Royal Commission into misconduct in the banking, superannuation and financial services industry

Module 5: Superannuation – Response to general questions in Closing Submissions

Submission of the Australian Greens

Introduction

This submission focuses on two principal issues raised in the Closing Submissions, namely: whether there are any institutional structures that raise inherent problems; and whether the present allocation of regulatory roles is appropriate. The Greens submit that these two issues are fundamental to the policy response to misconduct identified during the Round 5 hearings, as well as misconduct identified during other hearings.

Specifically, we submit that the best interests of members of superannuation funds would be best served by: structural separation of vertically integrated institutions so as to ensure that the interests of trustees and the interests of members are not in conflict; and assigning regulatory responsibilities based on a distinction between, and separation of, conduct (competition and consumer) regulation from system (prudential) regulation so as to encourage a timely, proportionate and public response to instances of misconduct.

We do not believe that consumers should be expected "to do anything more than peer dimly through the darkness". But we do believe that a "dedicated and active conduct regulator" can and should shine a spotlight on trustees; and that trustees could be trusted to be left "alone in the dark" if the powerful incentives for them to do things other than meet the sole purpose test are removed.

Before addressing these two issues, however, there are two principles that are worth outlining which guide our response to these issues, namely the interrelated issues of self-regulation and consumer choice.

Self-regulation has failed and was always going to fail

At various points during the consideration of policy and general questions the Commission has asked whether legislative intervention is preferable. Generally speaking, the Greens

support legislative intervention (government regulation).[1] We do so because we believe the alternative (self-regulation) has failed, and was always going to fail.

Self-regulation is a complement to the efficient-market hypothesis. The efficient-market hypothesis puts store in the idea that well-informed individuals will act rationally and seek out the best deal for themselves; and, in doing so, individuals will add discipline to the market and ensure that asset prices reflect their underlying value. In other words, the system will be self-regulating. In the context of this Commission's inquiry, the term 'self-regulation' will for the most part have a more specific meaning, referring to the *governance* of an industry by itself. But this is an extension of the *assumption* of self-regulation that the efficient-market hypothesis puts forward, and that has justified a *laissez-faire* approach to the financial sector.

The efficient-market hypothesis has been a central component of the economic orthodoxy, and a *laissez-faire* approach has been predominated in most of western world for most of the last thirty-odd years. Subscription to the efficient-market hypothesis is reflected in the architecture of Australia's financial system that is, by and large, the product of Keating-era deregulation; and that was bedded down through the 1998 Wallis Financial System Inquiry and the legislative response to it.

However, the Greens believe that the very existence of this Royal Commission—the first of its kind since the 1935 inquiry into monetary and banking systems—is evidence that the free-market hypothesis is false; that a reliance on self-regulation has failed the citizens of this country; and that this falsehood and failure can be confronted head-on. The free-market hypothesis and self-regulation has failed because most individuals are unwilling or unable to be as well informed as the financial institutions who are providing services to—competing with—them, all the more so because of the increasing complexity of modern finance.

In the case of superannuation, Counsel Assisting well summarised the findings of the Productivity Commission's inquiry into superannuation and how members are falsifying the free-market hypothesis:

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[1] This is not to say that more regulation is necessarily better. Complicated regulations are more likely to benefit those who have the means and motive to understand them than those who do not.
See: Kay, *Other people's money: masters of the universe or servants of the people*, 2015.

> Australians are not, as a general rule, reviewing the performance of their superannuation fund, comparing that performance to other funds, and making rational choices as to whether they should remain with their fund or switch.[2]

Not making a choice is a valid choice

The Greens believe that the response to this should be to accept and confirm that not making a choice is a valid choice; and this should not be a cause of disadvantage for individuals, all the more so in the case of superannuation given that it is a compulsory product for most wage earners. Accordingly, we agree with the Royal Commission's submission that competition within and the nature of selection of default superannuation is not germane to the task of a conduct inquiry. In the case of default superannuation, *caveat vendor* rather than *caveat emptor*.

Not making a choice is implicit in the existence of the default superannuation system. The Productivity Commission—a body with an explicit mandate to seek to reduce regulation[3]—examined reform to the selection of default superannuation funds in detail; and recommended a model that not only validates that members should not be expected to make a choice, but would establish a list of ten independently selected default funds with one of the express goals being to reduce the proliferation of choice.

Furthermore, it is questionable as to how a society in which individuals are more focused on obtaining any marginal benefit available to them through activating competition between superannuation funds is a more desirable society. Another of the Productivity Commission's findings was that the average return on default funds (7.0%) outperformed that of choice funds (6.2%).[4] In other words, most people who exercised choice did worse as a result!

Relationships and conflicts

As is noted in the Closing Submissions, the instances of misconduct revealed by the Commission in relation to superannuation have almost entirely been within vertically integrated for-profit institutions. The Commission has well detailed such instances. The Greens support, as a minimum, the policy responses proposed regarding the relationship

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[2] Royal Commission, Monday 6 August 2018
[3] *Productivity Commission Act 1998*, ss. 8(1)(b).
[4] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness,* Draft Report, 2018

between trustees, their corporate groups and financial advisers at ¶763 and ¶773 relating to commissions and fees. However, we believe the more fundamental issue is the policy response to the questions raised at ¶776 and ¶777.

As you may be aware, the Greens were one of the first to advocate for a Royal Commission into financial services; and led the advocacy for a Royal Commission in parliament, including by drafting the *Banking and Financial Services Commission of Inquiry Bill 2017* that was sponsored by Senator Whish-Wilson and others, and that passed the Senate. That Bill's terms of reference provided for an inquiry into, inter alia:

- whether any practices within financial service entities have contributed to any misconduct … including (without limitation) the ethical standards, culture and structures of those entities…[5]

In distinction to ss. (d)(i) of the Royal Commission's Terms of Reference, this would have provided an explicit instruction for an inquiry to examine the role of vertical (and horizontal) integration in providing incentives for misconduct (or the build-up of systemic risk). We compliment the Commission for having seen fit to examine this issue nonetheless.

It has long been evident to observers of the financial sector that vertical integration is at the heart of a large number of instances of misconduct with the financial sector. This was evident during the Senate Economics References Committee's landmark inquiry in the conduct of ASIC that uncovered problems within the Commonwealth Bank's financial planning arm.[6] It was also evident within misconduct revealed prior to the Royal Commission within the financial planning arms of other institutions, including those involved in forestry managed investment schemes.

The Greens believe that the incentives to cross-sell and subsidise within vertically integrated institutions—including into superannuation—cannot be sufficiently regulated so as to prevent the myriad of ways in which consumers can be unfairly or unknowingly disadvantaged. It is simply too difficult for legislators and regulators to identify, and act to prevent, all of the opportunities that arise within integrated institutions to do something other than act in the best interests of consumers, be it by subtly but consistently directing existing customers towards in-house products, or by exploiting the loyalty and inertia of customers with

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[5] *Banking and Financial Services Commission of Inquiry Bill 2017*, ss. 7(1)(b).
[6] Senate Economics Reference Committee, *Performance of the Australian Securities and Investments Commission*, 2014.

excessive fees and charges. The profit motive is simply too strong and structural separation is necessary to curb its worst excesses.[7]

However, consideration of the issue of structural separation should not and cannot be constrained to a consideration of misconduct alone. The systemic implications of vertical and horizontal integration are equally important. The issues associated with institutions that are too-big-to-fail have received significant attention in the wake of the Global Financial Crisis. Less well understood and less well examined, particularly in the Australia context, are the concurrent issues of too-big-to-manage and too-big-to-regulate[8].

All three of these issues are a function of 'universal banking' where large integrated institutions offer a wide range of financial services under the one roof. These behemoths wield enormous market power and political power, and they are riddled with moral hazard as a result. In the case of the Commonwealth Bank of Australia (CBA), its

> …continued financial success dulled the institution's senses … a deterioration in CBA's risk profile.[9]

Unfortunately, unlike the Commission of Inquiry Bills that had the support of the Senate[10], the Royal Commission's terms of reference have been constrained to that of a conduct inquiry. Accordingly, we ask that the Commission considers making a request to the executive seeking permission to examine systemic matters during consideration of its policy response. Alternatively, if the Commission feels sufficiently empowered, we ask that the Commission makes a liberal interpretation of its terms of reference so as to take into account systemic issues, particularly when considering the structure of financial institutions.

Structural separation

The Greens have adopted a high-level policy position on the structural separation of financial institutions that responds to both conduct and systemic issues. The Greens propose that financial institutions be constrained through ownership to being one of the following:

- an authorised deposit-taking institution;

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[7] See: Akerlof & Shiller, *Phishing for phools: the economics of manipulation and deception*, 2015
[8] See: Curti & Mihov, Federal Reserve Bank of Richmond, *Diseconomies of Scale in Banking: Evidence from Operational Risk*, 2018
[9] APRA, *Final Report of the Prudential Inquiry into the Commonwealth Bank of Australia*, 2018
[10] See also: *Banking, Insurance, Superannuation and Financial Services Commission of Inquiry Bill 2017*

- a superannuation fund with more than four members;
- an insurance provider, including life insurance and general product insurance; or
- a provider of other financial services, including wholesale and retail wealth management, investment banking, shadow banking, hedge funds, self-managed super funds, financial markets, and auditors and liquidators.

Furthermore, the Greens would require mortgage brokers and financial advisors—retail intermediaries—to be individually licensed and separately owned from the institutions who originate the products they sell, save for the provision of financial advice by superannuation funds regarding the asset allocation of a member's contributions within that fund.

Taken together, this would make a distinction between the basic financial products and services that most people own and access on an ongoing basis—banking, superannuation and insurance—from the more complicated and niche services that are used occasionally; or are the domain of larger businesses, higher-net worth individuals and the adventurous.

Deterrence and insight

The Commission has well highlighted the shortcomings with the regulation of superannuation. The Commission has identified some issues with the scope of ASIC's powers, particularly the limitations on disgorgement. However, the Greens are of the view that the inadequate regulation of superannuation in the consumer's interest—and the financial system more broadly—is not primarily a result inadequate power. Rather, we are of the view that it is primarily a result of regulators having a conflicted mandate; and the concurrent tendency for these conflicted regulators to be subject to regulatory capture and take a soft-touch approach.

The Greens commend the Commission in its Closing Submissions for drawing attention to the inherent conflict between conduct regulation and system regulation. In the case of APRA, this was adroitly identified by Counsel Assisting in his Opening Address to the Round 5 hearings:

> First, it is not obvious that it is possible to separate public enforcement action from a regulator properly undertaking conduct regulation. Secondly, there may be an inherent tension between,

> on the one hand, maintaining stability and, on the other hand, the destabilising effect for one or more entities of public enforcement action.[11]

ASIC's mandate is similarly conflicted, and requires it to undertake their consumer protection responsibilities whilst striving to:

> maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy.[12]

Further, by virtue of the task they are assigned with—understanding the risks within financial institutions—system regulators need to work closely with the very institutions they are regulating. In combination with their conflicted mandate, this makes them vulnerable to regulatory capture whereby the employees of the regulators and the employees of banks see their interests as being aligned.

The Greens believe this goes a long way towards explaining why ASIC and APRA have taken an approach more focused on negotiating an outcome behind closed doors to preserve the system, than on public enforcement and deterrence.

This soft-touch approach is an extension of the *laisse-faire* approach to the financial sector more generally. Ian Harper, a member of the Wallis Inquiry, reflected on the wisdom of relying on this approach, and the fact that it has been exploited by the financial sector, stating that:

> We placed too much faith in the efficient market hypothesis and in light touch regulation.[13]

And:

> With the benefit of hindsight and what's been coming out at the royal commission, the weaknesses of the specialist approach we took to regulation are also evident.[14]

In respect of ASIC, Allan Fels, the inaugural Chair of the ACCC, but it more bluntly: they "are not feared".[15]

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[11] Royal Commission, Monday 6 August 2018
[12] *Australian Securities and Investments Commission Act 2001*, ss. 1(2)(a)
[13] Martin, *'Benefit of hindsight': ASIC may have been wrong body to protect consumers*, Sydney Morning Herald, 24 April 2018
[14] Ibid.

Regulatory responsibility

In respect of questions asked at ¶821.2 and ¶821.3, the Greens have adopted a high-level policy position regarding the regulation of financial entities that complements our policy position on the structure of financial entities, and that largely adopts a so-called Twin Peaks model where one regulator is:

> responsible for regulating to prevent financial crises (the prudential regulation peak), the other to ensure good market conduct and consumer protection (the good conduct peak).[16]

Under our proposal:

- ACCC would be the conduct regulator for basic financial services—banking, superannuation and insurance—and retail grade intermediators—financial planners and mortgage brokers;
- APRA would continue to be the system (prudential) regulator for basic financial services; and
- ASIC would be the conduct and system (market integrity) regulator over the remainder of the financial system.

This is not a conclusion that the Greens came to in haste. Throughout the Senate Economics References Committee inquiry into the conduct of ASIC, the Greens were critical of the performance of ASIC, but largely supportive of the institution. Faith in public institutions, as the Commission alludes to, is important to the operation of the financial system. We were also strong advocates for an reversal of the funding cuts to ASIC brought in by the Abbott Government that, we believe, had constrained ASIC's ability to do its job. However, as has become clear as a result of the Commission's hearings, the structure of ASIC and APRA are fundamentally flawed.

Greater public oversight

In response to the question of the submission at ¶821.1 regarding what can be done to encourage a better response by the regulators, the Greens propose two further changes in the regulatory architecture:

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[15] ABC AM, Thu 9 Aug 2018
[16] Schmulow, *South Africa joins the club that regulates financial markets through 'Twin Peaks'*, The Conversation, 29 April 2018

The Greens believe that the role of the Council of Financial Regulators should be elevated.[17] An independent Chair should be appointed and minutes of the meetings should be published in a similar vein to those of the Reserve Bank of Australia. Further, and in accord with our recommendation regarding its expanded remit, the ACCC should be given a permanent position on the Council, along with ASIC, APRA, the Reserve Bank and Treasury.

The Greens also support the establishment of a Financial Regulator Assessment Board (FRAB) to advise Government annually on how financial regulators have implemented their mandates, as recommended by the 2014 Murray Financial System Inquiry.[18]

[17] See: Erskine, *Funding Australia's Future: Regulating the Australian Financial System*, 2014.
[18] *Financial Systems Inquiry: Final Report*, Recommendation 27 — Regulator accountability, 2014.