

Overt penalising of Australian banks may also ultimately act to the detriment of these Australian shareholders by playing into the hands of overseas owned financial players who are only too keen to pick up Australian lending and other financial services business at the expense of Australian banks and their shareholders.[15] In some cases this may also be to the detriment of customers as overseas based online financial players and products (such as digital currency providers) are not, and possibly cannot, be adequately regulated by domestic prudential, disclosure and market regulators with their jurisdictional limitations.

So a considered view must be taken of these complex matters. The preliminary conclusions of the Royal Commission appear to indicate that this will occur.

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[12] See e.g. Business Council of Co-operatives and Mutuals Submission to Senate Select Committee file:///C:/Users/mduffy/Downloads/sub83_Business%20Council%20of%20Co-operatives%20and%20Mutuals.pdf

[13] See e.g M Duffy 'The Murray Goulburn dilemma – co-operatives are dying out but they're still needed' https://theconversation.com/the-murray-goulburn-dilemma-co-operatives-are-dying-out-but-theyre-still-needed-86678

[14] https://www.asx50list.com/

[15] See e.g Felicity Hannah, 'Could banking with Facebook and Google become the future' Independent Online 24 June 2018 https://www.independent.co.uk/money/spend-save/online-banking-facebook-google-personal-finance-social-media-a8409686.html , Jim Christodouleas, 'Escaping the commodity trap: The future of banking in Australia' (PWC September 23 2016), https://www.strategyand.pwc.com/au/report/future-banking-australia; Oscar Williams-Grut 'It could be easier for Facebook and Google to get into UK banking thanks to new rules starting Saturday' (Business Insider January 13 2018) https://www.businessinsider.com.au/open-banking-will-facebook-google-and-amazon-get-into-finance-2018-1?r=UK&IR=T