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UNSW Business School

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APRA Capability Review

Thank you for the opportunity to make a submission to the Panel reviewing APRA's capabilities. This submission is largely based on those I made last year to the Financial Sector Royal Commission (FSRC). I have included relevant extracts from them for convenience, as they provide the background to the recommendations below. It is made in my personal capacity and does not necessarily reflect the opinions on anyone associated with UNSW

Yours sincerely

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Submission by Anthony Asher to Capability Review

My recommendations to the FSRC have necessarily been adapted in some instances to fall within the terms of reference of the Panel. There are, in any event, a variety of alternative approaches to addressing the problems that the submissions identified, and the Panel is welcome to consider my recommendations as examples of the type of response that might be made to respond to the issues identified.

I have over forty years of experience in the financial industry, divided more or less equally between practice and academia, and between South Africa and Australia. I have been involved in Policy formulation for thirty of those years, mainly through the professional actuarial bodies, but also on my own account as an outworking of my academic research. I also worked in the policy division of APRA for three and a half years and have considerable respect for APRA staff and their approach to regulation.

My recommendations focus on two issues where I believe APRA's institutional structure falls short: regulatory capture and that of appropriate engagement with other Australian financial sector regulators. Both fall within the Panel's terms of reference because they relate to "decision-making that balances financial safety and financial stability, and considerations of efficiency, competition, contestability and competitive neutrality," but also have a bearing on governance, resource allocation, expertise and fit-for-purpose statutory powers.

Regulatory capture

Capture has the capacity to distort the institutional narrative of a regulator so that the regulator focuses on unimportant short-term issues that benefit vested interests at the expense of its long term responsibilities. It is discussed in section 4 of my submission to Round 5 of the FSRC (pages 14 to 24 below); in section 4.2 of my submission to Round 6 (page 34), and in my Submission on the Interim Report (pages 35 ff). Based on these discussions I therefore suggest that the Panel consider the following in making its own recommendations:

1 Of the recommendations my submission to Round 5 in Box 12 (page 23), the second, third and fourth are relevant:

- Second ... to allow for an informed debate among different stakeholders, steps need to be taken to address the informational advantage of all industry insiders participating in any RIS-related consultations. For example, both the APRA and the ASIC need to be empowered to generate and disseminate information to remedy the informational disadvantage vis-à-vis the industry and any lobbyists. This release of data: 'will help energize the public to overcome collective action problems and rally behind the agency … so that they can engage in the issues, possibly against the deep pockets of the incumbents'.[1]

  Third, that ... RISs (Regulatory Impact Statements) document consideration and adopted solutions to any potential issues that may be perceived as arising around rent seeking. In the case of the Australian superannuation industry, given the size and power of the Financial Services Sector, consideration of this variable should be included in RIS

[1] Pagliari (ed), 2012, page 19 below n 66, p24.

processes particularly around potential rent seeking activities that impose costs on fund members. Included within this point should be the prioritisation of the completion of outstanding Post Implementation Reviews (PIR).[2] Ensuring reviews conducted around superannuation revisit legislation that may have previously been exempted through grants of exemption 'carve outs' would be meritorious and, going forward, should align with standards arising out of recommendation four below.

- Fourth, there is a need for the ongoing development of more rigorous statistical parameters for both the related costs and benefits of any proposed regulations, as suggested by Posner and Weyl.[3]

2 From Round 6 (page 29), extending the second recommendation above:

- APRA should consider the appointment of advisory committees for life, general and health insurance with elected representatives from industry, consumer groups and relevant university departments.[4] Representatives appointed by government will inevitably have less confidence to challenge regulatory capture. The minutes of such advisory committees should be public.
- Data collected by the regulators should also be made public.[5] Items that might unnecessarily expose insurers to a crisis of confidence can be released after a delay – of perhaps two years.

3 I would like to make some additional points about the need to address intellectual capture, which is covered in sections 4.6 and 4.7 of my submission to Round 5 (pages 19 to 23) and virtually all of my submission to the Interim Report. While the issue is much larger than APRA, APRA's effectiveness will be significantly blunted to the extent that capture is an issue and APRA does not include it in its thinking and processes.

I concede that much of the literature on capture is contested, but the possibility seems universally accepted, and that is enough to require that it be examined. It forms a significant part of the academic literature of economics, sociology, law and management. Apart from public dismay at the failure of governments to respond to excessive executive remuneration, which is one of capture's manifestations, there are many informed parties that see a problem. I asked the audience at a plenary discussion at the 2018 Actuaries Institute General Insurance Seminar: "Do you think that it is important to find ways of reducing excessive CEO power and remuneration?" Of the 93 responses, 24% thought it was critical and 82% thought is more important than not, for an average of 7.4 on a scale

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[2] As detailed on the OBPR site, <https://ris.govspace.gov.au/files/2012/04/03-PIR-Table-Required-2014-15_22072015.pdf≥ as 30th June 2015, there were a total of 90 post-implementation reviews (PIR) required. Of the 90 PIRs, in 57 cases the regulation has been implemented, whilst in 4 instances the regulation has not been implemented and 29 PIRs were completed and published. Eight PIRs were non-compliant for not having been completed in the required timeframe.

[3] Eric Posner and E Glenn Weyl, 'Speculation, Insurance and Financial Regulation: Benefit-Cost Analysis for Financial Regulation' (2013) 103 American Economic Review: Paper and Proceedings 393

[4] My experience of membership of such committees in South Africa were that they did provide scope to escalate issues of importance. See Asher, A (2015). *Working ethically in finance: Clarifying our vocation*. Business Expert Press. p32-35.

[5] See also Zingales, L., 2015. Presidential address: Does finance benefit society? *The Journal of Finance*, *70*(4), pp.1327-1363, p1352.

from 1 to 10.[6] Given all this, the apparent failure of APRA (and other regulators) to give the possibility any real consideration[7] becomes a source of concern and an indication itself of intellectual capture. Very difficult questions that need to be asked are the extent to which APRA's culture is itself captured, and whether its remuneration hierarchy is contributing. (See section 3 of my submission on the Interim Report, page 47.)

Apart from the recommendations above, I would suggest that APRA itself needs to create space within the organization for a critical examination of its structure and processes for regulatory capture. It may need a separate team, or perhaps be included in those responsible for risk culture, perhaps with a reporting line to independent advisory committees as suggested above.

Complexity

The corrupting influence of complexity is subtle, difficult to address, and goes beyond issues of capture. I have left in the comments on the SIS Act in section 4.7 even though they might be thought to go beyond the Panel's terms of reference. APRA's standards, in any event, are relatively well drafted although insisting on good legal drafting is an ongoing struggle. There is however a case that the combined weight and detailed reach of the standards disempower the senior management of regulated entities by absorbing a disproportionate share of their necessarily limited attention, and by shifting the onus of thinking to the regulator. The example given page 21 below relates to ASIC but could as easily applied to APRA.

Two other examples may be helpful. The first is the treatment of operational risk, where the Basel Committee has now effectively conceded that the "sophisticated" internal models it encouraged were unnecessary complex and of minimal value.[8] APRA's operational risk financial requirement for Superannuation is just as unhelpful and, at 0.25% of assets, immaterial.[9] The second arises from a presentation made by Anthony Michael, Chief Investment Officer of Allianz Australia[10]. In order to introduce a new investment class into the portfolio, he reported that he had to go through 15 different compliance committees in the group, including those governing the 3 different capital

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[6] See https://www.smh.com.au/business/banking-and-finance/why-overconfidence-creates-reckless-ceos-20190115-p50rhi.html?csp=2b24555617e835c380fcae00c4d7acac *and* https://www.actuaries.digital/2018/12/06/does-excessive-executive-pay-lead-to-misconduct-opinion/

[7] A search of the APRA website finds one oblique reference in a speech in 2010.

[8] See page 5 of https://www.bis.org/bcbs/publ/d424_inbrief.pdf

[9] I expressed my view in 2011, when this was first suggested: "I respectfully suggest that neither APRA nor other advocates of this financial requirement have fully applied their minds to the materiality of operational risks – in the context of the very much larger investment risks to which superannuation funds are exposed. A typical superannuation fund, with just 50% of its assets in equities, is more likely than not to lose or gain the suggested minimum reserve of 0.25% every working day. Over a period of a year, even the largest operational risks, other than massive fraud, are unlikely to be more than a few percent of expected investment profits and losses. The subject of materiality in the context of unit price errors, which make up a significant portion of the operational risk, is discussed in more detail in Asher and Duncanson.(http://www.actuaries.asn.au/Library/FSF08F_5e_paper_Asher%20&%20 Duncanson_Fair%20unit%20pricing.pdf) In the context of the large investment risks already being born by members, I would suggest that no member will be materially worse off if operational risk losses are deducted from unit prices as and when they occur.

[10] at a [i3] Insurance Luncheon on 5th April in Sydney

requirements to which the local company is subject. Capital requirements are at best a fuzzy estimate of what may be needed to ensure insurance benefits are met; pretences of accuracy are spurious and extensive multiple calculations wasteful. There is no reason for APRA to insist on detailed separate reporting following local standards. Even if the local standards are stronger than the international ones to which the company is subject, a simple increase in requirements would be more than adequate.

At very least, Regulatory Impact Statements prepared by APRA should more explicitly consider the costs of greater complexity, and the materiality of the benefits, and there should be ongoing reviews of the combined weight and reach of its standards.

Engagement with other regulators

My submission on Insurance to round 6 largely deals with the fragmented nature of the insurance sector, and incoherence in its regulation by governments in Australia. To illustrate, Australians are more than thrice covered for medical costs and loss of income if they have an accident that involves a motor accident and their employment, but without cover for many disabilities that do not involve accidents. Understanding the gaps and overlaps is well nigh impossible for any individual.

The background is repeated on pages 29 to 34 below. Of all the government departments and agencies that deal with insurance (life, general and health), it would seem that APRA has the greatest capability and widest insights. My recommendation is that it be given the powers and responsibility to co-ordinate with all other governments and agencies with a view to developing greater coherence of a regulatory structure that promotes "efficiency, competition, contestability and competitive neutrality."

FCR for superannuation funds

This is a separate idea that would perhaps assist in the transfer of the onus of regulation to the industry and inject greater another professional code into the superannuation industry. I made the suggestion in section 4.4 of Round 5 (page 17), that the financial governance of superannuation funds would be enhanced if APRA required the trustees to obtain a financial condition report from an actuary. An example of what it would entail is in the appendix to be found on page 25 of this submission.

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

Written Submission by Anthony Asher in response to policy-related issues raised in

MODULE 5: SUPERANNUATION CLOSING SUBMISSION

Executive summary

Misconduct in the superannuation industry has occurred partly because much of it is in thrall to service providers that have developed a culture that panders particularly to greed. The sector has grown by over-servicing and over-charging, extracting economic rents made possible by various forms of regulatory capture, and of which the law breaking reported to the Royal Commission (RC) are symptoms. Community expectations, of compulsory superannuation particularly, are that services and charges are fair, and that the organizations are primarily focussed on their social purpose.

The suggestions in this submission are the RC recommend:

- The Parliamentary Office of Best Practice Regulation require Regulation Impact Statements to document consideration and adopted solutions to potential issues of *rent seeking* – and political parties be less ready to make superannuation promises at elections.
- The Gordian knot of regulatory complexity be cut by replacing much of the Superannuation and Corporations legislation with the General Law's proscription of conflicts of interest.
- ...

1 Introduction

I welcome the RC's incisive and disinterested approach to the sector, and the opportunity it offers to address *economic rent seeking* and *regulatory capture* – especially as there appears to be bipartisan support for meaningful change.

If press reports are indicative, the RC is likely to get a few submissions along similar lines[11], although there may silence from the sector itself. Reference to the possibility of regulatory capture and rent-seeking is absent from the recent Financial Services Inquiry and the Productivity Commissions reports into Superannuation[12], nor is it considered by APRA, ASIC or the Treasury paper on the RC website. The questions may be too uncomfortable to

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[11] Melbourne Economic Forum (Allan Fells, Ross Garnaux, John Daley) http://www.abc.net.au/news/2018-09-04/banking-royal-commission-embarassing-apra/10200028 and Ross Gittins https://www.smh.com.au/business/banking-and-finance/economists-do-little-to-promote-bank-competition-20180210-h0vvku.html

[12] http://fsi.gov.au/ and https://www.pc.gov.au/inquiries/current/superannuation

address and would require a level of public self-reflection not available to agencies and civil service.

My forty years' actuarial experience - divided equally between business and academia – with an ongoing interest in ethical and policy issues,[13] may mean that my approach questions from a different angle to other submissions. In what follows, I focus particularly on greed and economic rents in the culture of the finance sector; the response of regulation and why it fails; and then on more detailed discussion of how the financial sector extracts unacceptable levels of economic rent from superannuation. The ideas are hardly new – perhaps most eloquently expressed by Adam Smith:

> *The interest of the dealers, however, …, is always in some respect different from, and even opposite to, that of the public. To widen the market and to narrow the competition is always in the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public, but to narrow the competition must always be against it, and can only serve to enable the dealers, by raising their profits above that which they would naturally be, to levy, or their own benefit, an absurd tax upon the rest of their fellow-citizens. The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous but the most suspicious attention. It comes from an order of men, whose interest is never exactly the same as the public, who have a general interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.*[14]

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The boxes in the text are quotations from my own research to clearly distinguish them from quotations from others more expert. References and footnotes have been reformatted for clarity – so the quotations are not exact.

2 The standards to apply

In his opening remarks, the Commissioner mentioned (p8) the ideas and links between the ideas of purpose, fairness and expectations. These are worth unpacking. Alisdair McIntyre's modern revival of Aristotelian virtue theory[15] highlights the link of ethics with purpose: the financial system will be good if it fulfils its purpose. Fairness requires justice, one of the main cardinal virtues and a cornerstone of ethics, without which the purpose will be missed.[16] Justice is served if a proper process is followed by those with power; that recognises people's needs and just deserts; is reluctant to interfere in their lives; and strives to achieve equality.

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[13] More details can be found at https://research.unsw.edu.au/people/associate-professor-anthony-asher

[14] Smith, Adam (1804) An Inquiry into the Nature and Causes of the Wealth of Nations, Volume 1, https://play.google.com/books/reader?id=n1FHAAAAYAAJ&hl=en_GB&pg=GBS.PP16, p207

[15] MacIntyre, Alasdair (1981). *After Virtue: A Study in Moral Philosophy. University of Notre Dame Press.*

[16] My book, Asher A, (2015) *Working ethically in finance: Clarifying our vocation (Business Expert Press, NY),* explores these themes in more detail. Also see Asher A, (1998) "Effective and Ethical Institutional Investment", British Actuarial Journal 4.V: 969-1027.

Overcharging and overserving leads to enrichment at the expense of others is unjust: it cannot be justified by desert or need, and undermines equality and efficiency. This is aggravated where people's freedom has been circumscribed by compulsory contributions. I think it follows that in the financial sector, injustice is most evident in overcharging and over-servicing which offend each of these criteria.

Within compulsory superannuation particularly, members might reasonably expect the trustees to both treat them fairly and do their best to serve their needs for financial security – particularly in old age. The law already includes provisions that "obligations implied by the promotional material of the company, and policy owners' *reasonable benefit expectations* based on past company practice"[17] will need to be met (by insurers at least.)

There are other legal concepts where overcharging and over-servicing – depending on circumstances – can be regarded as the unacceptable exploitation of weaker parties. One is "unconscionable conduct"[18] which will depend on the extent of the over-charging and the relative weakness of the exploited members, and can lead to restitution. A third possibility is that the terms of a contract that give too much unfettered discretion to a stronger party can be "void for vagueness", or at least reset to reasonable levels.[19] Fourthly, "secret profits" may have to be disgorged – particularly if a fiduciary duty is involved.[20] Finally, failure to observe the proscription of conflicts of interest should lead to the disgorgement of profits.[21]

3 Culture

The cultural crisis in finance, recognised in the RC's terms of reference as a cause of misconduct, is captured by some of the quotes in Box 1.

Box 1[22]

Cultures play a role in promoting harmful practices, through for example, socialization of new members (of boards of directors, executive teams, trading teams) into value sets that place 'winning at all costs', 'fleecing the customer' or 'covering up' at the centre of a firm's culture[23]. The US Financial Crisis Inquiry Commission[24], for example, found that "the captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public. Theirs was a big miss, not a stumble." Moreover, in many

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[17] APRA Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital. (My italics)
[18] Defined in Section 12BG of the ASIC Act as causing a "significant imbalance in the parties' rights and obligations."
[19] Lucke, H.K., 1977. Illusory, vague and uncertain contractual terms. Adelaide Law Review, 6:1-25.
[20] Justice James Edelman (2012) *Fiduciaries and Profit Disgorgement for Breach of Contract* Speech Given To The Journal Of Equity And Commercial Law Association Conference, Sydney, 30 March.
[21] Edelman J, (2012) "Fiduciaries and profit disgorgement for breach of contract" Speech given to *The Journal Of Equity And Commercial Law* Association Conference, Sydney, 30 March.
[22] This section is taken largely from a draft paper, likely to be entitled Asher, A and Wilcox T, Virtue and Risk Culture in Finance. An early version can be found at https://www.actuaries.asn.au/Library/Events/ASTINAFIRERMColloquium/2015/AsherWilcoxVirtuePaper.pdf
[23] Darley, J.M. 2005. How Organizations Socialize Individuals into Evildoing. In Collins-Chobanian S. (Ed.) *Ethical Challenges to Business as Usual*, Pearson Prentice Hall, Upper Saddle River NJ, 211-223.
[24] Financial Crisis Inquiry Commission, 2011. *The financial crisis inquiry report.* US Government Printing Office. http://fcic.law.stanford.edu/report/ p xvii.

finance organizations, mistakes are hidden and those who admitted to them are ‘punished’ in some way. These cultures did not come into being through some chance set of circumstances or at the other extreme as the inevitable outcome of ‘natural laws’ of economics.

… Economist Jeffrey Sachs has expressed this concern stridently, claiming:

I regard the moral environment as pathological. And I am talking about the human interactions that I have…They have no responsibility to pay taxes; they have no responsibility to their clients; they have no responsibility to people, to counterparties in transactions…They are tough, greedy, aggressive and feel absolutely out of control in a quite literal sense, and they have gamed the system to a remarkable extent.[25]

The ‘dominant’ logics and sense-making practices in the finance sector have their roots in neoclassical economics[26] ... Agency theory, for example, is premised on a “normative theory of practical rationality” that categorizes moral rules and cooperation as “irrational”, and opportunistic self-interested behavior as “rational” [27]. These “rudimentary assumptions” of self-interest and profit maximization are, Enderle notes, “not only taken as explanatory variables, but also as normative demands indicating how economic actors should behave.”[28]

It is difficult to find hard evidence that these flaws are worse in finance,[29] although it is widely agreed that failure to manage them contributed to the recent financial crisis – and the misconduct already identified by the RC. As a UK report has it in respect of the financial crisis: “First, to pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis.” [30]

3.1 Greed

These mortal flaws do however need to be addressed. As Donaldson puts it: “Greed … a persistent feature of the human condition … rather depends on opportunity and rationalization.[31] Most commentators and regulators accept the inevitability of greed (rational self-interest), focussing on “perverse incentives”[32]. They seem unconscious of the possibility that agency theory may have limitations and create normative perversions as raised in the last

[25] https://www.nakedcapitalism.com/2013/04/jeffrey-sachs-calls-out-wall-street-criminality-and-pathological-greed.html#Gi77xWO2eYLE1jTD.99
[26] Lounsbury, M. and Hirsch, P.M., 2010. Markets on trial: Toward a policy-oriented economic sociology. In *Markets on Trial: The Economic Sociology of the US Financial Crisis: Part A* (pp. 5-26). Emerald Group Publishing Limited.
[27] Heath, J., 2010. Agency theory. In Boatright (ed). *Finance ethics: Critical issues in theory, practice*, 125-142, p. 136
[28] Enderle G., 2000. Whose ethos for public goods in the global economy? An exploration in international business ethics. *Business Ethics Quarterly*. 10(1), 131-144.
[29] Some research has found that bankers’ professional social identity, when salient, predisposes them to more greed and dishonesty, even when it leads to relatively small personal gain. (Cohn, A., Fehr, E., & Maréchal, M. A. 2014. Business culture and dishonesty in the banking industry. *Nature*. doi:10.1038/nature13977). Others have questioned the interpretation which they have had difficulty replicating. (Vranka, M.A. and Houdek, P., 2015. Many faces of bankers' identity: how (not) to study dishonesty. *Frontiers in psychology, 6*, p.302.)
[30] Financial Crisis Inquiry Commission, 2011. *The financial crisis inquiry report.* US Government Printing Office. http://fcic.law.stanford.edu/report/. Conclusion, xxii.
[31] Donaldson, T., 2012. Three ethical roots of the economic crisis. *Journal of Business Ethics*, *106*(1), pp.5-8.
[32] See UK Parliamentary Commission on Banking Standards, (2013) note 69

paragraph of Box 1 on page 9. At risk therefore of belabouring the point, Box 2 spells out the argument in more detail.

Box 2[33]

Legal academics, such as Jaap Winter[34], and philosophers, such as Joseph Heath[35], are prominent amongst the critics of classical, or positive, economics.

They identify the major issue as the misuse of the assumptions made about people's motivation and rationality. As you would have been taught, all other things being equal, we can assume that people want to make economic decisions rationally. This will mean that they want to maximise some *utility*, which is often their personal material wellbeing. Difficulties arise, however, when other things are irrelevant rather than equal, when people are assumed to make entirely rational decisions, and when *utility* is seen purely in private material terms.

Heath shows that many economists make these irrational jumps in the development of their theory and practical recommendations. The errors are not merely theoretical and easily undone. He looks particularly at agency theory, which has been used to justify the granting of the excessive remuneration discussed above. The problematic assumption is that executives need material incentives to perform their jobs diligently not only flies in the face of the evidence, but:

> … even a well-designed system of external incentives has the potential to undermine moral motivation, and thus to create agency costs where previously none existed … People may be active cooperatively merely because they consider it the right thing to do. When they are subsequently offered an external incentive, it may have the effect of changing their perspective, so that they no longer consider the question from a moral point of view, but rather examine it from the standpoint of their self-interest. …Sophisticated practitioners of agency theory are familiar with these limitations, but a large number of enthusiast are not. Because of this agency theory can serve as a source of considerable inadvertant mischief when treated as an accurate representation of reality.[36]

He then goes on to suggest that management begin to work on the view that people are only interested in their own material interests, and:

> … it would be no surprise to discover that a social environment in which the dominant assumption is that "it's every man for himself" is one that would not only encourage unethical behavior, but could become positively criminogenic.[37]

Aggravating the problem is failure to incorporate the desirability of personal and social virtues into our thinking. This is illustrated in a popular recent book, *Animal Spirits* by two

[33] See note 16 above *Working ethically in finance*, p72-73
[34] Winter, J. (2010). Corporate governance going astray: Executive remuneration built to fail. *DSF Policy Paper, 5*.
[35] See note 27 above.
[36] Ibid.
[37] Ibid.

well-known economists, George Akerlof and Robert Shiller[38]. They appear to have written the book in haste and can be criticised at a number of levels – as by Richard Posner, a US judge, in a review: *Shorting Reason.* What I find interesting is that even the legally trained do not find it strange that they describe the concept of "fairness" as irrational. People can of course behave irrationally when their interests are threatened – as employees when their jobs are at stake, as discussed in the book. People may also use arguments involving fairness that are not rational. The need to create a fair society is however entirely rational … The more we are certain of fair treatment, the more we are free to concentrate our efforts on mutually beneficial production.

It can also be pointed out that giving prominence to the power of greed – to tempt and to create injustice – is common in religion. Greed is one of the three poisons of Buddhist teaching, the tenth commandment is against it, St Paul identifies it with idolatry and the King James translators saw it as "the root of all evil."

Apart from setting out moral codes and ethical reflection, the time-honoured approaches to removing ethical temptations to greed are by the prohibition of conflicts of interest addressed in section 4.1 below, and ensuring the appropriate accountability of those in power, which are covered in section 4.2 and 4.3 below).

3.2 Hubris

The complacency and recklessness issuing from hubris can perhaps be mentioned at this point. The hubris associated with corporate failure and misconduct can be linked to directly to overconfident CEO's and their excess remuneration.[39] While excesses of remuneration are less of an issue in Superannuation than in other parts of the financial sector, there is a risk that they will overpay internal investment managers for the same reason that they have failed to control the costs of outsourced management. More important for the overall economy, as major shareholders they have a critical role in ensuring directors have the courage to stand up to over-confident CEOs.

3.3 Economic rent

The economist's term for overcharging and over-servicing that may be the consequence of greed is economic rent.

> *"Economic rent" is a term that defines an amount of money earned that exceeds that which is economically or socially necessary. This can occur, for example, when a buyer working to attain a good or service that is considered exclusive makes an offer prior to hearing what a seller considers an acceptable price. Market imperfections thus lead to the rise of*

[38] Akerlof, George A. & Robert J. Shiller (2010) Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism, Princeton University Press

[39] Paredes, Troy A., 2014, Too Much Pay, Too Much Deference: Is CEO Overconfidence the Product of Corporate Governance? Washington U. School of Law Working Paper No. 04-08-02. https://ssrn.com/abstract=587162 and Plöckinger, M., Aschauer, E., Hiebl, M.R. and Rohatschek, R., 2016. The influence of individual executives on corporate financial reporting: A review and outlook from the perspective of upper echelons theory. *Journal of Accounting Literature*, *37*, pp.55-75

> *economic rents; it would not exist if markets were perfect, since competitive pressures would drive down prices. Economic rents should not be confused with normal profits or surpluses that arise in the course of competitive capitalist production. This term also differs from the traditional use of the word "rent," which applies to payments received in exchange for temporary use of a particular good or property, such as land or housing.*[40]

The definition goes on to say that "economic rents are considered to be unearned." When applied to superannuation, economic rent arises if providers were to charge greater fees for services than they would strictly need to provide the services, or to profit by providing more services than are necessary: i.e. overcharging or over-servicing. This is the "absurd tax" referred to by Adam Smith above. In a compulsory superannuation system, the community might reasonably expect not to be subjected to such a tax.

3.4 Financial sector rent-seeking

Box 3 [41]

A number of observers see the increased funding of social security systems as contributing artificially to the growth of the finance industry – both ideologically and in its share of GNP. …

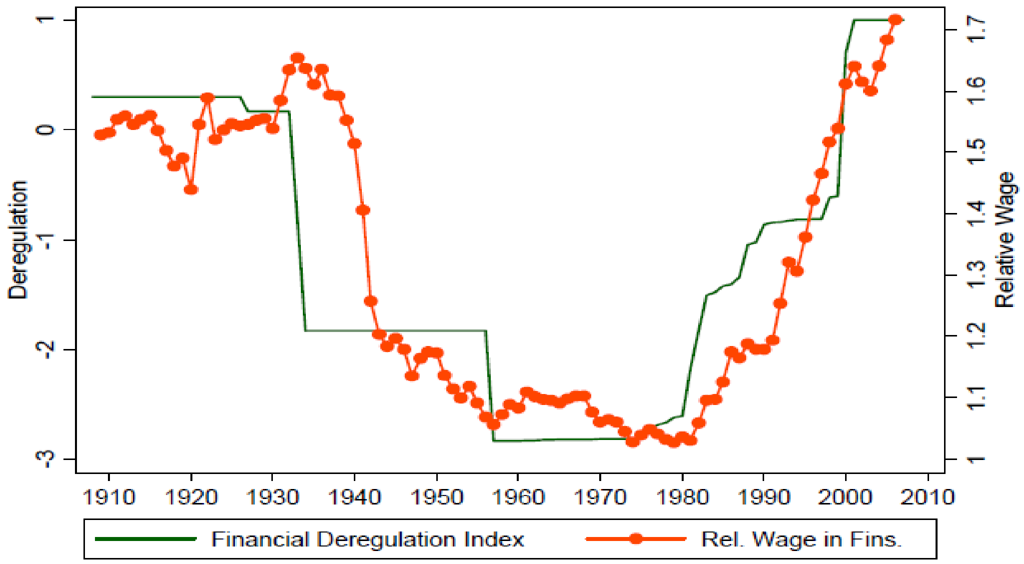
Adair Turner, then head of the UK Financial Services Authority and with a much closer link to the sector, takes a similar view:

And, indeed, there are good reasons for believing that the financial industry, more than any other sector of the economy, has an ability to generate unnecessary demand for its own services – that more trading and more financial innovation can under some circumstances create harmful volatility against which customers have to hedge, creating more demand for trading liquidity and innovative products; that parts of the financial services industry have a unique ability to attract to themselves unnecessarily high returns and create instability which harms the rest of society. [42]

There are other reasons for the growth of the financial sector, and evidence that it contributes to economic development. ... Rajan and Zingales[43] document the contribution to economic development, but note the role of private interest groups in obstructing development in various countries of the world during the twentieth century. They suggest that one way of limiting the power of such interest groups is "public awareness of the hidden costs of policies that ostensibly promote economic stability."

[40] https://www.investopedia.com/terms/e/economicrent.asp
[41] Taken from Asher A (2014) "Redistribution and capital market impacts of social security retirement systems: principles and scope for actuarial involvement" *The Australian Journal of Actuarial Practice* 2:13-20
[42] Adair Turner, 'Speech by Chairman, FSA' (Speech delivered at the City Banquet, The Mansion House, London', September 22 2009, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0922_at.shtml.
[43] Rajan, R. G., & Zingales, L. (2003). The great reversals: the politics of financial development in the twentieth century. *Journal of Financial Economics*, 69(1): 5-50.

Figure 1 provides further evidence of the growing share of the financial sector, and perhaps more importantly – shows that it does not have to be this way.



Notes: Wages are computed from the Industry Accounts of the U.S., from Kuznets (1941), and from Martin (1939). The relative wage is the ratio of Fins to Non Farm Private wages. See the text for the definition of the deregulation index.

Figure 1 Finance sector wages[44]

4 Regulation

This section looks at how regulation should perhaps respond to the temptations of greed, on the one hand circumscribing the ability of those with power to exploit others, and on the other responding to misconduct so as to create disincentives and to compensate those who have been exploited.

4.1 Conflicts of interest

4.2 Accountable to members

These sections have been removed as they went beyond the Terms of Reference of the Panel.

4.3 Accountable to the law

Confucius: "If people be led by laws, and uniformity is sought to be given them by punishments, they will try to avoid punishments but have no sense of shame.[45]"

[44] Taken from Philippon, T. and Reshef, A. (2009) *Wages and Human Capital in the U.S. Financial Industry:* 1909-2006 NBER Working Paper No. 14644. http://www.nber.org/papers/w14644 accessed: July 2013, Figure 6.

[45] Analects II/3

Misconduct often calls for harsher retribution, but this can be an overreaction without consideration of the implications. Tatum[46] suggests that punishment of financial crimes should be seen as much more than deterrence, but rather as in the (Canadian) Criminal Code in having broader and more humane aims: “denounce unlawful conduct, deter the offender and community from committing offences, assist in rehabilitating offenders, provide reparation for harm done to victims, and promote a sense of responsibility in offenders.”

4.3.1 Restorative justice and responsive regulation

These broader aims are addressed by the holistic response briefly described in Box 7 .

Box 7 [47]

One of the perverse results of a mechanistic approach to management is the idea of “zero tolerance” for mistakes. Human error or mistakes and unfavourable outcomes from business risks are often difficult to distinguish – and often require the same type of response. Neither can be entirely avoided, both should be acknowledged and taken seriously.

Risk cultures must go beyond awareness, to being quick to acknowledge and correct errors. This entails an admission to being prone to making mistakes, a quickness to admit when they are wrong, and correct and often to forgive them. Many huge losses can be blamed on failure to ensure that there are sufficient checks and balances – because people do not admit they are prone to failure. This is more obvious in health and safety matters: protective clothing and safety mechanisms being unused. In finance, it is back offices disempowered and auditors belittled.

Mistakes and failures will occur. In order to be addressed and addressed quickly, the perpetrators must have no need or incentive to protect themselves or hush up the error. In many organizations, those who admit to mistakes are routinely punished for them, in some way. Too often, the boss’s response to being told of an error is: “bring me a body”. ...

Braithwaite advocates a responsive regulation involves a variety of strategies. It builds on those moral standards that are demonstrated by meaningful internal codes of ethics and industry standards. These provide the basis not for punishment, but for “re-integrative shaming”, where peer pressure is positively brought to bear on excessive risk takers and those that make mistakes. It can be contrasted with “stigmatising shaming”, which drives offenders into a counter-culture of passive resistance and mechanistic compliance.

[46] Tatum, Jeremy (2012) Enhancing Corporate Accountability under the Criminal Code through Enforcing Corporate Social Responsibility. https://ssrn.com/abstract=2143940

[47] Taken from Asher, A and Wilcox T, Virtue and Risk Culture in Finance. Presented to the IAA Colloquia, Sydney 23-27 August 2015. http://www.actuaries.asn.au/Library/Events/ASTINAFIRERMColloquium/2015/AsherWilcoxVirtuePaper.pdf

One of the points made by Braithwaite[48] is that one cannot have a hierarchical view of regulators, as “if the n+1th order guardian is corrupt, the whole edifice of assurance can collapse”. The regulators themselves need active monitoring – not just by politicians.

Box 8 highlights the problem with criminalising many white collar crimes. While it may achieve some general deterrence, failure to obtain a conviction fails all the other objectives of the criminal code.

ASIC is on record as wanting to criminally charge institutions for poor culture,[49] and when questioned did not seem aware of the South African experience in Box 8 . I think this is to face the wrong way.

Box 8 [50]

One of the debates in regulation is the extent to which unsocial behaviour should be punished. This is partly a matter of desert; it would be unfair that bankers who steal should get lesser sentences than burglars do. There are also considerations of liberty and efficiency: whether it is necessary to take the dishonest banker off the street when society can be made safe if they are kept away from financial institutions. Both desert and efficiency come into play with the difficulty in obtaining criminal convictions. The standard of proof is that the matter must be beyond reasonable doubt, and wealthy individuals can employ good lawyers to sow such doubt. The South African experience is described in the Johannesburg Stock Exchange:

> *South Africa was the first country to initiate civil prosecution of insider trading with the added advantage of compensation for those prejudiced by insider trading. … The civil provisions of the Act have been the main tool utilised by the FSB, resulting in settlements since 1999 totalling more than R93 million. In all cases, the persons involved were named in press releases.* [51]

They go on to report on a survey of market participants, where over three quarters felt that the new approach had reduced insider trading. Dennis Davis[52] reports that South African company law has followed this approach more widely in decriminalising many offences that can be dealt with more efficiently otherwise.

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[48] Braithwaite, J. 1999. Accountability and governance under the new regulatory state. *Australian Journal of Public Administration*, *58*(1), 90-94
[49] http://www.abc.net.au/news/2015-06-03/asic-considers-criminal-sanctions-for-poor-company-culture/6517684
[50] See note Working Ethically in Finance, p133ff
[51] Johannesburg Stock Exchange (2013) Insider trading and other market abuses (including the effective management of price sensitive information)
[52] Davis, D. M. (2010). Dealing with corporate defaulters: curbing the unfettered exercise of criminal law: enforcement and regulatory regime: part IV. *Acta Juridica: Modern company law for a competitive South African economy*, 411-432.

4.4 Codes of ethics

In addition to removing temptations, we can reinforce private consciences by encouraging the adoption of professional codes of conduct, as in Box 9 .

Box 9 [53]

I have found that the ethical codes of the actuarial profession do make it easier to challenge unethical behaviour in other actuaries. I have therefore invested many hours in attempting to refine them so that they can be used in this way. The codes have, however, recently have tended to grow into depressingly detailed lists of what not to do. While this makes it easier to convict an offender, the aim should be to reform poor – and reinforce better – behaviour. It is easier to phone a fellow professional and suggest that he or she is close to a rather vague line, than to point out that they have infringed a clear boundary that must be enforced.

On the other hand, I have not been enthusiastic about company codes of ethics, because they seem to feed hypocrisy. I seem to have been wrong. The research does indicate that affirming the virtues, even in such ways as signing a code of ethics, does help make people more honest[54]. The risk of hypocrisy is however just another manifestation of vice, and should not prevent us from acting. François de la Rochefoucauld puts it nicely: “Hypocrisy is the homage which vice pays to virtue”.

Ethical codes should however be simple. Ten Commandments are more than enough! Focussing on meeting the needs of clients is a good start. Peter Drucker regards the most important ethical principle for businesses as the same as found in the doctors’ Hippocratic Oath, “primum non nocere – ‘Above all, not knowingly, to do harm.’” This involves avoiding unintended consequences, and is often a high standard.

My bias is obvious, but I do see advantages in requiring trustees to obtain a regular financial condition report from an actuary – as I have previously suggested to APRA, the relevant sections copied in the Appendix to this submission.

4.5 Regulatory Capture

The power of greed can pervert not only private organizations but regulators. Box 10 explains, but Adam Smith is more colourful:

> *The member of parliament who supports every proposal for strengthening this monopoly, is sure to acquire not only the reputation for understanding trade, but great popularity and influence with an order to men whose numbers and wealth render them of great importance. If he opposes them, on the contrary, and still more if he has authority enough to thwart them, neither the most acknowledged probity, nor the highest rank, nor the greatest public service, can protect him from the most infamous abuse and*

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[53] Taken from *Working ethically in finance,* note 16 above, p182

[54] Shu, L. L., Gino, F., & Bazerman, M. H. (2009). Dishonest deed, clear conscience: Self-preservation through moral disengagement and motivated forgetting. Harvard Business School.

detraction, from personal insults, nor sometimes from real danger, arising from the insolent outrage of furious and disappointed monopolists.

Box 10 [55]

Public interest theory is built on the fundamental assumptions that economic markets are subject to market failures and, as a result, can operate inefficiently. … Thus, the public interest paradigm is based on the assumption that the government will act on behalf of the public to improve welfare in situations where the market has failed to do so.[56] …

In contrast to this public interest theory, the 1980's 'Stiglerian'[57] version of *private interest theory* was developed by economists, building off Adam Smith and Mancur Olson.[58] Findings in this respect have highlighted outcomes wherein government regulations appeared, in many cases, to have primarily served the interests of small, powerful interest groups rather than the public interest. Within this framework, government regulation is seen as a market for wealth transfers, with politicians having the power to coerce to affect wealth transfers, which product is then 'sold'. ... The sale price takes the form of explicit payments to Governments (eg bribes, campaign contributions, etc) or subtler forms of payment (eg assurances of factional voting support).[59]

Producers within this original formulation of the private interest model will generally seek to maximise their wealth by lobbying for regulation involving less competitive market dynamics (e.g. price fixing, restriction of entry, subsidies, and suppression of substitutes). As producer groups are generally small relative to consumer groups, and where profits are potentially large, producer groups are easier to organise and strongly incentivised to seek self-benefitting regulation. Consumers, conversely, face an insignificant incentive per person to oppose regulation. The 'protective' regulatory shield sought by incumbent producers is to ensure that these benefits are 'delivered' by government in an opaque manner, such as in the form of highly technical and complex supervisory regulations, which allow little scope for fund member/consumer recognition of the 'hidden' benefits/subsidies to producers and, therefore, see no reason to mount any form of counter lobbying campaign.[60] …

[55] From Taylor, Sue, Anthony Asher, and Julie Anne Tarr (2017). "Accountability in Regulatory Reform: Australia's Superannuation Industry Paradox." *Federal Law Review*. 45(2), 257-289.

[56] Refer to the seminal publications: Barry M Mitnick, *The Political Economy of Regulation* (Columbia University Press, 1980); Douglas Needham, *The Economics and Politics of Regulation: A Behavioural Approach*, (Little, Brown and Company, 1983); Richard A Posner, 'Theories of Economic Regulation'(1974) 4 *The Bell Journal of Economics and Management Science* 335.

[57] George J Stigler, 'The Theory of Economic Regulation'(1971) 2 *Bell Journal of Economics and Management Science* 3.

[58] Mancur Olson, *The Logic of Collective Action* (Harvard University Press, 1965).

[59] See, more broadly, Eric A Posner, 'Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective' (2001) *University of Chicago Law Review* 1137; Sam Peltzman, 'Towards a More General Theory of Regulation' (1976) 19 *Journal of Law and Economics*, 211, 109–48; Gary S Becker, 'A Theory of Competition among Pressure Groups for Political Influence' (1983) 98 *Quarterly Journal of Economics* 371.

[60] Sue Taylor, 'Captured Legislators and Their Twenty Billion Dollar Annual Superannuation Cost Legacy' (2011) 58 (3) *Australian Accounting Review* 268.

Regulatory capture theory provides another perspective that aligns with the regulatory outcomes described. Harvard's Tobin Project[61] has generated a range of studies around industry-based capture deriving from barriers to entry and which can be argued to characterise current superannuation regulation. Tobin research reconsiders Stiglerian concepts of regulatory capture which predominantly focused on rent seeking activities designed to generate *more regulation:* for example, creating barriers to entry to new firms. …

Our research[62] finds that the changes to Australian law and regulation over the past two decades has persistently failed to meet its own standards of Regulatory Impact Assessment.

4.6 Intellectual capture

The victory of vested interests over regulation is described by academic John Kay as:

> *...regulation that is at once extensive and intrusive, yet ineffective and largely captured by financial sector interests. Such capture is sometimes crudely corrupt, as in the US where politics is in thrall to Wall Street money. The European position is better described as intellectual capture. Regulators come to see the industry through the eyes of market participants rather than the end users they exist to serve, because market participants are the only source of the detailed information and expertise this type of regulation requires.*[63]

There is a widespread view that this is related to neo-classical economics as raised in Box 2:

> *ascendancy within the academic community and many regulatory authorities of ideas highlighting the efficiency of financial markets at understanding and allocating risks, their self-stabilizing nature, and the benefits of financial innovations for the economy...* [64]

In a similar vein, in a book on the place of trust law in superannuation[65], Scott Donald questions Australia's legislative program of the past decades as favouring a view of the member as a "consumer of financial products" and thereby losing some of the "valuable protections" (55) that stem from Equity. In another chapter, Pamela Hanrahan suggests, in particular, that market conduct regulations "default" to the investor perspective, expressing disquiet at the process, which appears opaque, overly complex and prescriptive: "there is no need to use all regulatory interventions on all people". (32)

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[61] Daniel Carpenter and David A Moss ,*Preventing Regulatory Capture: Special interest influence and how to limit it* (The Tobin Project, Cambridge University Press, 2014).

[62] Note 55 above, and Tarr, Julie-Anne, Taylor, Sue and Asher, Anthony (2016). "Australia's flawed Regulatory Impact Statement (RIS) process" *Australian Business Law Review* 44: 361-376.

[63] http://www.johnkay.com/2012/07/22/finance-needs-stewards-not-toll-collectors

[64] Stefano Pagliari, Making good financial regulation: Towards a policy response to regulatory capture (Grosvenor House Publishing, 2012, p15–16.

[65] M Scott Donald and Lisa Butler Beatty, *The Evolving Role of Trust in Superannuation*, The Superannuation Committee of the Law Council of Australia, The Federation Press, 2017.

4.7 Complexity

This leads to perhaps the most insidious channel through which regulatory capture works:

> *the complexity inherent in financial regulatory policies and the built-in advantage that the financial firms targeted by specific regulation have in terms of knowledge and information vis-à-vis other stakeholders are factors that increase the dependence on industry for expertise. Moreover, many analysts have lamented the lack of engagement with financial regulatory debates from stakeholders such as deposit holders, investors, and consumers of financial services. Besides being disadvantaged vis-à-vis financial industry groups in terms of financial resources and technical expertise, these groups' voices remain hindered by their diffuse nature and the resulting 'collective action problems'.*[66]

And again, from John Kay: "This complexity has created a financial regulation industry – an army of compliance officers, regulators, consultants and advisers – with a vested interest in the regulation industry's expansion."[67] Justice Stephen Rares has raised other issues with complexity:

> *the policy choice of using prescriptive drafting that most Commonwealth legislation has reflected over the last two or three decades needs urgent reconsideration. It has really significant impacts on the whole community in terms of comprehensibility, compliance costs and, to use a political catch cry, access to justice.* [68]

The UK Parliamentary Counsel Cabinet Office makes further points:

> *we should regard the current degree of difficulty with law as neither inevitable nor acceptable. We should be concerned about it for several reasons. Excessive complexity hinders economic activity, creating burdens for individuals, businesses and communities. It obstructs good government. It undermines the rule of law.* [69]

In the context of Australian superannuation, I suggest that "… the tsunami of financial regulation over the past few decades has swept aside much of the sense of personal accountability."[70] My views were captured in an Actuaries Institute submission to ASIC:[71]

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[66] See note 64 above, p10.
[67] See note 63 above.
[68] Steven Rares J, 'Competition, Fairness and the Courts' (2014) 28(3) Commercial Law Quarterly: The Journal of the Commercial Law Association of Australia 17.
[69] UK Office of the Parliamentary Counsel, *When laws become too complex* (16 April 2013) Cabinet Office https://www.gov.uk/government/publications/when-laws-become-too-complex/when-laws-become-too-complex.
[70] https://theconversation.com/why-we-cant-just-throw-more-regulation-at-the-ethical-issues-raised-by-the-banking-royal-commission-96646
[71] https://www.actuaries.asn.au/Library/Submissions/2016/20152016SubmissionASIC.pdf

> *We believe that this area is too complicated and fluid at this point to benefit from detailed regulations, but rather suggest that the area will develop best if providers of robo-advice are required to obtain appropriate professional advice. We suggest that members of the Actuaries Institute, the CFA Institute, and professionally qualified accountants can fulfil these roles. The advantage of professional oversight is that members of these professions have:*
>
> - *Appropriate in-depth training as to the subtleties of the various issues involved*
> - *Have access to the combined wisdom of the profession (reflected in standards and guidance notes)*
> - *Must limit themselves to areas of advice where they have appropriate knowledge*
> - *Are subject to professional discipline in order to limit commercial excesses*
>
> *Detailed rules shift the locus of responsibility from industry to the regulator. It therefore stifles innovation and deflects energy into unnecessary compliance costs – for the industry and the Regulator. The rules in any event, might focus on process not outcomes. The paper in the appendix[72], suggests that many existing robo advice calculators are not fit for purpose. While the opinions are debatable, the proposed regulations will do nothing to address the problems. Professional bodies so however provide the necessary institutional framework to address these debates and create generally acceptable principles.*

Interestingly, the first draft of this submission did engage with the detail of the ASIC consultation paper. My suggested changes to oppose detailed regulation by ASIC was welcomed by members of the ad hoc committee debating the wording. The voluntary resources of the profession, which was fairly successful for maintaining life insurance solvency for over a century before modern risk regulation, are normally too stretched by complexity to function as well as it might.

It may be objected that neither the entities, nor regulators, will always have the time or the intellectual and moral capacity[73] to understand the problem in sufficient depth to develop their own rules. Many people prefer detailed prescriptions that can be followed more easily. The apparent certainty of prescriptions, however, offers a false sense of comfort and reinforces immature thinking. It fosters uniformity and has the potential to create greater systemic risks.

[72] Asher, A, Adam Butt, Gaurav Khemka and Ujwal Kayande (2015) Formulating Appropriate Utility Functions and Personal Financial Plans, Presented to the Actuaries Institute, Sydney (April); and the International Actuarial Association, Oslo (June) http://www.actuaries.org/oslo2015/papers/PBSS-Asher.pdf

[73] It is somewhat disconcerting that researchers using the models of Jean Piaget and Lawrence Kohlberg have found that a *minority* of adults consistently use the “formal operational” thinking and “post-conventional” morality that would characterise a principled approach to risk management.

SIS Act

When the 1993 Act was eventually reviewed by the Productivity Commission[74], it identified that the legislation was 'voluminous, complex and in some respects, overly prescriptive'. Some suggestions for reform were made in Box 11 .

Box 11 [75]

The SIS Act and Regulations, which ought to be read with Superannuation Guarantees (Administration) Act 1992 and the Retirement Savings Account Act 1997 and their regulations, make up well over a thousand pages. They are particularly repetitive[76] and clumsy, contain a number of alternative and counter-intuitive definitions and compare unfavourably with other Acts administered by APRA as well as some international legislation such as the Canadian Pension Benefits Standards Act, 1985.

Specific suggestions for simplification would be:

- Transfer those parts and sections administered by the ATO and ASIC to legislation that they administer.
- The current plan to simplify taxation already requires a substantial re-writing. This could be put into another Act. (The opportunity should be taken to remove part 8, which is particularly convoluted and permits "in-house assets" that the common law would prohibit.)
- The terms of reference are somewhat confusing as APRA does not legally have the power to issue standards for superannuation funds and trustees. Issuing standards not already in the SIS Act is the prerogative of Treasury[77], which must incorporate them into the SIS regulations. We suggest that APRA's powers under the licensing regime allow for a rationalization of powers, and for some of these other sections of the Act to be removed. It would be better for APRA to be able to regulate superannuation funds in the same way as it manages its other industries. APRA should therefore be allowed to issue prudential standards that should specifically cover operating risks and fiduciary standards.
- Remove the distinction between superannuation funds and approved deposit funds, pooled superannuation trusts and retirement savings accounts. This would facilitate the removal of many of the repetitive passages that make the Acts so complex.

Given the extended powers of APRA since, a fresh start with a total proscription of conflicts might be easiest and produce a much shorter replacement.

[74] Productivity Commission, Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Similar Legislation, Inquiry Report No 18 (10 November 2001).
[75] Andrew Gale and Anthony Asher from what was then Trowbridge Deloitte, in a submission to the Joint Committee Inquiry into the structure and operation of the superannuation industry in September 2006.
[76] We note that the drafters of the Acts seem to approve repetition of provisions when they are applied to different circumstances. The counter argument is that this makes it necessary to read much more material when one wants to know the difference between each of the circumstances. It is suggested that there would be much greater clarity if identical provisions were not repeated, and that the distinctions were separately identified
[77] In terms of section 31

4.8 Recommendations to address capture

Box 12 gives all the recommendations from joint work with Sue Taylor and Julie Anne Tarr.

Box 12 [78]

First, that both political parties, as a social imperative, pursue regulatory capture as a systemic risk across all agencies and legislative processes. As suggested by Whitehouse and Leach, consideration should be given to establishing an official public advocate, with expertise in highly technical financial regulation, who is charged with representing the public interest during the regulatory process.[79]

Second, integrated with the creation of an official, expert, public advocate, to allow for an informed debate among different stakeholders, steps need to be taken to address the informational advantage of all industry insiders participating in any RIS-related consultations. For example, both the APRA and the ASIC need to be empowered to generate and disseminate information to remedy the informational disadvantage vis-à-vis the industry and any lobbyists. This release of data: 'will help energize the public to overcome collective action problems and rally behind the agency … so that they can engage in the issues, possibly against the deep pockets of the incumbents'.[80]

Third, that political parties and the OBPR require RISs to document consideration and adopted solutions to any potential issues that may be perceived as arising around rent seeking. In the case of the Australian superannuation industry, given the size and power of the Financial Services Sector, consideration of this variable should be included in RIS processes particularly around potential rent seeking activities that impose costs on fund members.

Included within this point should be the prioritisation of the completion of outstanding Post Implementation Reviews (PIR).[81] Ensuring reviews conducted around superannuation revisit legislation that may have previously been exempted through grants of exemption 'carve outs' would be meritorious and, going forward, should align with standards arising out of recommendation four below.

Fourth, there is a need for the ongoing development of more rigorous statistical parameters for both the related costs and benefits of any proposed regulations, as suggested by Posner and Weyl.[82]

[78] Taken from Taylor et al, n 55 above.
[79] Carpenter and Moss, above n 61, 473.
[80] Pagliari (ed), 2012, above n 64, 24.
[81] As detailed on the OBPR site, <https://ris.govspace.gov.au/files/2012/04/03-PIR-Table-Required-2014-15_22072015.pdf> as 30th June 2015, there were a total of 90 post-implementation reviews (PIR) required. Of the 90 PIRs, in 57 cases the regulation has been implemented, whilst in 4 instances the regulation has not been implemented and 29 PIRs were completed and published. Eight PIRs were non-compliant for not having been completed in the required timeframe.
[82] Eric Posner and E Glenn Weyl, 'Speculation, Insurance and Financial Regulation: Benefit-Cost Analysis for Financial Regulation' (2013) 103 American Economic Review: Paper and Proceedings 393

Fifth, there is the desirability of significantly restricting the carve-out and exemption provisions that are included within the Australian Government Regulation Impact Assessment process, as flagged in the 2012 Borthwick and Milliner Review. Specifically, 'Prime Ministerial exemptions from the need to undertake a RIS should be provided only in genuinely "exceptional circumstances"'[83]

Finally, it is suggested that the Federal government seek contribution more actively and formally from Australia's highly experienced fund licensees in the early stages of the RIS process to ensure a 'voice' is given to them and, through their expertise, to those of the millions of fund members whose life savings are the subject matter of their fiduciary investment care.

Section 5 has been removed

[83] David Borthwick and Robert Milliner, Independent Review of the Australian Government's Regulatory Impact Statement Process, Review for the Minister for Finance and Deregulation (2012)., 11.

Appendix: Financial Condition Report[84]

It seems to me that the wider responsibilities of the trustees to consider all the financial interests of the beneficiaries would be well served if they were to be provided with a regular FCR. Such a report could address all elements of the wider scope that I believe is envisaged in the concept of "retirement incomes standards" in the APRA Act. This section sets out a potential scope for such a report, which would incorporate the risk management framework included in the discussion paper.

A FCR would provide an independent review of whether the Trustee had fulfilled its duty of care to:

- Financial soundness and the management of risks
- Optimise financial performance
- Make allocation decisions fairly
- Providing appropriate member products and services

An FCR would normally be produced by an actuary, or someone else with appropriate skills and experience, who would need to be given powers to obtain information from the administrators, investors and insurers of the fund. The complier of the FCR might well need to access other professional expertise to ensure that he or she has an adequate view of the financial consequences of elements of the funds operation.

1 Financial soundness

Most Australian superannuation funds are designed not to take financial risks, but they cannot be entirely avoided (and are identified in the discussion paper):

- Investment risk may be present in residual DB promises – and if fund marketing material creates benefit expectations of any investment guarantees – possibly related to exotic (or merely risky) investment options
- Insurance risk comes from residual self-insurance and risks arising from the solvency of insurers, especially in pandemic scenarios
- Operational risk from unit pricing errors or other inadequacies, benefit payments, and other administrative functions whether managed in-house or outsourced – combined possible with inadequate insurance
- Strategic & business risks from loss of membership leading to subscale operations or excessive expenditure on unsuccessful expansion
- Regulatory and political risks from compliance failures or sudden changes that cannot be met timeously
- Liquidity risk arises from unlisted assets, and listed assets with limited turnover. I would suggest that member choice requires that all assets be made liquid so that they can be sold on an exchange or at least distributed in specie if necessary.

[84] Taken from my unpublished submission to APRA on Prudential Standards for Superannuation, 23 December 2011.

This section of the FCR would provide the monitoring of the trustee's risk management framework and business plan, and provide evidence to APRA that the fund was adequately resourced as will be required by the new standards.

2 Financial performance

Given that risks to a DC fund are minimised, members are often more concerned about their value for money from the fund than its financial soundness. To fulfil their duty of care, the trustee needs to ensure that it is monitoring this adequately. This would include:

- **Relative investment returns.** Ultimately performance should be measured relative to the benchmarks that have been set in fund PDSs. This relative performance should also be compared with similar funds.
- **Investment performance attribution.** Investment returns are subject to significant random fluctuations, and the components of the returns should be monitored to ensure that they meet expectations (and inexplicably poor returns from some investments have been swamped by randomly good returns from others).
- **Stewardship of power to vote at AGM's.** Compulsory voting is required by the USA's ERISA legislation governing retirement funds on the grounds that the votes represent an asset of the fund. The fund ought to have processes in place to ensure this.
- **Stock lending.** Trustees need to fully understand and monitor the risks in stock lending. My experience is that they do not. The main risk faced is that of the bear squeeze, which is not uncommon in falling markets particularly.
- **Relative expenses.** Investment management, insurance premiums and administrative expenses should be monitored for reasonability and competitiveness. Investment and insurance brokerage and other costs that may be subject to conflicts of interest need particularly careful monitoring.

An FCR would review other reports received by the trustees on financial performance, and comment on whether the reports met best practice standards. This section needs to go further than that envisaged in section 8.4.2 of the discussion paper. Trustees are not sufficiently aware of the ways in which they are overpaying for investment services.

- Stockbroker charges vary considerably; I have been told that they add another 50% to the charges of investment managers – on average, and it is not clear that they always add value of money, particularly as they are generally not reported to the trustees. [85]
- There are risks that funds are not given fair prices for shares, various hedging contacts and currency deals. Again trustees seldom get reports on prices they are paying relatively to the value weighted average price (VWAP) of the day. There is little local evidence, but it can be noted that BNY Mellon is currently facing charges in the USA of having defrauded its pension fund clients of $2bn in currency charges over the last decade.[86]

[85] See Schwartz, R.A. & Steil, B. (2002) Controlling Institutional Trading Costs, *Journal of Portfolio Management* 28.4 39-49 and Glass, S. & Wagner, W. (1998) The Dynamics of Trading and Directed Brokerage, *Journal of Pension Plan Investing 2:* 53-72, available at: http://zenocg.com/pdf/DynamicsOfTrading.pdf
[86] http://www.boston.com/Boston/businessupdates/2011/11/bank-new-york-mellon-ceo-defends-company-against-foreign-exchange-suits/UN3zNtY9O4ttfWBna3axvI/index.html

- It is widely held that investment banks overcharge for IPO and other services. While Howa and Yeo[87] found no evidence of mispricing in the nineties in Australia, this needs ongoing monitoring.

3 Allocation of costs and benefits

There are limited “cross subsidies” in DC funds, but members (and regulators) expect none at all. Trustees therefore need to particularly careful in exercising and monitoring their discretions where cross subsidies might be seen to occur. They need to maintain documented reasons for their decisions.

- **Expense charges** can be allocated by member, by service provided or in proportion to account balances.
- **Insurance premiums** can be differentiated by age, sex, occupation, income level, habits or state of health.
- **Tax** can be allocated accurately or using approximate formulae. The allocation of deferred tax assets particularly requires judgement as to their recoverability. Another issue is the allocation of imputation credits – particularly to pensioners.
- **Unlisted assets** require a subjective valuation that affects transacting members
- **Unit prices** can be based on stale prices, subjective valuations or approximations. It should be noted that audit requirements do not currently extend to the audit of the prices used by funds in spite of their importance.

An FCR would review the documentation of these decisions, and report whether the reasons for making allocation decisions remained valid – and that processes for making decisions are being appropriately monitored.

4 Member services and products are appropriate

Some of the greatest damage to financial institutions has come from a failure to give reasonable value or meet real client needs. The mis-selling scandals in the UK cost the industry billions provide ongoing examples. These issues might be classified as business risks, but also incorporate questions relating to performance and allocations of expenses

- **Investment options.** These, particularly those involving additional risks such as gearing or inadequate diversification, are covered by section 8.4 of the discussion paper.
- **Information for exercise of choice.** As options proliferate, the information on each is at risk of becoming perfunctory.
- **Life, disability & longevity insurance**. Insurance covers should be “MECE” – mutually exclusive and comprehensively exhaustive. In many cases, members are covered more than once for some adverse events (particularly accidents and some traumatic diseases) but not at all for others (particularly temporary and partial disability). Often they do not know what they are covered for. Progress has been made in recent years in improving the situation.

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[87] Janice C.Y. Howa & Julian J.L. Yeo (2000) The pricing of underwriting services in the Australian capital market, *Pacific-Basin Finance Journal* 3-4: 347-373

- **Intra fund advice**. Members should be given illustrations as to the range of income that they might get from their funds. Trustees have been caught between expectations of members that they be given useful advice, and ASIC and other legal rules that mean that advice may be misunderstood or lead to claims for losses. Regular review is therefore important.
- **Rights and expectations of dependents.** Decisions to allocate benefits to dependents frequently have to be made in the face of insufficient information, which may later invalidate the decision. The process needs ongoing reviews

An FCR would review the products and services offered, and report whether they remained fit for purpose.

Overall, I believe that there is sufficient evidence in practice and in the literature to suggest that trustees do not adequately monitor performance, expenses or the appropriateness of benefits. This arises partly from their inexperience and partly from institutional inertia that makes innovation in this area difficult: service providers resist monitoring in a variety of ways. APRA’s new powers allow it to ensure that trustees are empowered to obtain a more complete picture of their stewardship of members’ financial interests.

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

Written Submission by Anthony Asher in response to policy-related issues raised in

MODULE 6: INSURANCE POLICY QUESTIONS

1 Introduction

This submission is intended to highlight, firstly, differences between insurance and other economic services, and secondly, the fragmented and clumsy nature of government intervention and regulation in response to these differences. I propose that the Royal Commission (RC) consider the following recommendations:

- the creation or nomination of a body to take overall responsibility for co-ordinating government interventions and regulatory responsibility, and
- extending the purpose and scope of the regulators to that of optimising insurance coverage of the population rather than its current narrow focus on prudential and competitive matters.

My experience (practical and academic) is mainly in Life Insurance, but I do make some comments on health insurance[88] and personal lines, but not commercial lines of insurance. I have mainly focussed on the general principles, agreeing with the assessment that:

> *… in design and application, the normative question of why one regulates trumps the technical consideration of how one regulates, which is a second-order consideration.*[89]

Section 2 of this submission makes the traditional case that insurance is not a normal economic good. Section 3 has been removed as it is not rel. Section 4 suggests how the many government interventions in insurance markets (that include regulation and several mandatory covers) might be co-ordinated.

2 Insurance pools and their protection

That insurance is not a normal good is indicated by over 3 centuries of regulation, and by government interventions to extend coverage. This section also shows that the regulation and interventions are somewhat fragmented. The implication is that coordination is required.

Insurance pools have the social and economic function of providing financial security: protecting families against significant loss of income from death and disability, and against

[88] Appreciating it is outside the RC's terms of reference.
[89] O'Brien J (2013) "Back to the future: James M Landis, Regulatory Purpose and the Rationale for Intervention in Capital Markets." In O'Brien, J. and Gilligan, G. eds., 2013. *Integrity, risk and accountability in capital markets: regulating culture*. Bloomsbury Publishing.

loss of significant assets. The benefits paid are intended to prevent people falling into poverty or needing to claim social welfare.[90]

The pools cannot function effectively in an unregulated market. Regulation – to ensure that policyholders have an insurable interest and have a duty of utmost good faith to disclose all relevant facts to the insurer – goes back at least to the 18th century.[91] These regulations have allowed for the expansion of insurance pools by reducing uncertainty and "moral hazards". The need for an insurable interest distinguishes insurance from gambling and reduces the incentives to engineer an insurance claim. Utmost good faith makes it easier for insurers to classify risks, and to charge fair premiums that match the risk of claim to the premiums.

Economists have been analysing the moral hazards and information asymmetries for over a century.[92] The best analysis recognises that these are "market failures" and require regulatory interventions:

> *… the price system is intrinsically limited in scope by our inability to make factual distinctions needed for optimal pricing under uncertainty. Nonmarket controls, whether internalized as moral principles or externally imposed, are to some extent essential for efficiency.* [93]

Much economic analysis cannot however be trusted; some making Procrustean attempts to fit insurance into an unregulated self-interested market. A thorough refutation of the worst analyses is given by Guy Thomas, whose book is reviewed thus:

> *Thomas also exposes myths of insurance economics, including Rothschild–Stiglitz, Miyazaki, Wilson, Spence*[94]*, and related classic equilibrium model extensions, that have been highly influential on theory and frequently applied in policy recommendations, despite being notoriously unreflective of actual real-world markets. Thomas refutes numerous myths, including: adverse selection always implies "efficiency loss," a small high-risk group poses big problems, deductibles make good screening devices, insurance for low risks is rationed, coverage for high risks is never rationed, and high and low risks differing only in risk must share uniform other endowments. Thomas also debunks several biases relating to asymmetries of information and behavior, as well as the common notion that any transfer from low to*

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[90] Provision of the latter is resented by some taxpayers and some eligible people experience shame. CF Manchester and KJ Mumford, 'How costly is welfare stigma? 'Separating Psychological Costs from Time Costs', 2009, http://ssrn.com/abstract=1544601 (accessed 3 April 2016).

[91] Insurable interest came in the British Marine Insurance Act 1745 and the Life Assurance Act 1774 while *uberrima fides* seems to have been first defined in Carter v Boehm (1766) 97 ER 1162, 1164,

[92] Rowell, D., & Connelly, L. B. (2012). A history of the term "moral hazard". *Journal of Risk and Insurance*, 79(4), 1051-1075.

[93] Arrow, K. J. (1968). The economics of moral hazard: further comment. *The American Economic Review*, *58*(3), 537-539.

[94] Miyazaki, H., 1977, The Rat Race and Internal Labor Markets, *Bell Journal of Economics*, 8(2): 394-418; Rothschild, M., and J. E. Stiglitz, 1976, Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, *Quarterly Journal of Economics*, 90(4): 629-649; Spence, A. M., 1978, Product Differentiation and Performance in Insurance Markets, *Journal of Public Economics*, 10(3): 427-447. Wilson, C., 1977, A Model of Insurance Markets with Incomplete Information, *Journal of Economic Theory*, 16(2): 167-207.

> *high risks through taxation or benefits is always superior to bans on risk classification schemes.*[95]

Thomas's main thesis is that insurance meets its social purpose by paying as many claims as can be covered economically. Intervention that prevents "competitive selection", where companies compete for the lowest risks by offering cheaper premiums, can be beneficial. An obvious example is banning genetic testing for life insurance. Another is the problem currently faced by Australian life and disability insurers where the better risks (those in good health) churn. This leaves unhealthy people behind in pools where the premiums must be increased to take the higher claims in to account. This is, obviously, aggravated by perverse sales commissions, but could be a problem even without commissions.

2.1 Government intervention

Not everyone vulnerable to economic shocks has the foresight and ability to buy the insurance they need. Governments therefore intervene in different, but not always coherent, ways. Although some of these interventions are beyond the remit of the RC, they have important impacts on the structure of private markets that are within its scope. The following provides a list, which may not be complete:

- The provision of social insurance normally provides an income floor in the event of disability or unemployment. In Australia, there is also Medicare.
- Most countries have compulsory retirement benefits schemes – often with compulsory life, disability and longevity insurance (i.e. life annuities). Australia's superannuation is unusual in not requiring some compulsory annuitization.
- Cover against accidents at work and on the road is usually made compulsory. These arrangements originated partly to ensure that employers and drivers took responsibility for harms they created.[96] The by-product is that they also provide *incomplete* cover against accidental death and injury. The incompleteness is partly addressed in New Zealand by a national no-fault accident compensation scheme[97], which does not, however, cover death and injury caused by disease. Benefits may also be insufficient to cover family members' losses.
- Private Health Insurance is encouraged by tax benefits and is subject to regulations requiring minimum levels of cover, "community rating" for premiums.
- Government has intervened in the definition of flood in the Insurance Contracts Act (ICA), sections 37A to 37E.
- State governments levy households or insurers for fire services.
- The *Terrorism Insurance Act 2003* provides re-insurance for terrorism.
- Many countries exercise price control on insurance premiums and commissions; restrict benefit and product structures, and limit shareholder participation in profits. Policy in Australia has moved away from this in the past three decades, but residues remain in Private Health Insurance, the CTP and workers' compensation schemes, in APRA's

[95] Ferguson, William L. (2018) Book Review: Loss Coverage: Why Insurance Works Better with Some Adverse Selection, by Guy Thomas, 2017, Cambridge, UK: Cambridge University Press, *The Journal of Risk and Insurance.* Vol. 85, No. 3, 865–867

[96] Epstein, R. A. (1981). The historical origins and economic structure of workers' compensation law. *Ga. L. Rev.*, *16*, 775.

[97] https://www.acc.co.nz/

Prudential Standard LPS 360 Termination Values Minimum Surrender Values and Paid-up Values, and the restrictions in the Life Insurance Act Section 60 on the distribution of profits.

The fragmented nature of regulation has been noted in the case of the development of longevity insurance, which has led recently to a cross agency process – led by the ATO – for seeking initial "concept exploration" or "product review" from the relevant agencies (ATO, APRA, ASIC and DSS).[98]

2.2 Company collaboration

Traditionally, Insurance companies also collaborated on ways to ensure the integrity of insurance pools. In my experience in South Africa, the insurers created a register of salespeople who failed to maintain ethical standards; a register of claims to prevent duplicate and fraudulent claims and created agreements to prevent unreasonable investment projections. I am aware that there was also a projection agreement in Australia. The actuarial profession also used to collect industry wide mortality and disability data. Competition law has made such collaboration more difficult, and the increased powers of the regulators have shifted the onus of maintaining standards from the industry. Such self-regulation, however, has several shortcomings, and needs to be supplemented by active regulation.

Section 3 has been removed

4 A vision of collaboration

If competitive markets will not provide efficient insurance markets, and the current state of government intervention and regulation is recognised as fragmented if not incoherent, the question arises: can one envisage a new model of collaboration between industry and regulators, with safeguards against regulatory capture? This thought has been partly captured by Part 1A of the ICA, although it is not sufficiently wide in scope, and the regulation of the industry is divided not just between APRA and ASIC, both of which are constrained to promote competition, but also between the other bodies mentioned in 2.1 above.

There needs to be a body with the responsibility for addressing the objective to *extend the benefits of insurance to protect members of the public against financial shocks*. Such a co-ordinating body would have the scope to address all private and public insurers: life, disability, health, accident (including CTP and workers compensation), motor and home insurance. One possibility is an overall co-ordinating body with a similar structure to The Board of Taxation. An alternative would be to house the responsibility within an existing regulator, which should probably be APRA rather than ASIC, given the latter's already large remit.

[98] https://www.ato.gov.au/Super/APRA-regulated-funds/In-detail/APRA-resources/Cross-agency-process-for-innovative-retirement-income-stream-products/

4.1 Regulatory objectives

The body would have the following objectives:

- **Prudential regulation** of insurers so that they are reasonably certain of paying insured benefits. Included in this remit would be responses to catastrophes, which might require government financial support (as with terrorism), or "resolution plans" as to how claims would be reduced in the event of the bankruptcy of companies such as occurred after the Christchurch earthquake.
- **Policyholder protection,** which would include making sure that products were fit for purpose, that prices and claim processes were reasonably fair, and that reasonable benefit expectations are met. This would be a positive aim, as against the proposed DDO Bill, which, for all its prolixity, merely addresses "significant detriment".
- **Optimisation of coverage,** by considering the extent of mandatory cover – ensuring that there are no significant gaps in coverage – or that gaps in coverage are highlighted clearly.
  This would also involve education; ways in which government could contribute to the collection and distribution of on-line data that could be used to facilitate people making financial decisions; managing the remuneration of financial intermediaries and advisors and the role of advertising – endeavouring to ensure that the public is not misled. An important element would be to limit the rating factors (such as genetic markers) used so as to increase loss coverage and prevent competitive selection.
- **The encouragement of innovation.** This would include research by collecting data on claim rates, and the impact of insurance on poverty reduction and the needs of policyholders. This should include collaboration with universities and other government departments. Box 1 suggests a further method of promoting the innovation that often seems missing in the Australian industry.

Box 1[99]

Lack of intellectual property protection

Innovation may also be constrained by the lack of intellectual property (IP) protection. Neither patents nor copyright offer protection to innovators, making it more difficult to justify an investment in a new product or method of doing business. I have personal experience of this difficulty in developing the product set out in Asher (2011)[100].

It seems generally agreed that IP encourages innovation. Some type of IP for financial products might do the same. My thoughts are that such an instrument might dispense with the patenting requirement that an invention be non-obvious and novel by a measure of whether the product was currently available in the market. A potential supplier might apply for a short term (say 5 year) exclusive licence.

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[99] Taken from Asher, A (2016) Productivity Commission Superannuation Competitiveness and Efficiency Review: http://www.pc.gov.au/__data/assets/pdf_file/0003/198075/sub021-superannuation-competitiveness-efficiency.pdf

[100] Asher, A (2011) "Salary Linked Home Finance: Reducing interest rate, inflation and idiosyncratic salary risks", *Australian Actuarial Journal* 17.1: 117-148

4.2 Addressing regulatory capture

Ultimately regulatory capture requires vigilance by everyone from politicians and voters to institutions and shareholders. Braithwaite's suggestion is that "we abandon arraying guardians in a hierarchy. Instead, we can array guardians in a circle where every guardian is accountable to every other guardian (as much as possible)."[101] Some ways of doing this are, that might be considered as recommendations by the RC:

- The appointment of advisory committees for life, general and health insurance with elected representatives from industry, consumer groups and relevant university departments.[102] Representatives appointed by government will inevitably have less confidence to challenge regulatory capture. The minutes of such advisory committees should be public.
- Data collected by the regulators should also be made public.[103] Items that might unnecessarily expose insurers to a crisis of confidence can be released after a delay – of perhaps two years.

In addition, as suggested in my submission to module 5, there needs to be a Consumer Advocate – possibly within the Treasury – with a specific remit to address issues of rent seeking and regulatory capture at APRA, ASIC or the RBA.

25 October 2018

[101] Braithwaite, J (2013) Cultures of Redemptive Finance. In O'Brien, J. and Gilligan, G. eds., 2013. *Integrity, risk and accountability in capital markets: regulating culture*. Bloomsbury Publishing.
[102] My experience of membership of such committees in South Africa were that they did provide scope to escalate issues of importance. See Asher, A (2015). *Working ethically in finance: Clarifying our vocation*. Business Expert Press. p32-35.
[103] See also Zingales, L., 2015. Presidential address: Does finance benefit society? *The Journal of Finance*, *70*(4), pp.1327-1363, p1352.

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

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.

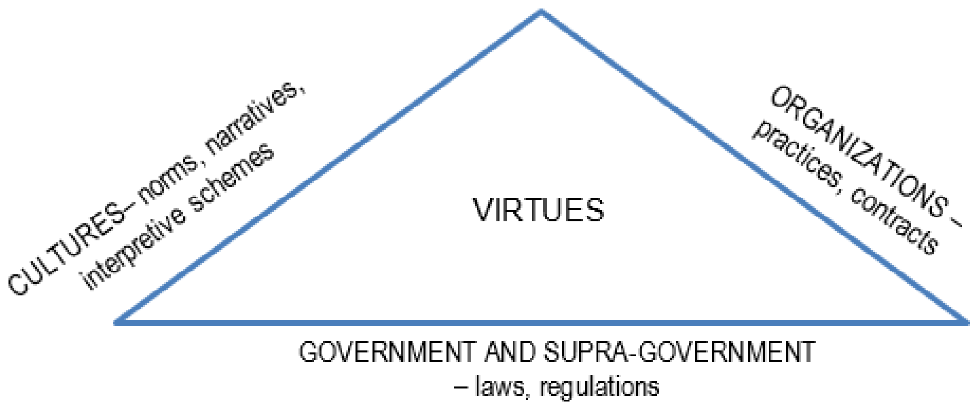

Figure 1 Structures supporting the virtues

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*[2], particularly the last chapter by John Braithwaite.[3] 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[4] and the organizational structures that encourage hubris, which is the focus of the third part of this

[1] Our working paper: Asher, A and Tracy Wilcox (2015) Virtue and risk culture in finance. Presented to the IAA Colloquia, Sydney 23-27 August 2015. https://www.actuaries.asn.au/Library/Events/ASTINAFIRERMColloquium/2015/AsherWilcoxVirtuePaper.pdf
[2] O'Brien, J. and Gilligan, G. eds., 2013. *Integrity, risk and accountability in capital markets: regulating culture*. Bloomsbury Publishing.
[3] Braithwaite, J (2013) Cultures of Redemptive Finance. In ibid.
[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[5] 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.[6] 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.

In addition, I suggest that the RC revisit its conclusions about the case of the aggrieved Bankwest borrowers on the possibility that CBA management engaged in “big bath” lossmaking.

2 Culture

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

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[5] This refers to traditional Virtue Theory as revived by Alistair Macintyre, with the question of purpose explicitly covered in Moore, G. (2012). Virtue in business: Alliance boots and an empirical exploration of MacIntyre’s conceptual framework. *Organization Studies*, *33*(3), 363-387.
[6] https://www.abc.net.au/news/2018-10-22/graeme-samuel-slams-asic-in-wake-of-banking-royal-commission/10403362

> *… 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:

> *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:*
>
> *first, the duty of protecting the society from the violence and invasion of other independent societies;*
>
> *secondly 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*

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

[8] Dent, E.B. and Parnell, J.A., 2015. Reconciling Economics and Ethics in Business Ethics Education: The Case of Objectivism. *The Journal of Ayn Rand Studies, 15*(2), pp.131-156

[9] Campbell, D. and Loughrey, J., 2013. The regulation of self-interest in financial markets. in *Regulating Culture* See n 2, 89

> *thirdly, 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.[10] 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 2[11].

Box 2[12]

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

[10] By requiring accountability and prohibiting conflicts of interest particularly – as argued in my submission to Module 5.
[11] For a more authoritative exposition of this distinction see Zingales, L., 2015. Presidential address: Does finance benefit society? *The Journal of Finance*, *70*(4), pp.1327-1363.
[12] Taken from Asher, (1998) "Effective and Ethical Institutional Investment", *British Actuarial Journal* 4.V: 969-1027.
[13] Baumol W J (1993) Entrepreneurship, Management and the Structure of Payoffs MIT Press, Cambridge Mass.

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

	Monopolist	Entrepreneur
The objective is to maximise	Market share Cost Savings	Turnover Efficiency
Particular Behaviour	Lobbying Restrictive Practices	Research Innovation

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.[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:

> *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*

[14] Frederick Herzberg (1987). *One More Time: How Do You Motivate Employees?* Harvard Business Review Case Services, 109–120.

> *perhaps be corrected, may very easily be prevented from disturbing the tranquillity of anyone but themselves.*[15]

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

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[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:

> *“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.” …*
>
> *“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.

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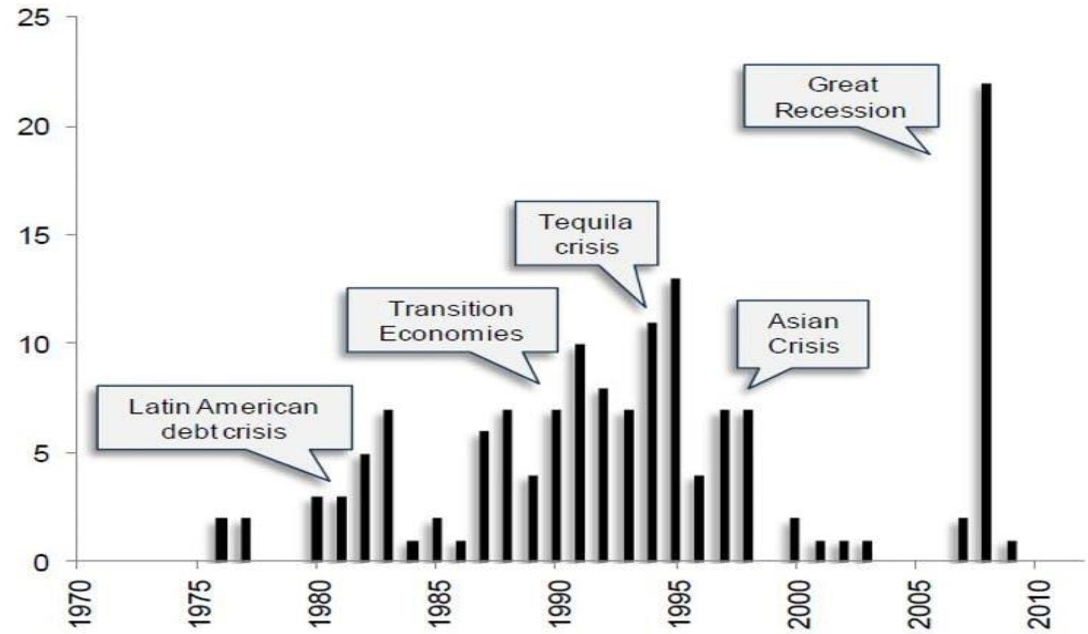
[15] From *Wealth of Nations*

[16] Greenwood, Robin, and David S. Scharfstein. (2012) "How to Make Finance Work." *Harvard Business Review* 90, no. 3.

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 modern economies would work."[18] With respect, I am not convinced that his concerns with the model of maturity transformation go far enough.[19] Certainly, speculative financing creates ongoing banking crises, as indicated in Figure 2.



[17] https://www.economist.com/economics-brief/2016/07/30/minskys-moment
[18] https://www.rba.gov.au/speeches/2015/sp-dg-2015-05-27.html
[19] Asher, A and E Rajadurai (2018) Investing Superannuation for the Public Good: Creating new markets to benefit members & fund necessary investments, The McKell Institute. https://mckellinstitute.org.au/app/uploads/FINAL_Superannuation_2018_WEB.pdf

Figure 2 Banking crises[20]

The issues of responsible lending are most clearly visible in Chapter 5 of the Interim Report and the treatment of Bankwest borrowers. Both borrowers and lenders are vulnerable to significant losses. The borrowers had taken long term loans, which the CBA was anxious to have repaid as soon as possible, and which led to significant hardship when the terms were reduced. 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: Bankwest's write-offs

As an aside, it appears as if the arguments of the aggrieved borrowers were largely discounted by the RC because they could advance no plausible reason why CBA would increase its own losses. The RC should however at least consider an alternative explanation. Companies routinely engage in "big bath accounting", and the GFC offered a special opportunity: "Australian firms engaged in a higher level of income-decreasing earnings management during the GFC."[21] Also: "After a takeover, newly appointed managers can take a "big bath", at the expense of their predecessor's record, enhancing their own apparent performance."[22]

Despite their rhetoric, managements do not always operate to maximise shareholder profits but may be more inclined to protect their own pride and pockets (as is covered in the next section). In the case of CBA's takeover of Bankwest, it is highly likely – given its rapid growth – that its loans represented a higher risk. The new CBA managers of the company certainly had an incentive to write down their value so that they could blame the previous management. An additional bonus would be that future profits would be inflated as losses were written back. In this case, the original write-offs in 2008 were not enough, and so further write-offs became necessary later – but the blame was clearly allocated to the previous management, not CBA's inadequate initial write-offs. In such a takeover moreover, there is the possibility that ex-CBA managers in competition with ex-Bankwest managers might find it convenient to "demonise" their previous behaviour. Given what is known about CBA culture, this cannot be discounted.

I am not able to evaluate all the evidence that has been presented to the RC, and it may well be that CBA was justified in its approach. There may however be a *prima facie* case that the bank discriminated against Bankwest borrowers by setting up Project Magellan and applying standards to them that were not applied to CBA loans. Again, I have not been able to look at

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[20] https://www.imf.org/~/media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/wp/2012/_wp12163.ashx
[21] Mollik, A.T., Mir, M., McIver, R. and Bepari, M.K., 2013, December. Earnings management during the global financial crisis: Evidence from Australia. In *Proceedings of International Business and Social Sciences and Research Conference* (Vol. 16, p. 17). See also Walsh, P., Craig, R. and Clarke, F., 1991. 'Big bath accounting' using extraordinary items adjustments: Australian empirical evidence. *Journal of Business Finance & Accounting*, *18*(2), pp.173-189. Fiechter, P. and Meyer, C., 2010, January. Big bath accounting using fair value measurement discretion during the financial crisis. In *American Accounting Association Annual Meeting, San Fransisco*.
[22] Meeks, Geoff, and J. Gay Meeks. "Mergers, accountants, and economic efficiency." *Economia e Politica Industriale* (2014).

all the documents, but if the concern about concentration made in the Interim Report refers to those a report to the Bankwest Risk Committee[23], the concerns seem to me to be irrelevant in the context of the whole CBA portfolio. The RC might revisit the findings of chapter 5, unless it is already convinced that CBA applied the same criteria and processes when dealing with loans it had originated to those that originated from Bankwest.

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 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 3 for a summary – which leads on directly to a valorisation or otherwise of greed.

Box 3[24]

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*

[23] EXHIBIT-3-113.pdf
[24] Taken from Asher (2015) *Working Ethically in Finance: Clarifying our vocation*, Business Expert Press 77ff.
[25] Friedman, M. (1970) "The Social Responsibility of Business is to Increase Its Profits." *The New York Times Magazine*, September 13, http://www.umich.edu/~thecore/doc/Friedman.pdf.
[26] Drucker, P. F. (1975) *Management: Tasks, Responsibilities, Practices.* Mumbai: Allied, p60

> *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

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27 Smith, A. *An Inquiry into the Nature and Causes of the Wealth of Nations.* Hazleton, PA: Pennsylvania State University, 2005, p19
28 See note 26, p60
29 See note 26, p61
30 Levitt, Theodore. Marketing Myopia. ***Harvard Business Review***. Jul/Aug1960, Vol. 38 Issue 4, p45-56. 12p
31 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.

preconceived ideas. It is however necessary for innovation which must go beyond what is already available.

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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[32] Asher A (2015) n 24, Part 3, p77-176.
[33] NMG: Australia Life Insurance Insights Report 2012, http://www.nmg-group.com/en/consulting/insights/insights_reports.php

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)[34]. Both metrics reduce involvement in otherwise profitable investments with a comparatively low ROE or high CIR.[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).[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.[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.

  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

[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/e4600e4db4d0cc89-nab.asx-3A492724/NAB_2018_Half_Year_Results_Summary.pdf

[35] The various problems of ROE are covered in Stern, J. M., Shiely, J. S., & Ross, I. (2001). The EVA challenge: implementing value-added change in an organization. John Wiley & Sons – see p 9 on the perverse impacts of ROE. For CIR, Burger, Andreas, and Jürgen Moormann. "Productivity in banks: myths & truths of the cost income ratio." Banks and Bank systems 3, no. 4 (2008): 85-94.

[36] See ibid EVA.

[37] https://www.weeklytimesnow.com.au/news/opinion/community-banks-can-replace-closed-branches/news-story/3b47f6a5571cd39124ad753ae91303f2

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

Removed because not relevant to terms of reference.

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 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.

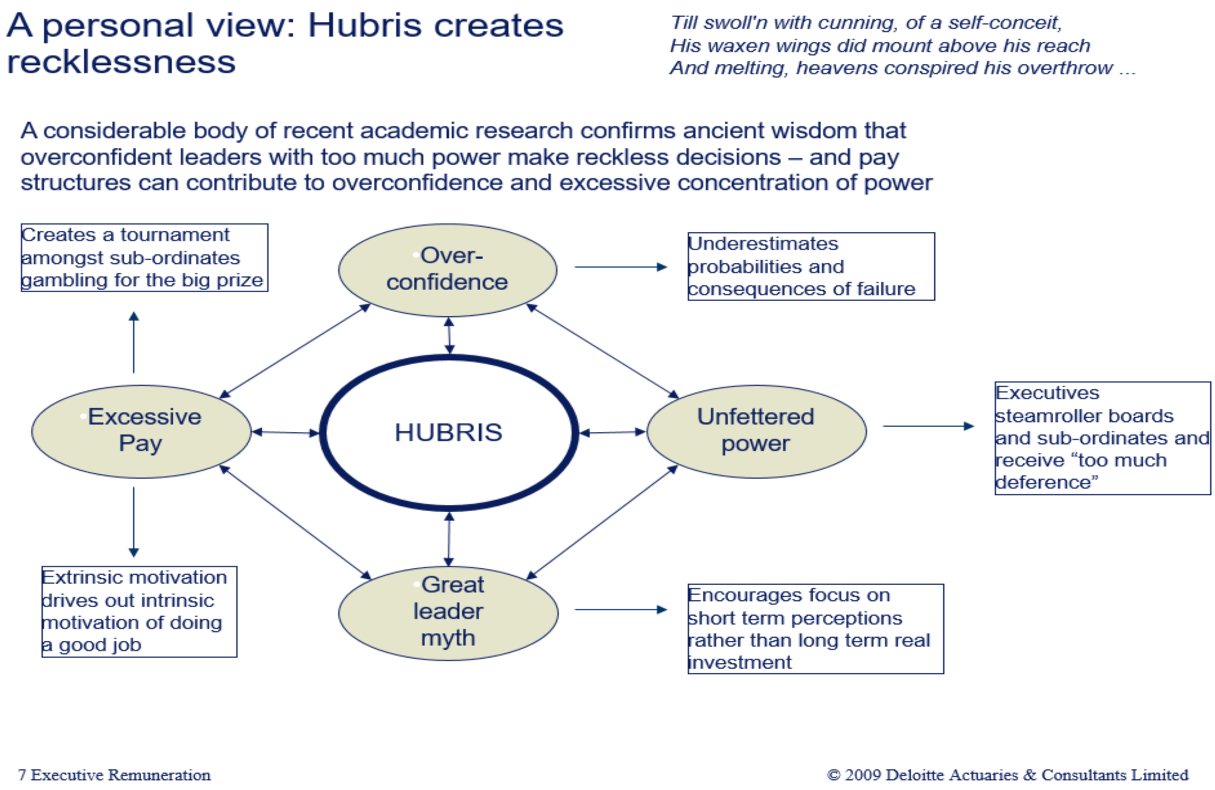

Figure 3 Pay, hubris and recklessness[38]

[38] Taken from a Deloitte presentation created for Chris Cass and Jon Finlay. The research refers to Renée B. Adams, Heitor Almeida & Daniel Ferreira (2005) Powerful CEOs and Their Impact on Corporate Performance *Review of Financial Studies* 18.4:1403-1432; Rayna Brown & Neal Sarma (2007) CEO overconfidence, CEO dominance and Corporate Acquisitions *Journal of Economics and Business* 59.5: 358-379 ;Mathew L. A. Hayward and Donald C. Hambrick (1997) Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris *Administrative Science Quarterly* 42.1: 103-127; Ulrike Malmendier & Geoffrey Tate (2005) CEO

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 jut some recent examples.[39] While much has been written by the regulators on the structure of bonuses and their impact on misconduct and recklessness, it is extraordinary is that the regulators have not made the connection between excessive remuneration and reckless and greedy behaviour.[40] 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[41] 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. (322)*

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."[42]

3.1.2 Motivated blindness

In their selfishness, they lead others to be dishonest. A review of 60 papers[43] found "overconfident executives to be embroiled more often in accounting manipulation (p56)." See

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Overconfidence and Corporate Investment The *Journal of Finance* 60.6: 2661 – 2700; Ulrike Malmendier & Geoffrey Tate (2005) Who makes acquisitions? CEO overconfidence and the market's reaction *The Journal of Financial Economics* 89.1: 20-43.

[39] Asher and Wilcox, n1 p5/6.

[40] As an example, take APRA's *Information Paper: Remuneration practices at large financial institutions* April 2018.

[41] Quotations from Desai, S.D., Brief, A.P. and George, J., 2009. Meaner managers: A consequence of income inequality, Chapter 13 in Kramer, R., Tenbrunsel, A., and Bazerman, M (ed) *Social decision making: Social dilemmas, social values, and ethical judgments*, New York: Psychology Press pp.315-334.

[42] Ascribed to Tom Murphy of Capital City/ABC by Crystal G S (1992) *In Search of Excess: The overcompensation of American Executives* Norton, New York.

[43] Plöckinger, M., Aschauer, E., Hiebl, M.R. and Rohatschek, R., 2016. The influence of individual executives on corporate financial reporting: A review and outlook from the perspective of upper echelons theory. *Journal of Accounting Literature*, *37*, pp.55-75.

also Box 4. If the RC asks, I would be surprised to find that companies have not massaging at least some of their results.

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.*[44]

Box 4[45]

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?'*[46]

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.

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 5.)

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[44] Gino, F., Moore, D.A. and Bazerman, M.H., 2009. See no evil: When we overlook other people's unethical behavior. In Kramer, RM, AE Tenbrunsel and MH Bazerman (ed) *Social decision making: Social dilemmas, social values, and ethical judgments*, pp.241-263.
[45] Taken from Asher (2015) n24, p93.
[46] Accessed November 24, 2014. http://www.investopedia.com/university/accounting-earnings-quality/.

Box 5[47]

While there is much to learn from anecdotes and more expansive stories of success (and failure), we need a deeper analysis. The research[48]suggests that optimism in business is more likely to end in failure than success. Donald Duchesneau and William Gartner[49] 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.[50]

3.2 Excessive remuneration

Box 6 gives a short summary of the view that executive remuneration has risen to excessive levels and the theories why this has occurred.

Box 6[51]

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.

[47] Asher (2015) n24 p172.
[48] Hmieleski, K. M., and R. A. Baron. “Entrepreneurs’ Optimism and New Venture Performance: A Social Cognitive Perspective.” *Academy of Management Journal* 52 (2009):473–488. Lovallo, D., and O. Sibony. “The Case for Behavioral Strategy.” McKinsey Quarterly 2 (2010):30–43; Ucbasaran, D., P. Westhead, M. Wright, and M. Flores. “The Nature of Entrepreneurial Experience, Business Failure and Comparative Optimism.” *Journal of Business Venturing* 25, no. 6 (2010):541–555.
[49] Duchesneau, D. A., & Gartner, W. B. (1990). A profile of new venture success and failure in an emerging industry. *Journal of business venturing*, *5*(5), 297-312.
[50] Jensen, Michael C. and Murphy, Kevin J. and Wruck, Eric G., Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them (July 12, 2004). Harvard NOM Working Paper No. 04-28; ECGI - Finance Working Paper No. 44/2004. https://ssrn.com/abstract=561305.
[51] Asher (2015) n24 p67-68.

Second is the view that money is the strongest motivator. There is ample psychological and economic evidence[52] 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[53].

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.[54]In comparison, Drucker[55] 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.

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

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[52] The best known is perhaps Frederick Herzberg (1987) n14.
[53] See Canice Prendergast (1999) "The provision of incentives in firms." *Journal of economic literature*: 7-63. for a review of the research.
[54] https://www.epi.org/publication/ceo-pay-continues-to-rise/
[55] Drucker, Peter F. (1985) *The Changing World of the Executive*. New York: Times Books.

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 [56] 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[57] 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

[56] Bank, S.A., Cheffins, B.R. and Wells, H., 2016. Executive pay: What worked. *J. Corp. L.*, *42*, p.59.
[57] Conyon, M.J., Fernandes, N., Ferreira, M.A., Matos, P. and Murphy, K.J., 2011. The executive compensation controversy: A transatlantic analysis. Institute for Compensation Studies, http://digitalcommons.ilr.cornell.edu/ics

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[58], 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[59] 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.[60]

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[61] 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[62], 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.

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[58] Hill, J. and Yablon, C.M., 2002. Corporate governance and executive remuneration: Rediscovering managerial positional conflict. *UNSWLJ*, *25*, p.294.
[59] See n50.
[60] B. E. Hermalin & M S Weisbach (1998) Endogenously Chosen Boards of Directors and Their Monitoring of the CEO *American Economic Review* 88.1: 96-118; Troy A Paredes (2004) Too Much Pay, Too Much Deference: Is CEO Overconfidence the Product of Corporate Governance? *Washington U. School of Law Working Paper* No. 04-08-02. ssrn.com/abstract=587162
[61] Turnbull, Shann, Corporate Charters with Competitive Advantages. St. John's Law Review, Vol. 89, 2000. Available at SSRN: https://ssrn.com/abstract=245691
[62] Branson, D.M. (1993). *Corporate governance*. Michie, Charlottesville.

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.[63] 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.

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 7 points out that it has frequently been applied to prune the temptation to arrogance.

Box 7[64]

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

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[63] Crawford, C. (2011). The repeal of the Glass-Steagall Act and the current financial crisis. *Journal of Business & Economics Research*, *9*(1), pp.127-134.
[64] Taken from Asher, A (2016) "The justice of Australian tax and redistribution in 2016". St Mark's Review No. 235, May 2016 (1) 28-43.

managers. Both ancient and modern literature identifies hubris as destructive of politicians[65], while powerful CEOs increase firm risks and exploit shareholders[66]. Democracies tend to have a more equal distribution of income and are apparently more resilient to economic crises.[67]

3.4.4 Empower research

Zingales[68] 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

4.1 Default interest and charges

4.2 Asset management

Removed because not relevant to terms of reference.

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[65] Owen D. Hubris syndrome. *Clinical Medicine*. 2008, 8(4):428-32.
[66] See, for instance, Adams RB, Almeida H, Ferreira D. Powerful CEOs and their impact on corporate performance. Review of financial studies. 2005 Dec 21;18(4):1403-32, and Morse A, Nanda V, Seru A. Are incentive contracts rigged by powerful CEOs? The Journal of Finance. 2011 Oct 1;66(5):1779-821.
[67] 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. *American Economic Review*, *98*(3), 808-842.
[68] Zingales, L., 2015. See n 11; 1352.