Preface

The Australian Securities and Investments Commission was pleased to host the ASIC Summer School 2010 in Melbourne from 1–3 March 2010. This was our 15th successive Summer School.

The theme for this year’s event was ‘Securities and investments regulation beyond the crisis’. Over the course of two and a half days, we discussed and debated the global regulatory agenda that has arisen out of the financial crisis internationally and what that might mean here in Australia. We focused specifically on the securities and investments markets.

This report is a record of presentations and panel discussions from the plenary and associated panel sessions. It also includes PowerPoint presentations and information about where to access papers referred to during speeches, if available.

Thank you to everyone who contributed to the success of this year’s Summer School. I hope you find this report useful.

Tony D’Aloisio
Chairman, ASIC
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Welcome and opening remarks

Mr Tony D’Aloisio, Chairman, ASIC

I welcome you to ASIC Summer School 2010. This marks the 15th time we’ve held this event and, as has been the case in the past few years, we alternate the Summer School between our two wonderful cities, Sydney and Melbourne, which are, of course, the two largest financial markets in Australia.

The longevity of the Summer School is really built on you, our delegates and our presenters who, for the third straight year, amount to more than 400 in number. That includes our international guests who have travelled so far to join us. This year we have over 50 international delegates from China, Chile, France, Germany, Hong Kong, Indonesia, Japan, Malaysia, New Zealand, Papua New Guinea, Saudi Arabia, Singapore, Sri Lanka, South Korea, The Netherlands, the United Kingdom and the United States.

Our local participants come from all over Australia, and are drawn from the business and corporate world—including financial markets, financial advisers, fund managers, banks, industry associations, consumer groups and professional firms—as well, of course, from government and government agencies. And there is a significant ASIC presence as well. By disseminating Summer School proceedings widely across ASIC, we make sure that all our staff benefit from the information and insights gleaned over the course of these few days.

A valuable dividend from the Summer School from ASIC’s perspective is the contribution it makes in keeping us in touch with what is happening in the markets and what are the big issues of the day. And a part of this is simply the opportunity for building and maintaining our networks of contacts. Our Commissioners and most of our senior leaders are here, as well as many other ASIC staff, and I encourage you to get to know them.

We hope, of course, that you enjoy the presentations, and find them informative. We really encourage you to participate and to speak out freely and frankly. We hope you will make new friends and renew old acquaintances, and through the course of the next few days, have some fun and perhaps get an opportunity to enjoy the sights and facilities that Melbourne offers.

Our panellists and presenters are leaders in their field. You will see their profiles in the booklet provided. We are extremely grateful to them and to our moderators for each of the sessions.

We also welcome the ASIC Minister, the Hon Chris Bowen MP, Minister for Financial Services, Superannuation and Corporate Law. The Minister will make a keynote address at lunchtime tomorrow.

So what is this Summer School all about? What are this year’s topics and themes? Last year we focused, naturally enough, on the global financial crisis (GFC): what had gone wrong, what had we learned, and what might the future look like. This year we would like to move on to issues for securities and
investments regulation beyond the crisis, and prudential regulation as well.

Today’s plenary sessions will focus on securities regulation, and our intent is to bring you up-to-date with what is happening internationally, and the implications for Australia. We hope to highlight some of the more perplexing and critical issues that remain unresolved, such as the ‘too big to fail’ concept, and the traditional assumption underlying regulatory practice, the so-called efficient market hypothesis.

At tonight’s dinner, our panel will look into the ‘crystal ball’ and attempt to envisage the shape that financial markets might take in 2016. Quite an ambitious task when we are not all that sure about their present shape. Tonight is a continuation of the special events tradition we have established in recent years. Even though it takes place over dinner, it should prove stimulating and informative, and I’m sure we are all looking forward to that discussion.

The focus at tomorrow’s plenary sessions will be on capital markets, the stock market and ‘over-the-counter’ markets, and span issues associated with transparency, ‘dark pools’, competition for trading services, and other key issues.

We will also look at the role of ‘gatekeepers’. It is not just ASIC and our fellow regulators who play a role in, and have an influence on, common market practice. The gatekeepers—the professional advisory firms—also play an important role. By providing specialist advice under professional standards of conduct, they should serve as a form of checks and balances on market players, and their boards and managements.

Wednesday morning is devoted to the retail investment and financial consumer sector. In Australia, retail investors have borne the brunt of the market downturn, and of the losses incurred in managed investments such as mortgage trusts. We will canvass the core issue of whether the disclosure regime is effective, and also take a look at credit reform and financial literacy.

Today and tomorrow, we will have workshops addressing various topics that will enable you to dig deeper into the issues involved. And the final session at lunchtime on Wednesday will be an opportunity to put questions directly to the ASIC Commissioners, on matters such as our strategic objectives and work priorities, and our progress in delivering on our desired outcomes. Again, this follows the approach we have taken in previous years.

You can see from that program that we are keen to get your views and thoughts, and to respond to your questions and comments. We think we have put together a program that will prove stimulating and entertaining on the issues of commercial and regulatory life in a post-GFC world.
MONDAY Securities regulation beyond the crisis

The Global Regulatory Reform Agenda: Revolution or evolution? What’s going on?

Mr Hans Hoogervorst, Chairman, Netherlands Authority for the Financial Markets

HANS HOOGERVORST

First of all, I would like to say it is a great pleasure to talk to you here at the ASIC Summer School. This is my first time down under and it was definitely worth the long flight. On the way over, however, I could not help wondering what I could possibly teach you here at this Summer School. After all, Australia is one of the few countries in the world, along with Canada and India, where regulators managed to steer their banks clear of the credit crisis. The Netherlands, on the other hand, is one of the countries whose financial sectors were hardest hit by the crisis. Relatively, our government rescue package was among the highest in the world.

What the Netherlands and Australia have in common, however, is that they both have the ‘twin peaks’ model of supervision. In fact, we were happy to copy it from you. My organisation, the Netherlands Authority for the Financial Markets, supervises conduct of business of banks, insurers, pension funds and the securities markets, while our colleagues of the Netherlands Central Bank are responsible for prudential supervision.

I am a strong proponent of the ‘twin peaks’ model. Supervision is a difficult job, as has become painfully clear. Therefore, supervisors should have a clear focus in their mission and they should avoid conflicts of interests as much as possible. Conduct of business regulation is all about transparency, while prudential regulators have a natural penchant for confidentiality. This tendency towards confidentiality of prudential regulators is easily understandable. For example, transparency may not always be the best way to prevent a ‘run on the bank’. Likewise, a prudential regulator might not be too motivated to fine a bank for treating its customers unfairly, while that same bank is in very bad shape financially.

In Europe, we have many single regulators that are both prudential and conduct of business regulators. They have to combine the penchant for confidentiality with their mission for transparency. This is not always easy. As a single regulator recently told me, ‘We have two hearts beating in our chest’. As a former Minister for Health, I can assure you that having two hearts is rather unhealthy, especially when they pump your blood in conflicting directions.

That being said, I believe that the credit crisis has shown that prudential regulators have a lot to gain by becoming more transparent as well, both in their standards and policies and in their governance. In these days of intensely prying media, institutional investors and activist shareholders, it is an illusion that you can keep real problems hidden for very long. Indeed, a perception that regulators may not be transparent about the true nature of the problems may serve to fuel undue unrest in the market.

The credit crisis has made it painfully clear that the international prudential standards
known as the Basel ratios were woefully inadequate. There was a growing distance between the risk-weighted Basel ratios and the tangible common equity figures as shown by plain accountancy rules. In hindsight, it is clear that the risk weights used to compute the capital ratios were not in line with the actual risks that banks were running. In Europe, it became normal for universal banks to become 30, 40, 50 times levered, or even worse. They would be showing beautifully Tier 1 ratios of about 10%, while their tangible common equity could be a frightfully low 2%.

Organisation for Economic Cooperation and Development (OECD) economist Adrian Blundell-Wignall (who, incidentally, was a speaker at ASIC last year) has shown convincingly that the Basel risk-weighting methods actually promoted the growth of leverage in the banking system. He has even found an inverse relationship between Tier 1 ratios and the capital losses that banks experienced. His research shows that while Swiss and German banks had among the highest and seemingly healthiest Tier 1 ratios in Europe, they actually suffered the steepest losses during the crisis. Some Dutch banks suffered the same fate. Just before the outbreak of the crisis a major Dutch bank felt justified to buy back 5 billion euros in stocks as the introduction of Basel II gave them greater scope for leverage. In sum, the conclusion seems justified that the Basel criteria may not have been much more reliable than the AAA ratings of the much-vilified credit rating agencies.

The question is: how could this have happened? After all, banks have notoriously volatile assets. At the same time, we know that banks hold a pivotal position in our economic system and that financial crises have a tremendous impact on the real economy. Looking back, it is obvious that the pre-crisis financial system was an accident waiting to happen. Obviously, it was sheer madness to allow the banks to operate on the flimsiest of capital margins.

Part of the answer to this puzzling question is surprisingly simple. Many bankers and prudential regulators told me that they were so much focused on the Basel ratios that they simply did not see the leverage building up in the system. Again, the analogy between the Basel ratios and the AAA ratings is striking: they both promoted a cavalier attitude in the market, with even presumably sophisticated market participants forgetting to look behind the numbers.

Another part of the answer is that the governance of the Basel Committee has some serious weaknesses. While the Basel Committee is composed of independent banking supervisors (usually central banks), it is no secret that it is subject to intense lobbying. Indeed, Nout Wellink, the president of the Netherlands Central Bank and the current chairman of the Basel Committee, has made it very clear in recent testimony before the Dutch parliament that the Basel standard setting process is highly politicised. The lobbying is indirect but intense: bankers who are concerned about the prospect of stricter capital requirements solicit their national governments, which then put pressure upon their central bankers to tone down the proposals. According to President Wellink, this political pressure was the main reason why the Basel II framework took so long to achieve and why it was ultimately so complex.\(^1\) On top of this, the Basel

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\(^1\) Voluntary testimony by Nout Wellink (President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision) before a commission of inquiry of the Second Chamber of the Netherlands Parliament, February 1, 2010.
Committee strives to govern by unanimity, making it vulnerable to the lobbying of small, motivated groups. The consensus model, in effect, tends to make the Basel Committee as strong as its weakest link.

Wellink is concerned that the outcome of the current reform of Basel may not be sufficient. A lot of far-reaching proposals for more stringent capital and liquidity requirements are currently out for consultation, but are already meeting a lot of push-back from banks and politicians.

I am afraid I share this concern about the Basel reforms. A telling sign is that the current reform is being presented as a mere adjustment of Basel II. According to Bank for International Settlements (BIS) chief Jaime Caruana, it is evolution we need, not revolution. As a former conservative politician, I am not much inclined to revolution myself. But when a system is radically wrong, radical solutions are needed. We do not need a Basel 2.1, we need Basel 3.0!

Secondly, one of the most important proposals—the introduction of an unweighted leverage ratio—is running the risk of becoming a stillborn child. I believe the introduction of a leverage ratio is extremely important. First of all, we supervisors should simply acknowledge that in the risk-weighting game, we are always running the risk of being outsmarted by the banks. A leverage ratio is simple and therefore less easy to game. It may be crude, but crudeness is exactly what we need. Secondly, a leverage ratio will make the overall leveraging of a bank continuously visible to the market and the regulators. Thirdly, a leverage ratio was successfully applied by our Canadian colleagues, proving it can work in practice.

However, it is clear there is already huge resistance against this proposal. Tellingly, the leverage ratio is proposed to be initially introduced in Pillar 2 ‘with a view to migrating it to a Pillar 1 treatment based on appropriate review and calibration’. For those not familiar with Basel theology, Pillar 2, with the mysterious title ‘Supervisory Review’, is the non-binding part of Basel that gives the supervisor leeway to deal with the shortcomings of Pillar 1. So, there is a considerable risk; it seems likely that a future leverage ratio will be both too low and non-binding.

I think that for the reform of the Basel II to become a success, the governance of the Basel Committee itself needs to be improved. First of all, the Committee could introduce formal voting procedures and should accept that reaching consensus is not always possible. This will make the standard setting less vulnerable to small groups of members who are highly motivated to keep capital requirements low. For this, it would probably be necessary for the Basel Committee to adopt a formal legal existence, which it currently does not have.

Finally, the Committee could improve the transparency of the standard setting process. Currently, the minutes of its meetings are not made public. This lack of transparency helps to keep lobbying efforts in the dark, where they are most effective.

In strengthening their governance, our Basel colleagues could take an example from the accounting standard setters, such as the International Accounting Standards Committee Foundation (IASCF). To begin with, the IASCF has a very clear constitution and governance, both designed to shore up its independence. All substantial meetings of the bodies of the IASCF are held in public.
and are webcast as well. Meeting minutes are made available to the public.

I am convinced a similar dose of transparency would be very healthy for the Basel Committee. It would make visible to the outside world which members are pushing for less stringent requirements. This would give a clear indication which country is sitting on the biggest problems. By making the decision making more transparent, the role of politicking could be greatly reduced, although it is, of course, an illusion that it can ever be completely abolished.

Increasing capital and liquidity requirements is important, but it is not enough. There are other necessary reforms to our financial system that have a lot to do with increasing transparency. For example, we need a strong infrastructure to make the derivatives market and counterparty risk much more transparent.

I also agree with Paul Volcker that reform of the financial sector cannot be complete without putting stricter conditions on the business model of banks. There are many reasons for putting banks’ business models under close scrutiny. First of all, the present oligopoly of a few investment banks is socially and economically unacceptable. This is in itself enough reason to make such banks quite a bit smaller.

Furthermore, we need to confront the rampant conflicts of interest that are endemic in both the investment and universal banking industry. Can we allow banks with access to insured deposits and central bank money to engage in extremely risky activities? Can we still accept that banks sell financial instruments while they cover their own positions in those same instruments? Do we really believe that Chinese walls are sufficient to contain all of these potential conflicts of interest?

If we answer these questions with a clear ‘no’, we would make the markets a lot more transparent, while going a long way to solving the ‘too big to fail’ issue.

I am, obviously, aware of all the objections about the Volcker rule being too blunt and out of touch with present day finance. But when we take a closer look at Volcker’s proposals, we will find that he is not advocating an extreme form of ‘narrow banking’ or a simple return to Glass-Steagall. He realises very well that most big banks need to engage in proprietary trading to some degree. It is the principle of his proposal that counts; complications are there to be resolved.

I started my talk by extolling the virtues of the ‘twin peaks’ model of supervision. You might wonder why a conduct-of-business regulator who believes in a strict division of labour with his prudential counterparts pays so much attention to matters of an essentially prudential nature. My answer is that it is the duty of both peaks to look at the health of the system as a whole. The International Organization of Securities Commissions (IOSCO) has learned from the crisis that securities regulators should not just strive for market transparency as a goal in itself. We should be much more aware of the contribution of transparency to reducing systemic risk. That is why we should feel responsible for the financial system as a whole. That is why the ‘twin peaks’ should always stand ready to give each other friendly advice.
MONDAY Securities regulation beyond the crisis

Implications of the Global Regulatory Reform Agenda for Australia: What do the Australasian regulators say?

Panel discussion

Moderator Mr Tony D’Aloisio, Chairman, ASIC
Ms Jane Diplock AO, Chairman, Securities Commission, New Zealand
Mr Hans Hoogervorst, Chairman, Netherlands Authority for the Financial Markets
Mr Jim Murphy, Executive Director of Markets Group, The Treasury
Dr John Laker AO, Chairman, Australian Prudential Regulation Authority
Mr Glenn Stevens, Governor, Reserve Bank of Australia

TONY D’ALOISIO
We now move to the panel session where we will pick up on some of the issues that Hans covered, and also this topic more broadly. Glenn, as Governor of the Reserve Bank, just starting with you, Hans has commented that the Basel model is inadequate. What’s your view on the Basel Committee and its work?

GLENN STEVENS
Of course, I’m not a supervisor, so I can speak with complete freedom about banking supervision matters.

I think it would be foolish to deny that capital regulation—and for that matter liquidity regulation, which is another big issue of this crisis—are in need of improvement. I think perhaps the supervisory community has spent a long time on capital, but not quite enough on liquidity, and others have also said that. So it would be foolish to deny that there are changes that ought to be made. I would not be quite as critical as Hans was about Basel II per se, because it seems to me that a lot of the risk that was embedded in the system actually arose before Basel II began. Quite possibly, Basel II might not have addressed that aspect adequately enough once it came into being, but you know, Basel I was the set of rules that most people were operating under and the US is still under it, in fact.

Any set of regulations will engender a certain degree of incentive to avoid them and the Basel rules are no exception, and a lot of the risk that we saw come into the system actually came via channels that had really been established to avoid regulatory capital, or at least lessen regulatory capital arrangements.

So I think in our future efforts to adjust these regulatory systems we need to keep that incentive in mind. The harder we regulate, in a sense, the more incentive there is for market activity to pop up outside the regulatory net in the future.

The second observation I would make is that most countries were operating under Basel rules but some countries had problems and some had far fewer problems. To my mind
that has to mean that the way the rules were applied matters just as much as the rules themselves. I think there were some countries—and I think we would, immodestly perhaps, include ourselves here—where the supervisors arguably did a better job of applying the given set of rules that the whole world was operating under, than did the supervisors in some other countries. And so, I would offer that perspective.

TONY D’ALOISIO
Jim, from Treasury’s perspective, how have you seen Basel operate? What’s been your view on some of the comments that Hans made about its adequacy and so on?

JIM MURPHY
Hans raised issues which I think are probably the solutions. There are general things that we are all aware of, such as better accountability and improved governance. I think what you’ve seen coming out of the global financial crisis—that is, the more coordinated global approach to regulation led by the G20—-is a very good thing. And the bigger role played by the Bank for International Settlements (BIS) is a very good thing. It has become a peak international body for regulation and other economic matters. And you’ve now got the Financial Stability Board (FSB) taking, in my view, a much more dominant position. And you have the oversight by the Basel Committee, the International Organization of Securities Commissions (IOSCO), the insurance regulators, and to some extent the International Monetary Fund (IMF) and the World Bank, also in this global space.

So I think those new arrangements will lead to better calibrated regulatory requirements for banks. Everyone has learnt from past experience. And I agree it is often not so much the rules but their application that matters. We found that to be very much the case in Australia, notably during the global financial crisis. In previous times we’ve had rules, but they weren’t enforced by the regulators, the regulators weren’t well resourced, and that made a heck of a difference.

So I think in regard to Basel, yes, things could be improved, and the work they’re doing now will fine-tune the rules for banking in light of the past experience. I’m quite positive about the work of Basel.

TONY D’ALOISIO
John, you’ve worked closely and are heavily involved with the Basel Committee. One of the comments that Hans made was he likened the Committee to the credit rating agencies when you look at the problems that have occurred and its responsibilities. He questioned whether it was a politicised process that the Basel Committee followed. We’ve heard some interesting comments. What’s your experience with the Basel Committee?

JOHN LAKER
Our experience, Tony and members of the ASIC Summer School, is limited, in the sense that we’ve only been a member of the Basel Committee since the July meeting last year, when we attended for the first time. We were invited to join in May last year, and it’s been a fascinating experience.

Herding sheep is really the simplest way I could describe it. To try and get an agreed position amongst quite different country groupings is complicated, and that’s particularly the case in Europe. The divide between the northern hemisphere and the

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2 A group of finance ministers and central bank governors from 20 economies: 19 countries plus the European Union. (Source: Wikipedia)
southern hemisphere is quite clear now, because many of the countries in our hemisphere have done well through the crisis while many in the northern hemisphere have not.

So there’s a lot of work still to be done to try and forge a consensus. There’s a lot of work going on behind the scenes at the moment on a quantitative impact study which will try and put flesh on the bones of the proposals that Basel has recently published. That’s quite important work, and it’s quite complicated work. The data hasn’t even come in yet. It won’t be until the middle of this year that we get a sense of how these proposals will actually work, given where banks are starting from. It will take to the end of this year, really, to resolve the Basel Committee’s position and then time to implement it.

All I can see ahead of me at the moment is a lot of hard work, and strong pressure coming from the political process to get this work done on a very tight timetable. That’s where the political pressure is strongest. The G20 are saying that there are fundamental fissures and cracks in the financial system and they’ve got to be addressed quickly, they’ve got to be addressed in a way that promotes a resilient and strong foundation and before inertia and resistance start to build up.

JANE DIPLOCK
As Hans was speaking, I was thinking of the IOSCO comparison, and I think some of the challenges the Basel Committee faces, IOSCO faces as well. The issue of consensus decision making is a difficult one and one that I actually had a little debate about last night with an ASIC Commissioner. And the trade-off and the difficulty arise if you actually want universal implementation and acceptance. For example, if you want the US, the UK, the European countries, and Australia and New Zealand, to all be comfortable about adopting the standard, then you do have to have an agreed process, even if it’s not absolute universality. Obviously a complete consensus means any one nation can veto a proposal, and that in itself could be problematic, because you would then run the risk of regulation deteriorating to the lowest common denominator.

I think the way that IOSCO tends to work in practice is that we set ‘aspirational’ standards that we all hope to approach close to over time, and therefore you don’t necessarily have to fully implement a new standard from day one in your own jurisdiction.

Now that is changing as we become more operational and we are now looking at actually setting standards that apply to the affected parties—people active in business or financial regulation, like rating agencies—in a very direct sense, and that’s becoming more difficult. What we’re finding is, even if we set a standard that starts off as an aspirational requirement, the actual implementation of that standard might vary across jurisdictions, and that can cause problems for market participants. We can see that reflected, for example, in the noise presently coming from the credit rating

TONY D’ALOISIO
Thanks, John. Jane, contrasting that to IOSCO and the work you’re doing there, are some of the descriptions about the Basel Committee all that different from what we see with other international organisations? What’s your view on what Hans has said?
agencies. And it also causes, I think, some difficulties in the setting of the standard itself.

So these issues are not solely matters of concern for the Basel Committee. Having said that, one of the differences we have with IOSCO is that IOSCO covers over 95% of the capital market, and each securities market regulator has a representative at IOSCO. That’s not the case for the Basel Committee, and I think that perhaps sets a different set of challenges for the Basel Committee than for IOSCO.

TONY D’ALOISIO
I want to come back to leverage ratios and governance and ‘too big to fail’ a little later. Just one more comment from you, Hans. Would I be right in saying that the way that these institutions—the Financial Stability Board, Basel, IOSCO, the International Accounting Standards Board (IASB), and the other international bodies—have responded to the crisis gives you some comfort that this time around, despite the politicisation, despite the limitations of consensus, there is actually a significant drive underway to achieve real change?

HANS HOOGERVORST
Well first of all I think it is interesting to note that the countries that were not part of the Basel Committee did best, like India and Australia. But yes, there is a lot of political impetus now to do the right thing. Earlier I quoted Nout Wellink saying in the Dutch parliament that he was very worried about political push-back and banking push-back against strict rules. And I’m also very worried about that.

I know that several European countries that have huge universal banks with huge balance sheets are pushing back against a leverage ratio, which I see as absolutely essential.

I know there are European countries which still have so many problems in their banking sector that they are not at the forefront of making all that visible, which is also a reason why there’s a lot of pressure from the prudential community on the international accounting standard setters. My speech was also a bit born out of concern about that pressure being put on the accountancy standard setters.

So it is very clear that, if anything, the current accounting standards did not show the problems sufficiently early, and there is absolutely no reason to go for a softening of the standards by the accounting standard setters; rather, the standards should be made more stringent.

So I am still very concerned that, as the banks gradually recover, the problems that were there may remain there and be forgotten, and that we will go back to business as usual.

I find it very disappointing that there is so little support for the ideas of Paul Volcker. European countries—in the first instance the French, which for political reasons said they supported reform, and they are now very busy ditching it in practice. And I gave a couple of, I think, very valid conduct of business reasons why this has to be looked at very closely. I don’t think it is going to be done.

So although I am generally rather optimistic by nature, in this particular instance I am not.

TONY D’ALOISIO
We will come back, as I said, to some issues: the work of the FSB and the ‘too big to fail’ rule. I want to turn now to Australia, because
you quite kindly said that we have fared much better than many other countries, so let us look at that. Is it right to say we’ve done much better and, if so, why? And to get the panel’s view on those questions, perhaps John, we’ll start with you. The notion that we have fared much better, is that right and, if so, why is it? What are the reasons?

JOHN LAKER
I think the general consensus is that we have done well through the crisis, both in terms of the performance of the economy and the strength of our banking system.

Glenn is better placed than me to talk about the macro-economic influences. I’ve summarised them in other articles as very deft handling of— i.e. aggressive—monetary policy, targeted fiscal stimulus and recovery in our Asian export markets. Behind these influences, though, has been the underlying strength of the banking system, which was in a position to support growth and did so without any government equity injections.

And behind the scenes, and it’s harder for me to speak because I’m the one involved, our regulatory system worked well. There are two elements to that. One is the rules. Glenn made the point when we came in that the rules we implemented in Australia were global rules. That was the Basel II framework. We implemented it. It’s done the heavy lifting for us. It’s done what it was asked to do. It didn’t cover all of the risks, and that’s why we’ve got more work to do.

The second element is the effectiveness of our supervision, which others can judge, but the Australian Prudential Regulation Authority (APRA) has been much focused and very active all the way through this period. We did our hard work, really, before the crisis started.

I’m open-minded about global reform. We live, and have lived in Australia, within a global banking regime. Where we have had some discretion in implementing it, we have ensured it made sense in the way it’s operated in Australia. And where there was discretion on the quality of capital, we always took the conservative approach, acting on behalf of depositors. Other jurisdictions didn’t take such a conservative approach.

What that means is that, when the new rules on capital quality come out, they will be, we think, closer to where we currently are. The impact on the banking system on the capital side in Australia is going to be much less demanding—if demanding at all—than it will be in other jurisdictions.

TONY D’ALOISIO
Can you give some examples of that and just expand it a bit for the audience?

JOHN LAKER
We have taken the view that the predominant form of high quality capital is equity and retained earnings. We like genuine shareholders that have skin in the game. We tightened up in 2005/06 to make that a much more important part of capital and to place less emphasis on the more heavily engineered, so-called innovative capital. And we took a pretty strict approach to what you didn’t count in capital calculations. Others took a less strict approach for other reasons. This will now be harmonised through the Basel process. As I have said elsewhere, we will continue to be conservative on capital. But it does mean our banks go into the reform process, in a sense, having done some of the hard yards anyway.

TONY D’ALOISIO
Jim, you probably have had a few sleepless nights the last little while, in terms of where
JIM MURPHY
Well I think there’s a combination of factors in relation to why Australia fared well in the crisis, and I agree with John’s comments about fiscal policy and the other factors that have played favourably for us.

But I’d go back a step, and say that for me it’s because, at a government policy level, the regulation of financial markets, securities markets, and corporate governance over the last—probably 25 years—has been a very important priority for the Australian Government. In every government I’ve worked for, it has always been the responsibility of a senior Minister. They’ve always been interested in and aware of, not only how the markets are operating, but also how the regulators are conducting their responsibilities. In Australia, it’s always been a major consideration of who leads the regulators involved, and of getting the best people possible.

So governments are involved, not too much involved, but always they have an oversight view of how financial markets and regulation arrangements are going. So I think that has actually stood Australia in very good stead, and so when you had the financial strains in Australia this time round, we were well-positioned.

Now, there is always a bit of good fortune in these things, and to some extent you make your own good fortune.

Everyone here will remember that we had the collapse of HIH Insurance Limited (HIH) in 2001, which was Australia’s second biggest general insurer. We had that, and we had a housing bubble in 2001 and 2002, which we managed. So we have had our strains, but we’ve learnt lessons from them and revamped regulatory structures, and improved regulation. So all along, over—dare I say it—the little booms and busts that have always happened in financial markets, we’ve come out of each of those, and re-looked at our system, and enhanced it where we needed to.

We are a medium-sized economy; and we are placed in a global financial market. And I think that came out clearly when we had to introduce the wholesale funding guarantee for our banks. Now, our banks were very well capitalised and very resilient and very well-placed, but the government still had to introduce a wholesale funding guarantee. And that’s because of the international dimension.

So all things considered, we were very well placed, but it’s hardly the time to be sanguine about these issues. It’s the time to be, really, on your game and be seeking to get the best international regulatory framework possible, and for Australia’s regulatory framework to fit within that international framework.

TONY D’ALOISIO
Glenn, I will get your observations also. We had issues with state banks and HIH. What is your view on how we fared better?

GLENN STEVENS
Well most of what needs to be said has been said I think by John and Jim. We might allow some scope for the banks, particularly the major institutions, having been pretty well managed themselves, no doubt under John’s tutelage of course, but I think that matters, and I think also that the long reasonably steady macro-economic environment at home has provided plenty of growth
opportunities for the financial sector. You didn’t have to go and do exotic things in foreign markets in the way, maybe, some European banks were pressured to do because natural growth in Europe has been lower. We’ve had plenty of natural growth at home, which meant banks could deal in plain vanilla things.

So that environment, I think, was helpful, and of course these things are mutually reinforcing; a stable macro economy helps the banking system, but vice-versa is also true.

I would agree that setbacks in previous years—HIH is one and various other things that have occurred—are lessons that should be very carefully considered, so that the necessary adjustments can be made to the regulatory and policy set-up. And if we’re smart, we will do the same thing out of this recent episode, despite the fact that we have come through better than most. It probably wouldn’t hurt for there to be a little bit more capital, more attention to liquidity, and more focus on the possibility that important funding markets that banks rely on can seize up. And that that’s got to be remembered when they’re managing their businesses.

So all these things are useful things for us to learn, despite the fact that the economy overall has come through pretty well so far.

TONY D’ALOISIO
Jane, just putting your New Zealand hat on as opposed to your IOSCO hat, what has been the experience with New Zealand? It’s also done reasonably well throughout this.

JANE DIPLOCK
It has, Tony. I think we have the benefit, of course, of our banking system being largely the Australian banking system, so we obviously had the strength of the Australian banks that has been discussed earlier by John and Glenn, and I think that stood New Zealand in good stead as well.

We have had problems with the credit channel and the fact that small- to medium-sized businesses have found it difficult to access capital, and that’s been not assisted by the fact that the finance company sector in New Zealand collapsed and reduced the access to mezzanine finance, and there’s been some difficulty in that area.

But the New Zealand economy is strong and certainly our major exports have held up, so I think we’ve had the benefit, to some extent, of a well-regulated banking system as well.

TONY D’ALOISIO
And Hans, you mentioned that the Netherlands has a ‘twin peaks’ model as well, and we’ve been just going through the virtues and the way that the Australian system had stood up. When you hear that and you contrast it to what happened in the Netherlands, what have been the things that have occurred there that haven’t occurred here?

HANS HOOGERVORST
Well first of all it goes to show that ‘twin peaks’ is not a guarantee for complete success.

TONY D’ALOISIO
That’s a bit of a worry.

HANS HOOGERVORST
I would truly congratulate the Australians for their regulatory competence because you guys did a really good job. And perhaps you were a bit lucky that you had a minor housing crisis beforehand, it’s very interesting to see that most countries that did well had a recent experience with a banking crisis in the past years. Most Asian countries did well and also
Australia. And furthermore, you were very lucky to be very close to Asia and to be very far away from the United States. That also helped. But I would say it’s more competence than luck.

Why didn’t things go as well in the Netherlands? I think it has a lot to do with the introduction of—there we go again—Basel II, which allowed banks to tremendously reduce the risk weights for mortgage lending. And Dutch banks are heavily engaged in mortgage lending. And one of the things that happened is that many of the Dutch banks levered up, because their capital requirements were actually lowered by Basel II.

Quite frankly, I think we did not look beyond the numbers and we’re paying a very heavy price for it.

TONY D’ALOISIO
If we can now move to the reforms themselves. Glenn, starting with you, does Australia need to do very much?

GLENN STEVENS
Well I think I would preface my remarks by saying that, in a country like ours, I don’t think we can feasibly expect to stand aside completely from the way international standards evolve. You can’t do that because, as Jim said, we’re part of a global system.

Secondly, yes, we now have a seat at the table. It turns out it’s a very big table, actually. The FSB in which I participate has 70 people around the table. The Basel Committee is—I’m not sure how big that is—but these are big groups now. We’re one voice and we have the opportunity to put our points and have some marginal effects on the outcome, but we shouldn’t kid ourselves that we are going to outweigh what is still the very dominant weight of the G7.3

With those caveats, I think that our interests are in making a contribution, to the extent we can, to the shaping of sensible international regulations. I fully endorse what John said about the need for the quantitative impact work to be done very carefully, and for adequate time to be allowed for that to be completed. The last thing we want is a rush to some ill-considered set of arrangements that have not been fully thought through, so that work needs to be done carefully. Certainly there shouldn’t be any delay but it does take a bit of time, so that time has to be granted.

I frankly think that it’s likely that there will be a sensibly applied leverage ratio. I don’t really think we need it, but it won’t do any great harm to Australia provided it’s calibrated sensibly.

I think on issues of quantity and quality of capital, as John said, we’re probably already doing well anyway so that will be at the margin.

Liquidity is going to be the issue where we will need to be careful, and to have the scope to tailor the set of principles in a way that works in Australia. And everybody knows what the issue is here: there’s not enough government debt to hold as the draft principles that were put out would require. So we’re going to have to have a solution that works on some other set of devices unless we want our government to run very much larger deficits and get that debt up, which of course for other reasons we may not.

3 The meeting of the finance ministers from a group of seven industrialised nations. It was formed in 1976, when Canada joined the Group of Six: France, Germany, Italy, Japan, United Kingdom, and United States. (Source: Wikipedia)
HANS HOOGERVORST
And government debt is not necessarily liquid these days.

GLENN STEVENS
In fact I think a lesson of the crisis is that lots of things that you thought were liquid are not liquid when markets seize up. So markets can have these seizures and, you know, you don’t solve that by just mandating to banks to ‘hold more of this particular instrument’.

I wouldn’t say that we need to do nothing. It would be foolish to think that everything’s just peachy here. I think there are things for us to learn, adjustments we can make, but we need to do that in a thoughtful way and what we really want is an adequate amount of flexibility at the national level to adhere to the spirit and the intention of the new rules in a way that in practice works for us.

TONY D’ALOISIO
John, you’ve come under some pressure from banks saying, ‘Well, really, we’ve done very well. Why do we need any change at all?’ What’s your take on what’s happening internationally and the impact here for you?

JOHN LAKER
Well, Tony, I do get counselled by boards and chief executives along those lines. ‘Not to follow blindly’, I think, was one of the phrases that was used.

I don’t know how many of you are from this particular state, but there is strange code of football played here in Melbourne called AFL, and you can think of that as a metaphor for what’s happening in the global regulatory environment. What’s very important with that game is that the players have a set of qualities which enable them to compete—they have got to be fit, it helps to be tall but it fundamentally helps to be very strong because it is a contact sport.

And that’s our role as the prudential regulator; we need to run our players onto the playing field fit and strong. The global financial market is not a place for the faint-hearted. It requires all of the participants to be fit and strong. And that was the failing through the course of 2008/09, when a lot of the stronger players really were unfit and they were certainly weak.

When Australian banks run onto this field they can’t say, ‘Well, I’ve got the Australian coat of arms on my jersey so I’m allowed to run 50 metres before anyone can tackle me’, or ‘Because I did really well in the crisis, I can take a second shot at goal if I miss the first one’. The world doesn’t work like that. We will be judged by global markets on the same standards as everybody else. As Jim said, even though our banks were well capitalised and well rated—the top four are AA-rated amongst a very small group of eight or nine players—they still found it very difficult to raise funds when those markets froze.

So Glenn’s right. What we need is a set of global rules that are sensible, not extreme, not targeted at extreme problems, but a sensible set of rules within which we can operate and which assure funding is available to strong players in the marketplace. Australian banks need strong counterparties. Otherwise there’s no funding. That’s why it’s a global effort and that’s why we’re part of it, seeking to make sure the regulatory regime makes sense when it operates in Australia.

As Glenn said, we’ve got a couple of unique issues to deal with because we’ve had a series of prudent governments. But we’ll work through those issues.
TONY D’ALOISIO
We’ve been focusing on the more prudential issues. We might now go to securities and investment, perhaps with Jim and Jane. Jane, in terms of IOSCO’s agenda on securities regulation, it seems to have a reasonably long list. Can you give us a bit of an update on that, and then I’ll ask Jim to comment about the impact of those sorts of changes on what is a very strong regulatory system that we have in Australia already.

JANE DIPLOCK
Thanks, Tony. I think the learnings from the global financial crisis are multifarious and we’ve heard some of them this morning. One of the things that has emerged very clearly is that, if anyone thought that markets weren’t interconnected, they are clearly wrong.

The concept that markets would automatically, as a matter of self-interest, regulate themselves or correct themselves has been found to be wanting. And I also think the orthodoxy which had been abroad—that, fundamentally, market stability was really only a matter for institutions and not for markets—is now being challenged quite significantly. And IOSCO has, as part of its response to the global financial crisis, is in the process of developing a new principle on systemic risk in markets.

In a way, I see a reflection or ‘mirror’ of the ‘twin peaks’ model as what I would call the virtuous twins of stability: the notion that institutions matter and markets matter. You can have the most perfectly regulated institution, but if the market goes haywire, that institution cannot function appropriately. Similarly, if you have well-regulated markets but poorly-regulated institutions, you’re going to have a problem.

So I think the ‘twin peaks’ model of both market regulation and prudential regulation is mirrored in the ideas of financial stability as well, and that’s certainly one of the major thrusts of IOSCO’s new principle. We’re trying to articulate that in a way that has practical implications for securities and markets regulators. So we are looking at securities and markets regulators having greater research capacity to try and identify discontinuities in market behaviour that may need addressing. To look at over the fence of the current regulatory boundaries, to see whether there are developments outside the current regulatory fence that may threaten the stability of the regulated markets.

I can remember being at a financial stability forum a number of years ago where one of our colleagues in the securities markets regulatory world, I think it was Andrew Sheng,4 tried to canvass the idea that beyond the current regulatory space there might be issues that could affect financial stability. And he was completely put down by some members of the US Federal Reserve (US Fed) at the time, who almost mocked the idea that external market disruptions might have a stability impact. And I think that is one of the learnings out of the global financial crisis.

If I could just say, IOSCO has published 20-plus reports, some of which look over the fence, some of which are trying to identify issues that might affect market stability, and some of which involve coordination with Basel and IOSCO through the Joint Forum—of which you, Tony, are presently Chair—and

4 Datuk Seri Panglima Andrew L.T. Sheng is the third holder of the prestigious Tun Ismail Ali Chair at the Faculty of Economics and Administration, University of Malaya. From October 1998 to September 2005, Datuk Seri Panglima Andrew Sheng was the Chairman of the Hong Kong Securities and Futures Commission. (Source: andrewsheng.net)
have been focusing on cross-border supervision. That is another important aspect of trying to identify and resolve market stability issues.

So, Tony, there’s a huge body of work that IOSCO’s undertaken. I won’t give this audience the full list, but if they look at the IOSCO website they can see it, and it’s really directed to trying to have a look at the learnings out of the global financial crisis and address them in a very practical way.

**TONY D’ALOISIO**

Jim is an avid reader of the IOSCO website, I know. Jim, we’ve seen the reforms that have come through so far that have been around short selling and around credit rating agencies, but looking forward, what do you see coming out of some of the IOSCO work that would be relevant to our regulatory system? I’m not suggesting that you’re announcing new policy, but your thoughts on the sorts of issues we may need to consider further as a country.

**JIM MURPHY**

I think in the conduct and disclosure area there are questions as to whether the basic assumptions for the regulatory framework are the right assumptions, and you’ve got questions about the efficient market hypothesis, you’ve got questions about whether people, especially at the retail end, can ever come to grips with some of the sophistication of certain financial products.

In Australia we’ve got an ageing population, we’ve got a retirement incomes policy which leads to a lot of people’s savings going into superannuation and other investment products, so I think we’re in a position where it very much behoves the Government and the regulator to have in place proper arrangements to ensure that risk is minimised to the greatest extent, especially risk that could impact on retail investors.

So I think some work on conduct and disclosure is very important. On prudential regulation, you can contain your scope somewhat through knowing very clearly which institutions you’re regulating. ASIC on the conduct and disclosure side, virtually regulates everything that’s not regulated by APRA. It’s a huge mandate, and when you think about ASIC regulating capital markets, as well as providing consumer protection to the financial sector, that is just a very wide mandate that needs to be managed by the regulator. You have to have, I think, some very clear rules, and probably you’ve got to also work on financial literacy education and those types of issues to really upgrade the general public in terms of their better assessment of risk.

I don’t think you can do it just through regulation, and I don’t think you can do it just by putting more ‘police on the beat’ through more resources for the regulator. It’s got to be very much a public educational thing as well.

**TONY D’ALOISIO**

Do you have a view—and it’s a hard question—about how far we can go, and at what point we should really let investors, particularly retail investors, face the consequences of their investment decisions and, if necessary, bear the losses? We’ve had quite a bit of criticism with the losses that have occurred at the retail investor level, and whether we could have done more to prevent them.

**JIM MURPHY**

Well I think it’s very difficult. I think they do take the losses at the present time. You can have these events happen—e.g. margin
lending—and we have a parliamentary inquiry as to why it happened, and people are rapped over the knuckles, and then we’re called upon to tighten up the regulatory framework. But is that really going to be an effective response? You’re continually coming to the problem after the event.

So I think the real issue for ASIC is to be innovative with the resources it is given, and to try to the greatest extent, to provide the best regulatory approach or framework it can for the general public.

I think it’s a time to be thinking about what you’re doing, actually.

TONY D’ALOISIO
There’s a question from the floor asking the panel to comment on bank regulation, noting the concerns of large sovereign debt and, for example, ‘PIIGS’, which I think colloquially refers to certain European countries presently experiencing severe budget pressure. And there is the related issue of bank nationalisation in Europe.

HANS HOOGERVORST
Can I say something about that? I am not in a position to give any advice to Australia, but if I were forced to, what I would tell you is: please continue to be more conservative than the rest of the world, and secondly, prepare for a very difficult economic time which you will not be able to continue to escape.

In Europe and in the United States we didn’t solve many of the problems; we merely shifted them from banks to government. Almost all major European governments are going in the Italian direction. We used to mock Italy for having a government debt of 100% of the gross domestic product (GDP) or more. Many European countries are going that way. The United States is going that way. We have horrible budget deficits, which are even more horrible than in the 1970s. We have very weird ideas coming into existence, such as the IMF wondering if central banks should not aim for inflation targets of less than 4%. I mean, we are going back to the 1960s and 1970s. Except that the budgetary problems are even bigger.

This is going to take a tremendous toll on the world economy for a long time to come and Australia will not be able to escape that. I’m absolutely sure of that because I don’t think that Asia, China, can completely compensate for all the problems in the western world.

So all I can say is you’re not complacent, but success always has the danger of leading to complacency. Don’t become complacent and continue to be as vigilant as you have been.

TONY D’ALOISIO
Any comments from other panel members?

JIM MURPHY
Well the fiscal challenges that are faced in Europe, UK, US, and let’s not forget Japan, they’ve been facing this for 15 years and actually they still haven’t had the inflation that you might expect would result from that.

HANS HOOGERVORST
Who can explain that to me?

JIM MURPHY
Well, my explanation is they’re the exception that proves the rule, but these challenges are

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5 PIIGS is an acronym used by international bond analysts, academics, and by the international economic press that refer to the economies of Portugal, Italy, Ireland, Greece and Spain, especially in regards to matters relating to sovereign debt markets. Some news and economic organisations have limited or banned their use due to criticism regarding perceived offensive connotations. The PIIGS countries are at the centre of the ongoing 2010 European sovereign debt crisis. Greece and Portugal are expected to undergo austerity measures. (Source: Wikipedia)
immense and the challenge for those countries is to articulate a short-term path that allows them not to knock the still rather hesitant economic recovery on the head, but does chart a path back to long-run sustainability, and that is going to be very, very difficult indeed.

From our point of view, of course, these things present as risks to the economic outlook for the major countries, but another perspective to keep in mind is, and I have said this all through this past couple of years, we can come out of this episode as the country that didn’t have to buy their banks, where government finances are in terrific shape, really—you know, the debt ratio will peak probably at 10% of GDP—and we have a strong regulatory framework. We are also the country that didn’t have to take very unconventional monetary or fiscal measures, the regular measures applied liberally worked, worked a treat actually. We remain open for business, plugged into the part of the world where all the growth is, so it’s not ‘Pollyanna-ish’—you know, ‘everything’s rosy’—but how many other countries are on that list? Not many.

TONY D’ALOISIO
It’s almost the sort of point where I should stop, I think, but no, I understand exactly the sentiments. I just want to go back to a couple of issues before we finish. Glenn and John, on the ‘too big to fail’ issue, the so-called Volcker rule, and the announcement that President Obama made, what is this all about? And do you see any potential impact on Australia?

JOHN LAKER
Tony, I think the question is often phrased these days not only as ‘too big to fail’, but also as ‘too interconnected to fail’, and it’s about the difficulty of unravelling linkages between institutions. This is the problem the Lehman case revealed. That’s where complexity became an issue. We know that there are solutions being discussed in global forums and being put forward on the political agenda. You either narrow the range of activities that these large institutions can undertake, or you have a higher capital charge for them, or you have more intense supervision, or some combination of the three. The fact that there are no clear answers is an indication of just how complex that set of issues is, even going to the very question of which institutions do you deem to be too big or too interconnected to fail? Very few countries would actually nominate those, and I think if they had, they probably still wouldn’t have picked up a Northern Rock three years ago.

In our case, we’ve always applied more intense scrutiny of our larger institutions and we have a risk-rating process that really forces us to do so. It is torqued in the direction of intervening more intensely and more quickly if the institution is likely to have a systemic impact.

So we do that—that’s our day job. What would still be part of any solution is that we will be breathing down the neck of larger

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6 A proposal by American economist and former Federal Reserve Chairman Paul Volcker to restrict banks from making certain kinds of speculative investments if they are not on behalf of their customers. (Source: Wikipedia)

7 Lehman Brothers Holdings Inc. was a global financial services firm. On September 15, 2008, the firm filed for Chapter 11 bankruptcy protection following the massive exodus of most of its clients, drastic losses in its stock, and devaluation of its assets by credit rating agencies. The filing marked the largest bankruptcy in US. history. (Source: Wikipedia)

8 In 2008 the Northern Rock bank was nationalised by the British Government, due to financial problems caused by the sub-prime mortgage crisis. (Source: Wikipedia)
institutions much more regularly than we would of a smaller institution. It’s almost as simple as that.

TONY D’ALOISIO
And Glenn, how much of it is a political issue and a regulatory issue, in the sense that you could come up with concepts of what too big is or what systemic is? But at the end of the day, when you have a Northern Rock, assuming it’s not in the systemic category or it’s not in the ‘too big to fail’ category, is it more of a political issue or is it an issue that the regulators can continue to work on?

GLENN STEVENS
I think in times of crisis it gets harder to judge ex ante who’s systemic and who isn’t, and I think the bar to be labelled systemic goes down; the bigger the crisis is the lower that bar gets. And it then becomes a rather courageous regulator who recommends ‘Yes, Minister, Entity X, you should just let it fail’. And an even more courageous Minister who may be willing to accept that advice. So in a time of crisis, particularly a really big one, these things are very hard.

If you have an idiosyncratic failure of a minor entity out of the clear blue sky and nothing else is going wrong, then it’s much easier to say, ‘Well, there are resolution procedures for these entities, that’s why we have the financial claim scheme now’, and the market processes would take their course.

So it tends to be unavoidably context-specific when you’re reaching these judgements, and I think that’s just the nature of things and a government is always going to have to ultimately be involved when there’s an institution of any size and the question is, ‘Do we save it or do we let it fail?’ I can’t see how—if it is tiny, sure, that’s different—but for anything of any significant size at all, how it would ultimately not involve a government having to make a decision there, whether it’s to rescue it or not.

TONY D’ALOISIO
And Hans, you are a proponent of coming up with rules on ‘too big to fail’. How do you see it playing out at the FSB level?

HANS HOOGERVORST
I have to confess I am not an expert on the issue. All I know is that it is, in the long run, totally unacceptable that a private company, or a company that cannot be allowed to fail, has no business being in the private sector. So if we don’t solve this issue we will end up with a nationalised banking sector, such as we have in many parts of the world at this moment. So it needs to be solved. And as I have said, there is no silver bullet for this issue because it’s very complicated and in many ways it might be as simple as being much more on top of the big institutions. The opposite happened in the United States and in Europe. They were left to their own devices, they were allowed to do their own risk management, and basically the central bankers kept a lot of distance from them.

There is no silver bullet; you’ll have to do a lot of things to address this issue. I think that Paul Volcker has delivered a couple of suggestions which make a lot of sense, not only from the point of view of ‘too big to fail’, but also from the point of view of conduct of business. It is simply unacceptable that an investment bank goes out selling collateralised debt obligations (CDOs) to so-called sophisticated investors, while at the same time they are covering their own behind for those same investments. We cannot allow that to happen in the future.

So I think there is a very good case, also from the point of view of conduct-of-business
regulation—even if we require Chinese walls—to split up each sort of activity. And that will go a long way to addressing this problem. On top of extra capital requirements, on top of extra liquidity requirements, a whole array of things has to be done.

TONY D’ALOISIO
There are a few things happening here—such as Volcker or Volcker-like ideas of separating activities; more instruments under CCP—central counterparty—so that when someone falls over there’s more insulation; and more intense supervision of the larger entities on top of the capital requirements. I suppose a more controversial idea is a systemic risk charge if you’re big, on top of the other requirements, and perhaps that is a good idea. And then there’s the idea of ‘living wills’.

I suppose from a policy point of view, you are absolutely right: a world in which the losses are socialised and the profits are privatised, is ultimately not sustainable. But there is, at least in principle, an argument, it seems to me, for allowing financial institutions—subject to conditions—to have global reach, for the same reasons that non-financial institutions have global reach. There are certain efficiencies to be gained there. So can we reap those benefits while also addressing these other concerns? Or if that’s not possible, in that case we’d have to choose. And it seems to me that, in the international regulatory community, we’re groping our way towards those questions without knowing where the answer’s going to fall.

HANS HOOGERVORST
This living will stuff, have you ever heard about dead people making ‘living wills’? Why are they called ‘living wills’?

TONY D’ALOISIO
Yes, it’s a question I’ve asked myself. It might be useful if, as part of the process of an institution drawing up in advance its ‘living will’, or wind-up process, that shows the regulators how complex their structure is, and then the regulator might say, ‘Hey, hang on. I want some more simplicity’.

Okay, we’re out of time, so I’m going to wrap up here and ask you to join with me in thanking our panel. We have in this session been concentrating more—given the calibre of the panel—on more prudential issues. The next session will be more on the securities and investment issues, but certainly can I, on behalf of everyone, thank each of you and Hans in particular, for a fantastic discussion. It was full, free and frank, and that’s what we wanted, so thank you.
Rethinking the fundamentals: The impact of the changes on the financial markets of the future—Efficient markets or not? Investor protection or not? Too much or too little regulation? What will be the impact of the reforms?

Global perspective: Mr Guillermo Larrain, Chairman, Securities and Insurance Superintendence, Chile, and Chairman, IOSCO Emerging Markets Committee

Australian perspective: Professor Ian Harper, Director, Access Economics Pty Ltd

Panel discussion

Moderator Mr Tony D’Aloisio, Chairman, ASIC
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TONY D’ALOISIO
This session is about rethinking the fundamentals. What we are trying to do is assess whether there is, and can be, a conceptual framework to drive the reform agenda. We are not asking questions about whether capitalism failed or not, or about what the economic framework should be; rather, we are asking questions about what the regulatory framework could be—a conceptual framework against which we might judge reforms going forward. Please join me in welcoming Guillermo Larrain.

GUILLERMO LARRAIN
Thank you very much Tony. In Chile, one thing we don’t share with Australia is we don’t have the ‘twin peaks’ model, and I would like to join Hans in praising this model. I am trying to propose this reform in Chile; however, despite not having the ‘twin peaks’ model, our economy was not hit as hard by this crisis as other economies in the world, because to some extent we had good policies.

I was very pleased to be asked by Tony to speak here today about the renewal of the fundamentals for securities regulations, so here I go.
First, in the last couple of decades, we have been building a bubble-prone world economy—something like a simultaneous Minsky\(^9\) process.

The first Minsky sub-process was that several elements of stability gradually started to appear in the world economy: monetary policy was better understood; and over the years there was improved institutional design for central banks; several countries, including Australia and Chile, adopted inflation targeting schemes that worked very successfully; and there was a large service sector with better and better inventory management. There was also better fiscal policy; despite large debts, the idea that countries could grow pushed by fiscal policy was abandoned, and how to manage fiscal policy for matters of cyclical considerations was also much better understood.

Inflationary pressure then faded away, but even faster when there was a large supply shock induced by the IT revolution and also by the emergence of China and India as economic powers with very low labour costs. Also, political risk fell due to the failure of the communist experiment, the fall of the Berlin Wall, and the disappearance of the USSR. All these led to a period of supposedly increased stability. Risk premia fell across the board, eventually overshooting at the long term level, and individuals and firms increased their leverage as a response to it, and this leverage eventually increased too much.

So this was the first part of the Minsky sub-process.

The second Minsky sub-process then started, creating the conditions for this bubble-prone world economy—deregulation started sowing the seeds for instability.

There was a deregulation process—and I am here basically talking about the US—that started early in the 1980s. There were those Acts there that helped households to refinance mortgages and to borrow against the values of their homes. There was the gradual abolition of the Glass-Steagall Act that separated investment from commercial banking activities. And there was persistent regulatory consent in many jurisdictions in the world concerning the appearance of unregulated entities, unregulated markets and cooperative jurisdictions, and for a long period of time we didn’t do much about this. Then there was the issue of liberalisation of capital flows without having the proper institutions in place. This was the case in Europe in the early 1990s—liberalisation of capital flows started in the 1980s, but there was a big crisis in the early 1990s; there was the Swedish crisis, and the pound was expelled from the ERM (European Exchange Rate Mechanism). Then Mexico, in trying to get in the accession process to the Organisation for Economic Cooperation and Development (OECD), was forced to liberalise capital flows without having the proper institutions in place, and there was the Tequila Crisis in 1994–95. And then there was the Asian crisis when Korea was trying to get accepted in the OECD that basically did exactly the same. Then regulation was also doing its own job and we adopted some procyclical capital requirements—I will talk about risk and regulation, and also about some procyclical accounting standards concerning fair value accounting, a little bit

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\(^9\) Hyman Philip Minsky (1919–1996) was an American economist whose research attempted to explain the characteristics of financial crises. He is sometimes described as a post-Keynesian economist, because, in the Keynesian tradition, he supported some government intervention in financial markets and opposed some of the popular deregulation policies in the 1980s, and argued against the accumulation of debt. (Source: Wikipedia)
later. And last but not least, lax monetary policy was accompanying this decrease in risk all over the place that, but given this positive supply shock, it was possible to have this lax monetary policy without creating inflation and avoiding two recessions associated with the bursting of the Asian asset bubbles and the high tech bubbles. It couldn’t avoid the third one, which is the one we are now here.

Why am I talking about this? It’s because the IMF, International Monetary Fund, recently published a paper— it was also mentioned earlier this morning—in which they reflect on the fundamentals of macro-economic policy and what we thought was good about the macro framework. They mention five elements, and these are the first three: we thought that a limited role for fiscal policy was good; we thought that stable inflation was good; and we thought that low inflation was good. We shall not discuss these three here; rather, I want to concentrate on the fourth and the fifth elements.

The fourth element is that we thought that, with only one instrument—the policy interest rate set by central banks—we were fine in terms of macro-economic management. And why did we think we needed only the one instrument? Because the real effects of monetary policy, we thought, came through interest rates and asset prices and not from monetary aggregates. Interest rates and asset prices were linked through arbitrage, so if you touch just the short end of the yield curve, then you will move all the way down to affect long interest rates. And as far as asset prices are concerned, they are given by fundamentals. Blanchard in his paper about banking regulation said, ‘Asset prices are given by fundamentals’. And so, we thought that asset prices were given by fundamentals.

The fifth element, which is very important, is that financial regulation was not regarded as a macro-economic policy tool. This is in the last part of Blanchard’s paper. So, we thought that securities regulators were not in the universe of the people developing the macro-economic framework.

So I thought, and this is an Alex Erskine suggestion, why don’t we do the same for financial regulation—i.e. outline what we thought we knew about financial regulation, why we thought it was a good idea, and what we have learned. The original idea was Alex’s, but this is mine, so this is my interpretation.

What we thought we knew about financial regulation is that irrational behaviour was unimportant—crazy sellers and crazy buyers would cancel each other out—and in normal times nothing happened. Irrationality or bounded rationality mattered at the individual level but not at the aggregate level. The market worked as if rationality were the rule, despite quite often having irrational people on both sides of the trades.

Risk was understood and under control. Sophisticated models assumed exogenous risk because it’s too complex to endogenise. What happened in the crisis shows that risk is an endogenous matter and value at risk models underestimate risk in ‘tail events’ and therefore become extremely procyclical.

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11 Monetary policy increasingly focused on the use of one instrument, the policy interest rate, that is, the short-term interest rate that the central bank can directly control through appropriate open-market operations. (Source: Wikipedia)

12 The ‘fundamentals’ refers to the risk-adjusted present discounted value of payments on the asset.
Risk exogeneity assumes that you know the distribution, and all models in all banks and insurance companies in the world presumed some distribution of risk. But when that distribution is heavily shot as in a crisis, and you may not know the distribution—you cannot really tell what the distributions are, you cannot tell what the risks are—and then the so-called Knightian uncertainty appears and the market cannot work.

Here I want to quote Tim Geithner. When he was Chairman of the Federal Reserve Bank of New York, at the end of 2006 he said: ‘Risk management has improved significantly, and the major firms have made substantial progress towards more sophisticated measurement and control of the concentration of specific risks’. This was said at the time when risks were probably at the highest level, i.e. at the end of 2006.

One other thing that we thought we knew is that agency problems were solved. Basel II expected banks to ‘act in a way that promotes confidence in their primary stakeholders’ but not just shareholders, also stakeholders, as if agency costs and conflicts of interest didn’t exist. A very interesting assumption.

Internal risk models are the core of Basel II. Internal risk models designed by banks were expected to induce them to have an aggregate cushion for risk-taking. But what about the asymmetry of information between the company that is developing their own risk models and the regulator that must, to some extent, verify that the models are proper?

Without conflicts of interest they can have a good risk process that works on assumption.

And the final of these things we thought we knew, from a selected number of things that we thought we knew, was that disclosure was basically a legal problem. As long as you disclose, we assumed you are being transparent and it did not matter much what format you used, and so on.

I wanted to emphasise the word ‘assumption’ because I will try to make a joke at the end of my presentation if time allows it, so the word ‘assumption’ is very important.

So, now I will speak about reviewing the fundamentals. Why must we review the fundamentals and in what ways? First, we need to review why the efficient market hypothesis has failed, at least in its strong form. I will talk about the rationality of the individual, the rationality of the firm, and then transparency beyond disclosure. I will also talk about some other issues, such as competition and governance of regulators, both at the national level and the international levels.

So first, I will speak about the failure of the efficient market hypothesis. This hypothesis was supposedly popularised by Eugene Fama in the 1960s and 1970s but, as Wikipedia says, this is not true; it was developed by Louis Bachelier at Besançon in the early 20th century. It is a very important and influential hypothesis.

So simply speaking, what does the efficient market hypothesis mean? This is

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13 In economics, Knightian uncertainty is risk that is immeasurable, not possible to calculate. Knightian uncertainty is named after University of Chicago economist Frank Knight (1885–1972), who distinguished risk and uncertainty in his work *Risk, Uncertainty, and Profit* (1921). (Source: Wikipedia)

14 Eugene Francis ‘Gene’ Fama (born 1939) is an American economist, known for his work on portfolio theory and asset pricing, both theoretical and empirical. He is currently Robert R. McCormick Distinguished Service Professor of Finance at the University of Chicago, Booth School of Business. (Source: Wikipedia)
paraphrased from Robert Shiller’s paper.\textsuperscript{15} It means that market prices coincide with fundamentals except for noise. Markets therefore will incorporate into asset prices all available information. And the noise has a distribution. The noise is random and has a mean—if you want the standard deviation, and it may have other moments on top of that. But its essence is that all that information should be included into the prices.

Now, what’s the process for this to happen? Well the process is that information is incorporated into prices by means of iterative transactions, therefore, by liquidity. Liquidity marginally affects market prices up or down, depending on the information that is conveyed to the market by market participants, driving them towards the fundamental value.

Now I don’t like this definition very much; however, I found an alternative definition of the efficient market hypothesis by Robert Lucas,\textsuperscript{16} which I think is much more workable. It says, ‘Traders will not miss the opportunity to make a gain provided there is enough and timely information’. Then I made a slight change to Robert Lucas’s presentation and I added two things: instead of traders I said ‘rational’ traders and instead of ‘timely information’ I put in the word ‘relevant information’.

Therefore, we can criticise the efficient market hypothesis basically on two fronts: one, on trader’s rationality and second, on transparency and disclosure.

So how rational is the trader? We think of the traders as one rational agent that, using all available information, would take ‘optimal decisions’. That is what we were taught at university, and all models basically tell us this; however, there is too much evidence that this was not the case in this crisis.

Once again, the IMF’s Chief Economist, Olivier Blanchard, wrote a year ago, that ‘investors replicated the price pattern of the last couple of years to forecast the behaviour of real estate prices for the next couple of years’. And then, once again, we must recall Hyman Minsky who said, ‘Stability is destabilising because capitalists’—I will later on add regulators, but for the time being—‘capitalists have a herding tendency to extrapolate stability, putting in place ever more risky structures that undermine stability’. Blanchard was basically using that same line.

Then Ben Bernanke, Chairman of the US Federal Reserve, said in his testimony before Congress on 23 September 2008, ‘The troubles at Lehman had been well-known for some time’—and this is very important—’and investors clearly recognised, as evidenced by the high cost of insuring Lehman’s debt in the market for credit default swap (CDS), that the failure of the firm was a significant possibility’. And then he extrapolated the right—at least, the rational—conclusion of that: he judged that investors and counterparties had had the time to take precautionary measures. But this is


\textsuperscript{16} Robert Emerson Lucas, Jr. (born 1937) is an American economist at the University of Chicago. He received the Nobel Memorial Prize in Economics Sciences in 1995 and is consistently indexed among the top 10 economists in the Research Papers in Economics rankings. (Source: Wikipedia)
something that did not happen, because when Lehman collapsed, then everything—the global market basically disappeared.

But Bernanke was basically taking the right lesson from the prices he was seeing in the market; therefore, prices were not conveying all the information at hand.

So rationality, it’s a very critical thing because we see very critical people taking decisions that are not as reasonable as one would expect. So how bounded or how limited is the economic agent’s rationality? It is an issue. And there is vast literature about this, but anyway, I want to stress one of the elements that I think is important.

It appears that people tend to stick to prior beliefs. It appears that they look for the closest match to past patterns, ignoring probabilities of new events coming in. It appears that individuals attribute to their own high abilities events that confirm their actions—and the contrary, of course. And successful traders appear to have an exaggerated opinion of themselves—they’re over-confident and think they can beat the market.

All this sentiment transforms itself into one market pattern, which is called feedback. And this is mentioned by several authors including, of course, Robert Shiller. And these feedback effects appear in the market: an inexplicable randomness, inducing prices to depart from fundamentals.

Therefore, individuals’ rationality has some impact on the market. And the tricky thing is that, once you are involved in an unstable path that was created by irrationality, it becomes rational to continue doing so.

Well, does it matter? In normal times it doesn’t matter much because, as we were saying at the beginning, crazy buyers and crazy sellers cancel each other out in normal times. But when the economy is shocked by something really important, then irrationality becomes really important.

Now the markets are not managed by individuals, they are managed by firms and therefore we need to talk about the rationality of corporations, and now we come to corporate governance.

So the firm’s rationality depends on what? It depends on an individual’s rationality, because the CEO can be irrational himself and he can force the institution to do irrational things. So irrationality is important. You can have traders with a lot of power that can, of course, do a lot of irrational things.

But then you have the intentional governance of the firm. Corporate governance is an intentional act of governance of a structure, which is a firm, and this is one important element. And then you have the firm’s rationality depending on the context.

In terms of the context, you have several issues and I would like only to stress three of them: regulation (including accounting issues); competition; and taxation. Regulation is important for how rational firms are, because the rules set by regulators affect the rationality with which companies behave. Competition is also a very important element, in particular, if you want to discuss later on either the Volcker rule, or the one I like more, Mervyn King’s\(^\text{17}\) idea. Taxation is also very important in explaining why firms do the things they do.

Now, onto corporate governance—there has been a lot of literature trying to explain what

\(^{17}\) Mervyn Allister King (born 1948) is an economist and Governor of the Bank of England. (Source: Wikipedia)
have been the failures in this particular crisis. Lucian Bebchuk\textsuperscript{18} from Harvard has been very active in analysing how managers influence performance-based remuneration, and discusses how opaque these schemes are. George Akerlof and Rachel Kranton are arguing now, in a new book that will appear in March,\textsuperscript{19} that in their view these performance-based schemes attract risk-takers and, therefore, they are easy to manipulate. Boards have a lot of challenges, risk poses a critical challenge in terms of identification, understanding, management, and timely communication, and sometimes banks fail to adequately manage risk.

Let me go now to the governance of regulators. Why should we change the governance of the financial regulator? Because, as it was mentioned by Jane minutes ago, financial markets have systemic effects. It’s not just institutions that have systemic effects. Markets have systemic effects and the market regulators need to be in that line as well.

The failure of traditional macro-management based on monetary policy necessarily will require regulators, both prudential and conduct regulators, to have some form of involvement in policy decisions. The Minsky process just talks about capitalists, but I would also say that regulators should more or less come exactly on the same path. When we see stability, and this was the warning that Hans was mentioning in the previous panel, this may lead regulators to allow more risk to be taken. This is something that we need to be aware of.

So what are the changes that regulators need? One comes from the literature about rules versus discretion: if prices depart from fundamentals and monetary policy counters, then all markets will be in disarray, because monetary policy affects all markets. But if you have a problem with one market it means that financial regulators can focus on the particular bubble in that particular market.

This means that the regulator will have the ability to take discretionary acts and we need governance, specific governance, for taking discretion in this sense. Now, discretion can be ex post inefficient and therefore governance, the sort that regulators should have, should mimic central banks—a hybrid model mixing rules and discretion and transparency.

A second argument about why our governance has to change comes from this counter-balance between being ‘conventionally wrong’ or ‘unconventionally right’. Fighting a bubble is unpopular. When there is a bull market, then no-one wants to appear to be destroying the good news or the apparently good news; therefore, regulators need to be independent, transparent, and accountable enough to take actions on a particular market in which good news is taking place.

Another element is that we need to have appropriate financing conditions. One condition for effective autonomy is financing, and not all regulators in the world have this in an appropriate way. For instance in my country, it is the budget that gives me the money on a yearly basis, at the United States Securities and Exchange Commission (US

\textsuperscript{18} Lucian Arye Bebchuk is Professor of Law, Economics, and Finance, and Director of Corporate Governance at Harvard Law School. (Source: Wikipedia)

SEC) it’s Congress, and therefore you are not as independent as you would like.

And one very important topic is research and analysis—if we want to intervene in a particular bubble market, we need to have very good arguments for what we are doing and, therefore, we need very sophisticated research and analysis that will convince everyone that what we are doing is really worth doing.

Now I go to international governance. Bubbles are often not country-specific, they are global in action, and unpopular measures may induce national pressures to avoid stopping the party. This is the politicisation element that was mentioned in the previous panel. And therefore my proposal here is that, instead of having one leader, we should have a web of various parties engaged in intellectual competition for identifying risks, rather than looking for a consensus and the lowest common denominator.

I would simply say that this web of institutions, as I see it, should have more or less the following form: you should have the IMF and the World Bank looking for anomalies at the global level, dividing themselves between developed and developing countries; then the standard setters—IOSCO, BCBS, IAIS, IOPS—looking at the situations in various markets; and regional banks should do the same in their own regions. They would all compete to bring the good news or the bad news to the market. Based on calculations on international wages for economists, I think it would cost around $150 million a year to establish this.

In relation to the G20 or the Financial Stability Board (FSB), I’m concerned about the fact that we are freezing membership in a way that many significant countries are left outside the decision making, and we need to find a way to avoid this.

I will skip the competition issue, we can talk about this. Let me go to the joke instead.

The joke is this. You have three gentlemen on an island, of course their ship has sunk and they have only two things on the island, one is a rock and the other is a can of food. So the challenge is how to open the can. The first gentleman says, ‘Let’s throw the can onto the rock and that will open it’. The second gentleman says, ‘No, you are stupid, we will do exactly the opposite. If we hit the can with the rock and that will open it’. The third guy is an economist—he’s the one with the tie. What is this economist’s reaction in trying to solve the problem? He said, ‘Well let’s assume that we have a can opener’. That’s why the word ‘assumption’ is important. We must be wary of the assumptions. So in trying to build good international regulations, we need to be very careful with assumptions because we are very good at making very strange assumptions.

To quote Sir Winston Churchill, ‘The era of procrastination, of half-measures, of soothing and baffling expedients, of delays, is coming to a close. In its place, we are entering a period of consequences’. And so, my feeling is that we need to push hard for international financial reform now, because it is the right time to do it.

Thank you very much.

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TONY D’ALOISIO
And now please welcome Ian Harper who will pick up the next leg of this, and then we’ll move into the panel.

IAN HARPER
It’s a great pleasure to be invited to speak to you today about rethinking the fundamentals of Australia’s financial regulatory arrangements. I had the privilege, along with four other Australians who collectively formed the Wallis Committee, of thinking these fundamentals through in the first place, and of helping to design Australia’s financial regulatory system back in 1996–97.

Many of our international guests have come to Australia to see first-hand how our system works and to understand why we have done so well during the global financial crisis (GFC). We are obviously very happy to receive their compliments but my message to us all today, foreigners and locals alike, is that the basis of our current financial regulatory arrangements needs to be thought through again.

It must be said that we have done very well. And it has been a mixture of good luck and good management. In saying so, let me quickly add that I do not mean to diminish the competence, professionalism and judgement exercised by our regulators during the GFC. I think we all should be grateful for the work they have done.

But sheer good luck also played its part. We happen to be heavily exposed to the growth of the Chinese economy; we missed out on a housing collapse on account of high immigration levels; both are important additional explanations for why we’ve done well.

On the good management front, our ‘twin peaks’ system of financial regulation served us very well, not least on account of the competence of those who lead our regulatory bodies. But in my view we need to think about how the system should be tightened up in the wake of the GFC. We especially need to question various assumptions upon which the system was built and which have been tested by experience during the crisis.

To use an analogy, we sent our regulatory ship to sea. There was a fierce storm, and she’s returned to port with rigging torn and a few containers missing from the deck. While the ship is basically sound, we need to send her into dry dock to check all her bulkheads and to make sure she’s strong enough to withstand the next storm, which we know will be different from the last and possibly more severe.

In short, we need to rethink the fundamentals of our regulatory system, not because the system is unsound but because it has come under severe stress and we need to check for cracks and fault lines. Some of the things we thought were true before the GFC have turned out not to be, and this requires us to look at our regulatory arrangements in a somewhat different light.

So what have we learned? Guillermo and several other speakers on this morning’s panel, including Jane Diplock, said something like this, ‘We have learned that systemic risk is far more pervasive and lethal than we thought’. I agree.

To some extent I think we can be excused for having underestimated systemic risk because the world is a very different place from what it was 14 years ago when the Wallis Committee designed our regulatory system. Capital markets in particular have become far more interconnected.
Back in 1996, we thought that systemic risk essentially afflicted financial intermediaries. It was a fancy term for a bank run. Instability in banking systems has a long history. If you’ve read Niall Ferguson’s book *The ascent of money* or seen the television series, you will know what I’m talking about. This has a very long history.

What we’ve learnt during the GFC is that systemic risk afflicts financial markets as much as it does financial intermediaries and this, I think, is genuinely new.

The Wallis Committee assigned responsibility for managing systemic risk to the Reserve Bank of Australia (RBA). Why? Because the Reserve Bank is the only regulator with a cheque book. It has the capacity to write cheques—i.e. to lend money and buy assets—at least up to some limit, as well as a brief that covers the entire financial system in Australia.

The other reason Wallis assigned responsibility to the Reserve Bank is that it is, after all, a bank and therefore understands banking. Yet, during the GFC, systemic risk afflicted institutions well beyond the banking system. I’m sure the RBA was as surprised as everyone else that it found itself acting not just the ‘lender of last resort’ to the banking system but as ‘market maker of last resort’ to the financial markets, especially for securitised financial instruments.

Of course, the Reserve Bank is no stranger to buying and selling foreign currency and government securities. But it found itself having to buy assets well beyond the normal range of its activities. Like other central banks around the world, it did so without a rule book—it made up the rules as it went along. And thank goodness it did. What we experienced during the GFC was systemic risk not in the banking system but in the financial markets, and on a global scale.

At base the GFC was the equivalent of a bank run in financial markets, and driven by the same ultimate cause, namely, excessive leverage. The most shocking words heard during the GFC were these: ‘There is no market. It’s closed’. For years I taught at the university that the market would always find its level—that there would always be a price, even if it wasn’t very high.

What we experienced during the GFC was the complete disappearance of markets, including markets for assets whose value people knew in their rational minds could not be zero. Banks would not buy obligations guaranteed by other banks, in full knowledge that the central bank stood behind them. The markets simply closed.

This is not an experience that we built into our regulatory framework. What are we to conclude? One way of interpreting the experience is to conclude that asymmetric information, which is lethal to markets, is far more ubiquitous than people generally thought.

Securitisation was supposed to make assets marketable that were generally regarded as not marketable, including, for example, bank loans. This would be done by remedying underlying information asymmetries through, for example, additional forms of guarantee and insurance.

We discovered that even assets whose transparency was augmented through securitisation suffered from enough information asymmetry for their markets simply to disappear.

Nobody doubts that there’s asymmetric information in the world of financial
intermediaries—banks and insurance companies. After all, that’s why they’re there. Financial intermediaries exist because the technology of balance-sheet borrowing and lending and risk underwriting is the only thing ever invented to deal with situations in which asymmetric information debilitates market exchange.

We have long experience in dealing with financial intermediaries. We know their weaknesses and how to regulate them. It’s an old technology but it works—most of the time. Thank goodness it worked during the GFC when the markets disappeared and financial activity rushed back to the balance sheets of financial intermediaries. Mind you, there isn’t enough capital for financial intermediaries to take up the entire load shed by financial markets but at least they kept pumping during the worst of the crisis.

Institutions that suffer from information asymmetry are regulated with prudential regulation. The Wallis Committee bundled them together and placed them under the jurisdiction of the Australian Prudential Regulation Association (APRA)—banks, building societies, credit unions and insurance companies.

Beyond that world, we assumed, lay the sunlit uplands of information symmetry. Up there, you see, the market has its head. It’s not that information is perfect or even that agents are rational. But the available information is symmetrically held, at least enough for the market to exist and do its job of matching buyers and sellers efficiently.

Is there nothing for a regulator to do in such a happy land? On the contrary. The regulator can work to improve the quality of available information and, if you like, double-check that information is symmetrically held by forcing disclosure, monitoring conduct and overseeing transparency. These are the weapons of a securities markets regulator.

So here are the ‘twin peaks’ of the Wallis regulatory framework: a prudential regulator for intermediaries racked by information asymmetry; and a conduct and disclosure regulator for markets where information is symmetric, albeit imperfect. APRA and ASIC—two regulators purpose-built to do different things in different jurisdictions for different reasons.

Overarching—or undergirding?—the ‘twin peaks’ is the central bank, with responsibility for managing systemic stability and administering monetary policy, the time-honoured functions of central banks down the years and around the world.

How kindly has the GFC treated this neat taxonomy? Not very. Information asymmetry has turned up in the domain of ASIC, having crossed the border from APRA’s territory. This muddies the waters, to say the least.

More fundamentally, it requires us to rethink the balance between market stability and market efficiency. In the final analysis, that’s what financial regulation is supposed to do—to undergird stability albeit at some cost to efficiency.

Unregulated markets are generally efficient in the narrow micro-economic sense. But they’re also typically unstable. Instability costs us money but so does inefficiency. Good regulation is about trying to strike a balance between the two.

Back in the late 1970s, before the Campbell Committee brought down its report, we had a system that was very heavily regulated by current standards. It was a stable system—no bank depositor had lost any money since
the Second World War. In fact, we'd had only one bank failure and that was not a bank failure to speak of, since the failed bank was quickly absorbed by one of the majors.

But by 1980 it was widely recognised that the Australian banking system was amongst the least efficient least innovative in the world. Those were the days when banks would not lend to women, married or not. We changed all that. We deregulated the financial system and two things happened. The banks became more efficient—bank margins came down and they became more innovative.

At the same time the system became less stable. By the time we got to 1990–91, we had bank failures again. We lost the fifth-largest bank in the country in 1990 when the State Bank of Victoria failed, and we lost the State Bank of South Australia in the same turmoil. Bank failures came back because we'd turned the dial in the direction of efficiency and away from stability.

The chief lesson of the GFC is that it's time to rethink this balance once again. We know already what the view is from outside Australia as the G20 orders the Financial Stability Board to oversee a major regulatory overhaul designed to shore up stability at the expense of efficiency.

At the time of the Campbell Inquiry, the late Chris Higgins, who was then Deputy Secretary of the Commonwealth Treasury, wrote the Treasury's submission to the Campbell Inquiry. He invoked the war-imagery of von Clausewitz when he said, 'In the fog of macro-economic war, micro-economic efficiency losses are collateral damage'.

Chris has been not with us for nearly 20 years but his words have once again gained currency. We are again on the cusp of discounting micro-economic efficiency losses as collateral damage in the bid for greater systemic stability.

Guillermo talked quite a bit about financial market efficiency. Let me make a couple of remarks about that. If we are once again rejigging the balance between stability and efficiency, to what extent can we rely on the markets themselves to deliver efficiency unaided?

There are two distinct senses in which the term ‘market efficiency’ is used. I must admit that I’ve been guilty myself of clouding these two and have been taken to task by colleagues! So let me be absolutely clear with you now.

The first sense in which people talk about market efficiency is this: they talk about Fama efficiency. That’s what Guillermo was just talking about. To boil it down, as he did, markets are Fama-efficient according to how you answer this question: can trading rules generate super-normal economic profit? That is, covering fully attributed, risk-adjusted costs. If trading rules generate super-normal profit, then markets are not Fama-efficient. But if they don’t, they are. End of story.

There is a much older and broader concept of market efficiency that is relevant to this discussion, and it takes us back to Vilfredo Pareto. Pareto efficiency asks a slightly

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21 Carl Philipp Gottlieb von Clausewitz (1780–1831) was a Prussian soldier, military historian and military theorist. He is most notable for his military treatise *Vom Kriege*, translated into English as *On War*. (Source: Wikipedia)

22 Vilfredo Federico Damaso Pareto (1848–1923) was an Italian industrialist, sociologist, economist, and philosopher. He made several important contributions to economics, particularly in the study of income distribution and in the analysis of individuals’ choices. (Source: Wikipedia)
different question, ‘Is there another set of prices and allocations which Pareto-dominates the outcome of trading on competitive markets?’

We should recall the fundamental theorems of welfare economics. A competitive market equilibrium is a Pareto-optimal allocation but only under specified conditions. One of those conditions is that information is symmetric. Not perfect, but symmetric.

If information is not symmetric, then a competitive market allocation need not be Pareto-optimal. That is to say, you can find another allocation of prices and quantities which Pareto-dominates what the competitive market will deliver. This opens the way for regulators to induce an outcome which is Pareto-superior to the competitive market equilibrium.

So the GFC has not necessarily invalidated Fama efficiency. That’s an empirical question. How many people made money out of predicting that the market was going to go into the GFC? I don’t know. It’s an empirical question.

The relevant question for regulatory design is a different one. Are financial markets Pareto-efficient? In other words, is there scope for regulatory intervention to improve on market outcomes in the Pareto sense?

The answer would appear to be that there definitely are allocations which Pareto-dominate what competitive markets will come up with, and those allocations have to do with greater stability, greater liquidity, and more symmetric information.

The GFC has widened the scope for government intervention to override Pareto-inefficient competitive market outcomes. That is why we have to rethink the fundamentals.

An appropriate notion of efficiency has directed us right back to the drawing board.

We thought symmetric information was more pervasive. Therefore, we thought we could rely on competitive markets to deliver Pareto-optimal outcomes in a wider set of circumstances. It turns out that asymmetric information is more pervasive; ergo, financial markets will not deliver Pareto efficiency in all the circumstances we thought they would.

We heard this morning about the different responses that are being made to this realisation elsewhere in the world. How should we respond? My view is that Australia’s regulatory framework needs review and adjustment but not a major overhaul.

It’s not that we’re wrong about markets having a measure of symmetric information and institutions being basically characterised by asymmetric information. That broad characterisation which underlies the ‘twin peaks’ system is not fundamentally flawed. Where we went wrong is that we drew the line of demarcation between the two far too finely.

Fortunately, those who administer the system exercise more discretion than the designers. So from the designers’ point of view, I thought it was black and white. The administrators, who should speak for themselves, probably never thought it was, but are still operating under rules which reflect the strict division. And that’s why I think it needs to be thought through again.

Moves are already afoot to tighten capital and liquidity standards, as we’ve heard. Credit rating agencies are now required to be licensed. A key concern for Australia, and this was hinted at in the last session, is that regulatory reform agreed through the G20...
might neither be appropriate nor necessary for our conditions. So just how far should we go along with international moves to reform financial regulation?

You would have heard people on this morning’s panel saying, ‘Well, look, the main thing is that we have scope for discretion’. So far it appears that might be the case; let’s hope it’s true. If there is discretion, we needn’t be too concerned. But that’s a matter about which you’ll find views differ.

What are the implications of the changes coming down the line? As the rest of the world changes its regulatory frameworks, having generally experienced a rougher ride during the GFC than we experienced, the cost of financial intermediation will rise and the return to equity for financial intermediaries will fall. This is inevitable.

If we do get stricter capital requirements on intermediaries and a leverage ratio, and stricter liquidity requirements, it must be true that the cost of intermediation rises. Indeed, that’s the point. You want banks to charge more for risk. You want them to carry more capital on their balance sheets.

So when you hear people talking about the higher bank margins reflecting less competition in the banking system, there may be a bit of that going on but it’s not the main story. The main story is that it’s a result of deliberate policy intervention to make the banks both here and overseas increase the cost of intermediation and lower risk.

Will this simply produce a new round of disintermediation? Glenn Stevens asked this question this morning, and it’s the right question to ask. We’ve been here before. The reason we deregulated the financial system 30 years ago was because of growing disintermediation. So if we now go back in the other direction and ramp up all the regulations, what guarantee do we have that it won’t simply foment the very problem we are trying to control?

One of the ironies of our current circumstances is this: 30 years ago we got rid of unweighted leverage ratios, liquidity ratios, and the like, as we deregulated the system. And now, 30 years later, we have people coming down here saying, ‘How well you’ve done! Oh, and by the way, you now have to comply with this new regulatory standard that’s being applied internationally’. In other words, go back to where we were 30 years ago!

Now, I’m being a bit naughty. That is teasing because the circumstances have changed. But I just want to make it clear to us all what we’re dealing with. We are being asked to reinvent a system with elements redolent of the one we abandoned a long time ago—to switch the dial back in the direction of stability and away from efficiency. And this when our deregulated system saw us through the worst financial crisis since the Great Depression.

Of course, in the end, how far we go will be a matter of political judgment. But it will cost us. And it will cost the world. It may force local regulators, for example, to apply prudential regulation to Australian mortgage trusts and hedge funds. If that happens, it won’t be done by APRA because mortgage trusts and hedge funds are not deposit-takers. It will fall to ASIC even though ASIC is not equipped as a prudential regulator.

It will raise the cost of capital which will be passed through to Australian businesses, slowing growth and reducing access to intermediated credit. Do you think the community is ready for that?
Our Australian regulators may face demarcation issues. In the original design, prudential regulation was APRA’s responsibility, while conduct and disclosure regulation was ASIC’s responsibility. The more you blur these lines, the more difficult it is for regulators to stick to their mission.

And then there’s systemic risk. We heard this morning that the conduct and disclosure regulator should also worry about systemic risk. I agree with that, because we’ve seen markets suffer from systemic risk. But that further blurs the responsibilities: how should the RBA’s oversight of systemic risk be shared with ASIC and APRA?

There’s no easy answer to any of this. What I’m saying is that it requires rethinking because the underlying assumptions on which the system was built have been called into question.

Let me conclude quickly. The scope for failure of financial markets is much wider than we thought. Information asymmetry affects markets as well as intermediaries, certainly during periods of acute stress. The scope for regulatory intervention is accordingly greater.

What does this imply? It means we have to re-draw or thicken the boundaries that presently separate prudential from conduct and disclosure regulation, and arguably we have to strengthen them both. Even at the risk of overlap and duplication between ASIC and APRA. In the end we can sort that out. We have mechanisms for cooperation among the three regulators—ASIC, APRA and the Reserve Bank—and those mechanisms will need to be exercised more vigorously as we re-draw the taxonomy.

We may even have to do something legislative here; we don’t know yet. But certainly they’ll have to re-jig the way they do things together. None of that is the end of the world. But it does mean that the neat division we once had is changing.

So here’s a final piece of advice to our international guests who have come down here very impressed with the ‘twin peaks’ system. We don’t sheet our experience wholly home to what happened with regulatory arrangements—there’s more to the story than ‘twin peaks’ but at least it worked!

However, before you go and imitate the Australian system, think carefully about the points that I and others have raised about the logic on which ‘twin peaks’ is based, because that logic has been fundamentally challenged by the experience of the global financial crisis.

Thank you very much.

TONY D’ALOISIO
Okay. Ian and Guillermo, you are both saying that the efficient market hypothesis needs to be revisited. I think, Guillermo, you put it more strongly than Ian. Just between yourselves, what is the actual difference between the two of you having heard each other speak? Are you really saying that the theory needs to be revisited in similar ways?

GUILLERMO LARRAIN
I don’t think that the theory should be revisited, it’s a theory. It’s a nice piece of intellectual work. My feeling, and I’m talking from the perspective of regulation, is that it is of limited value. I think we have learned several new things in this crisis that limit the basic implications of that particular piece of theory, which is that we as security regulators should basically be concerned about disclosure—if information is there then
the markets will work fine. And my feeling is that we need to go far beyond that.

So it's an interesting piece of theory that must remain there, but the implications for regulation are vast. That's my impression from this crisis.

IAN HARPER
Yes, again, Tony, I want to emphasise that in my own thinking about this, I had at the outset come out and said the same thing. The efficient markets hypothesis has been challenged fundamentally by this. And when my finance colleagues got to me, they basically said, 'Look, the efficient markets hypothesis is a very narrow proposition about whether traders can make money'. End. Traders may have made money or not out of the GFC. The efficient markets hypothesis says nothing about stability. And as they forced me to rethink, I realised it also says nothing about Pareto efficiency; it's just asking a different question.

So, really, what I wanted to get at was this. To what extent can you rely upon competitive markets to deliver outcomes that you cannot dominate by regulatory intervention? That's an old question in economics, and it goes well beyond financial markets—it could as easily be the market for bricks or bread. But the same principles apply. If people don't behave rationally, then of course competitive markets won't deliver Pareto-optimal allocations. You've just denied or violated the principles upon which that theory rests.

So, Tony, where I came to was this. After all, the context happens to be financial markets. Therefore the EMH, efficient markets hypothesis, gets raised. I think that's probably a red herring. The real issue is: can you rely upon competitive markets to produce allocations that a regulator couldn't dominate? And I think the GFC has demonstrated that the scope for regulatory intervention is clearly wider than we thought it was.

Let's get this clear: when banks refuse to lend to other banks, and there is no doubt about what's in their balance sheet, the market has become irrational. Who wants to say that the competitive market outcome in that instance is anything like Pareto-optimal?

So it's about expanding the scope of regulatory intervention and changing the way in which it's done, relative to the sort of neat division that I and my colleagues on Wallis came up with 14 years ago.

TONY D’ALOISIO
John Stuckey, at last year’s Summer School you expressed some views about your faith in the markets correcting things and, probably, the subtext was: keep the regulators out of it to a great extent. One year on, having heard this morning’s presentation, what’s your view on what’s happening in the move for more regulation?

JOHN STUCKEY
Tony, it feels as if you’re positioning me as the lamb that believes in markets before an audience of hungry regulators. But actually I’m quite happy to be cast in that position. Quite happy, I’m not a shrinking lamb, to mix metaphors. In fact I might actually say to your contextual comment there about what I said last year, I might say ‘I rest my case’. Regulators have done an awful lot of talking this year, but they haven't actually done a lot. And the economy, the Australian economy, is certainly in pretty good shape and the global economy is not in great shape, but it's in much better shape than I think we would have expected it to be this time last year.
But a bit more serious answer to your question, Tony, if I may. I think the distinction that Ian has drawn out between the finance theory definition of efficient markets, which is where this efficient market hypothesis jargon comes from, is a quite different topic to allocative efficiency in the way markets work well.

Let me talk about the first one. Eugene Fama came up with this thing and there was the strong form, the semi-strong form and the weak form. Ian was correct in saying that it’s an empirical question as to how accurate that is, but my reading of the literature is that it’s a no-brainer that strong-form market efficiency does not exist, there’s no question that it doesn’t exist.

By the way, there would be very few economists, apart from the odd person kicking around in old offices in Chicago, and very few regulators that would actually believe in that theory. I can remember as a graduate student in the US, I thought of it just now, but Chicago was having a big influence. I went to a university in the north-east and we thought Chicago was, you know, like a joke, and that is what we were brought up to think.

Anyway, Friedman and Co. sent one of their acolytes over to the east to present a seminar and all we graduate students showed up and looked and listened. And they really collected the front row forwards for this. So Samuelson\(^{23}\) came up from Massachusetts Institute of Technology (MIT), Modigliani\(^{24}\) came up from MIT, Tobin\(^ {25}\) came up from Yale and they took this guy apart. They took this guy apart and said, ‘This is just not the way markets work. Markets are not perfect. They don’t work in the Eugene Fama sense—they’re not perfect’

So I think that’s a little bit of a crutch that some people are using to say, ‘Well of course markets are not perfectly efficient’, so they’re using it as a bit of an excuse to say, ‘Well let’s re-regulate everything’.

The much more pertinent question is, ‘How well do these financial markets work in an allocative efficiency sense?’ And if you look at the standard old model that I suppose quite a few of you learnt in Economics I, the question was, ‘What are the conditions that are required for these markets to work well?’ Any old market, including, for example, a market for carbon credits, I might add, or any other market you want to think about.

You need to have a large number of buyers, you need to have a large number of sellers, it’s preferable to have a relatively homogenous product, and it’s a good idea to have fully informed buyers and sellers.

Now, one of the nice things about financial markets is it’s pretty easy to have a large number of buyers and sellers, which often doesn’t happen in goods and services markets, but you can tick those boxes. And that’s what everybody has done, I think, is tick those boxes but they’ve ignored—not ignored, but they’ve undersold the other two. And that’s what Ian was talking about as well.

\(^{23}\) Paul Anthony Samuelson (1915–2009) was an American economist, and the first American to win the Nobel Prize in Economics. The Swedish Royal Academy stated, when awarding the prize, that he ‘has done more than any other contemporary economist to raise the level of scientific analysis in economic theory’. (Source: Wikipedia)

\(^{24}\) Franco Modigliani (1918–2003) was an Italian American economist at the MIT Sloan School of Management and MIT Department of Economics, and winner of the Nobel Memorial Prize in Economics in 1985. (Source: Wikipedia)

\(^{25}\) James Tobin (1918–2002) was an American economist who in his lifetime, had served on the Council of Economic Advisors, the Board of Governors of the Federal Reserve System, and had taught at Harvard and Yale Universities. (Source: Wikipedia)
My view is that the regulatory paradigm that regulators should use in places like ASIC is about coming up not with the efficient market hypothesis, but let me call it the working markets hypothesis, which is to say ‘Which markets are working pretty well most of the time and which markets aren’t?’ In my view if you go for, say, 99% market stability, which some regulators and politicians would seem to like, you’re going to be throwing out the window a lot of efficiency and a lot of innovation, particularly innovation.

So I would encourage you not to go down the 99% stability route. Our existing set-up in Australia is not all that far away from the optimal trade-off between the stability and efficiency/innovativeness objectives, it seems to me.

However, when we do want to get in there, we should change some things relative to the way I think we’ve been doing them as regulators and as economic societies.

And the way we should guide ourselves along this working competition hypothesis is to get in there and say, ‘How can we actually make the products that are being traded on these markets a little bit more homogenous, which is to say standardised, and how can we get the traders on those markets to be more informed?’ There’s no doubt that there were a lot of securities products being traded in the last 10 years that the traders didn’t understand the value of and didn’t understand the full distribution of pay-offs to those things. Absolutely not. There’s no question about it.

And I think the best way—even though it comes at a bit of a price of financial innovation—is to have standardised contracts and to create public exchanges for those contracts and to publish the results of what happens on those markets.

Another valuable role for regulators is: don’t just disclose information about the number of trades and so on but, like the Reserve Bank is starting to do more and more of, or they’re at least being public about doing it, but also undertake analysis about what’s going on in those markets. What are the trends? What’s Tobin’s q running at? What’s the price-to-book ratio? Are real estate prices getting out of whack? How are all those things moving? And I think that could be something that ASIC could do more of as well and give the market information, ‘This looks like a bubble coming, everyone’. Get out there and tell. Glenn Stevens attempts to do that, he tells us, ‘There’s a housing crisis and we’re not going to let it happen, everybody, so don’t go paying too much at that next auction because we are going to kill you with interest rates’. I mean, Glenn’s doing it by threat half the time, and it seems to be working reasonably well.

There’s a bunch of other things that I could go on and talk about. I’ll maybe make one more—there’s another category of where these normal old markets don’t work very well, and that’s where you have incentives problems. Maybe a bit radical on this one, and I think the credit rating agencies are probably—of the so-called gate keepers—are probably the ones, and that is not picking on

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26 Tobin’s q is a ratio comparing the market value of a company’s stock with the value of a company’s equity book value. The ratio was developed by James Tobin (Tobin 1969), who called it “q”, the ratio between two valuations of the same physical asset. One, the numerator, is the market valuation: the going price in the market for exchanging existing assets. The other, the denominator, is the replacement or reproduction cost: the price in the market for the newly produced commodities. We believe that this ratio has considerable macroeconomic significance and usefulness, as the nexus between financial markets and markets for goods and services. (Source: Wikipedia)
the individuals or the individual companies, but they are almost in an invidious position because they know where their bread’s buttered, and that’s with their clients, and what are they going to do? They’re going to behave like other human beings, you know, and serve their own self-interests and they’re going to give good credit ratings.

I would seriously consider creating a public authority to do the credit ratings. Create another ASIC, or another equivalent of an APRA or an ASIC, and have the ‘triple peaks’. Not a huge thing but specifically for that purpose. Just to stir the pot, because I don’t think the market is ever actually going to be terribly efficient on that one.

Another area that concerns me is the herd mentality, macro-bubbles, macro-crashes and so on. Mr Larrain has talked about this. It still is an enormous problem, and that is particularly a role, I think, for the central banks of the world. It’s very, very hard to do, but I think more analysis and more telling us ‘There’s a bubble happening, there’s a bubble happening’, to try and actually talk us out of it.

**TONY D’ALOISIO**

Greg, just to pick up your work, you’ve now been in IOSCO a few years, and you’re seen as one of the main players in developing a forward agenda on re-regulation following the crisis.

Having heard the discussion about the efficient market hypothesis and the issues of re-regulation, what’s guiding IOSCO in what it’s doing and how is it approaching these issues?

**GREG TANZER**

Yes, I think some of the agenda is addressing things that we probably always should have done, and probably fits with everyone’s existing thinking about regulation.

And I heard John’s point about credit rating agencies. I think a lot of the work that we’ve been doing with respect to credit rating agencies, and that you now see replicated internationally, is really putting in place standards and that’s pretty traditional thinking for regulation. Fundamentally it’s about the quality of the rating and about dealing with conflicts of interest. I don’t see that as a major change in regulatory thinking. I think it’s a new player, we probably should have recognised it earlier and we should have dealt better with the conflicts of interest inherent in the model. And I agree absolutely with John, maybe the end result of this might be that we need some sort of public authority for that, if the conflicts are unmanageable.

I think the developments in hedge fund regulation are a little like that as well. They’re kind of pushing the boundary of what I might have called traditional regulatory thinking to a degree, because some of this is actually saying, ‘Look, these entities are significant enough in a market sense and in a stability sense that we may actually need to blur that boundary that Ian was talking about’. We actually don’t need to prudentially regulate them because we want them to be different to banks—because they’re not making promises about taking deposits or anything like that—but they can have such systemic instability features that we need to know a lot more about them, at least.

ASIC’s been at the forefront of this on securitisation, and some of the elements there are much more, I think, to take a term, sort of game-changing in nature about how we think about regulation. The idea that you would require an entity, which is in the game of packaging a product, to retain an interest
in that, that is a very prudential style of thinking. The idea that we might build in suitability requirements for certain types of products goes well beyond disclosure.

So I think you can see there that there are some elements of the traditional approach to filling gaps and there are also evolutions that are really saying, ‘Look, with respect to systemic risks building up in markets, maybe a retention requirement is one way of trying to prick a bubble’. Investor suitability, that’s going well beyond disclosure, and is quite new thinking, that will take a little while to work through.

There are two key themes to IOSCO’s work. One is a very strong emphasis on trying to understand systemic risks arising out of markets and market activity. At least to try and understand them so that we, as an international grouping of market regulators, can contribute to the debate and perhaps help to identify these bubbles and start to prick them. Even if we, as market regulators, don’t necessarily have the tools to prick that bubble, that’s one very key theme.

I talked a little bit about some of the regulatory changes that are coming. And our other key theme continues to be cooperation and coordination, which is absolutely essential. This comes back to some of the discussion earlier about ‘too big to fail’, where I think there are just enormous stresses because we do not have a world government, we have a series of national governments. That means implementation has to be driven nationally, and international bodies like IOSCO have to be active in encouraging implementation, but IOSCO can’t drive implementation at the national level.

TONY D’ALOISIO

Greg Medcraft, do you want to pick up securitisation as an issue? You have seen it from both sides, so to speak. Are we on the right track to reform? And why is any reform needed?

GREG MEDCRAFT

Yes, it’s a good point. I always remember Warren Buffet’s comment, ‘When the tide goes out you get to see who’s naked’. And I guess we saw that with liquidity and leverage and capital, and with new financial products, and I think with securitisation. When this all started blowing up, I took the view that the market would reshape based on what happened.

And what we’ve seen with securitisation is that the industry itself talked to investors about what they needed to buy products again, and they were issues like better low level disclosure and transparency, and there was the issue about ‘skin in the game’. That feedback came back from investors. And the third one was investor suitability. The industry itself commissioned a study by McKinsey back at the end of 2008 and that basically was that feedback.

What happened is IOSCO formed its own taskforce, and what’s been important is that they have been working jointly with industry in reshaping the way things should occur. And I think what’s really important is that, at the end of the day, bankers want markets to work, and there’s an alignment of interest in

27 ‘After all, you only find out who is swimming naked when the tide goes out.’ Buffet, W. (2008, Chairman’s Letter). full text available at http://online.wsj.com/article/SB1204321051999503761.html?mod=hps_us_whats_news. Warren Edward Buffett (born 1930) is an American investor, businessman, and philanthropist. He is one of the most successful investors in the world, the primary shareholder and CEO of Berkshire Hathaway. (Source: Wikipedia)
that they want markets to work and they want trust and confidence to come back. So there shouldn’t be a regulator-versus-industry thing, it should be about working in a partnership.

I think it’s quite important that we work in partnership and I think there are other important things, too—there’s coordination, which globally IOSCO is doing, but there’s also convergence. It’s no good having a common set of rules that are then applied unevenly. So I think the next step in securitisation is getting convergence, so that, because it is a global market like many financial markets, you try and get common and consistently applied standards across the world.

And another issue in securitisation, which we keep hearing from the global industry, is the industry wants the market to come back as much as we do, but they think we need to use caution, because there are so many regulations being proposed at the moment from the accounting perspective, from a banking regulation perspective, and from a securities perspective. As a result, many people are saying, ‘It’s just too hard’.

So I think we’ve got to be very careful. There are a lot of good ideas, but I think they have to be measured and developed over time. We’ve got to prioritise what we really think is important.

And I think the market’s going to come back because securitisation is an amazing technology in terms of what it’s done, that is lowering the costs of credit and increasing the availability of credit to consumers and businesses around the world.

In relation to the Australian market—we talked about lowering margins to mortgage holders in Australia. Frankly, it was securitisation that largely delivered that huge reduction in spreads. It wasn’t necessarily the great banking system; it was securitisation that largely did that. It was competition. And that’s why the G20 recognises it as being so important to economic growth.

TONY D’ALOISIO
We will move from looking at the issues here and now look at Japan, Hong Kong and the US. What’s been the approach to re-regulation or regulation following the crisis? What are the issues that have emerged in Japan?

MASAMICHI KONO
Well first of all I come from an integrated regulator and so I had to come here to say that at least there is such a thing in the world that is still working and not just a ‘twin peaks’ model.

And I would like to be a bit contentious here because in fact from the Japanese perspective I must say that there is still a sense of what we call déjà vu. That is, many people said that things are different this time in the great moderation and now when we are coping with the crisis and we are—I don’t agree, but anyway—when we are about to exit, then there is again talk of ‘this time it should be different, or it’s different.’

Well, from our perspective only half of the lessons from the Japanese crisis have been learned, and it will take time. In fact our last decade was not something that was a flat bottomed-out process, it was more like we had several storms and it looks as though at least at this point in time we may be seeing a fourth storm globally. I hope, of course, it’s not the case but our experience tells us that we’re still very much at an early stage of coping with the real problem. And the real
problem is really to deal with the risk on your balance sheet.

If you’re running out of time, I will just mention that if we run the course that we are going now, we will probably end up with too much regulation for bank capital and liquidity and too little regulation on non-bank activities and strengthening market infrastructure.

So in fact I think a lot that has been mentioned this morning, in the previous panel and on this panel, resonates with what I have been thinking—i.e. that market regulators should have a larger voice. They should be calling for more action in terms of covering or filling the gaps in the regulation, strengthening market infrastructure, more coordination amongst supervisors and finally, consistency of rules and accounting standards as well. And on that front we are really not even at the first step of conversion.

So I’m not sure whether I’m answering your question straight-forwardly, but from our perspective, that’s where we are and this is going to take time.

TONY D’ALOISIO
Roel, from the point of view of the US, where do you think you are in this debate about re-regulation and what’s coming through?

ROEL CAMPOS
Well, we’re not talking about Pareto efficiencies I can assure you of that. What is going on essentially is the fall-out and the difficulty of getting away from what was believed, strongly, almost religiously, that the markets would deal with themselves. And this was a religious view, quite frankly, that existed through most of the last decade of the 20th century and into this.

There’s a confluence here that happens in the US and I suspect other places. Friedman and the Chicago School theories became very useful to business lobbyists. So essentially you get a benefit from lobbying government to ‘leave business alone at any cost, because the market will take care of things on its own—that is the best policy’.

We all know that Alan Greenspan knew very well that loan originations were being made in the US to individuals who would never be able to afford to pay them back. But he, as he said, was confident that somehow reputational concerns would take care of that problem and we’d deal with it.

So I think like any religion, facts get in the way. So even though we have had this particular experience, it is difficult to stop the lobbyist and the supported business from arguing the same things, even the failed policies of the past, which is essentially to ‘keep government out of the hair of business’.

But we’ve had several things going on. Right now we have a failure of markets to exist in the balance sheet items that the banks have got. So for example, you’ve got items that are part of the securitisation fall-out, that if they are put in the so-called market situation, the prices will be 20–30% of par-value.

Now these are not prices that the banks are willing to accept. Why not? Well, because they’ll have to realise losses—it means the end of careers, it means a lot of things. It may mean failure to particular banks.

So there is a huge issue that we have, which I think we share with Japan: what to do about this. You know, if you continue to let this go on, this sort of zombie bank, you will have this situation for a long time.

The intervention here is difficult, which means that you have to allow banks to fail or
reorganise them or restructure them. This is similar to what the US had to go through in the thrift savings and loans situation. But no-one’s willing to do that, essentially, at this particular moment. So you don’t have a real market.

And then we have, in the short time now, we have commercial real estate loans that need to be refinanced without having a real market for them to be refinanced or at least no particular source.

So we have these difficulties. The US now has a political situation, and must deal with the populist anger against Wall Street. Wall Street seems to still be earning huge incomes, even though they almost took the economy over the edge, and so the government, the US Federal Government, needs to respond to that. And the government must also deal with what form systemic risk regulator will take. There’s not a clear answer. The Fed has lost some reputation and confidence on the part of Congress. There may be a council, but we’ll see what exactly happens.

But essentially, the Obama administration came out very suddenly, which I think shook some of the efforts to have an international understanding and to work together. Obama proposed the Volcker rule, which would place restrictions on banks’ liabilities and limit the size institutions to a particular level. But this proposal has yet to be resolved.

Essentially the US is struggling mightily. You still have a great divide, in terms of Congress and the two different parties, and the longer time goes on the less imminent the threat appears and the more greed has replaced fear. And so it’ll be interesting to see what gets done. I’m almost of the opinion that it’s going to take a series of executive orders as opposed to legislation going through Congress to have many of these reforms.

**TONY D’ALOISIO**

Martin, from the point of view from your neck of the woods?

**MARTIN WHEATLEY**

It was very interesting hearing the Australian experience of: no major systemic failures, no taxpayers’ money going in, and no banking crisis. In many respects Hong Kong is experiencing similar things, and I think that’s partly because we went through our reforms post the Asian financial crisis.

I was very struck by Ian’s comment about the G20 one-size-fits-all philosophy. The problems that have occurred, wherever they have occurred, will see a result that has got to be implemented everywhere, regardless of the cost of the implementation and whether that’s appropriate for the market.

We’re in a similar situation of looking at these suggested changes and saying, ‘Well, actually we didn’t have these problems here. Is this really an appropriate response here?’

In terms of the framework of regulation, there’s no real huge debate about completely overhauling the system. Our failures were in conduct and implementation rather than in the overall regulatory system.

I was very struck again by a lot of comments about whether there’s an information asymmetry here. We approved an initial public offering (IPO) recently that had a 1200-page risk disclosure document. Now, I don’t know how many people read a 1200-page risk disclosure document. The Minibond products, which have been hugely written about, had 200 pages of disclosure. Lots and lots of disclosure, but I’m not sure that it served its purpose.
So in my view, the concern is less about information asymmetry than a kind of competence or understanding asymmetry, and I think that’s true right across the board, from individual investors who invested in Minibonds to corporates who talk about currency hedges or oil hedges or commodity hedges. A lot of that comes back to the agency conflict and the conduct of the intermediary selling product.

So from our point of view that’s our focus. It’s not a regulatory overhaul.

TONY D’ALOISIO

It’s always unfortunate that, when you have such a distinguished panel, you go short of time. But I did promise some questions from the floor. Are there a couple of questions from the floor?

QUESTION

I’ve noticed that both the UK Financial Services Authority (FSA) and the US SEC have criticised themselves over the last 12 months for having a very legal focus and not as much of an economic focus as they should. The discussion this morning has been very heavily economically based. Going forward, what is the right perspective for the regulators? Is it a balance? Should we be leaning more towards economics? Short of becoming another Treasury, what perspectives should we be taking as we move forward?

ROEL CAMPOS

I’ll just start off and then let the others speak. In the US, instead of ‘twin peaks’ we have a dozen peaks. You know, it’s just fragmented regulation—we have six or so agencies that deal with the banks, for example.

So, we have a very pure, not necessarily a positive thing, securities regulator. We can’t give money. We can’t provide liquidity. I say ‘we’ because I spent so much time at the US SEC. The SEC can’t do any of those things.

So essentially the SEC has to deal with the traditional elements of disclosure—here and there operational items, but very lightly in terms of the way the markets work—essentially disclosure and enforcement, that negative word that scares business. It is not prudential, because enforcement on the part of the SEC, and the way the US works, is essentially to keep the retail investors in the market.

We have a large retail investor market like Australia, but I think not too many other jurisdictions are in this particular category. Most jurisdictions are primarily institutional. So you have a different need for enforcement and for consequences for misconduct.

So as far as economics goes, there is no proposal right now really to change the US SEC. So the SEC will remain a lawyers’ agency, essentially concerned with enforcement, keeping the confidence of the retail investor, trying to somehow find the Madoff problems before they occur, which is inherently difficult because there’s always a new type of fraud that escapes detection. The economics will stay with the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). There are some proposals that will bring several of these mini peaks together on the banking side. And the economist monetary policy, macro-prudential, which is the current vogue word,

28 Bernard Lawrence ‘Bernie’ Madoff (born 1938) is a former stock broker, investment adviser, non-executive chairman of the NASDAQ stock market, and the admitted operator of what has been described as the largest Ponzi scheme in history. In March 2009, Madoff pleaded guilty to 11 federal crimes and admitted to turning his wealth management business into a massive Ponzi scheme that defrauded thousands of investors of billions of dollars. (Source: Wikipedia)
will reside in the banking sector and not in the SEC.

TONY D’ALOISIO

Ian?

IAN HARPER

Thanks, Tony. I think the question identified another dimension of the challenge associated with blurring of the boundaries amongst the regulators. When Wallis created APRA and ASIC, it was well and truly in our minds that APRA would essentially be dominated by an economists’ culture and ASIC by a lawyers’ culture. After all, ASIC was the enforcement agency.

I think that should continue; there clearly needs to be an enforcement culture in ASIC. But let me put this to you: the more ASIC has a role to play in systemic risk management, and if ASIC finds itself prudentially supervising mortgage trusts and possibly hedge funds and maybe even securitisation vehicles, the more it will need to acquire an economists’ toolkit and adopt the economic way of thinking about things. Certainly if ASIC wants closer conversations with APRA and the Reserve Bank, it has to have that framework in mind.

This is yet another dimension of the likely culture clash that will come from having a less clear division among the regulators than we presently have. I’m not saying it can be avoided or even should be avoided, but it’s something that’s going to require careful management as we go forward.

MASAMICHI KONO

Yes, actually we are a legally-focused institution but we find ourselves having to coordinate more and more with our central bank and, particularly with regard to macro-economic analysis and also what we call macro-prudential policy. I would still argue that it might not be a particularly good idea to put everything inside the central bank because there are certainly conflicts of interest issues, but you need to have those resources coordinated and constantly debating with each other, given that we have this very complicated situation of interaction between the legal framework and macro-economic conditions.

GUILLERMO LARRAIN

Being an economist I have a sort of conflict of interest in what I will say, but I agree with Ian’s proposal. My feeling is that, and we would need to have a fluid discussion about this with colleagues in other regulatory agencies, it is critical that we use the same levels of information, and the same quality of information and analysis as central banks. I feel that, having now been in securities regulation for three years, our level of discussion is not exactly the same as theirs, and they do not consider us as part of the same level of discussion.

And this is very important if the Financial Stability Board remains as a sort of clearing house for where the regulation will go in the future—it is totally controlled by central banks. So the only way, this is my suggestion, the only way that IOSCO or securities regulators can be there and have a say is to speak exactly in their language because they control the tape.

TONY D’ALOISIO

Thank you.
The Financial Crisis and Securities Regulation: Towards Which New Fundamentals?

Guillermo Larrain

Superintendent, Superintendence of Securities and Insurance, Chile
Chairman, IOSCO Emerging Markets Committee

Presentation prepared for the ASIC Summer School
Securities and Investment Regulation Beyond the Crisis
Melbourne, March 2010

A simultaneous Minsky process: building up a bubble-prone economy

Sub process I: Ex ante stability gradually appeared

- Great Moderation*, ex ante more stable economy
  - Monetary policy
    - Better understanding of the monetary process (1980's and 90's)
    - Improved institutional design for Central Banks (1990-1998)
    - Inflation targeting scheme (1990-1999)
  - Larger service sector, better inventory management,…
  - Better fiscal policy (despite large debts): US and EU (1990's)
- Inflationary pressures faded away even faster due to
  - The IT supply shock: improved productivity
  - Emergence of China and India as economic powers with low costs
- (Political risk fell due to the fall of the Berlin Wall)
- All these led to a period of supposedly increased stability
  - Risk premia fell across the board (eventually overshoot long term level)
  - Individuals and firms increased leverage (eventually too much)

Sub process II: Sowing instability

- Deregulation
  - 1980 Monetary Control Act
  - 1982 Garn-St Germain Act
  - 1988-1999 gradual abolition of Glass-Steagall Act
  - Persistent regulatory consent to the appearance of unregulated entities (eg., hedge funds), unregulated markets (eg., CDS) and uncooperative jurisdictions
- Liberalization of capital flows (without proper institutions in place)
  - Europe (crisis in early 90’s: Pound expelled from MU, Swedish crisis)
  - Mexico (1994-95) – OECD accession process
  - Asian Crisis (1997-98) – Korea under OECD accession process
- Regulation
  - Procyclical capital requirements (due to risk endogeneity)
  - “Procyclical” accounting standards (ie., fair value accounting)
- Lax Monetary policy: without creating inflation avoided two recessions associated to bursting bubbles
  - Bubble on Asian assets, that led to the Asian crisis
  - Bubble of High Tech assets, that led to the dotcom crisis
Rethinking the fundamentals: The impact of the changes on the financial markets of the future

What we thought we knew…

Blanchard, Dell’Ariccia and Mauro (IMF, 2010): we thought we knew that the appropriate macro framework included

1. Limited role for fiscal policy
2. Stable inflation
3. Low inflation
4. One instrument: policy rate set by Central Bank
   - Real effects of monetary policy came through interest rates (and asset prices). No role from money aggregates
   - Interest rates and asset prices were linked through arbitrage:
     - Liquid markets
     - Long rate was weighted average of future short rates
   - Asset prices given by fundamentals
5. Financial regulation was not considered a macro policy tool (and they are almost uniquely considering bank regulation)

What we thought we knew…

- Irrational behaviour was unimportant
  - It cancelled each other out: “Rationality” or “bounded rationality” mattered at the individual level but not at the aggregate. The market worked as if rationality were the rule (assumption)
- Risk was understood and kept under control:
  - Sophisticated models assumed exogenous risk because it’s too complex to endogenize. (Danielsson, 2001 and 2010). Risk is endogenous, VAR underestimate risk in “tail events” and becomes procyclical
  - Risk exogeneity assumes you know the distribution. What if not? Uncertainty
- Agency problems were solved: no externalities, no public goods
  - Basel II expected banks to act in a way that promotes confidence to their primary stakeholders (Caruana, 2010)
  - Internal risk models designed by banks were expected to induce them to have an appropriate cushion for risk taking. What about the asymmetry of information with the regulator itself? (Assumption) Without conflict of int, they can do it well
- Disclosure was a legal problem
  - As long as you disclose, we assumed you are being transparent

Reviewing fundamentals

1. The failure of the EMH (at least its strong form)
   - Rationality of the individual
   - Rationality of the firm
   - Transparency beyond disclosure
2. Regulatory consequences of financial markets’ systemic risk
   - Basel II / Solvency II: some lessons
     - Governance
     - Risk
     - Procyclicality
   - Competition in the financial sector
   - Governance of regulators
     - Rules vs discretion
     - National implications
     - International consequences
   - A special role for Hedge Funds?
The failure of the EMH

- The Efficient Market Hypothesis, according to Samuelson, first developed by Louis Bachelier at La Sorbonne in early 20th Century, was popularized by Fama in 1960-70
- A strict formulation is the following

\[ P_t = E_{\pi_{t \to \infty}}(P_{t+1}^* (1+r_{t+1}^*)^{-1}) \text{ given information set } I_t \]

\[ P_{t+1}^* = P_t + u_t \text{ with } u_t \text{ a forecast error} \]

- Simply speaking:
  - Market prices coincide with fundamentals, except for noise
  - Markets will incorporate into asset prices all available information
  - Process: Information is incorporated into prices by means of iterative transactions (liquidity) which marginally affect market prices driving them towards its fundamental value.

The underlying micro causes of the crisis

- The previous version of the EMH (―markets will incorporate into asset prices all available information‖) is a definition without clear mechanics (―iterative transactions which marginally affect market prices‖)
- Let’s use an alternative definition of the EMH due to Robert Lucas which is more workable

**traders**
will not miss the opportunity to make a gain, provided there is enough and timely information

The underlying micro causes of the crisis

- The previous version of the EMH (―markets will incorporate into asset prices all available information‖) is a definition without clear mechanics (―iterative transactions which marginally affect market prices‖)
- Let’s use an alternative definition of the EMH due to Robert Lucas which is more workable

**(rational) traders**
will not miss the opportunity to make a gain, provided there is enough and timely (relevant) information

1. Trader’s rationality
2. Transparency, disclosure
How rational were we?

• “The trader”. We think of the trader as the one rational agent that using all available information would take —optimal decisions“. There is too much evidence that this was not the case in this crisis.

• Olivier Blanchard, Chief Economist of the IMF, said
  – investors replicated the price pattern of the last couple of years to forecast the behaviour of real estate prices in the next couple of years.
  (Recall Minsky: stability is destabilizing because capitalists have a herding tendency to extrapolate stability putting in place ever-more risky structures that undermine stability)

• Ben Bernanke, Chairman of the Federal Reserve, testifying before Congress on September 23, 2008 said
  – “the troubles at Lehman had been well known for some time, and investors clearly recognized— as evidenced by the high cost of insuring Lehman’s debt in the market for CDS— that the failure of the firm was a significant possibility. Thus we judged that investors and counterparties had had time to take precautionary measures” (Caballero and Kurlat, 2009).

Individual rationality and its limits

• Rationality. How bounded or limited is the economic agent’s rationality. Among other issues, behavioural finance has identified that individuals
  – tend to stick to prior beliefs,
  – look for closest match to past patterns ignoring probabilities
  – attribute events that confirm their actions to their own high abilities
  – successful traders have an exaggerated opinion of themselves (they beat the market)

  so that feedback effects appear in the market (as inexplicable randomness)
  inducing prices to depart from fundamentals

• The tricky thing is this: once involved in an unstable path, it may be rational to continue.

• Does it matter? In normal times not so much because “most of the time people’s actions cancel each other out” (crazy buyers with crazy sellers)

• But rarely the market is managed by individuals.

Firms do the task.

The complex rationality of corporations

Corporate Governance

Beyond individuals, firms have strategies and structures of control and surveillance of traders

Firm’s rationality depends on

– Individual’s rationality (behavioural finance)
– Intentional governance of the firm (following Oliver Williamson’s words as opposed to spontaneous governance or Adam Smith’s invisible hand)
– Context
  • Regulation (including accounting issues)
  • Competition
  • Taxation
Issues of Corporate Governance

• Remuneration:
  – Bebchuck: Managers influence performance-based remuneration, both level and conditions. Boards have little say.
  – Remuneration schemes are unduly complex and opaque
  – Akeloff-Kranton: performance pay is hard to monitor, attracts risk takers, easy manipulation
    • Boards
      – Independence: Necessary (but not sufficient) condition:
      – How are boards chosen? What incentives do they face?
      – Boards should enforce decisions
    • Risk
      – (a) identification, (b) understanding, (c) management, (d) timely communication
        • Danielsson-Shin: Endogenous risks and Tail events
        • Risk manager should report straight to the board and
        • Should not be a cost centre.
    • Specific concerns:
      – Credit rating agencies
      – Auditors
      – Institutional Investors
      – Regulators

Disclosure and Transparency

• We securities regulators are permanently looking for more transparency. We believe information is necessary for markets to work properly.
• But, what do we mean by “enough information”? 
  – Is “enough information” that contained in prospectuses of hundreds of pages?
  – Is it enough the innumerable quantity of notes to financial statements under IFRS? We need some standardization of information
  – When significant portions of information are unknown (such as the size and characteristics of the CDS market, the positions of Hedge Funds, etc…) a shock may create uncertainty if that hidden information is useful to understand the underlying distribution (Knightian uncertainty)
• This crisis suggests that eventually not. We now know that most of that information was basically useless, nobody read it.
• Traders or more generally investors finally did not take into account all available information.

Governance of regulators

• Why should change governance of financial regulators?
  – The systemic effects of financial markets,
  – The failure of traditional macromanagement based on monetary policy
  – Macroprudential policies (as proposed by BoE) need to consider securities
  – Minsky process just talk about capitalists: regulators are also part of it
• Which changes do regulators need?
  – Rules vs discretion.
    • If prices depart from fundamentals and monetary policy can’t solve one market disarray, financial regulators can focus on the bubble. This means discretion to act.
    • Discretion is ex post inefficient. Governance rules should mimic Central Banks: an hybrid model mixing rules and discretion under transparency
  – Conventionally wrong vs unconventionally right.
    • Fighting a bubble is unpopular. Regulators need to be independent, transparent and accountable enough to properly do so.
  – Appropriate financing conditions
    • A condition for effective autonomy, financing must be secure: many regulators receive funding from government (like SVS, Chile) or congress (SEC, US).
  – Research and policy actions: towards market reputation
    • Identifying bubbles and taking care of them requires extremely sophisticated analysis. Financial regulators should devote resources to build reputation in this regard
International governance of regulators

• Considerations
  – Bubbles are often not country specific: international action is required to identify bubbles and tackle them.
  – Unpopular measures may induce national pressures to avoid stopping the party.
• Therefore
  1. A web rather than one leader
  2. Intellectual competition rather than consensus
  3. A dynamic composition of concerned countries rather than a fixed group

International governance of regulators

1. A web of various parties engaged in intellectual competition
   • We need problems to be raised despite some countries being interested in denying issues or postponing their treatment.
   • A unique leader institution in charge of macroprudential supervision may be kept under the influence of few jurisdictions.
   • A web of international organization in charge of diverse issues may be better protected from those influences:
     – IMF, WB looking for anomalies at the global level dev/no dev
     – IOSCO, BCBS, IAIS, IOPS, looking at the situation in various markets
     – Regional banks looking at regions
     – All of them compete to bring to the market news from the market.

2. A dynamic composition of concerned countries rather than a fixed group
   • The G20 is a group formed during the Asian Crisis. We need to grant countries outside G20 that there will be some room to participate. We cannot freeze that membership.

Let's be careful about competition

• Reason 1: Competition and financial innovation. We need to take a closer look at how competition takes place in financial markets:
  – One general model:
    • Competition induces innovation
    • Innovation spreads fast
      – within the financial industry
      – across countries
    • Herd behaviour
    • Outcome: being conservative may not be a dominant strategy when all other participants play risky bets.
Let's be careful about competition

- Reason 2: competition and the length of deviations from fair value
  - Several authors have documented prolonged significant deviations from fair value (i.e., some ex post long term estimate of it).
  - The time length of such deviations impede arbitrage taking place, even if some traders (firms) even wish so:
    - If prices are considered too high, a short seller may pass quite a long time waiting for the correction and eventually run out of funds
    - If a manager simply sells an asset judged to be overvalued, and the correction does not take place in a short time, it will lose clients.
  - These elements induce more herd behaviour and to some extent prolong the over/under valuation

Let's be careful about competition

- Reason 3: concentration and strategic behaviour
  - Financial markets have become more concentrated in the last decade.

<table>
<thead>
<tr>
<th>Market</th>
<th>Largest Ten</th>
<th>Concentration</th>
<th>Top Ten</th>
<th>Pan-Global</th>
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<tr>
<td>Treasury securities</td>
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<td>6.67</td>
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<td>Corporate bonds</td>
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<td>Other securities</td>
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<td>Federal agency</td>
<td>600</td>
<td>1.20</td>
<td>45.5</td>
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</tbody>
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- An example: Credit Rating Agencies
  - For all practical purposes, the world market for rating services is an oligopoly and they face conflicts of interest
    - rating the same firm that pays for it and
    - providing it with additional services designed to improve rating
  - An oligopoly does not help: strategic behaviour is easily attained.
Final words

A joke…

… and a thought

The thought: remember Churchill…

―The era of procrastination, of half-measures, of soothing and baffling expedients, of delays is coming to its close.

In its place we are entering a period of consequences‖

Winston Churchill, November, 1936
Re-thinking the fundamentals

Professor Ian Harper
ACCESS ECONOMICS
1 March 2010

What have we learned?

- Systemic risk is pervasive and lethal, and afflicts financial markets as much as financial intermediaries
  - excessive leverage is still the underlying source of asset price bubbles but the capacity for leverage is greatly expanded in a globalised financial market
- Financial markets can suffer the equivalent of a ‘bankrun’
- Asymmetric information is more ubiquitous than we thought
  - securitisation also suffers from information asymmetry in spite of the ‘transparency’ of the instruments and vehicles involved

Balancing stability and efficiency

- Optimal financial regulation has always sought to balance stability against efficiency
- Chief lesson of the GFC is the need to re-strike this balance going forward …
Are financial markets efficient?

- Two distinct senses of ‘market efficiency’ —
  - ‘Fama efficiency’ – can trading rules generate supernormal economic profit, i.e., cover fully attributed risk-adjusted costs?
  - ‘Pareto efficiency’ – is there another set of prices and allocations which Pareto-dominates the outcome of trading on competitive markets?
- The GFC has not necessarily invalidated Fama efficiency – this is an empirical question
- It has widened the scope for government intervention to override Pareto-inefficient competitive market outcomes

Global regulatory reform

- G20 Pittsburgh Summit 2009
  - hold more and higher quality capital
  - develop international standards of compensation
  - launch framework for coordination
- Financial Stability Board (FSB)
  - charged with coordinating and monitoring the progress of international financial reform
- BIS - financial intermediaries
- IOSCO - securitisation and OTC markets
- IASB and FASB – accounting rules

How should Australia respond?

- Australia’s regulatory framework needs review and adjustment but not a major overhaul
  - moves are already afoot to tighten capital and liquidity standards
  - credit rating agencies now required to be licensed
- A key concern for Australia is that regulatory reforms agreed through the G20 are neither appropriate nor necessary for Australian conditions
  - debate is just beginning about how best to facilitate ‘mutual recognition’ of Australia’s response to regulatory reform
Implications?

- Higher cost of intermediation and lower ROE for intermediaries
- A filip to a new round of disintermediation?
- May force local regulators’ hands – e.g. concern over hedge funds/shadow banks may force prudential regulation of Australian mortgage trusts
- Higher cost of capital will be passed through to Australian business, slowing growth and reducing access to intermediated credit
- Australia’s regulators may face demarcation issues

Conclusion

- The scope for failure of financial markets is wider than we thought
  - information asymmetry afflicts markets as well as intermediaries, at least during periods of acute stress
- Scope for regulatory intervention is accordingly greater
  - regulated outcomes are Pareto-superior to market outcomes
    - again, at least in times of stress
- Re-draw (thicken?) boundaries between prudential and disclosure regulation & strengthen them both
  - more risk of overlap and duplication between ASIC & APRA

Thank you
MONDAY SPECIAL EVENT

2016—The Great Moderation Revisited

Panel discussion

Moderator Mr Peter Couchman, former ABC journalist and TV presenter
Mr Roel Campos, Partner in Charge, Cooley Godward Kronish LLP (previously Commissioner, US Securities and Exchange Commission)
Ms Jane Diplock AO, Chairman, Securities Commission, New Zealand
Mr Hans Hoogervorst, Chairman, Netherlands Authority for the Financial Markets
Dr John Laker AO, Chairman, Australian Prudential Regulation Authority
Mr Guillermo Larrain, Chairman, Securities and Insurance Superintendence, Chile
Dr John Stuckey, Senior Adviser, McKinsey & Company
Mr Greg Tanzer, Secretary-General, OICV-IOSCO General Secretariat, International Organization of Securities Commissions

PETER COUCHMAN

For tonight’s hypothetical, we’re going ask you to gaze into the future. We have a very distinguished panel to lead the exercise, and the good fortune of being able to draw on expertise from around the world. So, I think the discussion will prove to be both stimulating and insightful.

Now, we’re going to fast forward six years to 2016. Just imagine it. We’ve got a pretty fair expectation of the Australian population rising to around 24 million, and of a growing economy fuelled by a resources sector funded from overseas. And we’re expecting to see gross domestic product (GDP) growing at an annual rate of about 5–5.5%.

But in the broader scheme of things, globally, this will be a mere drip in the pond. For example, projections for the US economy, the world’s biggest, are at present showing its national debt doubling by 2016, and reaching nearly 100% of GDP by 2020.

So what will the global economy look like in 2016? Jane, what do you think?

JANE DIPLOCK

Well I think that if we look at securities markets, we’re certainly going to have a much more integrated global economy. Certainly markets, if they were already integrated during the global financial crisis, they’re likely to become even more so.

I hope we’ll see one set of global accounting standards. I hope we’ll see much more mutual recognition of market regimes. So we’ll see mutual recognition of different countries’ regulatory frameworks, even if not completely identical.

I hope we’ll see all countries implementing—or working very steadily towards implementing—all of the International Organization of Securities Commissions (IOSCO) principles and regulatory cooperation becoming a routine matter of course, so that it will be ‘business as usual’ for all regulators to be cooperating with fellow regulators.
I think we’ll see the Chinese market become much more open, and other countries finding it much easier trading into China.

I think we’ll see much more automated trading. I actually think computerised trading, or trading by robots or however you like to say it, will become flavour of the month. And if you ask me what the next crisis might be about, I suspect we might see some market manipulation issues involved with that sort of trading, and regulators might find it very challenging to keep up with the speed and scope of these technological developments.

PETER COUCHMAN
We’ll come to the challenges the regulators might face in just a moment, but Roel, do you agree that we might be fending off Armageddon in 2016?

ROEL CAMPOS
Well, I think the US will continue to have a few issues. We have close to 10% unemployment and that will come down very slowly in the US, given that the only fast way to reduce unemployment is to have very robust conditions in the construction industry and basic manufacturing industries, which we don’t have at the moment.

I don’t think that government debt in the US will be as bad as you’re indicating. I think President Obama will get re-elected for a second term, despite the tough times in the US at present, and there’ll be some constraints on the US debt. I’m not suggesting we’ll have a balanced budget any time soon, but we will have a structure in place for bringing down debt, including by way of new taxes, perhaps on energy, or perhaps even in the form of a value added tax, which we haven’t had before in the US.

I also think we’ll continue to see banks with ‘bad’—and hard to shift—assets on their balance sheets. That will continue to be a drag on our economy and regulators will be challenged for the next four or five years over how to clean up those bad banks and get them lending again.

PETER COUCHMAN
Hans, are you as pessimistic about 2016?

HANS HOOGERVORST
Well I just called my aunt who emigrated to Australia in the 1950s, and said there might be a good chance of me following in her footpath in five years time to escape taxes and inflation in Europe, and find a good home here in Australia, which is a really wonderful country.

PETER COUCHMAN
Guillermo, what about South America? How do you see the future for your part of the world in 2016?

GUILLERMO LARRAIN
Well we are quite dependent on international developments and on the state of the world economy generally. And what I see in that regard is more storm clouds than sunshine ahead of us. I’m thinking of the financial reforms that should follow on from this crisis, and my feeling is that we are advancing extremely slowly, and we don’t know exactly what will ultimately happen in the US. I agree with the comment in today’s New York Times saying it would be better to have ‘no reform’ than merely ‘mild reform’. Without significant reform in the US, and given the fiscal problem threatening the European Union mentioned by Hans this morning, I’m actually quite pessimistic. And that’s without even mentioning China.

PETER COUCHMAN
Where does China fit into all this?
ROEL CAMPOS
There’s going to be a trade war—I’m certain of that. I think the Chinese are incapable of doing the sensible thing and letting the yuan appreciate. They are politically incapable of that because the state is in the hands of their industrial sector. It’s far from a democracy, and will not be a democracy for a long time to come, and that will inevitably ignite a trade war with the United States and Europe.

GUILLERMO LARRAIN
The politicisation of China’s exchange rate policy carries a real and major risk. And the other thing everyone talks about—but which I haven’t seen comprehensively analysed—is the condition of the Chinese banks. After decades of trade growing at 15–20% per year, you would normally expect some problems in the banking sector, but we haven’t seen that yet. And that’s another storm cloud among the many on the horizon.

Latin America itself is not in bad shape: Brazil is doing wonderfully well; Mexico is in fine shape; and Peru is doing very well. We have problems with some other countries, but those countries and my own country, which is now beyond the earthquake, are all doing it fine. So Latin America as such is not in a bad way. The problem is the exposure to the global environment.

PETER COUCHMAN
Can we turn now to the question of who is going to be driving the world economy? Not the United States, I think you indicated, Roel?

ROEL CAMPOS
Well, driving is a relative term. I think, despite all this gloom, when I look at the economy and the prospect for innovation in the US, and not to be overly defensive about it, but the country still seems to be driving technological innovation, whether it’s in the form of Apple iPods or whatever. And so long as innovation continues to be strong in the US—because of its culture, its entrepreneurial spirit and its investment in R&D—then that system will continue creating the right conditions for world growth, certainly for the next five years.

Now, over another generation things will change, but when I look at national cultures in, say, Europe or in Asia, I don’t see that same drive for creativity or innovation that still seems to be alive and well in the US.

GREG TANZER
Peter, if I might just comment on that, I think a critical aspect of this crisis is that it started in the most developed markets of the world, but then went on to infect other markets, including the emerging markets. But the emerging markets managed to find their way through this, and that has given a number of them a great deal of confidence in the way their economies are developing. Even in Africa, a continent riven with strife for one reason or another over hundreds of years, confidence is growing that the region could become the ‘new Asia’, that is, a new force in the world economy based on its undoubted potential, especially in the resources sector, if they can just get their governance issues resolved, and their sources of development capital lined up.

So I think there may well be a change in the way countries see themselves, from just following the course and meeting the needs of the developed world, to thinking more autonomously about, and taking more responsibility for, how best to chart their own future course.
PETER COUCHMAN

Let’s move on. Within the global economic context in 2016 that you’ve painted for us, what do you think the securities markets will look like? Jane gave us a hint there of what she thinks, but what do the rest of you think? How do you see the exchange and securities markets operating within this global economy that you’ve painted?

GUILLERMO LARRAIN

My sense is that over time the markets will get more organised because investors find that organised markets work better for them. So what you will see are more securities traded on the exchanges—whether stock exchanges or futures exchanges. And that’s going to be a very important development.

I would like to see retail instruments like consolidated debt obligations (CDOs) being unbundled—to some extent, at least—into separate components with their own particular risk attributes, so that the composite risk can be distributed among specific retail clients, according to their risk preferences. And I would also like to see improvement in corporate governance. We have been extremely naïve about governance practices and governance regulation, and we need to think quite a lot more on the issues involved.

HANS HOOGERVORST

Guillermo mentions the word CDOs, and what I find interesting is that it is actually banks that are able to write insurance against sovereign risk, against the risk of states failing, while the banks are themselves being supported by the state. How can this be possible?

ROEL CAMPOS

The government can print money. That’s how it’s possible.

PETER COUCHMAN

We’re still in 2016. Have we seen only ad hoc fixes for the problems of the past, or have we actually been able to create a new regulatory system for securities markets that results in them operating both efficiently, and to the benefit of consumers?

ROEL CAMPOS

I think that we’ll have made progress, but we will not be anywhere near nirvana or any great accomplishment in five years. I think that the world will remain competitive, and that what we need internationally is a common understanding. Otherwise, we’re still going to have regulatory arbitrage across different jurisdictions, and those with lower standards will attract more business. It was only a couple of years ago that we were talking about light-touch jurisdictions being exploited by hedge funds and so forth, and we still have those problems. We still have to figure out what to do with global universal banks. I don’t think jurisdictions that support large banks are going to want them broken up, and there are benefits to business in having a large balance sheet.

The problem ends up being: how do we make sure those big banks don’t again collapse and need to be bailed out? To me that means going back to some sort of system of reserves and some restrictions on leverage. But the world has yet to agree on that, and may never really fully agree on that. And then the quality of capital is always being debated. And then finally, in every jurisdiction, certainly in the west, you have lobbying going on. You have essentially the industry lobbying or pressuring the regulators to go easier on them by relaxing the capital requirements. That is what has happened historically, and that hasn’t changed, despite the crisis. Memories are short, and after a year or two, they’ll continue
to pressure governments and politicians to make their life easier.

PETER COUCHMAN

What do you think, Hans?

HANS HOOGERVORST

I think we need to convince our people that you can at the same time be both tougher on your financial system, and remain competitive. Australia has shown that, Canada has shown that, India has shown that. Mind you, Asian countries that suffered from the crisis in the late 1990s have also shown that. In the short run, it might be damaging to their competitive position. But a crisis like this shows that, if you are more prudent in the good times, and you don’t allow profits to go as high as you might wish, you may end up being much more competitive in the long run. That is the real story that we have to get across.

PETER COUCHMAN

John Laker, have we achieved any kind of consistency in the regulatory system globally in 2016?

JOHN LAKER

Well, before I heard Hans speak this morning, I would have hoped, to use the language that Jane used, that by 2016 we will have higher and stronger minimum capital standards, we will have higher-quality liquidity buffers, and we’ll have a framework to deal with excessive incentives for executives. There’s a lot of work to go, but I think there’s momentum behind those reforms.

But they are minimum requirements and I have another perspective. I think I’m the only prudential regulator sitting round the table. Now, we prudential regulators have a lot of endearing qualities. One of them, which I’m learning is not unique, sitting next to these two gentlemen, is that we are pathologically paranoid. I get paid for it.

And the concern we have, if you want to paint the optimistic scenario for Australia, is that these minimum standards may not be enough to curb complacency. We’re hearing black stories around us, but I think you have very good reasons to be optimistic about where Australia will be in 2016.

The danger from our point of view is that Australian financial institutions will quickly forget the lessons of 2008 and 2009—it wasn’t as near-death an experience as it was in other countries. With the usual Australian enthusiasm, it could be ‘hats in the air’ and we’ll find in 2016 that we’re trying to rein in exuberance, rein in aggressive strategies, we’ll be fighting against cut-backs in risk management functions. All of those are manifestations of the sense that it’s blue sky ahead.

So I think that, from our perspective, we’ve got a good story to tell and we hope it will be the same in 2016. We hope we are supported by stronger global foundations but we still have to make sure that the memories of 2008 and 2009 are front of mind for a long time to come.

PETER COUCHMAN

What are you thinking here, John Stuckey? Will it prove possible to achieve any kind of consistency in a global regulatory system, or is that a pipe dream?

JOHN STUCKEY

I’m not a global regulator, Peter, but my guess is no. My casual observation of international organisations post World War II is that they’ve achieved not very much, in terms of unifying anything. So I wouldn’t be terribly optimistic. But I’m just looking at the past track record, so I don’t really know.
But what I am perplexed about is the shift in mood over the day. This morning we had a number of sessions which made it look like Australia was absolutely on top of all this. We had the Governor of the Reserve Bank, we had John Laker, we had a senior representative from Treasury, and the message was: Australia is just going to walk it in.

Then tonight I hear some very cloudy and gloomy scenarios, including even that China’s going to go down the drain. So is there a juxtaposition here that makes any sense? How can the Australian economy have so much promise, when we’re also visualising such a problematic global economy? To answer my own question—and others may have a different view—if China does go down the drain in some sense or other, I think it will make life a lot more difficult for us, so I do have concerns about some aspects of the Australian situation.

For example, we cite the favourable prospects for the mining sector as if that sector accounted for 75% of GDP. In fact, the mining sector share is 3 or 4% of GDP—it’s a drop in the bucket. The bulk of Australian GDP is in sectors like health, education, services, transport logistics, retailing. And I’m seeing productivity in those sectors going absolutely nowhere.

We’ve been fortunate in having this sort of dual economy, where one part is pumping out natural gas, coal and iron ore—from places that none of us actually visit much—and we put it on ships and we send it off to China and Japan and so on, as we have for a long time. But for the other part of the real Australian economy—where all of us actually live—I’m not feeling all that optimistic. Our banks have got the cosiest oligopoly in the world, allowing them to jack up margins. I could go on.

**PETER COUCHMAN**

I might ask some of you others to join in here. If we’re assuming that come 2016 we’ve had to give away any serious thought of achieving consistency of standards globally, are we going to have regional differences and different jurisdictions applying their own standards? And are some of the weaker jurisdictions going to pull down the broader aspirations of the more idealistic economies? Greg?

**GREG TANZER**

Well, just in defence of international organisations, frankly, it’s pretty hard to get everyone to agree to something. You’re talking about a lot of people all around the world with different levels of development, different backgrounds, different aspirations, so this is a difficult task. But I do think we have seen over the last 12 months some unprecedented and incredibly well-coordinated global action in this joint effort to stimulate the global economy.

Now, you can argue that we’ve had a terrible problem and we shouldn’t have been there in the first place. But if you reflect on this past year, we have had 20 jurisdictions around the world all agreeing to stimulate their economies and to reduce interest rates in a coordinated fashion, and that was a pretty impressive effort. And I can tell you there’s a lot of effort going into dealing with the aftermath and trying to avoid the potential for this to recur in future.

What we all absolutely know now, is that all of this is interconnected. So if you’ve got a weak spot, you know, the water’s going to flow to there and then it’s going to go down the drain hole and disappear. So we’ve all
got an interest in trying to make sure the system works. I don’t by any means say that that’s easy, but there’s a lot of effort going into that at the moment, and actually a lot more good will than I’ve previously seen in my experience.

PETER COUCHMAN
All right, well how are the rest of you feeling about this?

HANS HOOGERVORST
Well, you know, the problem with this debate is you picked the wrong year. Long term I’m very optimistic; I completely agree with Guillermo. There is absolutely no way to hold back the emerging economies in the long run. Asia is going to continue being very important into the long term, and do fantastically well economically. It is just that the damage that has been inflicted by this crisis is so severe that it will take at least a decade to work through it. And so that is why, if you talk about 2016, I’m still very pessimistic. And we’ll make a lot more mistakes before we will find the solutions.

PETER COUCHMAN
Jane?

JANE DIPLOCK
I’d just like to add something to what Greg said, and really to perhaps challenge John’s analysis, which may be very fair for every other international organisation, but isn’t fair on IOSCO. And the reason is that, despite the difficulties that Greg’s outlined, we have got enormous consensus and global agreement on the way in which we exchange information about enforcement.

In IOSCO, we set ourselves the objective in 2005 of having our entire membership—covering over 95% of the world’s capital market—signed up to a fully-audited, tough agreement by 1 January 2010. And ladies and gentlemen, we did it. We have 60% that have signed up, put their legal frameworks in place, and been audited. And the other 40% have ‘hand on heart’ agreed to make the necessary legal changes.

Obtaining that outcome just through the power of persuasion and a spirit of cooperation is actually an amazing achievement, in my view. And we might have been prescient in a way, because without that infrastructure, most jurisdictions, including our own, would not have been capable of participating in a cooperative cross-border response to the sort of tricks and deceptions that went on during the global financial crisis. In the great scheme of things that might seem a small triumph, but to those of us in IOSCO, it was a big triumph.

PETER COUCHMAN
So you’re modestly optimistic about the possibility of achieving a broader consensus by 2016?

JANE DIPLOCK
Well I’m not unreservedly optimistic. I agree with Hans that we have set ourselves a very short time frame, frankly. And if we think that the pattern of forgetfulness and then exuberance comes in about seven year cycles, then by that time we may be just about to move into the next cycle.

PETER COUCHMAN
That leads me to the next question I was going to put to you, by way of summing up. How robust do you think the regulatory system is likely to be in 2016?

JANE DIPLOCK
Well I think we need some new thinking on the regulatory frameworks. And part of it goes to some of the things we were talking about this morning. We’ve been following an orthodox approach in how we think about
regulation, based on the efficient market theory, and so on. Now, we shouldn’t throw all that out the window, and of course market disciplines still matter, but I think we have to start to think in a far more focused way about suitability, for example. It may well be that we need to rethink the whole question of who gets sold the products, and how well they understand them, and what are they buying into. There might need to be two markets in the world: one that sells mysterious, complex products to mysterious, sophisticated people; and another that sells simpler products we can all understand to the rest of us. Now, that’s in a way contrary to current orthodoxy, but maybe that’s where we need to go and where some rethinking needs to be done.

GREG TANZER
I think Jane’s hit on a very important point there. I think regulation will be more robust in 2016; I’m reasonably optimistic about that. But if it is going to be more robust, we’ve got to take a lot of ambiguity and mystery out of the system.

You know, we used to see—and John will be familiar with this—the term ‘constructive ambiguity’ pervading the prudential world. You had this unspoken promise in the minds of the public that no bank would fail, but there was the ambiguity for banks that you didn’t guarantee them, because you didn’t want them to engage in really risky activity. That ambiguity has, in a sense, now gone, because we know that if you’re a big bank, you won’t be allowed to go to the wall. And regulation should be structured to make that quite clear.

And Jane’s hit on another very important point, too. If you’re a customer, an investor, you need to know: what is a safe thing to put your money in, and what is at risk, and what is at greater risk. Because otherwise we will have everybody expecting that everything that they invest in is safe. And that would mean a financial system and a regulatory regime that try to take all the risk out of the system. That would be a disaster.

PETER COUCHMAN
You’ve identified one of the things we’ll need to deal with in the run-up to 2016, which is the consequences of the big government bail outs, such as the precedent of some banks knowing they’re ‘too big to fail’. We can’t kid them anymore, can we? What are the consequences of that in 2016?

JOHN LAKER
Peter, can I go back to your earlier question about the robustness of the financial regulation framework in 2016?

I think it will very much depend on how sensible are the proposals that we’re currently evaluating and whether they address the problems that the global financial system manifested. To plagiarise Professor Harper, a key question is, ‘How come, teacher, that the whole class is in detention because two boys were caught smoking?’ This is a really difficult issue because the banks that transgressed, that ran the most aggressive risk policies, were not large in number.

The global solution has to address the excessive risk these banks took on, without at the same time penalising everybody else and dragging economic growth down. If we can get the reforms into a sensible shape so that they really are targeting the transgressors, but not those institutions that did well, then I think we will have a more robust system but one that won’t require anywhere near a comprehensive or draconian set of reforms in 2016.

PETER COUCHMAN
Guillermo?
On the question about how robust will the system be, I would like to go back to the joke I made this morning about not fooling ourselves over what we can realistically achieve.

For instance, if we insist on making our companies—insurance companies or banks—adopt very complex models for making risk assessments, we’ll be fooling ourselves, because what this crisis taught us is that we don’t really understand the risk process, at least for very damaging events in very extreme situations such as when you are in a crisis. If you accept that, it means that you need to use a different approach to risk and to capital requirements, or technical reserves in the case of insurance companies.

And it’s the same with rating agencies; we are all aware of the problems they have. And many countries, including my own, have rating agency classifications embedded in their law. So why don’t we do the right thing, which is to take all those things out of the law, and just leave them as benchmarks for the market to use, instead of forcing investors to take insufficient care about their investment decisions.

In regard to the ‘too big to fail’ issue, Hans said something this morning that was very interesting. He said, ‘There cannot be a private enterprise that it is too big to fail’. If it is private, then it must be allowed to fail. And if not, it’s not a private enterprise. Now I’m not talking about nationalisation or state ownership. I’m talking about ‘essential facilities’ that need to be regulated with a different logic.

If banks want to be as large as some are, then ultimately they will need to accept that they are essential facilities and will be regulated as such. If they don’t want this, then we need to take a different approach. And the different approach, in my view, is closer to Mervyn King’s approach, which is some form of Glass-Steagall Act, different of course, but close to that. I believe that’s appropriate. Then you have a part of private enterprise that can fail, and another part under tighter regulation which is not risky.

Peter, I’m not a regulator, but it seems to me from the recent experience that if I’m CEO of a big bank, I’m going to make sure I’m in the ‘too big to fail’ category, because the government has essentially just granted me a virtual free option. And the free option is that if you do something risky and it fails, no worries, we will pick up the pieces. If you take a risk on the right-hand side of the probability distribution, no worries, the bank’s going to do well and you will get paid extremely well. So what am I going to do? I’m going to take punts that have a reasonable chance of having my bank end up on the right-hand side of the distribution, all the time feeling safe because the government will save us if by chance we end up with a ‘black swan’ on the left-hand tail of the distribution. Now, I’m not saying CEOs would be quite that irresponsible, but that is the trend.

Let’s bring it back home in Australia—and I don’t expect John to make any comments about this—but definitely the big four banks are in the ‘too big to fail’ category. And recent experience might suggest that the second-tier banks are also in that category. And we haven’t even talked about insurance companies. So it’s as if they’ve all been underwritten by the government.

So do you end up limiting the size of institutions to ensure that there’s nothing
that’s big enough to bring down the whole economy?

JOHN STUCKEY
I wouldn’t do that in a direct way. I’d be interested to see what the actual experts say about this, but it seems to me—with my economist’s hat on—that from a society point of view, we’re saying that there are diseconomies of scale in financial institutions. That is to say that you’ve got an increasing cost function, if you take account of the related external collective costs. And therefore we need ways of actually having each bank believing that it faces an increasing cost function, particularly as a function of the complexity of the instruments on the balance sheet. If you can somehow do that, so that the institution incurs more expense as it moves further out in both risk and size, then you start to get a self-correcting mechanism.

PETER COUCHMAN
Roel, what do you think?

ROEL CAMPOS
Well I think what’s going to happen in the US—and not necessarily because of the efficient market theory—is a practical response in the form of an effort to develop a systemic risk regulator. Different ideas have been thrown out in this debate, and it’s not exactly clear whether it’s going to be the US Federal Reserve or some council of independent regulators. But essentially it will mean that companies that you can’t necessarily define, but you know them when you see them—the big global banks—will simply be regulated more carefully.

We’ll have what Hans talked about this morning: restrictions on leverage, capital requirements, liquidity ratios, whatever ends up being the right formula. And that may vary by jurisdiction, but essentially they will be monitored very carefully.

PETER COUCHMAN
So you limit the growth of these enterprises?

ROEL CAMPOS
Well yes, essentially these ratios set some limits. And President Obama, in fact recently, without a lot of consulting—which is a problem for our international situation—did come up with a proposal for restrictions on caps in terms of percentage of liabilities and so on. That’s still being debated.

But, again, if you want a casino, you can put it outside the traditional banking sector. And no-one is saying, for example, that the hedge funds—which most people agree were not the problem in this particular crisis—shouldn’t be allowed to take risks. Or that you can’t take risks through other means. It’s just that if you’re a deposit-taking organisation that has the benefits of low interest rates and the Fed discount window and so forth, then you should not be in a position to threaten taxpayers’ money. And some version or other of that model, I think, will be what we see across the world. The US will have its version, Europe will have its version, and so on.

PETER COUCHMAN
So there’ll be regional interpretations of the same principle.

ROEL CAMPOS
I think so, yes.

PETER COUCHMAN
Hans, you’ve been strongest on this. What are your views? How does it actually work? Are you quite happy to limit the size and growth of those institutions?
HANS HOOGERVORST
Well as an ex-politician, can I make a more general political comment?

There has been a horrible failure of the financial economic elite in the world, and also of many politicians. And this has tremendous long-term consequences, in terms of political support among the population for the market economy, if we don’t take drastic action very soon.

People are not crazy. They cannot accept that the people that caused this crisis have hardly paid a price. Warren Buffett today basically said the same thing. People cannot accept that after bailing out banks in Europe, we might have to bail out other countries that have willingly fooled the system.

So, if we are committed to maintain long-term public support for the market economy—and as I have said, I was a conservative politician, although in European terms I’m a liberal, and a firm believer in a free market economy—then it is absolutely necessary that we are going to do all that it takes, and I am not sure that we are doing so at the moment.

PETER COUCHMAN
Yes, John Laker?

JOHN LAKER
I was going to respond to John as well. I think both Hans and John have highlighted what the policy issue is, and it’s an equity issue, really, at its heart.

A banking system shouldn’t be built on a premise that management and shareholders get rewarded on the upside, and if the risk materialises as feared, the taxpayer cops the penalty on the downside. It’s just inequitable and it’s not sustainable over time.

So, one of the things that policy makers need to look at is the set of incentives that are built in for management and shareholders, and John’s highlighted the asymmetry there. If you do really well and you bet the bank in the short term, you get rewarded fabulously. But if you get the bet wrong, you should be ‘punished’ under the same set of financial incentives. And the shareholder in the end should be wearing the cost. There should be a genuine focus on ‘claw back’ and on balancing risk and reward much more than was the case in the lead-up to the crisis.

That’s why prudential regulators now are moving into the question of the incentives provided to executives. It wasn’t an area that prudential regulators previously touched. We knew that was one of the risk elements, but now we’re charged by the G20 with coming up with a framework, and my colleague John Trowbridge has done a lot of work in the Australian Prudential Regulation Authority (APRA) to put ours on the table. Prudential regulators round the globe are now zeroing in on what the chief executive and others are paid, and where is the give-up if things don’t work out? That’s part of the things we are building.

PETER COUCHMAN
So what are the risks that you’re facing in 2016? Now, Jane’s already reminded us that we tend to go from boom to boom in a period of about seven years. That takes us to the brink of another boom. And that has more or less been borne out by some research of Ken Rogoff and his colleagues at Harvard, just published recently, in which they looked at the last 700 years and they found that we

29 Kenneth Saul ‘Ken’ Rogoff (born 1953) is currently the Thomas D. Cabot Professor of Public Policy and Professor of Economics at Harvard University. (Source: Wikipedia)
go from boom to boom every seven years, and that the same things happen every time.

Every crisis has exactly the same features. And every time, somebody says: this must never happen again. Most of the crises have been driven by debt, usually from a housing boom, and inevitably the debt crisis is followed by sovereign debt crisis. In six years from now, 2016, are we facing another period of over-exuberance? Or this time, is it different?

JOHN STUCKEY
Well you might hope so, because then we could get the growth rate up in the meantime.

To stir the pot a little, I think we were fortunate to have the boom, because if you average things out over time, then you need the booms to make up for the slumps. And if the only way you can get the boom is to pay the price of a slump, then I’m happy to take that deal, because the average still comes out pretty well.

Just to be a little provocative, I don’t think it’s necessarily a bad thing. If we’ve been going with these cycles for 700 years and we’re all doing pretty well, then it’s not all that bad, is it?

GREG TANZER
It’s not that bad. But it’s the government subsidising the main risk that I’m concerned about, actually. It’s true the cycles are all a bit the same, but they’re not exactly the same, with due deference to Mr Rogoff, who’s studied the 700 years, so he probably knows what he’s talking about. Now, I haven’t studied the history to that extent, but I’m prepared to offer an opinion as long as you keep letting me talk, Peter.

The issue that worries me is that we focus on the safety of the market at the institutional and professional end, but we don’t give enough attention to all the difficult investment decisions that retail investors face. And the risk for the next crisis is that retail investors—as opposed to the professional investors who made the really bad decisions this time around—may be the ones making those bad decisions the next time round, and there may be no money to bail them out. And there’s actually not enough political support to bail out a stack of retail investors and that will be a huge personal tragedy for all of those people who are making no worse a judgement than people made this time around.

PETER COUCHMAN
Jane, are you and your fellow regulators in 2016 dealing with the onset of another period of irrational exuberance? Or this time is it different?

JANE DIPLOCK
No, I don’t think it is different. I actually agree with John to some extent, that the pattern is one which we should see as somewhat inevitable. The issue we have to be very careful about, though, is that we don’t create next time’s problem by overreacting to this problem.

One of the things that rocks around my head when I wake up at two in the morning and think about financial stability, for example, is that we can become so obsessed with financial stability that we see any innovation as a negative. And yet, we have had a very long stretch of financial improvement and periods of market buoyancy, which have actually helped the economies of many countries around the world.

So I guess I’m worried a little that financial stability becomes an end in itself somehow, and therefore the balance that Ian Harper mentioned this morning somehow gets out of kilter and we condemn ourselves in a way to a very dreary period where nothing much happens, but gosh it’s stable. Now, I think that’s a real risk and I don’t necessarily want
to see that happening either, so the fine touch is actually what’s important here. And I think that’s going to be something that we as regulators need to have a very clear view on.

**PETER COUCHMAN**

Guillermo, what risks are you dealing with in 2016?

**GUILLERMO LARRAIN**

Well to respond to two points, one from Jane and one from Greg. First from Jane: several people, including Adair Turner, have mentioned the social usefulness of some innovations in the financial sector. And I’m not sure if I share that opinion or not, but it’s a subject that’s on the table and I think it’s important to analyse to what extent the innovations of the last couple of years are really socially useful or not. And indeed, whether it’s really an innovation at all. For example, securitisation’s an innovation, but once you create that, you have millions of applications of that particular innovation.

People tend to think that there was an enormous amount of innovation because you have complicated structures with hundreds of underlying assets, but that doesn’t necessarily mean those innovations were anything more than the original one. So I’m not sure that we have that much actual innovation. It’s like saying that we invented the car, and then we saw red cars and blue cars and white cars appear, and that those are also innovations. So I have doubts about this, and it’s a point, I think, that we need to understand.

Concerning the point about retail investors, the most striking thing in this crisis is not what happened to retail investors, but to professional investors. You have pension funds and insurance companies and mutual funds all buying assets without a clue about the risk involved. So we haven’t focused on the problem of the retail investor yet, and not solved the problem of the professional investor really either. And we have a really big challenge there.

**PETER COUCHMAN**

Can I just go back to the central role of the regulator and get some opinions on that? We know that consumers don’t always act rationally, and that’s sort of an established fact. We also know that credit providers don’t always act responsibly. So can you regulators ever hope to save consumers from themselves, and also stop credit providers becoming too enthusiastic about driving their markets?

**HANS HOOGERVORST**

Well I’ve been rather pessimistic today, but I am optimistic about our future. Yes, as regulators, we are in a terrible mess. We need at least a decade to unravel and salvage the problems, and this is a great time for regulators. I started this job at just the right time. I saw it as sort of a pre-retirement transition, but I have never been more active in my life.

But seriously, there’s very important work to be done. Not just in acquiring the knowledge we need in our job, but even more importantly over the next decade is having the right attitude, because regulation and supervision face very difficult challenges. You are constantly being pressured by consumers, by banks, by politicians, who always want to cut corners. And our role is to prevent people from cutting corners.

So what we need most of all is courage, which is difficult, but we need the courage to stand up to the special interests, and in order to stand up to the vested interests, we need independence. Independence is of paramount importance to both regulators and standard setters. And I also hope the
constant pressure on, for example, the accounting standard setters, will stop, so that they can do their job with the professional independence required.

**PETER COUCHMAN**

Well one of the things Ken Rogoff has to say is that the regulatory system needs to be separated from the political process. And that in the build-up to a boom you get pressure on governments and regulators to ease back, because otherwise they’re interfering with the markets. In the wake of the boom or the bust, you then get equal pressure saying, ‘You’ve got to tighten regulation’. Now, is it possible to remove the regulatory system from the political process?

**HANS HOOGERVORST**

No. I was completely shocked when I read the letters that were received by American regulators from congressmen and from senators—aggressive letters, putting very severe pressure on the regulators to change their attitude. Even the Democrat who’s leaving politics now—Chris Dodd—at the height of the crisis he sent a letter to provincial banks in the United States saying that they should not be so tough with their lending standards. This is right in the middle of the crisis. Can you believe it?

And even in the Netherlands, I’m also under political pressure quite often. Even now, I’ve been on the phone all day long. It is very tough, even in a country where regulators are much more independent than the United States, but in the United States it is just terrible. And you guys have to do something about it.

**ROEL CAMPOS**

But it’s not just the United States. We do have to do something about it. But do you think French banks don’t pressure their regulators?

**HANS HOOGERVORST**

No, they’re all in the same game now. It’s not a question of pressure; they’re just being French.

**PETER COUCHMAN**

John, what do you think about this?

**JOHN LAKER**

This question about the relationship between financial regulation and the political process is a re-run of the great debate about monetary policy and the political process, which has led most countries to have an inflation target set in agreement with the government, and then the central bank uses whatever ways or means it can to meet that target.

This debate has now moved across into financial regulation, and there’s one particular aspect which is on the table for discussion in the banking world. That is the idea of some kind of counter-cyclical rule which would take the discretion away from supervisors and require that capital be built up during the upswing and run down in the downswing. A simple sort of ‘Taylor rule’ as we would call it.

Now, the reason it’s been made a rule—or at least proposed as a rule—is because of the feeling that regulators won’t be able to resist pressure in the boom to allow a thousand flowers to grow. The immediate answer says, ‘Well, let’s make it a rule and deny discretion’. The danger with an untested rule is that it may be the wrong rule and we may be all slavishly have to adhere to something we know in our hearts we shouldn’t be doing, because we’re not trusted enough by the politicians to make our own judgment.

This is very difficult work and we’re only in the early stages of it, but that debate will flourish for a good while to come, I think.
PETER COUCHMAN
Guillermo?

GUILLERMO LARRAIN
I agree with Roel that political pressures are impossible to eradicate. You can’t separate the two things, politics and regulation. As Rogoff says, that’s an Alice in Wonderland assumption. So what we must try is to find some hybrid between some rules, because I agree with rules. The problem is that in the securities market you will not easily find a rule, because it’s a much more complex, heterogeneous and diverse world than the central bank and the inflation problem, which is very complex by itself.

Imagine you have a number of markets, then finding the one proper rule is very difficult. There will always be some room for discretion in the securities market, and as long as you have discretion, you also have interests pressing for something beyond the use of that discretion purely in the markets’ favour, whether those be industrial or political interests or whatever.

My feeling is that we need to create our institutions and governance arrangements in such a way that those pressures are eventually all on the table, and not just on your phone. That’s one thing. And then the decision making should not depend solely on any one person’s criteria, but on a group view. And then you have a socialisation of the political impact, but politics will always be there, and we better get accustomed to it.

JOHN LAKER
Well, yes. But if the foundation of the argument is that regulators and governments can be persuaded to ease back on regulation because it’s too costly, then I think it’s going to take a while before that argument prevails again, because people are very sceptical about the argument that less regulation would be much more efficient. There may be some benefit for the public interest—and that is something that regulators should certainly have regard to—but I don’t think it’s as simple as saying, ‘We don’t like that regulation because it’s too costly’. I just don’t think there’s political support for that.

PETER COUCHMAN
There’s just one point I want to finish up on. It’s a central dilemma for regulators, and to quote from Deborah Ralston, Director of the Melbourne Centre for Financial Studies, ‘The best regulatory model strikes the right balance between market efficiency and consumer protection’. She asks, ‘What is the minimum level of regulation?’ and ‘How do you get the right balance between market efficiency and consumer protection?’

ROEL CAMPOS
Well that’s an aspirational standard. We used to say, when I was a regulator, that the best regulation is the least that’s necessary. Now, the industry you’re regulating will tell you when they think you’re over-regulating. Of course, most industry—whether it’s banks, broker dealers, or whoever else we’re dealing with in the securities world—don’t like any regulation at all. So, they’re constantly pressing for less, and this goes back to the political situation.

The industry pressures politicians who normally wouldn’t even be thinking about regulation, but because they have constituents who contribute to their campaign funds and so forth, they feel this pressure. And so the situation is always going to have tension. There is a tension between effective regulation—which probably the public presently favours given the failures, the bail-outs, and the tax money used to support the system—versus how well an industry’s doing, how many jobs are being created, and what
productivity and prosperity’s are being generated. If there’s a feeling that prosperity is being sacrificed at the altar of regulation, then the public will turn against the regulators.

JANE DIPLOCK
A cynic would say you only know this in retrospect. One of the things we see is that, when you’re in a boom time, you’re always over-regulating. And when the busts have come, you’ve under-regulating. So as a regulator, you’re damned if you do and you’re damned if you don’t.

PETER COUCHMAN
Well how do you know where you’ve got the balance right, Jane?

JANE DIPLOCK
I don’t think you actually do. It’s really ‘suck it and see’. You’re trying to exercise your best judgment to get that balance right, and every now and again, you get it wrong. You get it out of kilter. And the pressures we’ve just been talking about, the political pressures, they can be extremely difficult.

When everybody appears to be making money, and there’s exuberance in the markets, it’s extremely difficult to be the Jeremiah saying: ‘Look, that’s a cliff you’re about to run over’. Nobody wants to hear that message, least of all the politicians whose funds are perhaps being swollen by the very people making all this money. Perhaps I’m being a little gloomy, but the pattern I see is that you’re likely to get it wrong now and again, particularly in the boom phase when it’s extremely difficult to actually intervene.

During a bust, you’re usually beaten up for not having gone harder in the preceding boom. It’s something that you can only really see in retrospect. While there might be some magic art about it, most of us who have actually tried to do that balancing act have found one of the most difficult things to be working out where you are in the cycle, and what intervention is appropriate.

JOHN LAKER
Peter, if I could just add, this is an area where you can’t really disentangle financial regulation from the political process, because the way the Professor has posed that question is really asking, ‘What is society prepared to pay for a strong financial system?’ By ‘pay’, I mean in the sense of foregoing efficiency and income. Now that’s not a question a regulator should be answering. That’s really a question the politicians and the political process should be determining, because it’s a trade-off for society.

In my case, I have four or five different objectives I’m supposed to balance. But in the end, I shouldn’t be making the decision as to whether to put the financial system into a straitjacket. That would suit me but it may not suit the community, so in the end the government lays down a broad mandate.

PETER COUCHMAN
Guillermo?

GUILLERMO LARRAIN
I believe it’s a false trade-off, at least in the way you express it, because if I heard you correctly, you’re saying there should be a trade-off between market efficiency and consumer protection. You cannot have an efficient market at the expense of consumers, because there would be no consumers for your market, and then there would be no market. This is a false trade-off.

PETER COUCHMAN
So, to sum up on the question of whether we’re reasonably happy with the way things are working out and the prospects for 2016, I have the impression we have some ‘Yeses’ and some ‘Maybes’. Thank you very much to our panel, and thank you everybody.
The quest for transparency: Exchange-traded equities and derivatives, and OTC markets—
How did they perform during the crisis? What reforms are under way? What’s the future?
What do we do about ‘dark pools’?

Dr Ruben Lee, Chief Executive Officer, Oxford Finance Group

Panel discussion

Moderator Ms Belinda Gibson, Commissioner, ASIC
Mr Peter Clifford, Deputy Secretary-General, World Federation of Exchanges, Paris
Mr Tony Mackay, Chairman, Chi-X Global Inc
Mr Malcolm Starr, General Manager, Regulatory and Public Policy, Australian Securities Exchange Ltd

BELINDA GIBSON
I want to welcome you to Day 2 of the conference. I have primary responsibility within the Commission for the capital market side of things and today’s focus is the capital markets. These are changing very much now as the global financial crisis (GFC) is behind us, though I suppose those who were listening last night, even the optimists, might have pause to think about whether the crisis really is over.

Last night the panellists worked hard for their supper and it’s clear we are at a bit of a cross-roads about what the regulatory framework will look like in six years. This morning’s question is: what will our markets look like in six years?

Today Australia has just the one substantial equities exchange with just the one platform and that is the Australian Securities Exchange (ASX). The ASX has recently announced plans for a new platform, a new routing system, new technology. The expectation is that sometime in the next six months the government will approve competition for market services and Chi-X Australia, amongst others, has indicated its interest in that, and we have people from ASX and Chi-X Australia here today, on our panel.

Feeding into the exchange markets are the dark pools, if you like private exchanges that match orders off-market. Meanwhile, we have the over-the-counter (OTC) markets and last year the value traded on our OTC markets was in the order of 70 trillion dollars, that’s about three times the value traded on the exchange rated markets.

Our session this morning will look at where we are in OTC, what developments we are looking at there, and then we will look at the
exchange markets. We have to remember one of the lessons of yesterday, which was that stability of the markets is critical. Not just stability of institutions, but stability of the markets. In that context we have to look at transparency, of prices and volumes, we have to be concerned about fragmentation of the market in the context of competition. Is that impeding price discovery? Or are these markets improving price discovery and therefore market efficiency? Then what about dark pool, within high frequency trading?

Our speaker this morning is Ruben Lee, Ruben has a great deal of experience and makes his business consulting on markets—how to manage markets, how to oversee markets. He is going to explain the mysteries to us all, and then there will be a discussion amongst panel members.

RUBEN LEE
I am going to talk today about exchange and OTC markets. I am going to look at three broad areas: their structure; their performance; and some places where I think reform might be required.

As you may know, the issue of market structure is being widely examined today, both because of the financial crisis, but also because of two specific revisions of law and regulation. One going on in Europe where we have the so-called MiFID—Market in Financial Instruments Directive—and one going on in the United States, where Securities Exchange Commission (SEC) Chairman Shapiro has instigated a big re-examination of the US equity markets and their structure. And indeed in the States this follows a long and fine history of such examinations. Today, I don’t want to focus too much on the details; I’d rather look at the big picture. I am going to discuss four broad areas: competition, transparency, OTC derivatives clearing, and market infrastructure governance.

**Competition**
So let’s start off with competition. I think we need to understand some terminology when talking about competition. In this space there are in fact three broad areas of competition that are important: between orders, between trading systems, and between exchanges. There is a complicated relationship between these three different types of competition. So, for example, if you want all orders to compete against each other, you would mandate complete concentration of all order flow on a single trading system. Conversely, if you have multiple trading systems, that may mean that some orders don’t compete against other orders because some go here and some go there. There is then a very important issue as to the extent to which linkages between different types of networks can mitigate the adverse effects of such competition.

Similarly, one can have competition between exchanges to provide different products, throughout indeed the whole business flow—trading, clearing and settlement—and sometimes exchanges can offer, as we hope to see here in Australia, different forms of trading systems. So there is a very complicated set of inter-relationships between the three types of competition.

Fragmentation: fragmentation is a word that is used in a very confusing and confused manner around the world. I want to be clear that there are two ways in which it is used, one of which I think is the appropriate way of doing so.

It is used first to describe a market—that is to say that the market is in some way split. So there might be a split between order
execution mechanisms, the trading systems, or between the order routing systems or between the information dissemination mechanism. This is a purely descriptive use of the word.

It is also used in a prescriptive way to say that if a market is fragmented, it is bad. My view is that this is not a very useful way of employing the term. I think we should seek to describe the structure of a market and then define the criteria by which we assess its performance, be this liquidity, volatility, capital raising and so on and so forth. We can then use ‘fragmentation’ in its descriptive sense and ask, ‘Does fragmentation lead to better or worse performance?’

However, in the world when people say markets are fragmented, most people say, ‘Oh, that’s terrible’. The SEC has finally recognised that there is this ambiguity about the use of the term fragmentation, so in its concept release, it prefers the use of the word ‘dispersal’, and I think that’s a fairly good response.

So what are the factors affecting competition between trading systems? There are a whole lot of them and I want to just identify some of them. The most important is the so-called network externality, that means that if a network has a certain amount of order flow, this gives it a very strong advantage competing with other networks because order flow attracts order flow. The likelihood of your getting an execution is greater the more orders go to a particular network. As I have already hinted, there may be ways of linking different networks so that the network externality is mitigated, but still it’s very important.

Competition also arises because different people have different preferences about how they want their trades executed. Some want it fast, some want it without market impact. Some want to execute contingent orders, so I’ll do this if I can also do that. There are a whole series of different types of preferences, and new technology has allowed these different types of preferences to be fulfilled by delivering different types of trading systems.

Internalisation is not new. Internalisation is where a financial intermediary chooses not to send orders to a central order book, typically on an exchange. There are two reasons he or she does this: one is to escape the fees the exchange demands, and the second is hopefully to take both sides of the trade and maybe the spread. It is not new, but new technology has brought its existence to the fore in ways that weren’t recognised before.

Automation, as I’ve indicated, may be another important factor affecting competition. Disintermediation is a very important factor in competition. Intermediaries have costs, new trading systems can allow these costs to be eliminated if you don’t have to use the intermediaries.

Finally, order-routing technology may be another factor that affects competition between trading systems. Let me give you an example. Suppose I am a new trading system competing with an existing network, so I have to face the very big disadvantage that I don’t have the network externality working in my favour. What I can say is, look, you send your order to me and I guarantee you a better trade than is available on other systems, but if I can’t execute your trade immediately I will send your order to the big system so you won’t lose anything by sending it to me. That is one way of breaking the network externality.
What are the key effects of competition between trading systems? I should say, on the one hand, that the existence of these various reviews of market structure indicate that there is confusion about what the right answer is. There is no consensus about whether there should be competition and how it should be structured. On the other hand, and in my view, there are very strong reasons for believing that competition is beneficial: it leads to falling prices which in turn are likely to lead to more trading, a better and wider range of services, and more innovation.

As a result of this, exchanges sometimes find that their revenues from trading diminish because the fees that they can charge diminish. Sometimes there’s an elasticity effect so that they can get a greater amount of trading proportionately than the fall in their revenues, but nevertheless, what that then often means is that exchange executives focus on clearing, settlement and data revenues, where they can make that up.

There are people and friends of mine who believe that consolidation of order flow both spatially, that is to say on a single exchange or trading system, and temporally, so we have a single batch order auction at a particular time, delivers great benefits—and I think they do … but I think the effects of such consolidation are outweighed by the effects of competition.

Certainly trading is more complicated. You have got to decide: where do you send your order, and how do you decide which trading system to send it to? It is also harder both to assess and to achieve best execution. If the price is 99 there and 98 here, but you can only get 100 done there and 5,000 done here, how do you assess which is better? This has led to a whole group of intermediaries selling their services both in monitoring and in delivering best execution.

You may need more linkages, so there’s not just one trading system you’ve got to be linked up to but more, or you may have to subcontract linking up to these different exchanges again to an intermediary, and competition between trading systems may also have an effect on capital raising. I think this effect is relatively nuanced. There has not been a lot of empirical analysis about whether competition between trading systems allows better capital raising, but there has been a range of evidence which supports it.

First, to the extent that we get better liquidity, i.e. tighter bid-ask spreads, we often get better value in new initial public offerings (IPOs). The second type of evidence concerns the determinants of where to list—these are in part determined by market competition, but only in part. There are many other factors relevant to a company in deciding where to list, including, ‘What’s your product market? Where do you want to advertise? Do you want to do any corporate transactions in a particular market? Where are your analysts?’ and so on and so forth. All these factors go into capital-raising decisions, not just competition between markets. So the answer regarding competition between trading systems: support it!

Transparency
The second key issue I examine is transparency—and it’s complicated! It is really about what can you see and is what you see the truth. There are a range of different aspects of transparency concerning who has access to what information, when, and at what price. And all these different
elements are themselves very, very multifaceted.

Consider the type of information concerned, for example pre-trade information about quotes: so exactly who is doing it and how much information about the quote is available, and when do you get it, and so on and so forth. It’s very, very complicated simply describing transparency.

The amount of transparency in a market has a wide range of effects. Most importantly it enhances the speed and accuracy of price information. We want prices to reflect full information for a whole range of reasons, and transparency encourages that. It also facilitates choice of best price, so if we can see which prices different trading systems are offering we can choose between them. It allows better monitoring of executions, so that we can compare the price at which our trade was executed at, both versus the quotes and versus the prices of other executions at the same time.

Its effect on volatility is uncertain. The big negative—and this has always been the case—is that it reduces some investors’ willingness to trade. And why is this? It is because if I’m a big seller and I advertise I’m a seller, then because everybody knows that I’m a seller, they know there’s going to be stock on the market, so potential buyers run away and mark the price down. The mere advertisement of my willingness to trade moves the price against me. That has always been the case and in all exchanges and markets there have been ways in which some lack of transparency, or opacity, has been present. For example, in the old New York Stock Exchange it was actually down on the floor. Only the floor guys knew what was going on.

This is nothing new, but its presence has been more greatly remarked on than before and, as a result of the incentive I talked about, sometimes bid-ask spreads can widen. Let’s give an example. If I’m a dealer, say I’m quoting 99 to 101, to buy at 99 and sell at 101. Suppose I actually buy shares at 99 with full transparency, then everybody sees that, and immediately they mark the price down. So the price was 99 to 101 but now it goes down to 98 to 100. Immediately the price is moving against me, and I know this will happen, so instead of quoting 99 to 101, I now quote 97 to 103 to protect myself. More transparency can thus lead to wider spreads, and it also affects competition between trading systems. If you know what’s going on you can route orders to different systems.

Stepping back, it is also important to understand when assessing the performance of a market, that one needs to consider some very broad criteria, and the best ones to adopt are the International Organization of Securities Commissions (IOSCO) core principles. These are currently being revised but the key ones are investor protection; transparency, efficiency and fairness; and systemic stability.

Transparency very much affects fairness. Do some people have preferential information and access because of that information? It can affect trading system revenues. The way it affects them is context-specific, but in the States for example, they have a consolidated tape and the amount of revenues exchanges get depend on the amount of information they submit. Quite a lot of the smaller exchanges and trading systems submit quite a lot of information, but the value of the information is probably not very much, because most of their prices and quotes are derivative of, that is based on, the prices on
the big exchanges. So the rule for splitting revenue dependent on data is very much affected by how you require transparency. It obviously also affects futures pricing, fund pricing, index pricing and performance and allocation of capital.

What does all this mean? The answer is: it is difficult. If you are a regulator you need to recognise that there are multiple effects on multiple constituencies. You need to take account of both actual and potential competition. You must confirm the merits of transparency, but also acknowledge that sometimes excessive transparency has costs. You’ve got to be realistic about its enforceability, incentives and data. Let me be explicit regarding enforceability: if you require too much transparency and the big investors don’t like it, they will find another way of getting their trades done in a more opaque manner. You’ve got to understand, ‘What are the incentives for people to want to release transparency?’ and very important, you’ve got to understand, ‘What are you actually seeing?’ Is what you get what you really think that you’re getting? Very often it is not. That requires a judgement, but in my view the judgement must normally be to get as much as you can, but not too much! Indeed, there used to be a regulatory—if you will, even a theological—belief that more transparency was always better. That has been mitigated to a great extent over the past five years or so. So even with at SEC, where that belief was the strongest, we are now seeing some sanctioning of non-transparent markets.

**OTC derivatives clearing**

We are in a dangerous world, there are rogue players, you don’t know what their creditworthiness is like and you need to protect yourself. There are different ways of doing this. I think that, however, one should be very cautious in this space, and I am going to be very sceptical about the current political trend exhibited yesterday about the merits of requiring, or mandating, OTC trades to be cleared via a central counterparty (CCP). The argument goes, in the global financial crisis, bilateral credit-monitoring and performance failed. We didn’t know who was going to fall down and that was a big problem, and people did fall down.

On the other hand the central counterparties performed brilliantly, although what you saw probably was not everything that was going on, so some of them may not have performed as brilliantly as you think that they did. Nevertheless, the argument goes, central counterparties performed brilliantly, OTC was terrible. So the logic is, push all OTC trading to be cleared via central counterparties. It is the silver bullet.

My view is that this argument is deeply flawed for a range of different reasons; firstly, it does not recognise that there has been a long and fine history of failures at central counterparties, it ignores the factors that really go into a clearing house’s decision as to whether a particular type of asset or contract is eligible for clearing, that is to say, whether a clearing house can actually manage the risks of clearing of a contract. Various factors going into determining eligibility. One is whether a contract is standardised, although this is not necessary.

Another is the pricing transparency of the asset. Why? Because if I am a central counterparty and one of my members goes bust that is fine, then I have to take on his positions. But then I need to get rid of them. In order to get rid of them I need to know, ‘What is the price of them?’ But prices are not always transparent and indeed, specifically in quite a lot of these markets, they are determined by a relatively limited
number of market makers. So then I am dependent upon these market makers who know my weakness, I’ve got to sell, and they will make a market against me. More importantly, there are contexts where I can’t sell the assets that I’ve got as a result of a bankruptcy and there are other aspects to do with eligibility, which concern volatility and my risk management capability.

Most important of all there is a moral hazard problem; if a regulator or government, says, ‘Clear these’, then what happens is if there is a problem? People will assume that the government will stand behind the CCP, which will mean that the CCP, as with all moral hazard problems, does not look enough to its own heart and its own risk management processes sufficiently.

Why is this happening? In the States, it is pretty obvious, says I. Firstly, politicians say we need a political response to the crisis: we’ve got to do something, anything—and OTC derivatives, those damn speculators, looks a great place to start. The second is—and it was mentioned yesterday, but let’s be explicit—it’s turf. The US Federal Reserve (the Fed) has been compromised by its performance in the financial crisis, the SEC has been compromised by its performance with Madoff, so neither of them can to be too expansive in their reach. This leaves the Commodities and Futures Trading Commission (CFTC) to make a big land grab.

Finally, there is convergence between some specific business organisations, in particular those which are going to benefit from clearing, sometimes at the expense of OTC trades. So that is why it is happening in my view, and here I think one should notice a difference—a nuance, but I think a very important and surprising nuance—between the European approach and the American approach.

For once the American approach is much more dogmatic, almost theological, whereas the European approach is actually more pragmatic and probably, appropriate. This is very surprising.

The answer, a big question is, you should let the decision taker, as to which assets are going to be cleared on a central counterparty, bear the consequences of taking the decision. So the regulator is making the decision but the central counterparty is going to bear the risk. That is a wrong incentive structure.

There are contexts where we could have more clearing of OTC products right now, and those need to be addressed. Where those arise is typically because we have a group of a limited number of OTC dealers who want to maintain their market share in an OTC product, which could be well cleared by a central counterparty, but they like the opacity, because it gives them bigger spreads, and historically they have sought to exploit their better creditworthiness than other counterparties. That better creditworthiness is disappearing, but still, cartel behaviour is not, and that’s where regulatory attention should focus on this space.

I think the more that we get clearing of more exotic products, the more regulators need to be all over the CCPs, and if you want to be radical, and sometimes I do, one might want to encourage competition even in the future spaces, where currently fungibility between products is essentially nonexistent because each futures exchange owns the intellectual property in its own particular contracts.
Governance of market infrastructure
The last area I am going to look at is the governance of market infrastructure. It’s about power. Who has it? How do they get it? How and why do they get it? And how and why do they exercise it? And why is it important in the context of exchange versus OTC? It is important because governance power affects performance. Why is there concern? As a result of the financial crisis there’s been a paradox.

On the one hand, as we’ve seen illustrated in the OTC space, regulators and policy makers have wanted to place more trust in the infrastructure. In this context it’s been clearing, but there have been other contexts where both exchanges and CSD—central securities depositories—the other types of infrastructure, are being more and more relied on. So we had problems in the OTC space, we want to go where we’re sure it’s systemically stable. This is the infrastructure.

On the other hand, the very concentration of trading, clearing and settlement on such institutions exacerbates the risks associated with their operation. So there is a paradox here, which is one reason why there has been a great focus on such institutions.

There have been a lot of problems with market participants wondering whether different governance structures, the for-profit structure for example, have provided efficiency in terms of services and fees.

There have been a whole range of conflicts of interests in these different types of institutions. Some of these institutions have undertaken regulatory duties, but some also haven’t, they just undertake commercial activity. How to resolve these conflicts has put greater emphasis on governance.

There has been consolidation, both nationally between exchanges and CCPs and CSDs of the same country trading the same types of assets, and between exchanges trading different types of assets, and between exchanges and CCPs and CSDs internationally. And with such consolidation has become greater perceived market power.

Finally, globally, there has been a big examination of corporate governance over the past perhaps ten years, and there has been a question as to whether the corporate governance codes for corporations have been appropriate for financial market infrastructure. Now my view is, in one word, ‘not’. Corporate governance essentially focuses on protecting shareholders and minority shareholders in particular. The question is, ‘Is the protection of shareholders good for the delivery of the three objectives that we want regarding market infrastructure, namely: investor protection, fair efficient and transparent markets and systemic stability?’ In my view, not necessarily, although it could be.

When examining governance, and it’s too big a topic to look at today and—a piece of advertising—I’ve just finished a huge big 600-page report, and you can download it from my website.30

When examining governance, there are three core policy issues that need to be addressed. First, efficiency, ‘What governance structure best delivers an efficient model?’ This type of efficiency is a very opaque concept; it is really to do with transaction costs of all different types. I want to be very generic here.

The second core question is, ‘What regulatory powers should be allocated to

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30 www.oxfordfinancegroup.com
market infrastructure institutions? I know we have had an instance here of stuff being taken away from ASX, but I think the OTC derivative space is exactly an example of that where what is being proposed is that the decision as to whether to clear or not should be taken away for the central counterparty and given to the regulator. I have given the reasons why I think that movement is a bad idea.

The final core policy question is, ‘What regulatory intervention in governance should there be?’ To answer this is beyond today’s talk but I want to give a few hints about it. The first is, there is no single, global optimal solution for governance in answering any of those three questions—efficiency, and allocation of regulatory powers or regulatory intervention. That does not mean, however, that there is not a right answer for every particular context. There is a right answer, but it has to be specific to the context. You need to understand all the concepts but you also need to know, ‘How many banks are there in Australia? What concentration do they have? What incentives do the other guys face?’ All this sort of stuff.

In some contexts governance can restrict anti-competitive activity. For example, when there is a monopoly that might undertake anti-competitive activity, but you have some sort of mutual governance structure— notwithstanding the trend to demutualise exchanges everywhere. The reason for this is that the users are the owners. So what that means is if a monopolistic infrastructure says, ‘I’m going to charge you a monopolistic anti-competitive price’, the users can say, ‘No, no, no, we’re the owners, we tell you what price to charge us, please charge us the competitive price’.

Finally, good governance may promote systemic stability. This is not to say that the for-profit demutualised model or even the government-owned one is better in any particular context, but I have given you an example where I think that not allowing a CCP to make the decision about what to clear would actually reduce systemic stability and increase risk.

Let me conclude, and I am going to summarise in a very broad caricature manner. First, in my view there are very strong benefits of competition between trading systems, although there are problems—such as good execution is harder to assess and to achieve. Second, transparency has great merit but too much can have adverse effects. Third, mandated clearing of OTC derivatives is inappropriate. Finally, infrastructure governance is critical.

Thank you very much for your attention.

BELINDA GIBSON
Ladies and gentlemen, I hope you’ve learnt a lot in that exposition. These are very difficult concepts and I want to thank Ruben for expressing them so simply and outlining the propositions we need to face.

What I plan to do for the next 40 minutes is explore some of these issues with the panel. Peter, the notion of competition, is it of benefit of not? Ruben definitely says yes and supports it, but perhaps you would like to take us through some of those issues.

PETER CLIFFORD
Thank you, Belinda. Tony D’Aloisio, who was once on the board of the World Federation of Exchanges, has always been a very good aid to us as we try and figure out the changing market structures as well, and we’ve maintained good contact with him since. So it’s a pleasure to be here, to be working with
ASIC on this, and also to be on this panel with these gentlemen as well.

I prepared a few remarks a couple of weeks ago before I was leaving Paris, and I looked at some of the literature that was coming out then, in particular some of the statistics that were coming out at that time. I would like to preface my remarks by saying, these are not necessarily the official viewpoint of the World Federation of Exchanges; rather, these statistics are some of the most recent findings that may be new to this audience. Exchanges themselves don’t necessarily agree on some of these issues, so no opinion should be considered a one-size-fits-all solution.

There are two concepts that have come out of Ruben’s paper that should be cleared up first of all. First is the question of whether exchanges resist competition. The World Federation would say no, and there may be several of them ready to operate in Australia one day, and if you look at Europe and the Americas, you see in fact that exchanges are getting involved in all kinds of markets.

The second question is: are exchanges opposed to OTC? This is a misconception, but maybe if you’re looking at this for the first time, you might have got that impression. The derivatives markets, the exchange-traded derivatives—which performed brilliantly during the crisis—owed much of their popularity to the volatility in the OTC space.

What the regulated markets do emphasise is—it is quite interesting to look with hindsight at the year as to how OTC markets worked, and not only credit default swaps (CDSs) but other dealer markets including corporate bonds—couldn’t improvements be considered, given that investors faced a very different challenge there than in almost all of the exchanges? The regulated markets stayed open, traded, did not add to systemic risk, managed to—even in the worst times—maintain liquidity and properly provide post-trade services.

The landscape that Ruben described here was very much the landscape that he was describing 10 years ago when we worked with him on a couple of projects in the European space. But I would say to people here, the European space is very different, and taking the point of view from the London investment banks and putting it in Australia might not be appropriate. In fact, there are serious concerns in Europe about the new features in the market landscape.

I mentioned looking at the reports of the last two weeks on this subject, but I also looked at an earlier report prepared in November 2009 by the Chartered Financial Analyst (CFA) Institute. According to the CFA Institute, in a recent survey conducted by both buy-side and sell-side firms, 68% responded that the new rules fragmenting the market made trade reporting harder, 64% said that it increased the cost of data access. Concerning best execution for clients, nearly twice as many firms felt this had been impaired compared to those who saw an improvement. By a similar margin it was felt that price discovery on exchanges had been damaged.

More recently, if you look at costs, the French Trade Association for Investment Bankers and Institutional Investors last week released a report that the overall transaction costs had actually gone up 12% last year on the cash markets.

On 12 February 2010 a report by a French agency broker noted that, while the entry of
trading venues such as Chi-X had had the desired impact on fees at exchanges, investors were worse off. Crédit Agricole Chevreux Paris noted that ‘while the costs of lit markets in basis point terms decreased by 30% and settlement-delivery costs were down 47%, transaction costs rose 24% between 2007 and 2009, at the same time, implicit costs also sky-rocketed. Intra-day volatility, which might have been considered linked to the effect of the financial crisis on markets, has not gone back down and, combined with the reduction in liquidity, has ultimately increased the impact retransmitted to the market. This is how building any position of significant size implicitly became more costly.’

Now to one last report from 18 February 2010. A recent report on the website of the French Ministry of the Economy, Industry and Employment31 says, ‘if the increased complexity of the financial market was expected due to the multiplication of execution venues, what was not anticipated is the dominant conclusion of market participants concerning the degradation of quality of transparency, pre-trade and post-trade.

‘The increased cost for data and, above all, the bad quality of trade data is truly a failure for the directive. Listed companies are severely critical about the growing difficulty in following what is happening in the trading of their shares. The end investors have not benefited from lower rates for trade execution and clearing services, which have been more than offset by the cost of connecting to multiple venues, the need for new technology, as well as the implicit costs linked to the smaller trade sizes per transaction.’

To conclude, the problems that are being reported in Europe, and that have been dealt with for several years in the Americas, are due to fragmentation of orders and data, not competition. By creating gaps in the system of oversight and competition among dealers, a host of market quality issues arise.

**BELINDA GIBSON**

Tony, would you like to respond to that and pick up the issues that are arising about price discovery and the notion of the consolidated tape. In the US there is an obligation to report trades through to a consolidated tape so that there is, if you like, mandated price discovery, and with that comes the associated issue of the best execution rule, that is, ‘How do you mandate to brokers that they are to fulfil orders? Is it just best price available or is it, as in the European system, which might explain some of these issues, a more principled base that tries to balance the questions of volume, price and availability?’

So Tony, if I might ask you to speak, then Malcolm and then Ruben can wrap it up.

**TONY MACKAY**

Thank you, Belinda. I left Australia in 1986 but I’m a very proud ambassador for Australia, and I am very excited about what’s happening down here with the markets opening up, and I think there’s a lot of things that we can learn from what has happened in the States and what has happened in Europe, and we can pick what is best for Australia, which I think is the most important thing for everybody in this room.

I think Ruben made an excellent presentation this morning showing the pros and cons, and Peter has raised some very interesting

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comments on the European side. It was very clear that competition in the European marketplace has probably been far greater than most people expected it to be two or three years ago. I think there was a belief that, if you had an electronic order book and an established exchange, it was going to be very difficult for anybody to compete against it. However, the reality was, at the time most of the participants in the market and people that had never traded the market, actually wanted to trade more.

We used to refer to it as the Oliver Twist story. We would go to the exchanges and say, ‘Please sir, we want to trade more. Can you make your system faster? Can you make your system cheaper? As you do more volume, can we get some of the benefits of the reduced marginal cost of trading?’

And the exchanges didn’t listen because, as public companies, they were driven for profit, so a lot of the biggest users set up these alternative trading systems (ATSs). Are they competition? Well, it’s not really competition when what you are doing is increasing the volume of trading in the overall market. So what we have seen post-MiFID, is in fact the volumes in the European marketplace really grow quite rapidly. It’s very difficult to put absolute numbers against absolute numbers because there are spikes and everything in the national trading volumes, but I think most people believe trading volumes are up at least 50% post the competition.

MiFID 1.0 has been a great first step but it left a lot of things to the market itself to sort out, and the market itself doesn’t always solve those problems. The lack of a consolidated quote is a really important problem and that is the source of frustration for a lot of the investors in Europe. They look at it and say, ‘If I look at and quote a stock on Reuters and I quote a stock on Bloomberg, I’ll get two different prices. How can that be right?’ It really depends which feeds Reuters are taking versus Bloomberg. What you need is one central consolidated quote so that everybody gets access to what is the best price, and coming out of that consolidated quote there should be a consolidated tape of executions, so that you can see when your order was executed, what was the market on the alternative exchanges, did I get the best price?

The second thing that has made things very complicated in Europe is that about 25% of the volume in European markets is actually done through OTC markets, so it doesn’t go through any of the traditional or new exchanges; it doesn’t go through Chi-X Europe, it doesn’t go through the dark markets like Liquidnet or others; they’re really done over the telephone between the broker dealers themselves. There might be inter-dealer brokers like ICAP Management Services Pty Ltd (ICAP) involved in the middle. And then the reporting of those trades was once again left as almost optional. Under MiFID, people could report those trades to remote locations such as, say, Bulgaria, even if they were based in London.

Effectively, traders have gone to extreme lengths to legally hide what they are trading and I don’t think that has been good for the market. This is what people have complained about. Ruben talked about too much transparency might be a bad thing, but equally not enough transparency, especially post-trade, is a bad thing. So the points that Peter makes are very valid. By leaving the rules to the market itself to sort out, the market will do, unfortunately, what maximises their profits, and that is not necessarily in the interests of the end investors.
If you look at what they have done in America where the Consolidated Tape and the exchanges have to link to and onward to each other—that is in the ultimate protection of the retail investor. On the panel last night, someone questioned whether retail investors should be investing alongside institutional investors. The stock market is one of the unusual situations where this happens and I don’t think that is really going to change, so what we need to do is make sure that we do protect the retail investor as well as protecting the interests of the institutional investor, who is often representing the interest of a group of many retail investors through pensions, super funds, et cetera.

One of the factors that I think will help in Australia is a strong vendor by the name of Iress, which provides the connectivity to the Australian market for most of the small- and medium-sized brokers. We have done a lot of work with Iress in the Canadian market; Chi-X operates a market there alongside three or four other ATSs as well as the Toronto Stock Exchange. So what Iress has done is to offer to all the small- and medium-sized brokers connectivity to the various marketplaces with a smart order router. I think whatever ends up in Australia, we’ve got to ensure there is a strong independent operator like Iress in the market. Unlike other markets where Chi-X operates as an alternative market, our market operator licence in Australia, which, if it is granted, will put us on the same regulatory standing as the ASX. I think on that basis there is a strong case that we should be doing whatever we can to link the orders together so that if there is a better price on one platform versus the other, we pass them through. This would effectively create a consolidated quote, which would solve a lot of the problems that have really come up in Europe and the States.

BELINDA GIBSON
Thanks, Tony. Malcolm, do you want to comment on those issues?

MALCOLM STARR
On the question of whether competition is of benefit, the potential for competition between trading systems needs to be available so as to allow the best to prevail, to use Ruben’s terminology. So the fact that competition between trading systems has to be allowed by every sensible framework is just taken as a given. The issue that you then need to address is that increasing the competition between the venues results in a reduction in competition for orders within each particular venue. So the debate needs to be about what choices should be made from the menu of possible regulatory interventions of the type that Tony has just been describing, such as, ‘Do we need a consolidated tape? Should best execution obligations be about achieving the best possible price?’

It is those choices which determine whether the reduced competition for orders in a particular pool does in fact end up being a negative or, instead, ends up being a positive by virtue of the successful linking of the various liquidity pools.

Most of these difficult choices have to be made by regulators and policymakers rather than the market. There are hard choices to be made between imposing trade through rules along Northern American lines or less prescriptive best-execution obligations along European lines. The calls that are made on issues like that will in fact have significant advantages for one particular business model and significant disadvantages for another business model. As Tony says, not all of those decisions can be left to the market to sort out and that is the debate that has to happen—i.e. getting down into the
detail of which is the best type of best execution obligation, for example.

Policymakers also need to ensure that similar activities are regulated in the same way. There is much to learn from the Markets in Financial Instruments Directive in Europe and Regulation National Market System (Reg NMS) in the US about how not to leave loopholes that can be used to avoid electronic trade matching systems being regulated consistently.

In Australia, we are a long way ahead, in some respects, on creating a level playing field between the different types of trading systems in our regulatory framework. Most operators of trade-matching systems require the same licence, so there is less scope for unfair competition than under MiFID with its three categories for regulating similar systems alongside a big loophole that allows broker internalisation to avoid this regulation. Australia has some potential regulatory arbitrage risk depending on how we ensure fair competition between trade matching in the form of broker internalisation under a financial services licence and trade matching by someone else as a licensed market operator. But we’ve reduced the scale of the risk by having fewer licence categories. So we need to recognise the bits we have already solved, as well as the bits we’ve still got to solve.

BELINDA GIBSON
Ruben, did you want to take up any of those points?

RUBEN LEE
Yes, just a couple of points that I wanted to make. I’d firstly like to refer to something that Malcolm said. The point about my joke was that you’ve got a lot to learn from us on how not to do things. That is the first point I make. The second is, however, there is a difference between the nature of competition that is proposed here and the nature of competition that currently exists in the US and the EU.

Here we have a monopoly, which it should be recognised has performed very well over the past, so don’t forget that history, but we have a monopoly and the issue is what can be achieved by opening up that monopoly to new participants, which initially and even over a fairly extended period are unlikely to get huge traction.

TONY MACKAY
That’s what they said in Europe.

RUBEN LEE
That’s what they said in Europe, yes, correct, but the question is, ‘What are the marginal benefits of competition, or breaking the monopoly to allow new entrants?’ Let’s say you do get a high share of trading—10, even 20%, which is remarkable—‘What benefits can be got from that versus a situation in the EU and the US which are highly competitive, very highly competitive at the moment in a range of different ways?’ So the extra benefits in the EU and US with more competition are much more nuanced, and how you manage that competition becomes very, very finicky and detailed. Here the big question is, ‘Do you want to allow it?’ And then, yes, there will be different ways of sanctioning it, but it doesn’t matter so much, just allow it and you’ll get the big result, that’s the big win, the low-hanging fruit. That’s the first thing that I would say.

The second is, I think that implicit in all three co-speakers when talking about the States is a mistaken belief about the merits of some of what’s going on in the States. So there’s a lot of talk about a consolidated tape, which has been a central tenet of the US views and
approach since 1975. I am very strongly supportive of a central consolidated tape.

It has problems however. It has problems because what you see is not always what you get. If you go to the Financial Industry Regulatory Authority (FINRA) in the US, there’s a huge big problem, even with a consolidated tape, of trying to track down an audit of when trades were actually done. So you think that you’ve got this audit of when trades were actually done, but you haven’t. Everybody needs the same caesium clock and not only that, there are different forms of latency in the different systems and—it’s very complicated.

Similarly, you think that you are seeing indications of interest, that is to say orders on the consolidated quotation system, but there are lots of ways in which you’re not. So all I’m saying is don’t hope for a miracle in terms of some form of linkages between the two systems. I agree with Malcolm that this will be a large determinant of how things work. I also think that to some large extent the private sector has a very strong advantage to provide its own linkages. So for example, if you talk about different groups of order flow on different trading systems, if there are not linkages between them one way or another, somebody is going to make a profit out of it and they will arbitrage away those price differences. I don’t want to be too ‘Chicago-ish’, too dependent on the view that the market will solve everything. It hasn’t in Europe, we’ve had a series of problems, but I think one should rely on it to the extent one can.

BELINDA GIBSON
I think we might move to the issue of dark pools and lit pools, and your explanation was very clear about why people tend to dark pools. I will ask the panel to address the question of dark pools and liquidity, because the proposition is that, if you have a large number of dark pools, overall the market is benefited because the price ultimately will reflect the greater liquidity and the speed at which it can get reported. Perhaps Malcolm, we might start with you on dark pools.

MALCOLM STARR
In this particular session when we talk about transparency, we quite quickly get to a focus on pre- and post-trade transparency as to prices. Ruben had a marginally broader definition, but essentially that’s where we got down to. In nearly every other debate—and I’ll bet it happens at nearly other session in this conference—we use transparency in completely different senses of the word.

The very first thing we should be doing is actually making sure, especially in an environment where trading system providers have actually got a statutory obligation to create a market that is transparent, that we specify what this transparency obligation involves. Lots of other trading systems don’t have the very same obligation to provide price transparency, and so you have instantly created an arbitrage issue. I don’t care whether it’s in legislation or ASIC rules, but we should actually make sure we know what we’re talking about and use transparency consistently when it’s the subject of a core licence obligation for some licensees and not others. So that’s the very first point.

I think the transparency debate in relation to dark liquidity is really about whether the regulators need to safeguard price formation or whether market forces can be relied upon. It’s not the existence of dark liquidity that’s a problem. That’s been around for years in the form we have in Australia. We’ve had our dark pools in the form of broker
internalisation. We’ve had our dark pools in the form of other independent operators of systems that come in as a customer of a broker.

It’s the absence of any contingency plan for dealing with the possibility that the spreads will increase in transparent public markets if too many orders are diverted to dark pools that we have to be thinking about as the issue, and what that contingency plan should involve. Can we unscramble the egg if in fact we find that—in particular stocks 50–60%, pick whatever large number you like—of trades in that stock are actually conducted opaquely? Is that the point at which we think ‘Market forces didn’t actually sort it out, it did actually increase spreads in the public market, what do we do now?’ You’re not going to suddenly turn around and take licences away from all the dark pool operators. You are not going to suddenly go back and say you can only have a certain share of the market. So, as policymakers, you have to think quite creatively up-front about what other measures you put in place for the event that you hope never happens.

The fact that our legislation regards fair, orderly and transparent trading as the hallmark of a properly regulated trade-matching system, suggests that it is a regulatory responsibility to achieve lower spreads in public markets and not just focus on identifying the manipulative orders. Or is that not a true statement? We frankly have to establish whether that is a regulatory responsibility to focus on what might happen to spreads, or is that just a market forces issue.

One consequence of there not having been a great degree of clarity in some jurisdictions as to how much transparency is required of those already licensed as a trading operator, is that of course, the exchanges have said, ‘If we can’t beat them, join them’. So of course we have exchanges all around the world trying new order types that have a greater element of opacity. We are no different; we’ve got our particular variant with ASX’s Volume Match initiative, and other order types that we’ll be making available shortly, which match large trades anonymously. But at a price that is predetermined by reference to the central limit order book. It doesn’t mean that it’s the ideal but at the end of the day one has to make a few decisions about how the dark pools interact with the central limit order books and not just cater to the desire to avoid transparency.

BELINDA GIBSON
Tony, do you want to pick up on that?

TONY MACKAY
The parent company of Chi-X Global is a company called Instinet, which developed the first electronic trading platform 40 years ago. The term ‘dark’ is so sinister. We used to have a terminology, which I think describes it better. We used to refer to trades as being ‘upstairs and downstairs’: downstairs on the floor of the exchange, or upstairs in the broker’s office when the client phoned it in.

What a dark trade in its truest sense really is, when a client phones a broker and says ‘I want to trade a big block of this stock, I can see there is only a little bit on the bid and offer on the floor, can you try and find the other side for me?’ Brokers have been doing that for years. That is the primary job of a broker.

One of the things that regulators globally have struggled with is: at what point do you change the way you regulate when the copper wire is being used to transmit data, rather than voice for the transmittal and
execution of the orders? I think it is important that we actually get back to a definition, ‘What is dark?’ Dark, in its truest sense, or an upstairs order, is really trying to find a natural on the other side, and automated trading systems that try to do that, quite frankly, really struggle. Because if somebody puts an order into a system and it is truly dark, it is a needle in a haystack. So there’s only about a 5% matching rate in Information Technology Group’s (ITG) POSIT, and if you put the total volume of all the business on all the order books in Liquidnet against its execution rates, it is between 5 and 10%. Even Instinet’s platform was in that range.

What we have seen in the last few years, though, is a lot of automation used by the brokers to make markets—you could call it flash orders, or indications of interest—are getting hit rates up to 20–25%. When you start getting matching rates of 20–25% in dark pools, then you are definitely taking some of the liquidity away from the exchange.

I think the issue that has to be addressed then is, ‘Is a dark pool, that is really operating with a broker-sponsored market maker in the middle of it, really a dark pool?’ Or is it a systematic internaliser? We need to differentiate between the two and make sure we end up with the mechanism that allows people to truly trade big blocks of stock. But the other type of systems, such as most of the dark pools in the States, the average execution size is as small as it is on the traditional and new exchanges. I would argue that that is not really a dark pool business and that most of that business should probably be going through traditional and new exchanges.

I think one of the things that we’ve got as an advantage in Australia is we can look at the lessons from overseas: in Europe they are very prescriptive about what a dark trade is and what price it can trade at, and consequently the market share of dark pools in Europe is very small. In the States you can trade as much as you want and whatever you want to call a ‘dark pool’. There are really no rules on size or anything like that as long as you don’t trade more than 5% of the stock’s total volume. Things have clearly gone out of control in that regard and that is why the SEC is now proposing to change the US dark pool rules.

So I think, once again, coming back to what is the best in Australia, you certainly want to have the ability for people to genuinely cross blocks of stock without, as Ruben put it, providing transparency—‘I want to trade a block of stock’—that adversely moves the market before you trade.

We also want to make sure that it’s not too easy for the internalisation of really small orders that should be part of the price formation process. They should come through to the traditional and new displayed markets.

BELDINA GIBSON

Peter?

PETER CLIFFORD
I’d just to pick up on what Tony said and fully support that. If you’re not familiar with dark pools debates, the terms are used for different types of trading. First is the original dark pool, used to execute block orders in an anonymous way, and almost everyone agrees that large investors need the capacity for these kinds of transactions.

But all the growth in dark pools in the US is coming from broker dark pools and

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internalisation. In the United States now, about 25% of the transactions are being done in dark liquidity. About 10% of that goes through dark pools. In dark pools, there are over 50 dark pools operating. There are only three that are focused on volume in block trades.

Of the block trades, there’s Liquidnet, Pipeline, and POSIT doing some business and there are a couple of others, but the rest of them are broker-owned dark pools and they’re taking customer orders or they’re buying customer orders and market flow off of the wholesale market and executing it through their dark pool first.

So you have the regulated exchanges and lit pools such as Chi-X becoming kind of the venue of last resort for trading. You take the best orders, the most uninformed orders you’d call it in the market, they are executed in a dark pool, then maybe you do a second dark pool and you let in some multilateral traders (MTF traders), and then you let in maybe two or three groups and then later it will hit on one of the exchanges, who finally execute what’s left over. One of the propositions in the US market is to correct this, that is to say, that retail orders shouldn’t go through dark pools.

I think the other concern people have with certain of these new aspects is the business model that’s being used for this. Ruben has talked a lot about the conflicts of interest within infrastructure. I think they’re minor compared to the conflicts of interest of deciding that you’re going to send a customer order to a venue that you actually own, and when you look at some of the venues out there—and I won’t name this particular one, but it’s one that is specialised in flash orders—5% of the business that they do is in flash orders, but 25% of the profit comes from those 5% of flash orders.

So there’s a very big incentive to set up your dark pool or set up the flash orders, but I’m not sure that it really works in the right direction of market quality, that’s the point.

Coming back to just one other point that links the two in, the competition question that Ruben talked about before. Fragmentation really is the name of the game. That’s really what some people want. It’s not an accident that this is happening. Once you can fragment the information and you have to rely on brokers to go out and link-in to all of these markets, that’s when people are going to really be making the money on that, so I don’t think it’s completely disconnected.

When you look at markets such as the US options market you have, I think, six exchanges listing all the same products, competing on all of the products, together with costs driven down very, very low. They’re still able to do business because there is no internalisation. If you look at the exchanges in India or the Japanese exchanges or some of these other Asian markets, they’re able to have block trading facilities but not weaken the capital markets by allowing internalisation to go off.

So there are plenty of models out there to consider, but what the US SEC has done over a number of years, or what MiFID has done very rapidly in a couple of years, as the most modern solution for markets, is not necessarily the most adapted to every country.

TONY MACKAY
Can I just add one clarifying thing on that? When we set up Chi-East, this pan-Asian dark pool, one of the important things that we were seeking to do with that is make it an
aggregation of connectivity to the various broker dark pools. I think there’s an important role for exchanges or independent operators to act as the gatekeeper and the seeker of liquidity that may not be ready to go into an exchange. I think the 100% owned broker dark pools are always going to struggle because Broker A doesn’t really want Broker B to pick off its liquidity and recycle it to a client.

If there is somebody in the middle—and this is where I think there is the role for an exchange-regulated dark pool that can aggregate these broker internalisations, and once again something like this—I think can go to your point about excluding retail from it. We can come up with something that I think will get the best of both worlds. We can support broker internalisation. We can have a genuine independent marketplace, essentially the wholesale marketplace for big blocks of stock that retail don’t need to interact with, and there can be rules of the game that actually protect all participants.

BELINDA GIBSON

Thank you.

RUBEN LEE

Just very briefly, I want to be much more simplistic about this. I love vampire movies. That is to say that I think dark pools have dramatically allowed institutional investors to get better executions and better prices than was available previously. So Liquidnet I’m a huge big fan of, and I think one needs to recognise the demand for this, which is valid, and I think to the extent that exchanges have been mimicking this, I think it’s wrong to characterise that as just because everybody else is doing it, we’re going to go down to the level. No, you’re going up to their level. They’re providing a service that is very beneficial. Not to say that everything dark is wonderful, but I think it’s a new way of doing business which has not happened in the past and has dramatically reduced market impact.

BELINDA GIBSON

Can I move from there to the other issue that I think is the major issue that we are contemplating, as we consider the market structure, and that is this issue of high frequency and algorithmic trading. The SEC concept issues paper is seeking to have a wide ranging discussion with the market—in particular, about whether its structures, its regulatory structures, are right.

It is balancing the interests of the long-term investor, taking into account the view that the markets had traditionally been very much focused on capital raising and for long-term holders against the professional trader. The professional trader represents, I think they say, 50% and likely more, I suspect more. It’s the people that have the very advanced computer systems that are in and out in—certainly in a day, and in a nano-second in some cases—and they use their IT to seek a price advantage for the short term. Could you talk a little more, perhaps starting with you, Ruben, about the damage to the market? Is it beneficial to have more of this trade? And are there some regulatory issues we should be contemplating to accommodate it?

RUBEN LEE

Absolutely. I think the key regulatory issue here is access, privileged access, where retail is deemed to be unfairly treated at the expense of those institutional guys who have access to it. Also, where as is sometimes talked about, we’ve got this ‘arms race’ of technology, so that only the big guys can deal in that.

My view is several-fold on that. First, I believe that competition for technology has
always been wonderful, it got rid of the trading floor, which was good in its time, and it is delivering new types of trading systems, so I don’t think you want to get rid of that incentive.

The second is that much of this algorithmic or high-frequency trading is in fact acting like market making used to be, it’s providing the liquidity on the other side.

The third factor is, to the extent that retail is being unfairly treated here, it has the simple option of opting out of having to deal against these better trading systems which are faster. It can choose to deal at a batch auction, at opening time, or other types of trading systems which mean that it is not susceptible to whatever it perceives to be disadvantageous to it. So once again, I am fairly pro-market on this issue.

PETER CLIFFORD
I would be inclined to agree with Ruben on most of that. I think that it’s a good development in the market. I think without high-frequency trading, without algorithmic trading (algo-trading), we wouldn’t have any prices left on the market, so we need them, first of all on the business case.

I disagree with Ruben that retail actually has a choice, because when retail goes through a broker, the broker usually makes the choice.

To go back to a story I mentioned yesterday, at the World Federation of Exchanges we do quite a lot of training workshops and one of them is on exchange technology. We were at the Massachusetts Institute of Technology (MIT) talking about that last November, and one of the stories that the engineers told us there was about being called over to air bases in the UK during the Second World War. These planes would come back completely shot full of holes, and they were asked to look at all the holes and then figure out ways to reinforce the planes where these holes were. They looked at it for a while and they mapped the holes, and then they went back to see the people in charge of the military, the Defence Department, and the Defence Department said, ‘What are you going to do to fix these holes?’ And they said, ‘Nothing, because those holes are the holes you can make and the plane still can fly back.’ It’s where there aren’t any holes—if the planes got shot there, they would blow up and not come back. So those are the areas that you have to strengthen.

Concern over new techniques on the regulated markets need to be taken seriously, but that is not where the damage occurred during the financial meltdown. We need to think about the planes that did not come back, so that reform is rightly looking for solutions to systemic risk in the OTC derivatives markets and other dealer markets.

If innovation is banned on the regulated markets, that liquidity will disappear. A serious concern at the moment is how you can get orders back on to the lit market. If you want transparency, the people who are most into transparency and want transparency on everything are the high-frequency traders.

Transparency is not necessarily something you want to have a quest for in all circumstances, because you do legitimately need to do block trades outside the order book. But still, if you want the champions of transparency—the Citadels, and Timber Hills—they want everything on an exchange or lit venue such as Chi-X, and they want everything transparent so they can do high-frequency trading.
TONY MACKAY
When we were looking to set up Chi-X in Europe one of the really big fundamental decisions we had to make at the time was: who did we want to partner with? Turquoise, which was a consortium of about nine banks, was trying to set itself up. And so, after Instinet initially launched it, we partnered shortly thereafter with Gecko, Citadel, Optiver, and a number of other high-frequency firms on the basis, as both Ruben and Peter have mentioned, that they are the modern-day market maker. They were willing to post prices that were immediately inside the spread in the major stocks. They did it in good volume and that was the thing that enabled Chi-X to gain traction very, very quickly. And I think what we’ve seen is that the high frequency trader does want to post prices, and that they are willing to operate in dark pools, as we’ve seen with Chi-X Europe’s Chi-Delta dark pool. Some of them modify their algorithms to provide dark liquidity and there’s also some of these high frequency traders that are trying to set out platforms to deal specifically with retail orders.

So I think that over time the guys that are using technology as an innovation will come up with solutions that will help most of the market and we should encourage it.

MALCOLM STARR
You asked the question Belinda, ‘Are there any issues for the regulators?’ Like the other speakers, no, I’m not suggesting there is anything that should be done to deter the high-frequency trading or the algo-trading. I think the only aspect I’d emphasise is that these developments make it a bit more difficult for the regulator in looking at manipulation.

As an example, if you have got, as we have in Australia, something like an order to trade ratio of 7:1—i.e. only one trade results from every seven orders, whereas in other jurisdictions, where the high-frequency trading constitutes a bigger proportion of activity, and you have got ratios of something like a 100:1, it doesn’t take long to work out that your task, when you are trying to detect manipulation, just got awfully difficult and you will just have to develop some different systems, but in terms of the core activity, no issue.
Questions from the audience (names withheld)

**QUESTION**
I would just like to ask the panel to comment—because of the size of the Australian market, particularly where it relates to algorithmic trading, surely when you get algorithmic trading down and stocks, say after the top 200, it actually is not market making at all because what you find is, you’re getting trades of one and two shares. Now because the volumes are too small at that end of the market, surely algorithmic trading should be confined in Australia to about the top 100 or top 150 companies. Could you comment on that please?

**TONY MACKAY**
Just as a generalisation, one of the reasons is algorithmic, as opposed to high-frequency. A lot of institutions are all benchmarked, so when they give orders to brokers they say: ‘I want volume-weighted average price over the day’. So, by definition, they have to break the order into smaller slices, and they actually found the computers did it better because the computer doesn’t go to the bathroom, the computer doesn’t have lunch and, if the stock only trades a small volume during the day, to get that average price that the institution wants, the order size becomes pretty small.

So I think algorithmic trading even for the smallest stocks is still a necessity. I think algorithms have to get smarter and work out how to interact with blocks and perhaps advertise that. I’d much rather trade 200,000 shares than two shares of this thing. That is where I think over time, the development of true dark pools of liquidity to allow these blocks will benefit everybody.

**RUBEN LEE**
I agree with that. I’m not worried that it will lead to any adverse effects, I am just not sure that it will be beneficial in some contexts because liquidity is so small. But that’s fine, then people will use it and it won’t pay, so it won’t be used. But I have nothing against it per se.

**BELINDA GIBSON**
I might draw the session to a close, and leave OTC for another day or another year. I think Ruben, your exposition of the issues was very clear. I want to thank the panel for attending here today and answering the questions and Ruben, you in particular, for your presentation.
Exchange and OTC Markets: Structure, Performance, Reform

Ruben Lee
Oxford Finance Group

Overview

1) Competition
2) Transparency
3) OTC Derivatives Clearing
4) Market Infrastructure Governance
5) Conclusions
Competition

Terminology

- Competition
- Orders
- Trading Systems
- Exchanges
- Fragmentation
- Descriptive
- Prescriptive
- Dispersal

Factors affecting Competition between Trading Systems

- Network Externality - Order Flow attracts Order Flow
- Different Trading Preferences
- Internalisation
- Automation
- Disintermediation
- Order-Routing Technology

Key Effects

- Falling Prices
- More Trading
- Better and Wider Range of Services
- More Innovation
- Focus on Clearing, Settlement & Data Revenues
Competition

Issues

- Spatial & Temporal Fragmentation Effects
- Trading is More Complicated
- Best Execution Harder to Assess, and to Achieve
- More Linkages may be Needed
- Greater Intermediation may be Required
- Effect on Capital Raising

The Answer

- Support It!

Exchange & OTC Markets: Structure, Performance, Reform

2) Transparency
Transparency

Definition

- Who has Access,
- To What Information,
- When, and at
- What Price?

Effects I

- Enhances Speed & Accuracy of Price Information
- Facilitates Choice of Best Price
- Betters Monitoring of Executions
- Effect on Volatility Uncertain
- Reduces Some Investors’ Willingness to Trade
- Can Widen Bid-Ask Spreads
- Affects Competition between Systems

Effects II

- Preferential Information and Access
- Trading System Revenues
- Derivatives Pricing
- Fund Pricing
- Index Pricing and Performance Assessment
- Allocation of Capital
Transparency

The Answer

- Recognise Multiple Effects on Multiple Constituencies
- Take Account of Actual and Potential Competition
- Confirm Merits of Transparency
- Acknowledge Excessive Transparency has Costs
- Be Realistic about Enforceability, Incentives, & Data
- Judgment

Exchange & OTC Markets: Structure, Performance, Reform

3) OTC Derivatives Clearing

OTC Derivatives Clearing

Mandated Central Clearing for OTC Derivatives: The Argument

- Bilateral OTC Credit Monitoring/Performance Failed
- Central Counter-Party Clearing Performed Well
- So push OTC trading to be Cleared via a CCP
OTC Derivatives Clearing

Flaws

- Long History of Failures of CCPs
- Ignores Factors affecting Clearing Eligibility
  - Standardisation
  - Pricing Transparency
  - Liquidity
  - Volatility
  - Risk Management Capability
- Moral Hazard with Implicit Government Guarantee

Congruence of Incentives

- Politics: Do Something, Do Anything
- Regulation: Fed & SEC weakened, Step Forward CFTC
- Business: Exchange Advantage vs. OTC Competition

The Answer

- Let Decision Taker Bear Risk Consequences
- Address Other Factors Limiting use of CCPs
- Reinvigorate Risk Management Regulation
- Encourage Competition
4) Governance of Market Infrastructure

Market Infrastructure Governance

It’s about Power

- Who has it?
- How, and why, do they get it?
- How, and why, do they exercise it?
- Power affects Performance

Why is there Concern?

- Financial Crisis
- Efficiency
- Conflicts of Interests
- Consolidation and Market Power
- Focus on Corporate Governance
Market Infrastructure Governance

Three Core Policy Issues

- Efficiency
- Allocation of Regulatory Powers
- Regulatory Intervention

Answers

- No Single Global Optimal Solution
- Answers must reflect Specific Context
- Governance can help restrict Anti-Competitive Activity
- Governance can help promote Systemic Stability
Exchange & OTC Markets: Structure, Performance, Reform

5) Conclusions

Conclusions

- Benefits of Competition between Trading Systems
- Good Execution Harder to Assess and Achieve
- Benefits of Transparency
- Too Much has Adverse Effects
- Mandated Clearing of OTC Derivatives Inappropriate
- Infrastructure Governance Critical
What is the role of gatekeepers? How did they perform in the crisis?

Professor Justin O’Brien, Professor of Corporate Law, UNSW

Panel discussion

Moderator Dr Peter Boxall AO, Commissioner, ASIC
Mr Matthew Grounds, Chief Executive Officer, UBS Investment Bank, Australasia
Mr Guillermo Larrain, Chairman, Securities and Insurance Superintendence, Chile
Mr Brian Long, Presiding Partner, Oceania Area Advisory Council, Ernst & Young, Australia
Ms Jan McCahey, Partner, PricewaterhouseCoopers, Melbourne

PETER BOXALL
This session is about: What is the role of gatekeepers? How did they perform in the crisis? We have Professor Justin O’Brien from the faculty of law at the University of New South Wales as our speaker and then afterwards we will have a panel discussion with four panellists.

JUSTIN O’BRIEN
Thank you very much indeed to Tony and to the organisers of the conference for inviting me.

I’ve spent more time than I care to remember sitting in courtrooms, from New York to Houston, looking at the results of financial failure and ethical failure. When I moved to Australia after the passage of Sarbanes-Oxley, I thought, ‘That’s it, everything’s over and we can all go home’. But now we see ourselves in exactly the same situation, in fact a worse situation.

I’d like to begin by telling three anecdotes. The first is a conversation that I had in early 2007 with Michael Gordon. Michael Gordon, as some of you here would know, was at the time the chief investment officer for Fidelity. He committed the sin of breaking the code of silence in the city by being very critical about the rise of private equity.

I went to discuss this with him and I asked what he felt was the mood of the marketplace, and he said, ‘Greed will destroy this; every restraining force in the city of London has gradually eroded’. I replied, ‘Well that’s a bit rich, isn’t it? We have seen these things before.’ And he said, ‘If you look back to New York in the 1980s, if you go back to London in the 1980s, the mood now is much, much worse’.

Fast forward to October 2007—this is after BNP Paribas analysts had famously said that large sections of the securitisation market in the United States had vaporised overnight. I went to see a very sage banker by the name William McDonough, former head of the Federal Reserve Bank of New York, who then went on to lead the Public Company Accounting Oversight Board set up in the aftermath of the Enron and WorldCom scandals, and then who later emerged to work for Merrill Lynch. I asked him, ‘How do you think the market is now?’ And he said,
‘Mark my words, this is a market of incendiary toxicity’. It was quite an interesting conversation. A couple of weeks later the head of Merrill Lynch was forced to resign, and a year later Merrill Lynch existed no more.

I went to see William McDonough again in 2008 when I was writing the book *Engineering a financial bloodbath* and I asked him, ‘Where do you think we are now?’ And he said, ‘We’re not even round the first corner, but if we think we can solve these problems in the financial market by reliance on technical solutions, we will be in effect rearranging deck chairs on the Titanic’. Ultimately, in McDonough’s view, the global financial crisis was an ethical failure, it was a result of a collapse of values, and a technical solution alone will be deficient.

Finally, I went to see the UK Financial Services Authority (FSA) in the aftermath of the Northern Rock failure, and I asked, ‘What happened here then?’ They said, ‘This isn’t a failure of our risk-based regulatory model; rather it was a failure to apply it’. I thought this was quite a self-serving ‘mea culpa’.

But I thought it was quite interesting, because what’s really important about the global financial crisis, it seems to me, is that this was not just a failure of rules as in the United States, because rules as we know can be transacted around. It was also a failure of principles-based regulation.

So, what do we actually know about the financial crisis? What we do know, and I think there’s common agreement on this, that there were these flawed governance mechanisms within the firms, there were these flawed models of financing, and there were these regulatory structures predicated on risk reduction that didn’t pay sufficient attention to systemic risk. It’s interesting that, in the period from 2004 onwards, business quiescence in the United States had dissipated, and the regulators as gatekeepers found themselves under sustained assault to weaken the regulatory structures so that New York could compete against London, and this was a result of a series of reports including a report commissioned by Hank Paulson, who was at the time Treasury Secretary.

So what we have seen in the United States is a failure of rules, because rules can be transacted around. We have also seen a failure of principles, because they lack the granularity to be enforceable. This dichotomy between whether we should have a regulatory system based on rules or a regulatory system based on principles has been proved to be a false dichotomy, because ultimately what the financial crisis has demonstrated is that rules and principles alone will not actually resolve the crisis. What we really need to think about is how those rules and how those principles are interpreted by specific communities of practice. So, for example, how do the lawyers, auditors and investment bankers interpret their responsibility, as critical gatekeepers in the financial markets with an obligation, in part, to ensure that the market behaves with integrity? Unfortunately, there is no sign that this debate has taken place in any meaningful sense.

The problem is that, in the aftermath of crisis, we have moved from government to governance, governance to responsibility, responsibility to integrity without stopping to examine how these concepts are interpreted in practice. This failure accounts, in part, for

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why reform of capital markets proved so elusive. It is because mapping the parameters of what constitutes accountability is a very complex task. We heard this morning issues about how transparency and its normative value is interpreted in a particular discrete part of the market in ways that conflict with non-technical usage.

Likewise, the creative ambiguity about what accountability is highlights a possible disconnection between the rhetoric and the substance of reform. So we have Gordon Brown, for example, talking about the need for a new social contract. We have Nicolas Sarkozy of France talking about the need for an investigation of the forces that destabilised capitalism, and we have Barack Obama talking about the need to inculcate a new ethos of moral responsibility. These are very, very complex questions that come to the heart of the problem, which is: what is the purpose of regulation? Not how do we regulate, but for what purpose do we regulate? Unless we actually have a serious conversation about purpose it is very hard to assign specific responsibility to any gatekeeper, whether it be a regulatory organisation or whether it be a community of practice.

Now it seems to me that the ultimate failure at the heart of the global financial crisis—which we have not gone anywhere towards resolving, other than in rhetorical terms—is a lack of understanding about what accountability and integrity mean. That is because we don’t focus on the normative dimension. In other words, what is, or what ought to be. Here political economy provides one of the reasons why.

Economists have had a hard time in this crisis, and I suppose one of the few left standing is Oliver Williamson, who won this year’s Nobel Prize with Elinor Ostrom. Williamson discussed the problem in a landmark paper in 2000 in which he talks about governance, the workings of governance, and how it operates in four distinct domains, four distinct levels.

So at the bottom, level four, in reverse order, is how people transact in the marketplace. They transact in the marketplace through governance arrangements that are basically established, calibrated, and re-calibrated in a 1–10 year time frame, and this fits within an institutional environment that tends to change in a 10–100 year time frame. So if you lived in the United States for example, you would look at the emergence of the New Deal architecture in the 1930s and then the progressive dismantling of that through governance arrangements in the intervening period.

What Williamson also suggested, however, is the critical importance of the level one domain, i.e. underpinning social norms. By social norms he is talking about variables such as trust, integrity, and honesty. There is a conception that these accrete over time, and they remain stable. The critical problem in the global financial crisis is that those social norms were actually much more eroded than we supposed and we have to understand why that is the case.

It is for this reason that I chose title for my latest book, *Engineering a financial bloodbath*. This was not journalistic licence.

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34 Oliver Eaton Williamson (born 1932) is an American author in the area of transaction cost economics. From 1965 to 1983 he was a professor at the University of Pennsylvania and from 1983 to 1988, Gordon B. Tweedy Professor of Economics of Law and Organization at Yale University. (Source: Wikipedia)
The title is a direct quotation from Mike Smith, the head of ANZ Bank, who, when asked to explain ANZ’s relative poor performance, said ‘If you think this is bad, go to New York, go to London, and see for yourself a financial services bloodbath’. Of course this bloodbath did not happen by accident; it was a result of engineered products and processes. The problem is not with the products or processes themselves; rather, it is the inappropriate application. The problem is not with securitisation per se, it is with the emasculated conception of responsibility for the design of that product.

So the critical issue that we need to resolve, moving forward, is how the social norms disintegrate. Why did they disintegrate? If we think that we can resolve this problem by reducing leverage ratios, by putting limits on proprietary trading, we are kidding ourselves. Unless we deal with the normative dimension we are not going to get anywhere.

So, following Belinda’s comments yesterday that we lawyers should basically learn from the economists and learn to speak with the economists, I thought it would be useful to go back to three of the kings of 20th century political economy.

So there are three quotations on the slides. Joseph Schumpeter36 is world famous about his notion of ‘creative destruction’. And one could say with the nature of financialisation, we have the literal inverse of that, we have destructive creation. Essentially this gale of change is Schumpeter’s major argument, but at the same time he recognises that no social system can work in which everyone is guided by nothing except short-term utilitarian ends.

So, for Schumpeter the stock market is a poor substitute for the Holy Grail.

Another critical figure is Polanyi37—these books were all written in the middle of World War 2—and Polanyi’s argument I think is really quite interesting. He argued that we have tended to separate the market from the political sphere and this serves very distinct purposes, we need to be aware of this. So this links into Ruben’s argument this morning about power. Who has power? How is that power used? Are the people who are exercising power accountable for the use of that power and, if not, what are the implications?

Even the most doctrinaire of the Chicago School, Hayek38 being the intellectual Godfather in many ways, argue that parties in the market should be free to sell and buy at any price. This is the classic Chicago line; however, at the same time, even Hayek recognised that, in no system that could rationally be defended would the state just do nothing. The state has a role to play, but so too do market professionals. So Hayek begins his book with an epigram from Lord Acton, and I suppose you could use a similar one in relation to the global financial crisis from GK Chesterton, which is, ‘it’s not that they can’t find the solution, it’s that they don’t understand the problem’.

This brings me to my third anecdote that I promised you. This centres on the defenestration of the former Chairman of the

36 Joseph Alois Schumpeter (1883–1950) was an economist and political scientist born in Moravia, then Austria-Hungary, now Czech Republic. He popularised the term ‘creative destruction’ in economics. (Source: Wikipedia)

37 Michael Polanyi, FRS (born Polányi Mihály) (1891–1976) was a Hungarian–British polymath whose thought and work extended across physical chemistry, economics, and philosophy. He was a Fellow of the Royal Society and a Fellow of Merton College, Oxford. (Source: Wikipedia).

38 Friedrich August von Hayek CH (1899–1992), was an Austrian-born economist and philosopher known for his defence of classical liberalism and free-market capitalism against socialist and collectivist thought. (Source: Wikipedia)
Federal Reserve at a congressional hearing in Washington. I was at the hearing in Washington. Greenspan comes into the room, he’s 82 years old. Last time he had been in Congress it was to receive an award from Congress. He had been regarded as a central banker’s banker, the maestro and the subject of Bob Woodward’s book. He worked the room like an accomplished star; he shook the hands of the people who were taking the testimony, including Henry Waxman who was the chair at that particular hearing. He nodded sagely to everyone around him and then he sat down and he took questions and he gave explanations. And this was a critical quote, he said he ‘found a flaw’. He admitted that his belief was ideologically driven. In other words, it was politically driven. It wasn’t necessarily economically rational. It was an acceptance of the danger of the bifurcation that Polanyi had talked about in the 1940s; it was an open admission that in actual fact this was true.

And it was amazing to see this guy age in front of me. I suppose he was as far away as Peter is from me here. It is quite a scary thought when you think he’s 82. But what was interesting was that was the moment in which a dominant paradigm broke, and we are now basically living with the consequences of that. So it’s ultimately the battle for political ideas, a Kuhnian moment. By that I mean, it is a moment when the actual paradigm itself loses credibility and, to remain wedded to it becomes exceptionally problematic, and one can only remain wedded to it if you pile on even more exceptions, even more assumptions.

So how then have policymakers responded? Well, in many ways they’ve responded in mechanistic terms. It was clearly a failure of the instrument or instruments and so the cure is simply to reform, replace, and repair. ‘Do something’, as Ruben said this morning. But accountability can also be conceived in normative terms. If it is a question of an absence or collapse of particular norms, mores, standards, then what we really need to do is we need to re-establish those.

This ultimately brings us back to the father of economics, to Adam Smith⁴¹. Now, a lot of the columnists like to talk about the invisible hand of the marketplace, but they lose sight of Smith’s more important work. Last year, by a quirk of circumstance, was the 250th anniversary of the publication of that work, *The Theory of Moral Sentiments*. A classic line is that a moral being is an accountable being. So the critical question for Smith and for policymakers today remains, ‘How do you make people accountable?’

There are different ways in which you can conceive of accountability. From the perspective of allocating blame, of course credit rating agencies have already taken quite a lot of the heat, in much the same way as the audit community took the heat in relation to Enron and WorldCom. And Obama, when he made his speech, took a swipe at the regulators—the regulators lack the authority to take action and they lack accountability for their own inaction. What Obama did not mention was the pressures that the regulators in the United States were under to do nothing from 2004 onwards.

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⁴¹ Adam Smith (1723–1790) was a Scottish moral philosopher and a pioneer of political economics. Smith is widely cited as the father of modern economics. (Source: Wikipedia)
And even the regulator that entered into this space most dramatically—the Department of Justice tried to deal with problems of creative compliance with creative enforcement mechanisms—found that its credibility was fundamentally challenged, in part because of mistakes it made most notably in a case being taken against KPMG in relation to tax avoidance or, as the Department of Justice put it, tax evasion strategies. KPMG did pay an enormous settlement, one of the biggest ever recorded. It did agree to an external monitor coming in to monitor its behaviour moving forward. It did agree to change its behaviour and to close down its wealth management practice.

If the Department of Justice had stopped there it would have had an enormous win; instead, the Department of Justice decided it would go after the named partners and criticise KPMG for providing funding for these people’s defence. As a consequence Justice Kaplan in New York accused the Department of Justice of putting a gun to KPMG's head and acting unconstitutionally. So the danger, and the lesson for regulators here, is that authority basically can move away very quickly if you try to deal with creative compliance with creative enforcement. You need to do something substantially more sustainable. What can you do? What ways can we conceive of this?

In a way three main strategies have been used, according to a framework developed in conjunction with my colleague Professor Melvin Dubnick of the University of New Hampshire. Traditionally we deal with accountability in relation to performative or managerial approaches. We’ll set what their agent is accountable for and we’ll allow the agent to determine how to do it in the good times, and we might use performative measures in the bad times and, if there’s a major crisis, we’ll move over to a regulative approach. Of course the failure of a regulative approach is made manifest by the infamous s404 of Sarbanes-Oxley. What happened to the internal controls? How come the internal controls didn’t work in relation to the global financial crisis?

If you look at the reform agenda that is now being followed at the G20 level, then you see that these three strategies are how we’re actually dealing with the crisis. I am not saying that these are not good things to do. Rather that they will not solve the crisis. The crisis is ultimately a crisis of a lack of integrity, a lack of values being lived. In that sense I would agree with Hans’s comment last night, that this is a monumental failure of the financial elite. It is not just a failure of the regulators. It is not just a failure of individual firms. It is a failure of the community that operates within financial markets to live up to stated values. Unless we deal with this problem on those terms we will, as William McDonough suggested, simply be rearranging deck chairs on the Titanic. Ultimately we will not be able to miss or evade the icebergs in front of us. So I’ll leave it there. I’m more than happy to take questions and thank you very much for your attention.

PETER BOXALL
Thank you very much, Justin, for a very intellectually stimulating presentation. We have a bunch of gatekeepers here and I look forward very much to discussion on Justin’s presentation.

You have raised some really big issues and I would be interested in the panel’s views. You mentioned that we have an issue of a lack of integrity, a lack of values, and the failure of the financial elite to live up to their values. These are all things that resonate
with me and I think they resonate with lots of people.

The big question is the question you asked, ‘How do you get people accountable and what do we do about it?’ You’ve mentioned a number of approaches and pointed out some pluses and minuses to those, but I would be really interested in getting the panel’s views on how you actually do something about this, how do you actually get people to live up to values that the community accept as the norm. Matthew, would you like to kick off?

MATTHEW GROUNDS
Sure. Let me first just introduce myself. UBS is a global financial services organisation. The reference to gatekeepers includes research analysts, and we’ve got more than 500 research analysts covering about 3,000 companies around the world. I guess you would say there are a lot of gatekeepers there.

I agree with Justin’s comments around accountability, I think it is hard not to, as that is the core of the issue. I am, however, not sure about Justin’s comments around social norms.

The crisis wasn’t a particularly good advertisement for financial services firms, but I think you’ve got to work on the principle that generally people in financial services firms, in senior positions, are trying to do the right thing. I think, when we look at this crisis, we also shouldn’t get overly excited about generalisations, because I think this really was a North Atlantic financial crisis and, if you look at our market here in Australia, we fared relatively well. Whilst there were isolated events, I don’t think your comments around social norms would apply as broadly in the Australian market.

Having said that, Peter, I don’t have the silver bullet. We as an organisation strive to make sure our staff are accountable. We try to make sure that we are managing our risks and we have incentive structures in place that actually deal with that.

I think a reward system based on, not unrealised gains, but more cash-based profit, and, if you like, risk adjusting the economic profit, is also going to be an important tool in terms of making our organisations more accountable, particularly to the shareholders and also to the broader market.

GUILLERMO LARRAIN
My feeling is that it is a bit early to try to make a bridge between these very high level observations that Justin has provided to us, and some implementable set of rules. But I would encourage Justin to continue on with the Centre he is establishing at the University, because this is the kind of discussion and reflection that we must continue having into the future, in order to guide practical applications of rules and principles.

Nevertheless, I would like to make some comments. One is that you mentioned that social norms have been eroded, but I wonder if that is true. Is it that we have a vision that everything in the past was fine, that we were happy in the wonderland in which we lived. Because if you look back at the past, what you will see is that the social norms in many cases were severely—and I mean severely—damaged.

Let’s think about greed, not so much in terms of money-making, but more broadly. When you think about the sorts of social norms espoused in the past—perhaps originally for political or religious purposes—you might wonder whether we might have understood
them as applying only to particular community activities and groups. For instance, there are certain types of conduct in politics that are no longer accepted anywhere in the world.

Then you might expect people to start looking for other outlets for satisfying their own internal greed. That is, outlets where they can express that greed more freely, and in a socially acceptable manner, for instance, today’s financial markets. That’s just an hypothesis, but I suspect that, if you think there was in the past a sort of ideal state of the world from which we have fallen, then I suggest that fall from grace occurred a long time ago.

Another thing that strikes me as relevant here is that I think human beings are prone to a kind of myopia. And I want to return to the point we were discussing yesterday about the recent developments in behavioural economics. For instance, it’s not by chance that social security is mandatory. It’s because human beings are myopic, and find it difficult to look into the future with much insight. And therefore some rules must be applied to compensate for that short-sightedness, because of that human failure.

The third point I want to make, is that ideological positions tend to distort the reasoning of people. I was really shocked when Justin mentioned that US regulators were persuaded by political pressure to do nothing from 2004 onwards, when they ought to have known that they should be doing something. Those same regulators travel around the world, meeting with fellow regulators, and representing their organisation and their country. And as they do so, those same regulators are subject to codes of conduct that do not permit them to accept a gift from a fellow regulator worth more than, say, $50. So when you say they were failing to perform their regulatory role properly and ethically, it seems strange to me to see that inconsistency in behaviour going on.

Finally, can I say with respect to the terms of reference for this discussion, that we need to look at what is going on with those gatekeepers, in particular, the regulatory agencies. We know that they travel around, at least since the Mexican crisis in 1994, and that the problems identified following that crisis have still not be solved in 2010. That is a big point, to my mind.

Concerning auditors, I think the audit industry resisted a lot of the improvements that were proposed after the Enron case. There were several reforms up for attention, but there was a lot of negative reaction. And so I don’t think we made as much progress as we should have. In regard to the regulators themselves, I go back to my comments yesterday about the governance of regulators. We have not paid sufficient attention to improving the standard of regulators in the current environment. We devoted the nineties to improving the standards of central bankers. We reformed central banks around the world and we gave them special social and legal frameworks. But we haven’t done exactly the same for regulators. So my feeling is that the next ten years will be the time to focus on regulators.

BRIAN LONG
Thanks Peter, Ernst & Young is a firm of about 140,000 employees around the world in professional services, and just a little bit less than half of them are involved in the assurance business, the audit practice, so you might say there are 75,000 to 80,000 gatekeepers in Ernst & Young and a similar or larger number in Jan’s firm. We are very
accustomed to the role of gatekeepers because we see that as a very large part of what our business is.

Over time there have been changes following some of the corporate collapses that have occurred, where rules relating to higher levels of independence and objectivity and the like have been put in place, and I am not sure I agree with the resistance that the profession has been said to have adopted.

Certainly there has been dialogue, but I think where the profession has gotten to in terms of its accountability, which is measured—if you say our role is a gatekeeper—by the things that we are being asked to hold corporations accountable to, and that is principally the framework of the accounting rules and the reporting standards.

Unlike some of the corporate collapses that we have seen in the recent past, prior to this event now, oftentimes it has been failure to do with how the rules have been applied. You know, there was creative accounting back in the eighties. There is a whole range, a myriad of things, where accounting failures don’t cause collapses. What they do is prevent the opportunity to detect them early enough. I don’t think in this recent crisis it has been a question of accounting failure as much as things to do with the business, so I can hear resonance with Justin’s comments about the issues to do with moral standards or integrity or ethical behaviour. In its simplest form, we all know what the right thing to do is given a choice, and it is choosing to do the right thing when those choices are presented.

From our perspective, looking at business over the last 10 years in particular, I think the compensation arrangements that executives have, not only in the financial services sector but also in others, are symptomatic of behaviours that might lead to people making choices that are not the right choices and for the wrong reasons.

JAN McCaHEY

While I concur with a lot of what Brian said, the notion of towards 100,000 gatekeepers is a bit of a challenge for me. I much prefer to avoid the notion of a gatekeeper, because that implies that somebody is going to keep people in, or keep people out. Whereas my sense is that thinking of this as a system, where there are lots of people who’ve got responsibility and accountability for together making sure that a market works well, is a far better notion for us to be thinking about. I do see all of us as being engaged in that and I would say that audit takes a pretty central role in ensuring that a capital market works well.

The other thing I’d say is that, while it is commonplace for us all to tend to look at what things went wrong and how we can fix them, I wonder if there is something else we should be doing too, and that is, looking at what things went well and how we can do more of that. So it does strike me that there are several respects in which Australia performed pretty well before and through this crisis. Maybe some of it is to do with the legislative reform that was established earlier in the 2000s in response to some corporate collapse activity and so forth.

But I do think from my observations that the role of audit has worked pretty well through the crisis. I think we’ve seen some examples where there has been the right level of tension in debates between people giving assurance and people preparing financial information. And it seems to me that we have seen in action a degree of professional scepticism and focus on risk that is exactly
what the community would expect to see. So I wouldn’t like us to get swallowed up today in a sea of disaster, because I think there is plenty of good that’s happened.

PETER BOXALL
Thanks, Jan. I actually feel somewhat more optimistic also. A question has come up from the floor, ‘Have investment banks and professional service firms got so large that it’s very difficult for them to manage conflicts of interest?’ What do you think, Matthew?

MATTHEW GROUNDS
Well firstly, in relation to conflicts of interest, a lot has been said about the rating agencies. A fact that actually surprised me when I was preparing for this is that 50% of the credit rating agency revenue was derived from structured finance transactions in 2007, which is quite a remarkable figure. Where there is potential for conflict of interest, and we’ve all talked about it already, it’s the concept of remuneration and I think that needs to be addressed.

Do I think that the size of the organisation is an issue? Look, I think you would have to say it contributed to the crisis, because when you think about the businesses within each of the investment banks that caused the problem, it was actually quite a small part of their overall business. In fact, in some cases there were 30 or 40 people involved in an organisation where there were more than 100,000 people employed.

So it would be hard for me to say scale wasn’t a factor in missing it, but when you think about the crisis and again, I come back to your comments Justin, one of the key causes was simply an over-reliance on the credit rating agencies. What these gatekeepers do is provide an opinion, but it’s not something you want to bet the farm on and clearly, there are a lot people that did bet the farm on an opinion, which was a mistake.

JUSTIN O’BRIEN
I’m not saying that people have become greedier; it’s simply that the opportunity costs associated with engaging in sub-optimal behaviour had changed, and I think we need to take that into consideration.

Likewise, I’m not saying that there was necessarily a problem with a moral failure of the regulators. What I am suggesting is that the regulators act within a space and we have to pay attention to how that space operates and the pressures that were being placed on the regulators. So for example, the US Securities and Exchange Commission (US SEC) accepted the Consolidated Supervised Entities Program in 2004 and basically in a hearing said, ‘Let’s see if this works, let’s cross our fingers and hope it works because if it doesn’t there’s going to be a major disaster’. When the Consolidated Supervised Entities Program was abandoned, Christopher Cox, who was the chairman of the US SEC at the time, said, ‘Let’s face it, self regulation doesn’t work’. This is what this demonstrates.

So if we want to move away from prescriptive regulation and we want to have a light-touch principles-based regulatory framework, then we have to make sure that those people who have been given delegated authority actually live the stated values and we need a framework to do this. So I’m not suggesting that we’ve had some ideal that we’ve fallen from, all I’m suggesting is you have to bear in mind the context in which regulators operate. You also need to understand that there were emasculated conceptions of responsibility, and so you had CEOs of major banks going to give testimony, in Washington and in Westminster, and being asked to explain in
simple terms a collateralised debt obligation (CDO) and they couldn’t do it.

The final point that I would make in relation to this is that the global financial crisis was, in the main, technically a legal crisis. This was not criminality on the margins; this was a collective myopia, a collective failure, and a collective failure of judgement. It seems to me that, if you look at all of the scandals that we’ve seen from 1998 onwards, we have a failure of institutional memory. How do we create systems where we have institutional memory retained so that we don’t repeat the mistakes of the past?

MATTHEW GROUNDS
On the conflict of interest point, it’s probably easier for me to talk on behalf of the auditing firms in the sense that there wasn’t a failure here of the auditor. This crisis wasn’t about a conflict of interest with the auditors or a conflict of interest in relation to the investment banks. I have already made the point about the credit rating agencies.

PETER BOXALL
So what do you think, Jan? Is scale an issue in terms of managing conflicts of interests within an organisation, institutional memory, and so on?

JAN McCAHEY
I think that scale just means that the restrictions and the processes that are put in place inside an organisation tend to, if you like, be more restrictive and, therefore, protect more against this sort of thing than otherwise.

So within an organisation that is a very large scale, there will tend to be far more restrictive processes and systems in place to avoid a conflict arising. So the independence rules, which would apply internally within a firm such as ours, will be at a more elaborate level than within the law and so forth, so that you tend to ensure that these sorts of conflicts don’t arise. So I don’t think that the scale makes it more likely that a conflict arises. I think in fact it becomes less likely.

And I would say just from an audit point of view, what we really are putting on to the bottom of every audit report is the name and brand of the firm, so there is just no way that taking on one client is going to be worth destroying the brand for. So I just really don’t see it as much of an issue in our context.

BRIAN LONG
I share that view, Jan. The reality is the task of managing conflicts of interest within major accounting firms needs to be systematised because of their size. And so with systemisation of those processes—and we have global IT-based systems—you simply can’t start work unless you’ve cleared all the conflict. So it’s considerably more rigorous than what otherwise has been a relatively ad hoc process for much smaller firms.

PETER BOXALL
Guillermo, you made the point that the last decade was about getting the central banks right and next decade it’s about the regulators. One reason that people got the central banks right in my view is because they started to focus on one end game which was inflation, although that’s now been raised as an issue by the Organisation for Economic Cooperation and Development (OECD). What do you envisage needs to be done in a general sense to embark on putting the regulators in a different environment?

GUILLERMO LARRAIN
Well, adopting the ‘twin peaks’ model is the short answer, because to some extent ‘twin peaks’ facilitates, at least in theory, the task of regulators. That’s because you can focus
What is the role of gatekeepers? How did they perform in the crisis?

on one particular function, and not on multiple functions which can sometimes be in conflict. For instance, I supervise insurance companies, and that means protecting not only policy-holder rights, but also insurance company solvency. And there can be a conflict there that I need to manage.

If we were to adopt the ‘twin peaks’ model, I would probably remain in the conduct and disclosure business, defending policy-holder interests, and let someone else safeguard the solvency of the company. Another agency, like the Australian Prudential Regulation Authority (APRA), would be in charge of that aspect. So to some extent adoption of the ‘twin peaks’ model, at least as I understand it, would help a lot in this regard. But you also need to other reforms along the lines of some of the ideas we discussed yesterday.

But let me mention another aspect that’s important, I think, for gatekeepers. It arises when you’re asked to say when something is going wrong, even though many people believe it’s going right. What we have is this interesting distinction between being ‘conventionally wrong’ and ‘unconventionally right’. Now, the gatekeeper is the one that should be ‘unconventionally right’, that’s what we want from them. So, if you’re auditing a balance sheet and the company’s saying all is wonderful, and they’re doing all the right things, it’s very easy to be ‘conventionally wrong’, and it’s very difficult to be ‘unconventionally right’. So we need to study a little bit more of this aspect, and how to give regulators rules to become ‘unconventionally right’ rather than ‘conventionally wrong’.

BRIAN LONG
I think Guillermo is absolutely right. I think in this part of the world, and I mentioned it at the beginning, that there had been lots of change over the last 10 years, or less than 10 years perhaps, around independence, around the law relating to how corporations need to behave with their auditors. I think all of that has been enormously helpful, whereas I think now you can separate corporations and their management from boards of directors and auditors, and the need to be unconventionally right is less so, I believe, in the environment here now.

So I think that there is an alignment of interests between boards of directors in corporate world Australia now and the auditors, whereas I can’t say that’s always been the case, and the alignment more often has been boards with management and the auditors being the ones seeking to blow a whistle.

PETER BOXALL
I was in Canberra in the 1990s when both the Reserve Bank targeting of inflation and the adoption of the ‘twin peaks’ in Australia were put in place, and I think that is the way to go in terms of providing a framework within which people can operate and minimise issues of conflict of interest.

I have a question here about the relative impotence of the regulator. How do we provide appropriate mechanisms or a framework to encourage the contrary view?

JUSTIN O’BRIEN
I think one of the problems is, in the aftermath of scandal, we tend to create these new rules, and of course they are all designed for the last scandal, which has already happened. So it seems to me that an effective regulatory regime is one which is dynamic and responsive and is forward looking and is able to catch, or spot, issues before they become major problems.
I don’t think this is something you can rely simply on the regulator to do. The regulator needs to engage on an ongoing basis with the regulated community in an honest, non-confrontational dialogue. The problem with that, of course, is the regulator always runs the risk of capture and that is a significant problem.

However, the flip side of that is that, by working together and addressing what are emerging trends in the marketplace and then debating these privately, through chat and seminars et cetera, and then publicly feeding this into discussion documents that are disseminated more broadly, this can have the impact of basically ameliorating problems before they become major problems and I think the UK FSA does this pretty well. I don’t see significant evidence that it is done here in Australia to the same extent.

PETER BOXALL
We have lots of discussion papers.

JUSTIN O’BRIEN
I don’t think industry would necessarily see that the consultative process is as strong as it could be. This is also raised in the report on ‘Australia as a financial services hub’, which calls for greater ongoing dialogue. I think that dialogue is really essential, because it is only through the market participants that you are really going to figure out what is going on in the marketplace.

GUILLERMO LARRAIN
I agree with that. One interesting thing concerning central banks, and one of the reasons why central banking has improved so much, is that they are extremely accountable, and not just to politicians. The central bankers must go to Congress and explain what they are doing, but they also are accountable to markets. And a feature of the monetary policy process is that it involves market expectations, and the market expectations about future policy movements reflect how credible the central bank is in conducting monetary policy.

So my feeling is that, in the securities regulation world, we need to find ways to be more accountable in this precise sense. And what you were talking about is the same kind of exercise, if I’ve understood the question correctly?

PETER BOXALL
No, that’s fine. I have a couple of other questions here which are coming up from the audience. Professor O’Brien spoke about the failure of integrity of the whole community. We now have the example of our federal government, demonstrating their interpretation of ministerial accountability; this is a very political one. So is this a matter of helping to set the norms in the community? Do markets follow the examples of their ultimate governing agencies?

JUSTIN O’BRIEN
Pass.

PETER BOXALL
Pass, well done. Do we have another question from the audience? Good, thank you
What is the role of gatekeepers? How did they perform in the crisis?

Questions from the audience

QUESTION
The moral hazard now is ‘too big to fail’, but there is an opportunity for the banks, the major investment houses, hedge funds, other participants in the market to say, ‘Well, that’s too big to fail, so I can go hell for leather’, I think it came up yesterday, ‘I can take a risk because I can make a super profit and if it really goes pear shaped, well, that’s what the government is for’. What do you think should be done to mitigate that ultimate hazard that sits there now?

MATTHEW GROUNDS
Look, it is clearly an issue and I think even investors are working on that basis, in terms of when they are investing now, and around financial services companies I think there is a view that the government will step in. It’s a little bit like with Greenspan, basically the expectation was he would do something. So it is an issue. How do you fix it? As I have said, I believe remuneration was an issue and I think it is being addressed and that is an area which needs to be focused on in terms of making sure the incentives are aligned with real profit, not manufactured profit.

GUILLERMO LARRAIN
It is not credible that if tomorrow JPMorgan Chase were to become bankrupt, or verging on it, then the American Government would not jump in. That is simply not credible under any administration, and that issue will be there always. How to tackle that? We had a very large financial crisis in Chile in the eighties, with several banks that went bankrupt. The difference with the current situation is that the ownership structure of our banks was different, because they basically had one very large shareholder and some much smaller minority shareholders. What happened to those banks in the eighties is that the largest shareholder lost everything. Even though there was state intervention, the major shareholder still lost the bulk of the asset that it had badly mismanaged. The problem for countries with a very atomised bank ownership structure is that you would let every shareholder suffer the loss. And that is a real problem, especially because they are basically not responsible for what happens. Those who were responsible in this crisis were the management. They gave themselves large bonuses, and now they are living happily in Fort Lauderdale with the beautiful houses and so forth. So we need to find a way to make the people who are responsible for the problem more accountable in some way. I don’t know exactly how it works in the US or here in Australia, but the managers who made those very poor decisions—even assuming there was no fraud—need to pay something, if they caused the need for the bail out.

JUSTIN O’BRIEN
I think what is interesting in relation to this is Lloyd Blankfein, CEO of Goldman Sachs, gave evidence in Congress a couple of weeks ago and stated publicly that the febrile nature of capital markets means that intervention may be necessary again and he fully expected the administration to move in.

The problem I think that we’re facing is we haven’t resolved the issue, we have just simply transferred it, and we have transferred it to the States, with limited and declining capacity to actually do anything about it, moving forward. I think that is a real problem.

Our capacity, certainly the capacity in the United States, to actually do anything substantive about this has been squandered.
Let’s be honest about this. The major commercial banks were able to exit the ‘Troubled Asset Relief Program’ under very light conditions, and with it the capacity of the state to impose the kind of reforms that would be necessary to ensure that there was more credibility in the efficacy of their internal systems. So I think we’ve got to be aware that the optics have changed and the reality has changed. The rhetoric is all things have changed fundamentally and the reality is, certainly in the United States, that the banks got away with it.

PETER BOXALL
We are getting a number of questions, and some of your comments about Mexico and the credit ratings agencies have given rise to this question. ‘If we’d known about issues with credit ratings agencies since the Mexican crisis in ’94 and are only acting now to tighten regulation, which gatekeeper would we be looking at closely in the next crisis? Research analysts? Investment bankers? Is this an issue of a lag?’

GUILLERMO LARRAIN
After the Mexican crisis, during a period when I was working at the OECD, we wrote a paper on the lessons raised by that crisis, and it demonstrates how slow people were in coming to understand what was going on in Mexico. Afterwards it was very clear, and it should have been clear much earlier. The problem, which is well-known, has to do with conflicts of interest, of which there are several, and you have mentioned one of them. But Mexico had the traditional one, which was the pressure on the advisory experts to go along with the party paying the bills. It is very difficult to know how to manage that issue of independent advice. We will not remove the risk of financial crisis without first making a serious effort to fix that particular problem. At present, we have politics being played with gatekeeper agencies, and that is complicating any effort to find real technical solutions.

MATTHEW GROUNDS
I think the regulatory reforms around more transparency, around the methodology used by the credit rating agencies to come to a view, will be helpful. I think it has generally been a bit of a black box. Hopefully, with more transparency around how they came to a rating, investors and people who rely on that will ask themselves, ‘Do I agree with that methodology?’

Historically, credit ratings have never been forward predictors and there is a great example in Babcock & Brown, in June 2008. Three months earlier the stock price was $25 and had I think 10 hours with screaming buyers on the stock; three months later when the market cap fell, basically all of those analysts moved to sell at $5. Finally the rating agencies came out and said, essentially, ‘We’re moving it from below investment grade because the share price has gone down’. So obviously in terms of what happened in the US around the sub-prime, it is another great example.

GUILLERMO LARRAIN
I don’t feel that transparency here is the real issue, because nobody will care about the methodology, nobody will read the detailed analysis, and there will still be pressure to put a positive spin on poor ratings. One option would be to have the investors paying for the ratings, but that would be very difficult to achieve. We have a solution in Chile, which is only practical for small countries, I would think. It involves having a semi-public institution that monitors ratings, case by case. I was the chairman of that organisation. If you were not convinced by the rating given in a particular instance, then you forced the
What is the role of gatekeepers? How did they perform in the crisis?

PETER BOXALL
That’s also a resourcing issue.

MATTHEW GROUNDS
Yes it is.

PETER BOXALL
There is some interest in the risk management system. This often comes up, the failure of risk management systems in banks or other financial organisations, so I’d be pretty interested to get the panel’s view on the state of the risk management systems and in particular in some of the large organisations such as UBS. Matthew, what are the consequences for unaccepted behaviour, for poor implementation of risk management for individual staff members or teams? I am also particularly interested in getting Jan and Brian’s views.

MATTHEW GROUNDS
On the second component, at UBS we have a new chairman, more or less all new non-executive directors, and we have a new CFO and new people running each of our core businesses.

If you look at what happened not just from a market perspective and a regulator perspective, but also from an employee perspective, I think that the vast majority of employees were pretty unhappy about what happened and certainly weren’t the cause of the problem.

Throughout the organisation, the focus and the re-focus now is around risk and how we’re measuring it, and also how we’re testing it against the ‘what ifs’, in terms of further scenarios on rating agency treatments for instance. So I would say that, out of this crisis, you are definitely going to get improved risk management systems.

JAN McCAHEY
I think that’s right. My sense is that, in many respects, there has been a tendency to over rely on quantitative models to assess risk and, of course, the problem with using modelling for any sort of purpose is that the models have to be built on the basis of experience. And so to the extent that that model is built based on experience, it is going to work well as long as the past experience is replicated through into the future. In circumstances where the past experience wasn’t replicated into the future, and you had a major unexpected event, naturally the models can’t cope with that.

So my sense is that we are seeing people focus much more intently on ‘what if’ scenarios, what is the worst that could go wrong here—the Black Swan type approach. Has there always been some of it? For sure there has, but we probably moved away as a community to focus more on the quantitative models, and now we are seeing people move back to greater incorporation of qualitative factors.

BRIAN LONG
I think there is no silver bullet to this, it’s clear that risk functions will need to become more effective, but I think if there were one thing that would make an enormous difference it is the degree of authority that the chief risk officers (CROs) have in organisations. I think, to date, my experience has been that the risk department is seen as a barrier to business in many respects and the CRO doesn’t have the power to overturn other executives. I think the CRO has to be given the mandate from the chief executive to be first among equals or maybe even ahead.
Firstly and secondly, and this is a behavioural issue, I think it has to be seen that the risk department is an enabler of business and integral to the strategic direction. Until the role is seen that way, and empowered the way I think it needs to be, then it could easily struggle in two or three years time.

JUSTIN O’BRIEN
I think that’s absolutely right, and let me give you an example of how this works in practice, with Goldman Sachs in fact.

What it has is this very interesting unit called the global business intelligence unit. Now this sits outside of legal and sits outside of compliance, both of which are not seen as profit-making centres and, therefore, risk being viewed within the firm—or indeed any investment bank—as facilitators to core business. The global business intelligence unit deals with reputational risk. That’s it. It works on the assumption that a proposed deal is legal, that it has passed all of the internal controls. The concern is what happens if this ends up on the front page of the Wall Street Journal, how does the bank deal with this?

The unit will talk with the individual bankers and the people who were involved in the deal and they will sit them down and they’ll talk through the issues and they will highlight their concerns. They are not saying, ‘No, you can’t do the deal’, they are asking ‘How do you address these concerns?’ If they are happy with the responses, well, that’s the end of that. If they’re not happy with the responses, they’ll say, ‘Well, again, we are not saying you can’t do the deal, what we are saying is we want your line manager to answer the following questions in writing’. At this stage the deal generally dies. So too does every other deal because what’s happened is that they have actually found a mechanism to institutionalise the limits of basically acceptable behaviour within the bank. Why does it work? Because the head of the global business intelligence unit reports directly to the chairman of the board.

PETER BOXALL
Just on the risk management, do we have enough training at university, are we getting graduates that are appropriately trained on this?

BRIAN LONG
My sense is probably not. I think they are given core training problems, but there isn’t an assembled body of knowledge and behaviour and skill sets that put a person out of university with risk management capability.

PETER BOXALL
There are some industry bodies that help in that regard but the reality is it’s more done internally.

BRIAN LONG
If we take Justin’s model we could start hiring people with first class honours degrees in philosophy and ethics. It would help.

JUSTIN O’BRIEN
It’s interesting. A lot of hospitals employ full-time ethicists because these are really, really tricky questions and which ultimately go to the heart of reputation, and reputation is a critical value in financial markets.

PETER BOXALL
Another line of questioning that’s coming up from the audience and which I pitch to you first, Guillermo: are there ways for regulators to encourage good practice with more carrots rather than sticks? Is this—in terms of incentives for good behaviour, as opposed to prosecuting or litigating—is this an issue of balance, do you think, for regulators?
GUILLERMO LARRAIN
You know, the first thing that comes to my mind is that we need to have both and to balance both. I don’t believe in either carrots by themselves, or sticks by themselves. You need to have both. And we need to be more precise about the regulatory consequences of misconduct, and the options available to the institution concerned.

PETER BOXALL
Now a question for the auditors, in particular on conflicts of interest, which we’ve already addressed. The proposition has come up that there might be a risk of losing clients if one takes too tough a line. Is this a dilemma that you’ve faced and dealt with?

BRIAN LONG
Yes. You know, it would be foolish to deny that partners in an accounting firm are interested in keeping the client list. These firms are in business. But the risk of poor behaviour simply to retain clients and risk damage to the firm’s reputation, well, as Jan mentioned earlier, the reputation of accounting firms is the greatest asset they have, perhaps beside only their people.

So you know, there is a risk and it’s a risk that the firms are well aware of, and they put in place a whole range of processes to diminish that, and I’m sure Jan’s firm is the same as ours. We wouldn’t contemplate ever putting a single partner involved in a significant client, particularly a risk client; and in particular you’d put a partner who’s got many years experience, who doesn’t have the fear of loss of a client as a primary driver. So it is a risk, it’s a real risk, but it’s one I think which is carefully managed.

JAN McCAHEY
I’d just like to take up only one thing, and that was the point that I think Matthew or maybe Justin made around additional disclosure. I think that we do see, you know, everybody sort of rustle around thinking that whenever there’s a problem that the solution to it will be making more information more available, and I think there is a real challenge with that certainly in the financial reporting area. For example, even coming out of the G20 proposals, a need to provide more and more information about fair value information, and my encouragement would be that we don’t end down that track because that just does tend to swamp people with data, not provide more real information.

BRIAN LONG
The only comment I’d make is something I alluded to along the way, and that is I don’t think there’s a need for despair about the effectiveness of the system in Australia from the perspective of the business that I’m in. I would attribute that to the fact that boards of directors have a heightened sense of needing to take objective and independent advice and assistance from organisations such as the audit firm, and I think that’s a real change that’s occurred over the past 10 years. I think now anyone who sits before a board of directors would sense that and feel it, and I think that’s a very positive thing. I think there is plenty of room to continue that though.

GUILLERMO LARRAIN
Just three ideas. One, the role of gatekeepers is very important here, because regulators have limitations on what we can see, and what we cannot see. Therefore, improving the way the gatekeepers work is critical to having a better financial system.

Second, concerning the carrot and stick question, we need to be to some extent creative and try to look for new ways of doing things. I was reading in the newspaper today
about an ASIC intervention called Project Mint that seemed to take a novel approach. That is the sort of thing that we should be looking for, innovative approaches which, if they work, fine, and if they don’t, we shut them down.

And third is this idea that we must work in the future towards improving the status and the legal framework for regulators—that’s critical.

MATTHEW GROUNDS
Yes, I would echo your second point. Over the last three years the regulators here have been quite dynamic in terms of raising issues, and I don’t think that Project Mint didn’t work; I think it probably did work.

GUILLERMO LARRAIN
That’s what the press said, I’m sorry.

MATTHEW GROUNDS
Yes, I think it did work. On a number of fronts it raised awareness of a particular issue that I think was important to be addressed. As Jan said earlier, we should take a lot from some of the positive things that we’ve done over the last three years.

The raising of capital at much finer discounts for all of our banking system, for instance, is something that could only have been done if the market had confidence in the gatekeepers, and the true gatekeepers in my view are the regulators and the auditors, sorry Jan, and I think the transparency around our financial system allowed Australia to come through this crisis in relatively good shape.

JUSTIN O’BRIEN
Yes, I think Australia did come through the crisis in relatively good shape but we need to be careful not to believe our own press. There were significant problems in the Australian marketplace and there’s a lot of political pressure to deal with those, not the least of which was the Ripoll Inquiry.

So I think we need to take stock of where we are. We need to be aware of the risk of complacency and I think we need to be really careful moving forward that, when we are designing regulatory reform, that the regulatory reform is dynamic and responsive and forward-looking, rather than reactive, and is based fundamentally on a dialogue between the regulator and the regulated, based on a common understanding of common purpose.
Guarding the Guardians

Private Rights, Public Duties and the Search for Accountable Governance

Justin O’Brien
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The Australian National University
ASIC Summer School, Melbourne, 2 March

Setting Up the Board

- Three interlinked global phenomena:
  - flawed governance mechanisms, including remuneration incentives skewed in favour of short-term profit-taking;
  - flawed models of financing, including (but not limited to) the dominant originate-and-distribute model of securitization; and
  - regulatory structures predicated on risk reduction which created incentives for arbitrage and paid insufficient attention to systemic risk.

Research Problem

- Why has effective reform of capital market proved so illusive?
- Mapping the parameters of what constitutes accountability is an exceptionally complex task
- The creative ambiguity of accountability highlights a potential disconnect between the rhetoric and substance of reform.
- The failure of effective accountability to date rests essentially on the failure to focus on the normative infrastructure.
The New Institutional Economics Framework (Williamson, 2000)

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The Return of Depression Era Economics

The ‘perennial gale’ of change incessantly revolutionises the economic structure from within, destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism (p.84)

“No social system can work in which everyone is supposed to be guided by nothing except his short-term utilitarian ends... the stock market is a poor substitute for the Holy Grail (p. 137)
Re-Embedding the Market

- "A self-regulating market demands nothing less than the institutional separation of society into an economic and political sphere" (p.74)
- Aim was to ‘annihilate all organic forms of existence and to replace them with a different type of organization, an atomistic and individualistic one... best served by the principle of freedom to contract... To represent this principle as one of non-interference... merely the expression of an ingrained prejudice in favour of a definite kind of interference, namely such as would destroy non-contractual relations (p.171)

Unshackling Hayek

- “Parties in the market should be free to sell and buy at any price at which they can find a partner to the transaction” (p 27).
- “To create conditions in which competition will be as effective as possible, to supplement it where it cannot be made effective... provide indeed a wide and unquestioning field for state activity. In no system that could be rationally defended would the state just do nothing. An effective competitive system needs an intelligently designed and continuously adjusted legal framework as much as any other” (p, 29).

The End of History or the Demise of Hubris?

- ‘We shall not grow wiser before we learn that much that we have done was very foolish’ (p, 177)
- ‘Few discoveries are more irritating than those which expose the pedigree of ideas’ – Lord Acton (p, 1)
- ‘I found a flaw. That is precisely the reason I was shocked because I’d been going for 40 years or more with very considerable evidence that it was working exceptionally well’ – Alan Greenspan, 23 October 2008
Focus on:

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<tr>
<th>Perspective:</th>
<th>Cause</th>
<th>Cure</th>
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<tr>
<td>Accountability-as-Mechanism (i.e., control)</td>
<td>Failure of instrument</td>
<td>Reform, replace, repair the instrument</td>
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<tr>
<td>Accountability-as-Setting (i.e., normative infrastructure)</td>
<td>Absence or collapse of norms, mores, standards</td>
<td>Reestablishing, rebuilding moral community based on effective norms/standards</td>
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Figure 1: Accountability’s Discursive Roles

Change we can believe in?

The actions of many firms escaped scrutiny. In some cases, the dealings of these institutions were so complex and opaque that few inside or outside these companies understood what was happening. Where there were gaps in the rules, regulators lacked the authority to take action. Where there were overlaps, regulators lacked accountability for their inaction – President Obama, 17 June 2009

Figure 2: Accountable Strategies
Applied Ethics and the GFC

- Categorical imperative, namely ‘act only according to that maxim whereby you can at the same time will that it should become a universal law’
- Utilitarian approaches apportion blame on impact
- Essential to differentiate between the product and the inappropriate uses to which it was put to work
- It is a deficient defence to claim ignorance of how these products were structured or how unstable the expansion of alchemistic engineering had made individual banks or the system as a whole

The Promise of Integrity

- Elevation of the values of the market to a central social place’ risks creating the circumstances in which ‘the concept of the virtues might suffer at first attrition and then perhaps something near total effacement’ (After Virtue, p 256, p.196)
- Effectiveness in organizations is often both the product and the producer of an intense focus on a narrow range of specialized tasks which has as its counterpart blindness to other aspects of one’s activity’ (1982)
- Compartmentalization occurs when a distinct sphere of social activity comes to have its own role structure governed by its own specific norms in relative independence of other such spheres. Within each sphere those norms dictate which kinds of consideration are to be treated as relevant to decision-making and which are to be excluded’ (1999)
Integrity in Practice and Practise

- External gatekeepers should explicitly take disclosure into account when issuing valuations but also risk that enhanced levels of disclosure can obfuscate as well as illuminate.
- Attention must also be placed on and accountability demanded from those providing corporate advisory services and the creation and dissemination of technically legal but misleading advertising (i.e. not just trustees and auditors but also copywriters, production teams, publishers).
- Requires professional groups to acknowledge their own responsibility and be accountable: acquiescing to external scrutiny of what codes of conduct mean in practice.

Strategies for Development

- Retrieving the Meaning of Accountability in the Causes of the Global Financial Crisis
- Retrieving the Meaning of Accountability in the Policy Responses
- Explaining the Gap Between Rhetoric and Substance in Capital Market Regulation
- Transcending Regulatory Failure by focusing on interaction of Rules, Principles and Social Norms in Capital Markets
- Integrating Integrity into Accountable Design
Beyond disclosure: How did retail investors and financial consumers fare in the crisis? Is there a need to improve outcomes for consumers and retail investors?

Professor Dimity Kingsford Smith, Faculty of Law, UNSW
Moderator Dr Peter Boxall, Commissioner, ASIC

PETER BOXALL
Good morning and thank you all very much for coming. I am moderating the first plenary session this morning.

This morning’s session has a particular interest for me because of its focus on financial consumers and retail investors, and the introduction of the new credit regime and responsible lending.

There’s been quite an impact from the global financial situation on these groups of investors, and not surprisingly, inevitably this has raised questions about the system of regulation.

The new National Credit Act is probably the most significant Act since the Financial Services Reform Act of 2002.

Once these new credit requirements are in place, all credit providers and credit assistance providers must comply with the responsible lending regime. This is a new area for ASIC and we’ve put out a number of consultation papers and regulatory guides including, most recently, a regulatory guide on responsible lending.

In any case, we have two very well-qualified speakers to discuss these issues. The first is Professor Dimity Kingsford Smith who will speak on, amongst other things, the vexed question of disclosure, and the second is Catriona Lowe who will discuss the consumer credit reform and responsible lending.

FULL TEXT OF PROFESSOR KINGSFORD SMITH’S PRESENTATION

At the beginning of the global financial crisis (GFC) Rahm Emanuel, President Obama’s Chief of Staff, is reported to have said that no good crisis should be allowed to go to waste. By this he meant that crisis situations are a good time to bring about reforms that would be politically impossible otherwise. It seems to me that in receiving this invitation to speak to you today, I have been the recipient of a crisis rethink opportunity, and I am very flattered. After all, how often is a securities and financial services regulation nerd like myself given an opportunity to think about things other than disclosure? With apologies to the Scarlet Pimpernel, disclosure in securities regulation is quite the opposite of...

42 The author is very grateful for the research assistance of Julia Roy in the preparation of this paper and for the comments of participants at the ASIC Summer School 2010. This paper has been written with the assistance of the Australian Research Council and is part of the work of the Regulating Online Investment project at the Law Faculty, University of New South Wales
http://www.cyberlawcentre.org/onlineinvesting/
that elusive hero: ‘you find it here, you find it there, in fact you find it everywhere’.

Time does not permit me to address all the questions raised by the title to this talk in the program—in any case many of them have been thrashed out already in the last two days. I am going to concentrate on what could lie beyond disclosure. But I would like to make one thing clear. Disclosure is like democracy: in some places it doesn’t work very well, but it is the best we’ve got and we should strive to make it the best it can be. We also need to supplement it, where it reaches its limits. And one of those places is in the markets for products and services designed for financial consumers and retail investors.

Before I discuss these matters I think it would be helpful to set out a few assumptions, on which the recommendations I have about what might lie beyond disclosure are based. I hasten to add that these are not economist’s assumptions, like those of the third man on Guillermo Larrain’s desert island. These assumptions are more background information developed through research on the attitudes and behavior of consumers over the last 15 to 20 years, and which now frames our understanding of consumer and investor behaviour.

I. Some Assumptions

a) That individuals will be increasingly required to provide for their own financial well-being rather than the state

In the last 20 years there has been a radical extension of the levels of participation of ordinary individuals in investments and other financial products such as insurance and credit. This is due to a combination of government privatisations, individual provision for needs previously provided for by the state, such as education and retirement income and because of growing affluence.

Related to this, but lurking beneath the policy surface, lies a fundamental change in the vision of the citizen, which is rarely discussed in financial markets regulation. The extension of retail investor market participation ‘all leaves unasked one crucial question—where should responsibility for citizens’ longer-term financial security lie?’ In the last generation western economies have concluded that, after government provides basic welfare services, if individuals want greater provision, they must save and invest themselves. In other words an implicit social and political consensus has developed that individuals will bear the risk of investing in financial markets to provide for long term personal welfare. They will bear the risk even if it is rare, uncontrollable, and like the

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45 In health, education and the age pension for example.
46 If dramatic institutional failure threatens the safety of the financial system, governments may alleviate the worst effects, e.g. Maxwell pension fund failure in the UK, HIH Insurance in Australia, Northern Rock Bank in the UK and even an investment bank, Bear Stearns and American International Group Inc in the US. Otherwise, governments will not rescue people from investment failures—even when the investment itself is mandated by government such as in Australia’s compulsory but privately managed superannuation system. Commonwealth of Australia, Financial System Inquiry Final Report (1997, AGPS) 91-92.
GFC, ‘results in an epidemic of capital destruction’.  

In Australia this change is most obvious in the provision of retirement income. Compulsory superannuation in Australia is a defined-contribution system, not a defined-benefit system: it individualises risk. Individuals bear the risk that the provision will be insufficient to meet retirement income needs. By contrast, most government-run programs, which are funded by taxes over time, and most corporate schemes up to the early nineties, used a defined-benefits system where the risk lay with the scheme promoter not the investor. The risk was shared over a large number of individuals and over time.

b) That many individuals have limited desire to engage with financial markets

On this question there is conflicting evidence. On one hand there is, from the do-it-yourself online investing segment, plenty of evidence that some investors are very engaged, perhaps even addicted to investing. Some, especially retired investors, see investing as their work, and they sit for hours every day watching the markets, seeking out financial and corporate information, and analysing it. They may take weeks of this behaviour before investing.

On the other hand, research done by the UK Financial Services Authority (FSA) has shown that many individuals are very disengaged with financial matters. US and Australian research tends to confirm this view. This ranges from budgeting, through the use of credit, to investment. This disengagement is well demonstrated by the reading of disclosure. While more engaged investors are what might be called ‘strategic readers’ of disclosure, homing in on what

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50 For example in the UK the State Earnings Related Pensions Scheme (SERPS) replaced with State Second Pension (S2P) since 2002 is a pension at retirement that is calculated with respect to career average earnings. Because SERPS guarantees a pension at a percentage of average salary, the scheme takes the long term risk that returns to the fund and invested contributions will be higher than pay-outs. There is also an element of retirement income redistribution to the calculation of the pension: http://en.wikipedia.org/wiki/State_Earnings-Related_Pension_Scheme and R Nobles ‘Pensions Act 1995’ (1998) 59 MLR 241, 243.

51 Although more secure even this is not an entirely risk-free system, for the bad times may make corporate schemes insolvent too and even the corporations that sponsor them: see the circumstances of General Motors Holden in the US, where it has been said that there is more health care and pensions expense in each car produced than steel. The company went into chapter 11 bankruptcy in June 2009, with a ‘bail-out’ by the US government equal to 61% of the company’s equity capital value.


54 This is confirmed by the analysis of as yet unpublished research derived from a national interview program that is part of the work of the Regulating Online Investment project at the Law Faculty, University of New South Wales http://www.cyberlawcentre.org/onlineinvesting/; the term is also contemplated by Edward Rubin, ‘The Internet, Consumer Protection and Practical Knowledge’ in ed J Winn Consumer Protection and the Age of the ‘Information Economy (Ashgate 2006) 33-58; a similar idea is mentioned by Geraint Howells, ‘The Potential and Limits of Consumer Empowerment by Information’ (2005) 32 Journal of Law and Society 349-370, p. 364.
they see as key elements, less engaged individuals are either skeptical of the benefits of reading disclosure, because there is little or nothing they can do to change the disclosed circumstances, or simply do not try to read disclosure. The empirical evidence from the Financial Services Authority in the UK is that there is a large group of individuals who simply do not wish to be engaged in the investing process, and not reading disclosure is one way in which they demonstrate this.

**c) That retail investors are not all the same**

To begin with, there is great disparity of investor competence, depending on age and education level. Also, individuals are not necessarily good at all aspects of money matters. Older individuals, for example, tend to be better at budgeting and making ends meet, and less knowledgeable about investing alternatives. Those in the pre-retirement years are better at planning for the future than those in their twenties. Younger people, males and those who have a background in IT or accounting, tend to be better at investing online, which is a non-advisory mode, whereas others may rely more on advice.

Gender seems to be important in financial decision making, and individuals look for different information and advice at trigger points in their lives—on marriage, having children, at divorce or retirement and when illness or death intervenes. Also, level of literacy and numeracy is crucial in this stratification of the retail investing group—literacy studies in UK, Australia and Canada show that a little less than half the population has a literacy and numeracy level of an upper-primary school child. This places in doubt their capacity to calculate percentages, for example, which is a foundational numeracy skill for dealing with money and investing. Disclosure assumes that the capacities of financial consumers and retail investors are universal and rational, when research is showing that this is not the case.

**d) That even experienced investors have biases in decision making**

This assumption derives from the conclusions of researchers in behavioural psychology about investment decision making. This shows that investors have biases (or heuristics) which strongly influence their decision making. The most robust finding is that investors suffer from overconfidence in their own capacity. Later work has shown that these and other biases are exacerbated when investors move to online investing. Relatedly, it has also been shown that investors think they have greater

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55 Ibid.
57 FSA, Levels of Financial Capability in the UK: Results of a Baseline Survey (London 2006)
62 Barber & Odean, ibid.
knowledge than they do, and they imagine this gives them greater control than in fact they have. Another bias shows investors have a cognitive conservatism—they tend to keep assets longer than they should after they have begun to make a loss. And yet another, the salience bias, is a tendency to give more weight than is warranted to recent and accessible information—especially if it is framed as a ‘crash’ or ‘catastrophe’. 63

These biases, heuristics or short-cuts are shared by people of all intelligences and education levels, and they are not easily unlearned. 64 They tend to continue even when the bias has been drawn to an investor or consumer’s attention. 65 This last observation should also make us cautious about the claims we make for the short-term transformative capacity of investor education, and its ability to ameliorate the limits of disclosure.

e) That in the GFC the consensus that markets can be made safe for retail investors has been lost

With the possible exception of Ben Bernanke, who knows more about depressions than anyone else in the world, most people had, prior to September 2008, begun to believe that huge and devastating financial catastrophes of the type seen in 1929, could no longer occur. Volatility was accepted, but changes in the stock market during which 40–50% of value was lost, were thought to be phenomena of the past. National monetary policy, international coordination, increased disclosure including forward-looking disclosure, and prudential regulation was all thought to have stabilised financial institutions, national and international economies. Within this framework of government and central bank direction, markets were thought, as Alan Greenspan famously said, to be self-correcting and to look to their own self-preservation in making financial decisions. As he pointed out to US Congress, there had been considerable evidence over the 40 years before September 2008 that this was correct. 66 This consensus has been severely shaken by the GFC, and it is likely that it will influence regulatory decision making about financial consumers and retail investors, perhaps permanently.

II. Beyond Disclosure—Some Recommendations

a) Reduce complexity and exotic/toxic products—go for straightforward or default Products

The market has responded with a huge variety of instruments that are designed to meet the purposes of the new class of retail investors. 67 Not only have investment forms diversified radically, but so have the means of participation in them. It is in this context that we have come to rely more and more on

63 Howells, above note 12 and Williams, (2007), above note 3, 244.
64 Howells, (2005), above note 62, 359 and Williams, (2007), above note 3, 247
65 Williams, (2007), above note 3, 244
66 In Congressional testimony on October 23, 2008, Greenspan acknowledged that he was ‘partially’ wrong in opposing regulation and stated ‘Those of us who have looked to the self-interest of lending institutions to protect shareholder’s equity—myself especially—are in a state of shocked disbelief.’ Referring to his free-market ideology, Greenspan said: ‘I have found a flaw. I don’t know how significant or permanent it is. But I have been very distressed by that fact.’ Rep. Henry Waxman (D-CA) then pressed him to clarify his words. ‘In other words, you found that your view of the world, your ideology, was not right, it was not working,’ Waxman said. ‘Absolutely, precisely,’ Greenspan replied. ‘You know, that’s precisely the reason I was shocked, because I have been going for 40 years or more with very considerable evidence that it was working exceptionally well.’ Greenspan admitted fault in opposing regulation of derivatives and acknowledged that financial institutions didn’t protect shareholders and investments as well as he expected.
67 Gray & Hamilton, above n 3.
disclosure, rather than more substantive protections in the style of ‘merit’ regulation. This is despite the increase in the range and complexity of all aspects of retail investing.

Merit regulation has had bad press until very recently—but we should not forget that it was only in the early 1980s that the state securities regulators in the US abandoned merit regulation, and joined the US Federal Reserve (the Feds) in a regime based pretty much entirely on disclosure. I hate to admit this, but I am just old enough to remember when the Australian State Corporate Affairs Commissions used to review and issue queries on the terms of unit trust and debenture trust deeds—none other than good old-fashioned merit regulation, although within a disclosure setting.

How might we respond to this feeling that disclosure has fed and fed off product complexity, and for retail investors it has come up short? From a number of possibilities (and we can discuss some others later) there are two stand-out recommendations. One is, as I have been leading up to suggesting, to introduce an element of merit regulation to lessen the reliance of investors on disclosure. The other is a more graduated approach to investor capability, that would qualify investors to enter certain sorts of financial products or services. These could be matched with different levels of product risk and an investor’s capabilities, which I discuss in a minute. Both these suggestions would apply only in retail investment.

Merit (or product) regulation would involve one or other of regulating product terms, or prohibiting a product altogether. So, for example, regulators may follow the example of the US Securities and Exchange Commission (US SEC) and not permit retail offering of contracts for differences (CFDs), a highly leveraged derivative product that is for trading not investing, and would only very rarely be suitable for most retail investors. 68 Alternatively, they could follow the lead of the UK with CATS and ‘stakeholder’ products designed for the needs of modest investors that have been launched with regulated terms. 69 A proposal to require limited prescription of product terms has also been adopted by the US Department of the Treasury in its recent proposals for the reform of financial consumer law. 70

One use of regulated terms, that specifically responds to the complexity problem, would be to require consumer financial products to be designed so that the financial choices people have to make are simpler. Building sensible choices into financial products, so that the one suitable for most people is the default option, would do this. Then the majority of people who are disinclined to

68 The Ontario Securities Exchange has recently permitted CFDs to be offered to retail investors, but on quite stringent conditions: http://www.osc.gov.on.ca/documents/en/Securities-Category9/sn_20091030_91-702_cdf.pdf. Despite ASIC advice on its FIDO website http://www.fido.gov.au/fido/fido.nsf/byheadline/Contrac ts+for+difference%3A+complex+x+and+high+risk%3F?o penDocument that CFDs are ‘like borrowing money to gamble’ and the likelihood of ruinous losses is greater than at the track or casino, ASX has recently been permitted to establish a market in exchange traded CFD’s open to all: http://www.asx.com.au/products/cfds/asx_cfds_produc t_description.htm though the standardization required for this might be an improvement over the aggressive selling through OTC offerings previously all that was available.

69 The ‘Sandler Suite’ of ‘stakeholder’ products where product features are mandated and CAT products where minimum standards as to charges (C), access (A) and terms (T) must be met; R Sandler, Medium and Long-Term Savings in the UK, July 2002 100-08; FSA ‘Options for Regulating the Sale of ‘Simplified Investment Products’ (January 2003) at http://www.fsa.gov.uk/pubs/discussion/dp19_newslette r.pdf;

seek information and make active decisions will, by doing nothing, make the most appropriate choice. They will not have to ‘opt in’ as is often the case at present, they can just do nothing. This is particularly appropriate for long-term savings products like superannuation. In this context it is interesting to note that this possibility is something that the current inquiry into the Australian superannuation system has included in the issues it has reviewed, culminating in the discussion of a ‘universal product’ that would be designed for ‘disengaged’ members.

b) Certifying investor capability for certain financial products and services

The second possibility builds on the insight that there are different types of investors. The picture of the investor is now richer, as a result of the research that has been done in the last 10 years or so. At one end of the retail spectrum there are internet investors who are encouraged to see themselves, and who often are, very knowledgeable about and engaged with investing. They feel they have the capacity, and want to be treated like sophisticated investors. By contrast there are also a lot of people who are very unengaged by financial matters, whose education is not up to analysing financial documents, who even after investing for years do not understand basic matters such as the calculation of fees. So the picture of the modern investor is multiple and contradictory.

Already under Australian legislation, investors may be treated differently depending say on mode of investing (internet or not), or type of product (packaged or exchange traded), or legal categorisation—‘retail’ or ‘consumer’, certified ‘sophisticated’ or ‘professional’. This shows the beginnings of a regulatory understanding of the need for a greater variation in regulatory treatment of investors. Again, this sort of thinking seems to be appearing in the deliberations of the Superannuation System Review and we can only wait and see what emerges from the differential investor categories (disconnected, universal, choice and self-managed super fund (SMSF)) and matching investment options being discussed there.

But thinking more widely than superannuation, the purposes of this differentiation are to provide protection to retail investors, while allowing greater flexibility for professional and wholesale investors. In between there are investor classes where an adviser or accountant must certify that an individual has the assets and

74 A Hung et al, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, (2008 Rand Institute for Civil Justice, study sponsored by the SEC) found ‘Even those who have employed financial professionals for years do not understand the fees charged for their services.’, 87
75 Section 761G Corporations Act 2001.
76 Section 12BC Australian Securities and Investments Act 2001
77 Section 708(8) and (9) or 761GA Corporations Act 2001.
knowledge or experience to be treated as a sophisticated investor. Using this existing framework, it would be relatively straightforward to develop a certification system that would, with appropriate protections, let a sophisticated investor invest using margin loans, share loans or contracts for differences. If governments wish citizens to invest to provide retirement income and so on, with what we know about the lack of capacity of many retail investors, it makes sense to take a fine-grained approach to matching what they can invest in with their demonstrated capability for investment decision making.

**c) Be clear about intermediaries’ duties and where responsibility lies**

The UK FSA’s research shows that the business of analysing risk, especially in relation to the complex packaged products that characterise retail investment markets, is just so difficult that most investors use one of the heuristic shortcuts to make choices. Instead of analysing risk information, retail investors resort to trust and existing relationships to decide. This is often manifested as a choice to go with a well-known financial services brand or issuer, or with the advice of an individual adviser they have come to trust. This is in line with recent psychological research, which sees emotional responses not as ‘sand in the machinery’ of decision making, but often as a more efficient or ‘fast and frugal’ way of processing decisions.80 This research about investors tells us that regulation should be helping to ensure that intermediaries are as trustworthy as investors think. That is, helping to ensure that advice is sound, that investor’s interests are put first in a customer relationship, and there is compensation if there is unlawful behaviour.

Conflicts of interest or divided loyalties bring all these issues of trust to a head. One dimension of conflicts of interest which has frustrated regulators, investors and providers alike for a long time, is fees and commissions. There is significant evidence that retail investors either do not know or do not understand that they are paying themselves from their own investment funds, when their adviser receives a commission.81 Even after investing for years a significant proportion do not understand basic matters such as the calculation of fees.82 It is here perhaps, that despite a great deal of good regulatory work, disclosure has been demonstrated most clearly to have reached its limits.

There is also a lot of evidence that retail investors do not shop around for advice or financial products, and so the normal competitive processes that would both reveal self-interested advice and reduce the amount of remuneration to intermediaries, do not

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81 US Research concluded ‘focus-group participants with investments acknowledged uncertainty about the fees they pay for their investments, and survey responses also indicate confusion about the fees.’ Hung et al note 32 above, p xix; the FSA reported that ‘most consumers are confused about how advisers are paid…only the most financially sophisticated understand that they pay for the commission the adviser receives.’ FSA, *Polarisation and Financial Services Intermediary Regulation*, (July 2000), p.3 and passim; in research on the disclosure of fees and charges Ramsay reviewed a number of studies including interviews of 500 investors which concluded ‘that close to one-third (32%) of consumers were unable to define the types of fees and charges they were paying’ I Ramsay, *Disclosure of Fees and Charges in Managed Investments* (ASIC commissioned report, September 2002) at 47 and passim.

82 A Hung et al, note 32 above found ‘Even those who have employed financial professionals for years do not understand the fees charged for their services.’, 87
operate. As a result, investors cannot perceive or do not understand that conflict of interest that may affect the advice or product they receive and its cost. The distortion is usually thought to be that the adviser may suggest an unsuitable investment. But more damaging may be that the desire to find 'investable' funds on which to earn remuneration leads to inappropriate asset allocation advice, or where the best advice is just pay down your home loan or do nothing.

It is important to address conflicts because of the growing reliance of investors on financial markets, and their impotence in negotiating the terms of 'mass market' customer agreements, which often include comprehensive exemption clauses and disclaimers. It is because of both the fluidity of the general law equitable requirement to prefer the interests of the customer, and the ready excludability of it, that recent proposals for a statutory fiduciary duty to 'put the customer first' make a lot of sense. Why should a customer dealing with an intermediary find themselves in the High Court as Mrs Daly did, trying to establish whether the kind of transaction she eventually entered induced the presence of fiduciary responsibilities on her intermediary? Similarly, why should a financial consumer or retail customer be subject to the self-dealing of their provider, because it had the foresight to include an exemption clause which could not be negotiated away? It is true that Australia has one of the toughest commercial moralities in the world when it comes to 'misleading and deceptive' conduct, and that this overlaps with some (but only some) of the equitable ground we are discussing here. However, there is a strong tutelary or symbolic dimension to enshrining obligations in statute, especially where the existing general law is protean in its operation, uncertain in its remedial effect and easily excluded. If the statutory fiduciary obligation is made non-excludable, simple in its terms and clear in its remedial effect it would be worth fighting for the Parliamentary time required for its creation. By placing the fiduciary obligation clearly on the intermediary, rather than on the customer which is what disclosure does, there should be a tangible rise in investor protective effect.

I suspect a statutory duty to 'put the customer first' would have two further benefits. I think it would hurry along the day when hourly-rate fees and performance fees replace commissions. This would ameliorate some of the more troubling aspects of commission remuneration in terms of investor protection. Secondly, I think that a statutory fiduciary duty would likely strengthen the suitability obligation of intermediaries—the requirement that all recommendations to a retail client have a reasonable basis. While breach of this statutory obligation is both an offence and supplies the basis for damages or

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84 Since economists agree that asset allocation has a far greater effect on performance than product selection Sandler, (2002), above n 27, p.13.
85 A Hung et al, note 32 above at 19 and 104 -05 confirming that retiring 'investors will face new challenges managing their finances for the rest of their lives ...and most will need professional help doing so.'
87 Daly v Sydney Stock Exchange Ltd (1986) 160 CLR 371 esp at 385
restitution\textsuperscript{91} it seems rarely used by individuals. There are some exceptions where there has been regulatory intervention: ASIC required an enforceable undertaking of AMP Financial Planning to require significant changes to the adviser’s business model, training and supervision practices as well as restitution to damaged customers, when it was discovered that 45\% of the files reviewed by ASIC showed inadequate disclosure of a reasonable basis for advice.\textsuperscript{92} It was subsequently revealed that the failures were in relation to 35,000 customers. A ‘shadow shopping’ exercise by ASIC around the same time, revealed similar failings in a wide range of financial planning businesses, not just at AMP Financial Planning.\textsuperscript{93}

So the reasonable basis requirement can be an effective one, but on its own it is often difficult to establish, because it requires a counterfactual—the proof that what was not done would have been more beneficial, than what was done. Just as the lack of reasonable basis action is easier to assert if there is misleading or deceptive conduct involved, I think it would likewise be strengthened if it were paired with a statutory fiduciary requirement to ‘put the client first’.

d) A retail investors’ compensation scheme

In Australia, industry dispute resolution schemes are one of the success stories of transplanting general consumer law ideas into the area of investor protection. But they are only as good as the compensation that reaches the investor in the end. Of course there is already provision in the Australian licensing regime for licensees to have compensation arrangements,\textsuperscript{94} but at the moment, regulations provide that licensees can do this through professional indemnity policies of insurance,\textsuperscript{95} rather than the establishment of a compensation fund. If determinations obtained easily and cheaply are frustrated by the lack of compensation, then little has been gained. This is a vast and complex topic\textsuperscript{96} about which I can really say little here, but perhaps enough to persuade you that Australian financial consumers and retail investors need a compensation scheme—and I mean an industry based or funded one.

Compensation arrangements are, like much else in modern retail financial markets, an interesting mix of public and private arrangements. They are usually industry based or funded. They vary from purpose-created statutory compensation schemes, of which the UK Financial Services Compensation Scheme (FSCS)\textsuperscript{97} is the most developed example, to patchy, voluntary-

\textsuperscript{91} Section 953B(1)© and (2)© Corporations Act 2001.
\textsuperscript{92} Gail Pearson, Financial Services Law and Compliance in Australia (CUP 2009), 201-204.
\textsuperscript{93} ASIC Report 69: Shadow Shopping Survey on Superannuation Advice, April 2006.
\textsuperscript{94} Section 912B Corporations Act 2001.
\textsuperscript{95} Regulation 7.6.02AAA Corporations Regulations
\textsuperscript{97} Established under the Financial Services and Markets Act and though independent, closely articulated with the FSA and the Financial Ombudsman Service. See: http://www.fscs.org.uk. Compensation funds for market transactions on stock exchanges are probably the oldest examples: in Australia, the National Guarantee Fund (NGF) http://www.segc.com.au; In U.S., the Securities Investor Protection Corporation (SIPC) http://www.sipc.org/who/who.cfm
entry professional indemnity insurance (PII) by financial advisers who do not handle client money.

For retail investors, the best arrangements are where compensation is available both when the intermediary is solvent and when it is not. Ideally professional indemnity and/or capital and liquidity requirements supply adequate funds to meet claims during solvency, and statutory compensation funds provide a safety net when the intermediary is insolvent or disappeared. This is the position in the UK. By contrast, unless regulatory requirements steer PII terms, the achievements of industry dispute resolution schemes could be undermined. For example, unless the regulator stipulates the scope of cover and the amount insured, these could turn out to be inadequate to cover the nature and quantum of an intermediary’s liabilities. There is a long list of other features of PII that makes it very unsatisfactory for compensating retail investors. Here I will cover just a few.

To be effective it will be necessary for the PII cover to include the determinations of industry based schemes and not just court imposed liability. The cover should include resolutions achieved through conciliation or mediation. The question of scope also arises in more subtle ways which have to do with modern trends in regulating.

The High Court of Australia recently decided that a large financial services provider was not covered under its PII policy for amounts it paid to customers, not because action had been started against it, but because the regulator bought influence to bear and achieved an enforceable undertaking. In this case the investors were the beneficiaries of the regulatory influence, and luckily the firm had capital to pay. But what of the customers of a firm that lacks the capital and whose PI insurer will not cover this regulatory liability?

PII policies often have large excesses which the firm itself has to pay, before the insurer is liable. The modern retail investor market is a ‘mass market’, where marketing, sales and executions are done in large numbers. A wrong or contravention is likely to be repeated, and large groups of investors suffer loss. If PII policies have high excesses, and a significant number of investors obtain determinations adverse to the firm, then it may fail in trying to pay these. In a recent case in Australia, a financial advisory firm handed in its license to ASIC and went into insolvency after the Federal Court found that it was subject to Financial Industry Complaints Service Ltd (FICS) jurisdiction, in relation to a cluster of its clients who had all been advised to enter a property investment scheme that had failed.

Finally, there is a group of traditional legal limits on PII which make it a clumsy vehicle for investor compensation in a regulatory context. There is a general law prohibition on the indemnification of criminal (here fraud

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98 Obviously this reliance will be less if a licensee is required to have capital requirements in addition. But in the case of advisers compensation arrangements require only PII.

99 Kingsford Smith note 31 above.

100 I am indebted to John Morgan, partner Allens Arthur Robinson and Adjunct Lecturer UNSW who first drew my attention to this point, and his paper Beyond Courts and Negligence: Insurance, Risk and Liability in the Age of Regulation (paper on file with author).
and dishonesty) behaviour, with the ironic result that the worse the regulated firm’s conduct, the less likely there will be insurance to fund compensation.  

103 If clients are advised to take investments that are not on the firm’s authorised list, then loss will likely not be covered. PII policies are ‘claims made’ not ‘claims arising’ policies. So if the insured does not tell the insurer of the claim during the currency of the policy, there will be no cover. If the insured firm admits liability without the insurer’s consent, that may avoid the cover too. This is a difficulty because licensees have an obligation to report breaches to the regulator (which does involve an admission) so they will be in breach either of their policy or their license conditions, neither of which is good for the retail investor.  

104 PII is a helpful component of a more general compensation system, such as provided for in the UK, but to be effective its terms should be mandated by the regulator. Generally, PII remains ill-adapted to fill the regulatory role of providing compensation arrangements.

These facts demonstrate that a more certain and consistent approach is required, and a compensation system that applies regardless of insolvency is the only fair way to meet the fact that much of the risk of investing falls on the citizen, in a fashion which challenges their capacities and some dimensions, of which the GFC teaches us, they cannot control.

III. Conclusion

Australia has probably gone further in some aspects than any other advanced democracy in requiring its citizens to become active in financial and investing matters, because it has made the contribution phase of superannuation compulsory.  

105 For most individuals that means at retirement they must become investors to manage their retirement income. They have little practical alternative to becoming a ‘financial citizen’. Given the range of risks that the accumulating and retired ‘financial citizen’ must conjure, the limited ability to control those risks and the limited capability for investing possessed by many, it seems only fair to revisit what might be done beyond disclosure.

I have suggested a number of regulatory approaches beyond disclosure, but there are others that I have not investigated: placing more emphasis on diversification of an investor’s portfolio, for example. Part of the tragedy of all of Westpoint, Opes Prime and Storm Financial was the lack of diversity in both product selection and asset allocation. Then there is the possibility of a regulator’s risk rating of products, providing an independent public resource for investors. In the UK the FSA provides comparative information like this in relation to fees and charges—would a regulator be prepared to go further and rate risk for retail products?

Another approach I have only mentioned is

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Investor education and participation. While we should encourage both of these at all levels, the changes they will effect are gradual and generational in their effect. Investor psychology tells us that it will take a long time for the new messages of investor self-provision and responsibilisation to take root—and for some people they will never be effective. We need to continue encouraging greater investor capability and participation, but we cannot think that these will be an immediate or complete counterpoint to the shortcomings of disclosure.

So I have set out in the assumptions with which I began what research has revealed as the difficulties that many financial consumers and retail investors face. In the list of recommendations I have tried to identify approaches that meet the difficulties and meet the limits of disclosure. None of these recommendations are earth-shattering: some of them have been tried before or already exist in various versions, and some are already flourishing in other markets that are not very different from ours, and some are under consideration for adoption here.

In Australia we have settled on a political compact that puts great responsibility on the shoulders of ordinary citizens in relation to their financial well-being. It would be in the spirit of fairness, that we like to think of as our national ethos, that regulation acknowledges the difficulties that ordinary individuals can face in financial matters. We should think seriously about supplementing disclosure in a fashion that addresses its shortcomings, and provides a modest increase in investor protection. Like Rahm Emanuel, I think we should seize the day and do this properly and promptly. Otherwise we will miss our chance: and the greatest lesson in three generations of how markets can cause immense social and economic damage, and the good that governments can do, will have gone to waste.

Questions from the audience

**QUESTION**

Professor, thank you for that. The one question I have is, in changing the focus to the intermediary from the consumer, is there not a danger that there is going to be a relinquishment of responsibility?

**DIMITY KINGSFORD SMITH**

In the short term, perhaps that’s right. I think we have to continue to work on delivering the message that people do have to take their own financial future into their own hands as much as they can. That is the long-term goal of investor education, and one of the things I think that we need to turn our attention to. What lies beyond disclosure will be a long transitional period, when ordinary citizens will become more au fait with financial matters. Perhaps one day we might be able to go back to disclosure as the sole thing that we rely on, although I think it’s probably an oversimplification of what we already have now to say that is in fact how it is, it’s just that disclosure’s very predominant.

So you may be right that there is a danger in that, but I think the pendulum has gone a bit far the other way. I think at the moment we place too much emphasis on self-responsibility, and what we know now is that a lot of people just can’t manage at the moment. Perhaps our children—if we have interventions in the school curriculum and we as parents, who are gradually becoming more responsible, transmit messages to our children and model good financial practices—will be much more competent, will be able to take matters into their hands in a
way that takes the emphasis off intermediaries.

Indeed, the growth of internet investing, which is a non-advisory mode, suggests that for the future, young people already do that often very, very successfully on their own, but at the moment I think that we need to think about a long transition phase if what we really want is for people to take their financial future into their own hands to the extent that the political consensus seems to be saying.

**QUESTION**

What should be the duties of product issuers who develop complex products that might be unsafe for many retail investors? Should those duties just extend to disclosure?

**DIMITY KINGSFORD SMITH**

Well, I think what I said suggests that in the design of complex products, product issuers should be thinking a bit more carefully about the gradations within the retail investing population that they’re going to offer those products to. And they may want to include in that design terms that accommodate some of the behaviours that we know investors tend to exhibit, which is my reason for suggesting that complex products should have a kind of default option built into them so that you don’t have to pay very much attention to the holding of that product, even at the time you get it, but thereafter as well. Product designers should think about that much more than they do at the moment.

It may mean that behind the product, what happens internally in the manufacture, is more complex for product issuers. I don’t know, I have to say I’ve never looked into product design very greatly. It seems to me that’s a possibility. On the other hand, if we are going to take this business of creating the financial citizen seriously, which in Australia politically I think we’ve made the choice to do, I think we have to do something differently in the way we offer these kinds of products to ordinary individuals.

**QUESTION**

When master funds were introduced some squillions of years ago, they actually could not be offered to the retail public without an adviser, so you actually had to go through an adviser and they had to certify that you could understand the product, and there had to be a certification from the adviser that they had explained the product to you, et cetera.

That was actually taken away because of pressure from the investing public on the political people because they said, ‘Look, you’re excluding us from actually accessing these fabulous products’. So the retail investing public often want to access products like CFDs, contracts for difference, and so forth, and who think, ‘Well, you know, you’re stopping us from having access to these things and who do you think you are? And you know, stop acting patriarchally towards us; don’t force us to drink beer, we want to drink whisky’.

So in many ways this is the problem within the Australian community. They want to have access to sophisticated products, and it is a problem if you say you can only be a sophisticated person if you have a certain amount of money. *Personal Investor* did a study not so long ago, and the people with the most money failed to understand what a unit trust was.

So we’d like to get your reaction to that.

**DIMITY KINGSFORD SMITH**

To start the discussion rolling, it’s a fabulous point you make and I must think about it much more. I think the sophisticated investor test, to the extent that it gives so much
Beyond disclosure: How did retail investors and financial consumers fare in the crisis?

weight to the question of how much you’re worth, is probably open to reconsideration, because what I’m trying to suggest is wealth may be a poor proxy for investor decision-making capacity.

Perhaps if one came to the point of deciding that you were going to have some sort of certification process for allowing more exotic and risky products to be available to certain people, that many of the people who were clamouring not to have to go to a financial adviser to access a master fund would in fact qualify.

But the thing that concerns me is the selling to people, with very, very modest capacities indeed, of very risky products, especially when it involves their retirement income wealth, and we’ve seen a worrying amount of that over the last few years and some spectacular crashes flowing from that.

So I’m not saying that what I have presented to you is thought out in every detail, it is some big picture ideas for discussion, but one would have to look at the capacities of the people who were saying they didn’t want to have these kinds of products advised to them.

And I accept entirely from my work in online investing that there is a very quickly growing group of people who learn on the job. Our empirical study of online investing practices and expectations shows that a lot of people do learn quite quickly on the job, but they do tend to be people with higher levels of education and who have IT and accounting backgrounds, which tends to qualify them in a way that might make them eligible for that category, where you would actually certify them to have the capacity to invest in more sophisticated things.

PETER BOXALL
Thank you very much, Dimity, for an informative and stimulating presentation.
Beyond Disclosure

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Some Assumptions

• Individuals will have to provide for their own financial needs;
• Many individuals are disengaged with financial matters;
• Retail investors are not all the same;
• Even experienced investors have biases in decision-making;
• Consensus that markets are safe for retail investors has been lost in the GFC.

Beyond Disclosure – Some Recommendations

• Reduce complexity - go for straightforward or default products
• Certify investor capability for risky or exotic products or services
• Clarify intermediary’s duties and where responsibility lies
• A retail investor’s compensation scheme
Good morning everyone. I would like to just go off the topic for a moment and thank Dimity for a really interesting presentation; there were a lot of ideas in there that we will be thinking some more about. It was great. It is also worth noting for the record, in relation to the compensation fund that you mentioned, that the consumer movement are very great supporters of that solution, not least because of the sorts of difficulties with professional indemnity insurance answering those problems that you have pointed out.

However, I am not talking to you today about investing. I am talking to you about responsible lending. In some ways I see this as the other part of the picture. We have talked a lot over the last few days about investors and retail investors and their capacities in that space. Obviously the other part, or a very key other part, of the financial picture for consumers is lending and borrowing, ideally to create wealth.

Is responsible lending going to work and does it represent an experiment in moving beyond disclosure?

I would first like to provide you with some context regarding the position of Australian borrowers at a macro, but also some micro, context, if I can put it that way. My organisation is based here in Melbourne and we talk to many thousands of Victorian consumers each year who have consumer legal problems, and many of them do relate to consumer lending issues. So we have some good sense of where consumers encounter problems and what their views might be about how they found themselves in that situation.

I also want to do a broad sketch of the responsible lending obligations. I am terribly conscious that there are some people in this audience who know these things upside down and back to front, but I'm also conscious that, for others, these things will be less familiar. So I will quickly run through the key elements and then some of the challenges in implementing those reforms, and then turn to the interesting question, 'Will they work, what is important to make sure they do work and do they represent a regulatory trend perhaps away from or less reliant on disclosure?'

So some consumer context. Dimity mentioned the policy settings, if you like, the political framework we have in place in encouraging individual responsibility in relation to investment. In particular, the superannuation framework we have in place effectively forces consumers to enter that frame at the point of retirement.

I think it's worth remembering as we move through this discussion that of course borrowing begins as a general rule much, much earlier in the consumer experience. You tend to get offered credit cards before you have left your teenage years these days and, whilst housing affordability might be causing people to put off the decision to buy...
a house for longer, they certainly have plenty of opportunities to engage in consumer lending prior to that time.

In that context, a statistic to bear in mind, whatever we might like in terms of people taking responsibility for their investment and lending decisions: according to an Australian Bureau of Statistics (ABS) study conducted in 1997, on the document scale 44.8% of Australians have poor or very poor skills; on the quantitative scale 43.3% of Australians have poor or very poor skills.

Now in that context, it is clear that the sort of generational change that is needed is very, very significant indeed, in order to equip consumers with the capacity to do some of the things that we are asking them to do.

Another statistic: according to the Reserve Bank of Australia (RBA) in December 2009, Australians had on credit and store cards a combined credit limit of $126,689 million, and $46,912 million outstanding of which $33,237 million is interest bearing. I think it is also worth bearing in mind the context that the global financial crisis did begin with a lending problem in America, and not to mention a culture problem. In this regard we have had some discussion over the last few days about Rogoff107 and the patterns over the last 700 years of boom and bust cycles, and they seem to strongly suggest that we are not as good as we would like to think at learning from past experience. If we are able to recognise that shortcoming, that then brings into focus the appropriateness of law reforms that take us a step beyond simply disclosing information and imposing some standards.

There are of course some real challenges in doing that.

One other impact of the global financial crisis is that it has given us very dramatic graphs to put up. This is a graph looking at applications for property dwelling, property possession across a number of Australian jurisdictions, and the trends and the shapes in those graphs somewhat speak for themselves, and you can particularly see it in New South Wales and also interestingly, Western Australia and Queensland.

Similarly, this graph represents housing loan arrears by various different loan types. The high bar across the top relates to the non-conforming loan products and you can see that that is up above 9%, 90 days past due at the end of 2008. We have also got a trend climbing in low-doc loans, with a more steady picture in relation to full-doc loans.

These problems are, if you like, the macro picture; but it is important to also reflect the stories that we hear coming through our door, of families who have had equity stripped out of their home by multiple loans that take excessive fees. Loans that simply transfer a consumer from one unaffordable situation to the next, and maybe take $7000 or $8000 worth of broking fees out each time. Inappropriate lending of interest-only loans to elderly consumers, who really will only be able to repay the capital sum by selling their major asset, which is obviously usually their home.

We see credit card problems. It disturbs me the number of times we see cases coming through our door of a consumer on a fixed income, perhaps a Centrelink income, who began with a very modest credit card balance of $500. Over some many years of at least meeting the minimum repayments and, perhaps from time to time managing to pay

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107 Kenneth Saul ‘Ken’ Rogoff (born 1953) is currently the Thomas D. Cabot Professor of Public Policy and Professor of Economics at Harvard University. (Source: Wikipedia)
off the balance, that behaviour encourages the issuing of unsolicited credit limit increase offers. And I kid you not, we see people in that situation who have managed to reach credit limits of $20,000 simply by ticking the box on the form and sending it back.

Then there is Dave—not his real name. Dave walked into a well known electrical retailer, looking to buy a fridge on interest-free terms. Dave was in a reasonably good credit position and walked out with a 24% line of credit of $10,000 that he had never requested. So it is into this sort of context that consumer advocates have very strongly supported the introduction of a responsible lending obligation, because we have not seen the framework that we have effectively address those sorts of problems on a systemic level as distinct from, perhaps, on an individual level.

So can responsible lending help address the sorts of problems that I have just outlined? The framing of the law and the ASIC guidance, which has been confirmed and released on Monday, does give us some prospect to hope that at least some of the sorts of issues I have just spoken about can be addressed through the application of these laws.

I will just quickly run through the context of the responsible lending obligation and the reforms of which it forms a part. It is part of the broader credit law reform that we have seen over the last 18 months or so and, for non-Australians in the audience, we previously had our credit framework regulated at the state and territory level. That has changed and it will now, in our view extremely logically, be regulated at the federal level. The new laws do pick up, however, many of the effective aspects of the previously existing law.

The National Consumer Credit Protection Act (2009) does a number of very important new things as well. It introduces licensing for credit providers and those people providing credit assistance, which is to be advice, broadly speaking, encouraging consumers into a particular product, as distinct from general advice around options.

With that licence comes a number of other very important obligations. All licensees are required, for example, to be a member of an ASIC-approved external dispute resolution scheme. That single reform alone will have enormous benefit for individual consumers, as it will provide them with a free option of resolving disputes, whereas before they may have been forced to go off to court to resolve those problems, particularly in states and territories which don’t have a low-cost consumer tribunal.

The licence also brings with it a condition to act efficiently, honestly and fairly, under s46 of the law, and of course, requires that responsible lending obligations are adhered to. The substance of those obligations really rest on two limbs: the primary obligation is to conduct an assessment of a proposed credit contract or lease, to ascertain that it is ‘not unsuitable’ for the consumer.

What does ‘unsuitable’ in this context mean? Well, it means either or both that it does not meet the consumer’s requirements or objectives. That covers off concepts like the consumer’s purpose in seeking the loan, but also, in our view, should extend to the consumer’s pre-conditions, if you like, in seeking that loan. So, for example, if a consumer is seeking a debt-consolidation product to lower their financial burden in making monthly repayments, then the debt-consolidation product should indeed mean that the payments they are ultimately making
after entering into that arrangement are less than they were perhaps when they had a suite of loans that they were servicing. The ASIC guidelines do deal with precisely that sort of scenario.

The product will be unsuitable where the consumer will not be able to meet the required repayments, either at all or without substantial hardship. Clearly, in terms of the effectiveness of these laws, the interpretation of the concept of ‘substantial hardship’ is going to be absolutely crucial. ASIC, in their recently released guidelines, have touched on the existing considerations of these words, and there have been a number of those that have come before the various courts in Australia, including the High Court, and as well have been the subject of guidelines issued by the Financial Ombudsman Service.

However, ASIC also, and very importantly in our view, does specifically say that they are not seeking to define this concept. Nor indeed we suggest would that actually be possible. It will be therefore critical though that ASIC takes a leading role in developing jurisprudence in this area, so that it is well understood what those words mean and where the boundaries of them sit.

The other element of the responsible-lending reform, that is perhaps less new in many respects, is a disclosure element regarding the provision of credit or lease terms via a credit guide, either or both by the lender and the credit assistor. In some ways we are not the biggest fans of consumers getting additional pieces of paper, particularly where it is a direct relationship between the consumer and the lender. But where we can see this requirement being very, very useful indeed is where there is one or more, as is commonly the case, intermediaries involved in a financial transaction. And the cold hard reality is that, often when consumers get to the point of complaining, they don’t know who was involved in the chain of the lending, let alone who was responsible for what and what particular role they took in the transaction. So having that sort of information available to consumers will be enormously helpful in that context.

What are the challenges in implementing these laws? Not least, they are in the nature of a principal. Responsible lending is not a tick-a-box type concept, that being ‘or at least ought not to be’. An obligation to lend responsibly is, in some ways, symbolic of perhaps a shift in our views around what is appropriate lending conduct, but that does bring with it challenges in terms of implementing it. Whilst the framing of the law as a responsible-lending obligation is very important in its aspirational context, as well as hopefully its impact, once one digs down into the actual operational test, ‘not unsuitable’, we do have concerns that this casting of the law will encourage a literal tick-a-box type approach, rather than a genuine cultural change. What, in our view, is needed to make this law truly successful is a focus on knowing the customer and genuinely considering the interests of the customer in entering into transactions.

Properly working, these sorts of laws should encourage communications that seek to, themselves, encourage rational decision making. I will talk a little bit more about that in the context of unsolicited credit card limit increase offers shortly. It will clearly require a commitment on the part of businesses to really to look at their processes in the light of these new principles, and critically examine whether they are meeting the grade.

In many cases, in terms of responsible institutions, they ought not in fact require
enormous system changes if people are making proper assessments of people’s capacity to pay. If they are looking and inquiring into a consumer’s circumstances, then that may not require areas of change, but we would suggest that most lenders will have at least some areas of their business where they will need to really think hard about the application of these laws to their circumstances. For business models that we see currently in the marketplace, that are targeted at vulnerable consumers, clearly there will be additional challenges in terms of how and, indeed, whether they are able to comply with these laws. I am thinking in particular of businesses that market ‘Don’t worry if you’ve got a bad credit rating’, ‘Don’t worry if you’ve been bankrupt, come here and we will lend to you’. There are real challenges in that space, I would suggest, around a responsible-lending focus.

There are also some practical challenges, in our view, in implementing these laws or, potentially, challenges for the regulator in making sure that they are able to address the sorts of market conduct they perhaps may like to.

The definition of credit assistance is one such area. It’s defined in s8 of the Act and, as I’ve noted, is linked to providing assistance in relation to a particular provider or a particular product, not the provision of more general assistance. But one of the areas that we see some potential for a problem might be a general business, ABC Debt Advice Pty Ltd, saying, ‘We’ll give you general advice about debt consolidation’, say for example, and once they’ve had that general conversation, you might just like to go next door to XYZ Debt Consolidation Pty Ltd who happen to offer debt-consolidation products. ABC Debt Advice Pty Ltd is giving general advice, provided that they don’t actually say, ‘By the way, this is the one for you’, even though they may have some sort of arrangement in place with XYZ Debt Consolidation Pty Ltd.

So we think that there will be a need for vigilance on the part of ASIC in looking at the market and seeing whether these new provisions and the new requirements that apply to credit assistance encourage the growth of these sorts of arrangements.

Another area is point-of-sale retailers. I mentioned Dave and his trip for his interest-free fridge. Because of Dave’s experience, and he is not an isolated incident, we are obviously of the view that there must be coverage of point-of-sale retailers. There is an enormous amount of credit and lending that occurs in that space, and it would simply leave a significant problem were that to be exempted.

How that issue will be dealt with is the subject of active discussion at the moment. There was initially a suggestion that point-of-sale retailers would be exempted through the regulation, but we have moved beyond that point, and the question now is how, rather than whether, they will be treated under the law. We will be supporting a position which allows Dave to suggest that what happened to him was not an instance of responsible lending.

Then I suppose there are the practical type issues of application to these laws, the real-world application issues if you like. We can perhaps see fairly clearly how a responsible-lending obligation might apply in a home loan, home lending situation. There is scope to look at what’s being presumed, by way of income that a consumer needs once they’ve made their repayments. And there’s also scope to look at some of those non-conforming products that I’ve mentioned, but perhaps we can see reasonably clearly how the law might apply in that sort of situation.
There are a number of other areas, though, where we suggest it’s going to be significantly more complicated because of the nature of the product. Consumer leases is one example. They are covered, very importantly, by the new laws and are subject to the responsible lending provisions, but what ‘substantial hardship’ means in the context of a car loan or a Flexirent computer arrangement is perhaps less clear, and is precisely the sort of area that will require earlier clarification and guidance.

We have already seen guidance from ASIC, and they give some of these sorts of examples to give us an indication of what their thinking might be in this area, and we are very supportive of that guidance. We think it sets the bar at an appropriate place. However again—and this is a theme I will return to—enforcement in this space, to get judicial interpretation of the application of these obligations in that context, will be critical.

Another area where we see some need for very early attention is in relation to continuing credit contracts and, in particular, credit cards. Certainly a formulation of ‘substantial hardship’ that says you’ve got to be able to meet the minimum repayment amount, in our view, would be a minimalist and unfortunate interpretation of these obligations, particularly once a consumer starts to have a reasonable credit limit. Paying off a balance by meeting the minimum repayment takes in the order of 10–15 years. That, in our view, is irresponsible lending and we will be encouraging a treatment that looks at the ability of the consumer to pay off the card in a more reasonable period of time.

The other real challenge in this area is that the focus of the responsible lending obligation is at the point of transaction, and some of my organisation’s greatest concerns about credit cards relate to the marketing of them and, indeed, the unsolicited credit limited offers that I referred to. Recently, we have been involved with a research report with Deakin University that looks at the psychological impact of the way that these offers are structured, e.g. the use of colour, text changes and images and the words they use or don’t use to influence a consumer’s ability to rationally consider whether the increase is appropriate for them, or to discourage consumers to engage with the offer in a rational way.

Of course not all consumers are susceptible. Yet it is not difficult to see the impact of the messages that, ‘You are doing the smart thing’, the message that is created by the fact that it is signed by the bank manager; that is a tacit endorsement that, yes, you can afford this and it is a sensible decision. It discourages some consumers from doing the sort of thinking around how long it will take to repay if they do use that additional credit limit. So that report advocates the creation of a psychological break in those offers, to encourage consumers to more actively and rationally engage with the offer. The challenge of a transaction-focused obligation in addressing that sort of conduct is fairly clear.

So turning then to the question, ‘Will it work?’ There are some critical aspects to this question, in our view. ASIC guidance talks about scalability in organisations applying for responsible-lending obligations, so it is a recognition that what might be necessary by way of inquiry for a home loan might be different to the inquiry that is necessary for a small personal loan. In our view—and ASIC guidance seems to suggest that this is a path that they also wish to follow—part of that equation has got to be looking at the consumer. So, whilst a personal loan might be less serious in amount than a home loan, if that personal loan nevertheless has the
capacity to mean the consumer falls into substantial hardship and is unable to afford basic expenses—or a credit card may mean that a consumer has no option but to sell their house to repay the debt—those are the sorts of scalability that we want to see as well. So yes, scalability in terms of product, but also looking critically at the individual and their circumstances. Put another way—the scalability needs to look at the individual consumer not just the product. Put yet another way, as I said earlier, know your customer.

We suggest it would be necessary to think carefully and understand well consumer behaviour in interpreting compliance with obligations, and behavioural economics, I think, gives us a lot of scope in this area: the importance and power of framing in terms of consumer reactions; the endowment effect once someone has bought something; the shortcuts that people use when they are faced with a difficult financial transaction; and consumers’ wonderful ability to discount today what they have to pay tomorrow. We may not like the fact that these are consumer characteristics, but we would be very foolish to ignore them.

Returning again to an earlier theme, clearly we are of the view that early, proactive enforcement will be critical to signal to the market where the line is in terms of this law, and to help develop jurisprudence about the meaning of the law. That involves, we suggest, taking a range of pieces of enforcement work, across a range of products, across a range of different scenarios, and ultimately a willingness on the part of the regulator to remove licences if behaviour cannot be made compliant, and of course, aligned to that, a willingness to prosecute unlicensed behaviour.

Is this an example of a regulatory trend? I suppose ‘We hope so’ might be one answer to that question. Taking a broader view, however—at its heart responsible lending is perhaps principle-based in its conception. We do already have in our law many powerful instances of principle-based law and they have stood the test of time. We have ‘misleading and deceptive conduct’ and there are other examples.

I have spent some time talking about the many reasons why disclosure is a pretty limited tool, particularly when one looks at complexity and difficult decision making for consumers, but I think Dimity has already well covered off on those points. So I will simply, in closing, note that Consumer Action have put together a list of characteristics that we consider are an indicator of effective regulation, and it obviously remains to be seen how responsible lending will stack up against these criteria. We think there is some real hope that it will stack up well, but ultimately there is a limitation on the capacity of a law to drive what, in effect, is cultural and some would argue, moral change. Nevertheless, the passing of the law in itself is a very important signal in that regard, that there is a desire for a sea change and that it is therefore now over to us, as consumer advocates, to ASIC as the regulator and, indeed, members of the industry, to take up that challenge and drive the sort of cultural change that we need to see. Thank you.

PETER BOXALL

Thank you very much Catriona, for an insightful presentation on a very difficult topic, and my colleagues and I in ASIC who work on this issue have been listening very carefully. Any questions?
Questions from the audience

QUESTION
Do you think the regulator should get involved in a design of a product by the product provider? For instance, in credit cards, the minimum repayment on some cards are at 1.5%, whilst in the US it’s been mandated at 3.5% in the same way with mortgage products, to extend it to a 40 year term or a 50 year term. Do you think there should be some sort of influence on that?

CATRIONA LOWE
Look, clearly it is problematic for a regulator to get right down into product design, and one suspects that it would have a somewhat dampening effect on perhaps the ability and the willingness, indeed, of the regulator to take enforcement action down the track if things went wrong.

However, I think there is enormous scope for there to be principles and guidance around ways in which business can be more assured that they are complying with the law. And there certainly is scope for regulators, as ASIC and other regulators do do, to say, ‘Well, if you are doing this, then that’s probably okay’, rather than saying, ‘Here is the line’, whether that be at 1.5% or 3%, as the case may be.

And certainly, I think there is also scope, to use the credit card example, for a regulator to say, in relation to a credit limit offer for example, ‘We will be much more interested, we will pay much more attention to your offer, if it does not do these things, if it does not provide the capacity for a consumer to get that psychological break, if it does not do more than say, “Please tick this box to say, ‘I can afford this and it suits’”,’. I mean, one can imagine, in relation to the purposes test, for example, that what we might see is a new line below the ‘I’m 18 and I can afford it’ box, will be another box that says, ‘Oh, and this is suitable for my purposes’.

If this law is going to be effective, we would be looking to see guidance that that is not viewed as effective compliance with the sorts of obligations we’re talking about because at their heart, they ought to encourage genuine enquiry. They ought to encourage knowing your customer really, not just ticking the box.

QUESTION
Thank you. I thought it was a great talk but I really worry about this word ‘responsible’, and imagine a situation where maybe house prices fall and a lot of borrowers end up in a negative equity situation, how responsible is that going to look?

CATRIONA LOWE
That is a very interesting question and to some degree the answer, I think, will depend on what happened at the time the loan was written and what sorts of assumptions were made. I mean, I think it’s important to say that, as I’ve mentioned, the casting of this law as a responsible-lending law is an aspirational thing. When one looks down to the actual test, what we are talking about is ‘not unsuitable’.

Some of us might argue there’s a gap between ‘responsible’ and ‘not unsuitable’. But in relation to a home lending context, I would see the sorts of considerations that would be relevant would be a consideration of head room, if you like, in relation to assessing what the consumer can afford in terms of assuming some interest rate rises.

I think you would be obviously more concerned if you were writing a 100% home
loan than if you were writing an 80% home loan. There are a number of factors that are present at the time the loan is written, that ought to, without obviously being able to predict where the market will head, ought to take account of the fact that markets fluctuate, and ought to take account of the fact that consumers, sensibly, should have a buffer in terms of not just the interest rate today, but the interest rate tomorrow.

And finally, as I touched on again, looking at those assumptions about what the consumer needs to live on, I mean, some of those assumptions back in the heyday really had consumers living on the poverty line in terms of a quarantining of day-to-day expenses, translating through to what we’re prepared to offer you by way of a home loan. So there is definite scope, well short of being in a situation where we say, ‘Responsible lending means prices can’t go down’—there are many, many things that are practically possible in that space.

PETER BOXALL
One last question down here.

QUESTION
Catriona, thanks for your speech, it was great. Actually I must say I like responsible lending, having seen the sub-prime crisis in action in America, which was tragic. And also, I’m a big adherent of determining suitability. So I just make that clear. I was wondering, in terms of the new legislation, to what extent does it anticipate online consumer lending and protections there for consumers?

CATRIONA LOWE
That is an interesting question. In some ways—I mean, a bit like the credit card example, there are going to be challenges in a remote environment that are not obviously present when you are sitting down in the bank manager’s office and signing papers, if anyone actually does that any more. Clearly, on the one hand, there is the issue of enabling efficient transacting by those methods, but equally it will mean additional enquiry and, potentially—particularly in situations where it might be termed ‘risky’, either on the face of the consumer circumstance or in some cases, by the nature of the product—that extra steps will need to be built in. For example, we see online payday lending and it is difficult to see how, if you are just asking someone to tick boxes, you can discharge an obligation to make a genuine enquiry into someone’s circumstances. So yes, there are going to have to be additional steps potentially, in some of that transacting, to discharge that obligation.
Consumer credit reform and responsible lending

An experiment in moving beyond disclosure?
Catriona Lowe
Co-CEO

Outline

- Some context
- A sketch of the responsible lending obligations:
  - Key elements
  - Part of broader credit reform
  - Key challenges
- Will they work?
- A regulatory trend?

Context

- 50% don’t understand 50%
- In Dec 2009 Australians had:
  - credit limits totaling $126,689m
  - $46,912m outstanding
  - $33,237m accruing interest
- GFC began with a lending problem & a culture problem.
Credit law reform

- Part of broader reform of credit law (National Consumer Credit Protection Act)
  - Previously regulated at state and territory level (with some overlap with general conduct provisions under ASIC Act)
  - Many provisions of previous UCCC picked up
  - Introduces licensing for credit providers & credit assistance (s.29)
  - Requires membership of ASIC approved external dispute resolution scheme
  - License conditions include a requirement to act efficiently, honestly and fairly (s.47(1)(a))
Responsible lending

- Primary obligation is to conduct an assessment of a proposed credit contract or lease to ascertain that it is ‘not unsuitable’ (Chap. 3).

- Contract is unsuitable where:
  - It does not meet the consumer’s requirements or objectives
  - The consumer will be unable to meet the repayments either at all, or without substantial hardship

Responsible lending (cont.)

- Other obligation is disclosure regarding credit or lease terms via a credit guide

- So not a complete move away from disclosure

Key challenges (1) – cultural change

- Risk that the way law is cast will encourage literal (tick-a-box) compliance rather than genuine cultural change

- Helpful that ASIC guidance is deliberately open-ended and non-prescriptive

- However is there enough emphasis on notion of consumer harm

- Risk that criteria which are chosen for their utility as a means of preventing harm (eg income, credit report data, variable expenses) come to be seen as an end in themselves
Key challenges (2) - coverage

- **Definition of credit assistance (s. 8)**
  - Linked to assistance in relation to a particular product or provider (cf. general advice about product types)
  - Potential to encourage avoidance – business structures

- **Point of sale retailers**
- Treatment under active discussion
- Were to be exempt from credit laws (under regulations)
- Strong view that they should be captured by the regime

- **Consumer leases**
  - Are subject to responsible lending provisions - but will it address Motor Finance Wizard or other rent-to-buy problems we have seen?
  - Disclosure of cost of credit & interest rates is not required
  - Significant scope for attention under unfair terms laws in this area
Key challenges (3) – in practice

- Focus at the point of transaction, ie not marketing
- Small amount, high cost lending (fate of interest rate caps)
- Continuing credit contracts, particularly credit cards
- Older borrowers

Dispute resolution

- Access to EDR a huge step forward
- However tribunals (in states and territories that have them) will lose credit jurisdiction
- Low/no cost list in Federal Magistrates’ Court (sections 199-200) – but with significant limitations:
  - Hardship and postponement of enforcement – no monetary limit
  - Compensation breach responsible lending, civil penalty breach of NCC, claim re enforcement expenses - $40,000 claim/order
  - Unjustness and unconscionable fees etc – value of contract up to $40,000 only

So will it work? Critical ingredients

- Focus on the notion of consumer harm in interpreting ‘scalability’
- Understand consumer behaviour in interpreting compliance with obligations
- Importance of active outreach and communication
So will it work? (cont.)

- Importance of early and pro-active enforcement – help drive cultural change
  - Across range of product types
  - Across range of scenarios

- Willingness to remove licences where necessary and prosecute unlicensed behaviour

Enforcement

- Current amendments to ASIC & ACCC under ACCA are very significant. In particular:
  - substantiation notices
  - refunds for non-parties
  - infringement notices
  - Powers were not picked up in new credit law (Part 4-2)
  - So above provision will apply to misleading and deceptive conduct but not a breach of responsible lending obligations

A regulatory trend?

- Disclosure tended to be the default option - overused
- Seen as less costly (and it can be) and not interfering with consumer autonomy
- However both of these assumptions are open to challenge
A regulatory trend? (cont.)

- If it doesn’t work it is all cost no benefit
- Growing evidence that poor disclosure not only doesn’t help consumers it can harm them
  - Number of studies show disclosure of a conflict can in fact increase consumer trust in the discloser eg. Schwarz –Beyond Disclosure: The case for banning contingent commissions (2007)

A regulatory trend (cont.)

- A sophisticated policy response is not linear (try solution a. before moving to b. )
- It acknowledges different problems require different solutions
- We therefore need to ask;
- What is the problem?
- Which tools will actually fix the problem?
Effective regulation?

- **Characteristics:**
  - Actually addresses the problem it is intended to solve;
  - Balances market efficiency & consumer welfare (including estimating the social as well as economic costs and benefits, consumer costs and benefits as well as business);
  - Provides effective avenues for consumer redress;
  - Enforcement is given a high priority;
  - Regulator has adequate powers;
  - Delegates & monitors where appropriate;
  - Encourages social responsibility;

In closing...an experiment?

- More a return to principled based regulation in a new sphere
- Other examples in our framework
- Will the experiment work?
- To some degree – will fix some problems
- But will it have a broader effect on lending culture?
Jump on board! Protecting retail investors and financial consumers in capital markets

Panel discussion

Moderator Mr Tony D’Aloisio, Chairman, ASIC
Mr Paul Clitheroe AM, Chairman, Australian Government Financial Literacy Board and Executive Director, ipac securities
Ms Linda Elkins, Managing Director, Russell Superannuation
Ms Elaine Henry OAM, Chief Executive Officer, The Smith Family
Professor Dimity Kingsford Smith, Faculty of Law, UNSW
Ms Catriona Lowe, Co-Chief Executive Officer, Consumer Action Law Centre
Mr Ian Silk, Chief Executive, AustralianSuper

TONY D’ALOISIO
This session will pick up some of the things we discussed earlier this morning and take some of them a bit further. We’ve had the so-called GFC, the global financial crisis and its impact, we’ve had losses at the retail investor level, and other consumer issues. Starting with you, Paul, what has been the impact of the GFC on retail investors, financial consumers, in your view?

PAUL CLITHEROE
This is probably a bit of an unusual opening, but the previous government really started the financial literacy push about six odd years ago. Prime Minister Howard said to me, ‘What do we really need to help financial literacy?’ And I said, ‘Look, Mr Howard, what we really need is a major downturn’, to which he said, ‘Not on my watch’.

I can understand the political point, but I sometimes think we miss the point here. I’ve been talking to people about money for a long time—I started on radio back in 1979 and on money shows on Channel 9. I’ve had over a million communications around money from real people, and the pressing issue that I get, both before and after the global crisis, remains unchanged. What I am still getting today is what I’ve been getting for nearly 30 years, is ‘When it comes to my money, who do I trust?’

TONY D’ALOISIO
So you’re saying really, the GFC may have accelerated some of the issues, but the issues have been there for a long time.

PAUL CLITHEROE
From a literacy viewpoint, as Warren Buffet said, and I love this saying, ‘You only know who has been swimming nude when the tide goes out’. In a sense, behaviour with money—it’s a serious point we are making here, is that we know full well, despite all the technical skills in the room, at the end of the day what we are trying to do with both regulation and certainly in my case, financial literacy education, we know full well we are fighting the two fundamental DNA issues of fear and greed.
There is no doubt in my mind that, while it is easy to say that investors have been terrified, at least, Tony, from my viewpoint, the idea that risk and return are real, is now very real. Because basically, in a boom, the more stupid you are with your money the better returns you get.

TONY D’ALOISIO
I am going to come back and we are going to delve into those issues a lot more, but just initially—Linda, what is your perception of the impact of the GFC on these sorts of issues?

LINDA ELKINS
I obviously agree with the point Paul is making, and the way we are seeing that materialise in our business is through increased engagement. So things like, you know, across the board of our contact centres—whether it be the website, participation in seminars, seeking advice, reading materials we send, calling our call centre—there has been a noticeable change in the way people want to engage with their superannuation. Ian, you may be experiencing the same thing, so if you like, what is almost the silver lining on an otherwise dark cloud is that it has made people take more notice and take time to engage and learn and understand.

The other thing specific to superannuation is that, while we saw this increased engagement, and an increased seeking of knowledge, what we didn’t see is kind of crazy knee-jerk reactions. We saw some of that, you know, some people who went and sought the bank guarantees over their super, or whatever. We had lots of people, around the announcement of bank guarantees, switching to cash within their super, so that was a double whammy, because not only are they now not participating in the market upturn, but they didn’t get the bank guarantee either.

So there were pockets of things that you saw, but by and large people didn’t do anything, they did stick with the strategy they were in.

TONY D’ALOISIO
Is that because they had confidence, or is that because they were, in a sense, complacent about it, maybe trusting? Ian, what is your view on it?

IAN SILK
The number of people that moved from a more aggressive option to a more conservative option, and it was usually the cash or capital guaranteed options, during the whole of the global financial crisis, was about 2% of our members. We put that down, frankly, in large measure to disengagement as opposed to a rational decision.

We have done some work on that 2% of people. Most of them moved late, so they had already lost a lot of money when they moved and most of them that have come back to where they were previously, have come in late, so they missed a lot of the uptick. 1%, or half of that 2%, have not moved back at all. So almost everybody that moved in response to the GFC, to the best we can assess it, has lost money out of those decisions. So the issue about financial literacy isn’t just a matter of taking action, it obviously needs to be informed action.

LINDA ELKINS
In fact I think this is hitting on a very good point about to what extent do we see the success of financial literacy being people feeling empowered and making lots of choices, rather than perhaps people just feeling comfortable, in the case of superannuation, relying on things like default
options or just trusting the system or turning to experts, rather than taking the action themselves? I think that is an important distinction.

**TONY D’ALOISIO**

Elaine, what is your overall view on what the GFC has done?

**ELAINE HENRY**

I am just going to look at mum and dad in the High Street, and mum and dad in this case, who have been employed, so they do have some superannuation—if we are sticking to superannuation. Psychology comes into this; but there is a lot of anger because people have seen over the last decade or so, their super going up, without realising there is great volatility in equities and at some point of the boom cycle there is going to be a bust, and all of a sudden we have taken something away.

Human beings have a very different reaction, when we gain something, and then when someone takes something away from us. ‘They have done it’—whoever they are—is what you are hearing in the High Street, so there is a bit of anger out there. Contrary to the trusting issue, there is quite a bit of distrust out there and I am sorry to say it is against the financial services sector.

**DIMITY KINGSFORD SMITH**

Yes, I think it is interesting that these comments tend to reflect some of the research that I was mentioning in my paper, and that what we have been increasingly able to do is move to evidence-based regulation. We find out what is actually happening and then we can craft some of our regulatory responses rather more around that, than thinking of how we might go forward with less information about what actually happens in the real world. It is interesting that your observation is that people are actually evidencing that bias about being conservative about loss and other people are being disengaged, fortunately disengaged to their benefit.

**CATRIONA LOWE**

I’d just like to pick up on Elaine’s point about anger. I think that is out there and policy makers and regulators ignore that at their peril, in terms of how we respond to some of this going forward. But I would add to that—we run a financial counselling service and have done since last year, and what we are seeing is that—we are seeing large-scale redundancies starting to bite in now. We’ve got an industry liaison officer going out and talking to workplaces, where several hundred people at a time are now being made redundant, the business having perhaps held on through the course of last year and now falling over. So what we are going to see I think now, is people that took the benefit of keeping their job and the low interest rate environment that we’ve had, are now potentially facing a double whammy, where their job may be less secure or gone and the interest rates are going up again. We’ve talked a lot over the last few days about the macro-economic emergence from this; I think we would at our peril ignore the fact that it ain’t over at the micro-economic level, and that is going to continue to drive consumer views about all of this for some time to come.

**TONY D’ALOISIO**

Let’s move then to rebuilding confidence, or at least, dealing with perhaps more apathy, in the sense of inaction, and move to some issues around how to better protect retail investors and pick up some of the themes in this morning’s session.

Just to kick off with a more general question for the panel, what is the balance of risk that
retail investors and financial consumers should carry? Are we looking at an environment where we want them to carry no risk? Sort of the guarantor of last resort? Are we looking at an environment where they do need to carry a risk, and if so, what is the balance there, how do we approach that difficult question?

From that we will then go into specifics about how they can possibly be better protected. But just from your experience and what you have seen—and I am happy for any panel member to kick off—what is the balance? What is the level of risk we want investors—or should investors carry risk and look after their own affairs?

LINDA ELKINS
I’ll start with this one because I think this is one of the most difficult questions that’s out there. Fundamentally what we’ve got now is a financial system that requires individuals to both take more responsibility and to bear the outcome of the financial decisions that they make. We’ve moved from paternalism by employers or governments to self-responsibility.

In that world it just seems impossible to me that we could ever then seek to limit the amount of risk that somebody can take if they so choose, so the challenge that we’re left with is how do we therefore manage making sure people can choose appropriate levels of risk for themselves? I don’t have all the answers to that, but I really love the concept you were introducing in the last question, which was this evidence-based regulation. And I think the power of that, not only from a legislative perspective but also for the financial sector, is to take that responsibility as well in terms of the way they offer or limit—not limit the offer, but the way they might go about offering products and services, and Elaine, you could probably quote some examples where you’ve seen companies effectively do that.

TONY D’ALOISIO
I take it from that then, Linda, your view is that there should be some risk that’s carried. It’s really where you draw the line.

LINDA ELKINS
No, if the responsibility is going to be with the individual, I don’t think we should have a system that in any way tries to impose limits on the amount of risk they can take.

So it’s more got to be, how do we, therefore, appropriately manage a system that doesn’t limit risk?

PAUL CLITHEROE
Haven’t we got to work out, though, a fair break point between: where is regulation and where is information? One of Tony’s favourites at ASIC, for example, is the property debenture company, you know FIDO, all sorts of stuff around that. I think ASIC’s done a good job in that area.

Maybe it’s a bit of fun to say that we decide today we’re going to start a property debenture company, we’re all going to be directors, and basically we could well argue intellectually the commercial property market has taken a bit of a thumping, and it’s a good time to place clients’ money in property-based mortgages.

Consumers are looking for a secure investment they can trust, and we decide to come up with a prospectus that may or may not be approved by ASIC, which talks about our wonderful new product that’s going to pay investors 11% over five years and 10% over three years.
Basically, we’re sitting back saying, ‘Hang on a sec, we know full well the risk-free rate of return is 6%, and what we should do as directors is buy our overseas airfares in advance of the next downturn’.

Maybe Tony should jail us in advance, because we know it’s going to fail in the next downturn, because you’re not going to get a 5% above risk-free rate of return if you are saying this to investors, whether it’s solicitors, mortgages in the 1990s, it’s Westpoint, it’s an Estate mortgage. We know some of these patterns so I think we want investors to be responsible, but if we’re telling them it’s capital stable and it’s not, if we’re letting advertisements tell them Estate mortgage is ‘Just like a building society or better’, the consumer’s got little chance.

TONY D’ALOISIO
Let’s use that as an example to test some of the concepts that have come out. Let’s look at disclosure first. We will take Paul’s example and look at disclosure. Dimity, you spoke about disclosure this morning and this is a question to the panel. Wouldn’t an argument be that the disclosure of the risks that Paul has talked about is adequate?

DIMITY KINGSFORD SMITH
I think Paul has already conceded that the disclosure of the risks is not adequate because he is kidding himself and we’re all kidding ourselves as the board, and we’re hoping that we will be able to kid the punters as well. So I think what Paul has outlined is the classic example of where disclosure is—

Speculative property investment in the Yarra Valley. There is no guarantee that you will get the 9% interest rate each year, and there’s no guarantee that when you come and ask for the amount to be redeemed that we will have the funds to redeem it. If you make those disclosures, one argument would be that, shouldn’t you then leave it to the retail investor to make their own decision?

PAUL CLITHEROE
Words are done by lawyers and they are very poor disclosure tools. What I would like on the cover is a group of retirees with their furniture in the street outside their house. Then I’m happy for the words to say, ‘This may not happen to you but guess what, mate’. That would get their attention.

DIMITY KINGSFORD SMITH
In a lovely way Paul has just said what I think is an important improvement we have to make about disclosure. A disclosure concentrates very often on telling consumers and retail investors about the return. It is not good at telling them about the risk, and in a Statement of Advice there’s not even a legislative requirement, direct and express, that you have to talk about the risk. And often you get cash flow worksheets in the back of Statements of Advice that tell you what your returns are going to be over the next 15 years or whatever. I think there should be some tables there that work—a risk scenario explaining what happens to your capital if it’s margined, what happens to your security if it goes backwards, not forwards.

TONY D’ALOISIO
Staying with disclosure, Ian, from the point of view of superannuation, are there improvements we can make in disclosure?
IAN SILK
There are, but I think disclosure is overrated in this sort of discussion, in the context that it is a panacea. Catriona started her presentation with a very arresting figure—50% don’t understand 50%. Frankly, any of the disclosure we have talked about, possibly including Paul’s rather evocative photograph, might be a struggle for half the population.

So as far as disclosure is concerned, you have to do it, but it has to be a lot better than what we have done to date, in this industry in particular, bearing in mind a lot of people follow the letter of the law in disclosure but actually there is a subtext of hiding the important information. Disclosure is like the floor you put in the building, but it is not the walls, it is not the roof, it is not any of the furniture. It’s necessary but not sufficient.

I think the bigger change needs to be putting a greater onus on product providers, product manufacturers and intermediaries, to make sure that their end client is an informed consumer, and I think there is a different issue in super versus non-super. Super is a compulsory product. Virtually the whole workforce is in it, and yet many of them aren’t aware of the details of it. I think that imposes a higher obligation on the trustees and they have a statutory obligation to act in the best interests of their beneficiaries.

Why a similar, not identical, but a similar obligation doesn’t operate in the discretionary savings area I don’t know. Catriona’s comment, I wrote it down, about credit contracts having to be ’not unsuitable’. I don’t know anything about the credit area, but I saw that and I can just imagine the tussling that went on between the consumers on the one hand and the product providers on the other, and it seems to me the product providers did a pretty good job. ‘Not unsuitable’. What an incredibly low bar that is to leap over.

TONY D’ALOISIO
Elaine, do you have a comment on this disclosure issue? Can it ever be adequate?

ELAINE HENRY
It is very interesting, what Ian was saying. To me if I step back, it is just pure business sense. If people want to understand where a lot of our population is at the moment in terms of financial literacy, and what I mean is—if they produce no-frill products that are understandable but fit for purpose is the way I might describe it, I think there is a great business opportunity.

What we are seeing now are some social ills, but if you are really smart as a business person, you see it as a business opportunity, and it works. It is working around the world in other nations, and I am not talking necessarily now about superannuation but any product. There are lots of people who can be part of a forward movement and secure their own future.

If you come back to what Linda was saying about individuals being responsible for their own actions, I think that is part and parcel of the culture of Australia. What we are actually dealing with now is something that has become quite complex in terms of the financial products that are out there and the gobbledy-gook that we apply that no one can understand, let alone the people I deal with.

And yet, if we step back and say the GFC has created greater awareness within the population and we then started to do something from the very basics—I’ll use the phrase of the moment, ‘going back to basics’. After all when I went to school, we learned a lot about financial literacy in school and then we got terribly sophisticated in the curriculum
and it just disappeared off the agenda. ‘Been there, done that, now we can move on.’ We then had compulsory superannuation. We had all these sophisticated superannuation products and so forth, but we left a fair number of the population behind, because they don’t talk our language.

TONY D’ALOISIO
What I want to do is to delve a little bit more into moving from disclosure into some of the other ways that we can protect investors, and pick up the issues and then get with the finale around financial literacy, but we are going to spend some time on that. Just before I move to there, are there any questions from the floor at this stage?

QUESTION
I am an absolute advocate for introducing a duty of care to oneself. I think for years and years we have always had the duty of care to third parties and sometimes occasionally we just have to step up and admit we might have made a bad decision.

I am interested in the social aspect of that, where people don’t have the tools to protect themselves and the views of the panel on, not financial literacy necessarily from the warning, as much as I quite like Paul’s idea of the picture on the front. When it came to cigarette packet warnings people just went in and said, ‘I want the cigarette packet that is harmful to unborn children, because I am a man, so’. I just fear that the picture of the pensioners will just be picked up by those who want to invest on behalf of their families. I am interested in the social aspect if we went to a duty of care to oneself.

IAN SILK
I might start off. I think in super, again it is easier than in the discretionary savings area, but the duty of a trustee of a super fund, if they know that they have a reasonable proportion of their members who are not engaged and are coming in often unwittingly into the fund—it is a classic case of an ill-informed consumer—the ultimate obligation is for that super fund to have well-constructed default settings in two areas: firstly investments, most importantly investments, but also in insurance. And so for most industry funds and possibly most commercial funds, we have that as our principal objective.

If we can get one thing right it is to get the default investment setting right and the default insurance setting right, because we know a huge proportion of our members are going to be where we put them and they won’t self-select out, probably ever, for most them. But as many of them go along a journey, and hopefully we effectively communicate with them, they may decide to do that. But interestingly, we don’t have an aspiration, we don’t even have an ultimate aspiration, to turn our members into great asset allocators.

Financial literacy for us is about getting them to be engaged with, hopefully, a growing pool of money and make some very simple decisions, consolidating their various accounts into one, having a look at whether they can afford extra voluntary contributions, have they got the right insurance, and so on. It is damn hard frankly, for the experts much less disengaged people, to decide whether emerging markets this year are going to be a better bet than developed markets, for example.

ELAINE HENRY
We are starting to touch on behavioural research, which is an aspect that I’m interested in. But just a quick story: last week we ran a workshop on money and wellbeing,
and we had experts from all disciplines around the table at AXA, and it was quite fascinating. There were people from all walks of life, and probably they were very financially literate, and we were working out how we can work with the general population, so we had the haves and the have nots in our view. And the view was quite unanimous: we just haven’t worked through emotional literacy, first as a foundation—it is as much of a foundational skill as reading, writing and arithmetic—and what we’ve seen are behavioural responses to a situation that we think are fairly crazy.

A lot of our people, and if I come to the more disadvantaged sector of the marketplace, just don’t have the skills. They have never in their home environment or their community environment, let alone a work environment, been put through the rehearsals that you need to have the confidence to stand on your two feet and resist buying or spending, or whatever it is that you are doing. Before you get people acting in a financially literate way, you have to make sure that people have got the emotional literacy skills that they need just to get through the financial literacy decisions.

PAUL CLITHEROE
I think the audience would find it fun to sit in some of the focus groups. Where this lack of trust comes from—Tony, your word around responsibility, and I have said this to a few CEOs over the years—is that when you offer a product called capital stable, which is then highly capital unstable, just in the back of your mind, wouldn’t you just say to yourself, ‘Tell the marketing team to behave in a socially responsible manner’. Have a think for a moment about what your retired mum or dad might think ‘capital stable’ may mean. So I think in terms of responsibility, yes, we have social responsibility. For the captains of industry in this room, if we as an industry want to obtain consumers’ trust, I think being dead honest is a really good start.

LINDA ELKINS
Perhaps one of the outcomes of the GFC is not only what consumers have learned, but what we have all learned in business as well—which is to have an ill-informed consumer, or to have inappropriate customers, in our products is not a position the industry wants to be in either.

ELAINE HENRY
But if you went even further, and you try and break down some of the stereotypical illustrations we use all the time—and coming back to the very first point you made, Linda, about aspiration—I do think we should not look at some of the disadvantaged in our community as not having the aspirations to asset accumulate like we all might have, we have just got to find out how we get the trusted intermediary into the picture to ensure that we give them some opportunities that I couldn’t imagine, as a business person, why you wouldn’t want to get involved with.

TONY D’ALOISIO
Let’s stay with the theme of protecting and assisting, and explore a few more ways of assisting investors and financial consumers. ASIC has run a program of ‘swimming between the flags’, what—and this is not a Dorothy Dix by the way, but we’d be interested because we are dealing with the very issue that we’re grappling with here about how far you go between the balance in protecting and assisting, and I will come to some of the issues about prohibiting some of these products—but the ‘swimming between the flag’ initiatives, we would like to hear your views on how you think that is working for us?
DIMITY KINGSFORD SMITH

I had a look at it on the FIDO website when I was preparing my remarks for today and I was enormously impressed by it actually, because it’s very straightforward and it has pretty much a single, clear message, you know, ‘Don’t try to be fancy, don’t try to be risk-taking, stay where you know you can swim safely’.

And one thing that occurred to me while we were talking earlier, is that we spend a lot of time in regulation in Australia looking after people’s superannuation in the contribution phase, and we spend much, much, much, much less time helping them, protecting them, et cetera, when they get into the retirement phase, and that’s where a lot of the grief occurs. And the ‘swimming between the flags’ thing, I think, points us in the direction of—and this goes back to your first question about risk and return and where the risk of loss should lie—perhaps we need to treat superannuation differently to other investments because of the very close attachment that it has to personal wellbeing in retirement.

So I think the ‘swimming between the flags’ idea is just tremendous because it taps into Australian culture, it sends a very clear message about being financially safe, and I think it can only be expanded in terms of what that message means.

CATRIONA LOWE

If I could perhaps just add a little bit to that, Tony? We have talked a lot about choice and consumers making choices, and I find that word an interesting one in the context of ‘50% don’t understand 50%’. I think it’s the wrong word in some circumstances. I don’t think people are necessarily making choices, I think they’re making lucky or unlucky guesses or being guided in particular directions. And the importance of a program like ‘swimming between the flags’ is, I think, it makes a crucial step from just giving people information to giving them guidance. There is a critical and fundamental difference between those two things, to allow people to identify in simple terms their own situation and then guide them towards what therefore might be the range of choices they should be contemplating, rather than just saying, ‘Here’s the pantheon of 150, you can go for completely high risk or all the way back here’. Guidance has got to play a role in all of this.

TONY D’ALOISIO

Ian and Linda, one of the comments that Dimity just made was really to say that superannuation should be separate. A counter-view to that would be that members of superannuation funds today, if you leave out the defined-benefits schemes, are actually retail investors, because it is their accumulation that is for their benefit, and that is invested professionally and so on. Should we not be thinking of super members as being really part of the retail investor set?

LINDA ELKINS

I think the fundamental difference, which Ian has already commented on with super, is that it is compulsory. So no, I don’t think you can just say we should treat these people the same way we treat all other retail consumers. Again, it comes to the heart of the ‘50% don’t understand what 50% is’ issue. So I’ve got a compulsory system that is converting wages into deferred income and I am applying that to everybody, you know, whether they want that, don’t want that, can understand or don’t understand.

So I think, no, fundamentally that is a different group of people that need a different
set of protections. I certainly support the idea that part of that has to be intelligent defaults, you know, make the do-nothing approach financially literate, and allow choice and all the rest of it to the people who either do have the skills, or do choose that they have the skills, even if perhaps they don’t.

IAN SILK
I fundamentally agree with that, there is clearly something in what you’re saying, because in a defined-contribution world, people have the same exposures as well as the opportunities, but in super at the moment, with 30 million accounts and 11 million people in the workforce, that is just a great demonstration of massive disengagement in the super system. So if I buy one of Paul’s property debenture products—

PAUL CLITHEROE
10% commission!

IAN SILK
—he is alerting me to the questions he wants me to ask. But I’ve had some role in it, I might not have been optimally informed, but I’ve had some role. But there are millions of people in super who have made no conscious decision to join the fund. So that places an ever greater obligation, I think, on the trustees of those funds to ensure that their decisions are genuinely guided by the statutory obligation to act in the best interests of the beneficiaries.

TONY D’ALOISIO
Paul, if we move to a couple of other ideas that are floating around to protect investors, and I use your example of the debentures again, there is the notion of prohibiting certain types of products; that in other words, they should only be available at the institutional level of the market and not at the retail level of the market. There are also concepts around that the regulator, or someone, should actually use a red flag on certain products, or should caution, not so much ‘swimming between the flags’, but going further and saying, ‘Listen, keep away from this, there’s a crocodile,’ or something. What is your view about how far you go in prohibiting and certifying products?

PAUL CLITHEROE
I don’t like prohibition. It didn’t work for alcohol and I am not sure it will work for investment. Look, the issue for me, why I guess—the corroborative statement about the cover, is in other words, I do think consumers actually should be encouraged, as they get more knowledgeable to take on risk. That is where return comes from. I struggle with, for example, ASIC saying, ‘This product is illegal’ and that’s why I wasn’t joking in a sense, if you like—the cover of my property debenture is really a red flag.

I’d like to turn disclosure the other way around—in other words the glossy brochure with all the wonderfully high returns and security. Then we find disclosure on page 61 or whatever. I really like the idea that this thing is forced to tell you in graphic terms that this, offering you 6% above the risk-free rate of return, come a downturn, there is every likelihood you are going to lose money, or at least your cash flow is going to stop, and know about that right up front, boom, right in your face. Then if you like, let the sales pitch be on page 61.

So, I am against prohibition, but I don’t think we’ve got the red flagging right. That’s why I love your ‘between the flags’, because I am an Australian, I don’t want to be told what to do. I like the idea that when I’m at the beach if I swim between the flags I am not guaranteed I won’t drown, but I probably won’t. If it is a rough sea, it is still my right to
go and swim in the middle of a rip, but I think I've got a pretty good idea what the risk and return trade-off is.

So I am really more interested in the consumer being able to say, 'I am quite happy with a property debenture company, and the board of directors'. If we want the cover saying, 'This is highly risky, it will probably work in the good times, but watch out in the bad times', I am quite happy with that. But that is not what we're doing and we are not making it simple.

On the financial literacy taskforce some years ago, when we did a huge longitudinal study, 63% of men said they were very capable of making investment decisions, and 61% said they wouldn't consider risk and return. But this is the problem we have in a very educated, intelligent audience—the problem we have is that, I agree very much with what everyone at this table is saying, but we are dealing with a human emotional condition.

Say my credit card is five grand and I think, 'I know, I'll do a balance transfer'. Now, financial literacy would say if you go from $5000 at 18% to $5000 at 6%, technically, that is financially literate. But as behaviouralists, we know full well we have missed the real point. Why did you have $5000 on your credit card? Because you’re spending more than you’re earning. We all know full well in a year’s time, that person comes back, they didn’t cut up the first card, we know full well in 12 months they’ve got $5000 back on the original card and they’ve got $5000 on the new card, the honeymoon is gone and it is now 18% as well.

So prohibition I am against, Tony. I would like the consumer between the flags to go, 'Yes, I can swim outside the flags if I want to, but I am risking my life'.

TONY D’ALOISIO
Let’s try a straw poll from the audience on the point. Do you think there is a role for prohibiting certain products for retail investors? Vote yes or no. Is there a role for prohibiting certain investments for the retail sector? Yes. Put your hand up. No. Okay, you won that argument, Paul.

PAUL CLITHEROE
Most unusual.

DIMITY KINGSFORD SMITH
Going back to the point about evidence-based regulation, there is a lot of evidence that consumers don’t only not read disclosure, but they don’t read and take in warnings either. I am pretty sure that the pensioners outside the front with their furniture would have an impact on many people, but I am not sure it would necessarily have an impact on the people that you want it to have an impact on. Warnings, unfortunately, have been shown to have not the effect that everybody hoped for them.

TONY D’ALOISIO
That’s fair. Is there a question from the floor?

QUESTION
If Australia is putting a lot of effort into grappling with the consequences of forcing market risk and longevity risk onto a population who largely don’t understand them, would we be better applying that effort into working out a way to adopt the European model of providing defined-benefit indexed pensions on a large scale?

LINDA ELKINS:
I guess the answer to that really is, that debate’s been had and lost already, hence the introduction of the accumulation-based
compulsory system in Australia. So it is a very fair question and I think, right now, after a GFC, the community would certainly support your view.

I think you have also hit on, as did the previous question, exactly what the pivotal issue we are dealing with is—i.e. a significant transfer of responsibility to individuals who yet don’t have the life skills to deal with those responsibilities. That is therefore the challenge: are these people passionate about financial literacy? It is part of the job of schools, it is the job of the regulator and it is the job of the industry, and I think you’re right that warnings are not going to do it all. It’s about the total framework: how does the industry, government and people taking personal responsibility, the school system, how does that all work together to create a life skill that is necessary in the 21st century, that doesn’t currently exist?

TONY D’ALOISIO
Do any other panel members want to return to defined-benefits?

DIMITY KINGSFORD SMITH
I am not sure that we can return to defined-benefits, but one thing that was kind of incubating in my mind earlier, which this question brings up again, is the current approach we have to superannuation in Australia, in which a retiring person gets a large sum of money that they then have to manage. It goes back to the days when the kinds of people who had superannuation entitlements was a much narrower group of people, in corporate schemes largely, and in government schemes. The sacred cow of the lump sum still is present in Australian financial thinking.

One thing I think we could do to come to a halfway point between the defined-benefit and pension stream, that is more common in the European schemes, and what we have in Australia now, is to have more on offer for the post-retirement phase that allows people with modest financial skills to purchase with that lump sum from the accumulation phase—something that looks a little bit more like a stream of income—and to perhaps work on engineering into some of those offerings, some of the things that we have been talking about now, like default provisions and so on.

TONY D’ALOISIO
I will just ask Paul and Catriona a question and then we will move to financial advisers. Paul, you talked about the risk award premium, and clearly if it is too good to be true, be careful, et cetera, 9%, 10%. Probably also there is the other issue about diversification of risk and how, in that sort of example you’ve talked about, how do you bring out the diversification issue? In other words, what we saw with, say, Westpoint, with a number of these collapses, was all the eggs were in one basket.

PAUL CLITHEROE
Where consumers have talked to me—and they talk to me in large numbers—people often get horrified when a young person rings in and I say, ‘You probably shouldn’t be diversifying, you are in the wealth creation phase, you need to let risk be your friend, given your time frame and cash flow’.

Yet for a retiree I am saying, ‘No, no, debt is a bad idea and, basically, you need to be at the other end of the risk spectrum’. So the problem is, Tony, we have got this quite complex thing, but the point that I would make is that I feel really firmly the solution is not the industry or us, as the financial literacy
board, or ASIC or anything else, trying to force these concepts down people’s throats.

What we know is that we get opportunities through the life stage where people will smorgasbord on your information, on the Understanding Money website, whatever it may be—all great stuff. But looking around the folk here today, I bet most of us won’t race home and rework our personal family budget.

So basically the issue for me is just making sure, whether it is diversification or any other issue, it is talking to people at those key life events—when they get married, when they buy a home, when they get divorced, when they lose a job. There are only several dozen key points in a person’s life when we are actually going to get their attention. One of those pointers will be around diversification. But it is a complex story, Tony, because we can’t just say, ‘Swimming between the flags is diversification’. Certainly when I was a youngster I put my limited money into starting a company, and thank God I did, because it allowed me to do what I am doing now, which is volunteer my time. But as a retiree that would be totally inappropriate. So we can’t just give a standard community message, it is really difficult.

CATRIONA LOWE
Starting with the diversification point, I agree, that is a long way down the path of financial literacy. It’s a good way down the path. We’re right back at the start, so I think yes, ultimately of course it would be great for consumers to understand and apply those concepts, but again, at the risk of sounding like a broken record, it requires before—if we ever get there—that we have safe defaults, that we have guidance for people around things like life stages, and we’re at least corralling the number of choices that they face.

The other issue though, it strikes me now every time we use this: ‘If it sounds too good to be true it probably is’. I don’t know that the global financial crisis hasn’t blown out of the water our ability to use that phrase, because what mum and dad consumers have seen is a whole bunch of people that were jumping at things ‘too good to be true’, and they were the professionals. So I’m not quite sure how much credence that phrase has left any more in the minds of the public.

TONY D’ALOISIO
Clearly the availability of advice must be an important factor in managing risk and assessing risk. What are our views about the availability of good advice out there—financial planners, financial advisers?

DIMITY KINGFORD SMITH
I think we know that a very small proportion of the population gets financial advice, and one of the things we probably should be doing is encouraging people across the board to get much more financial advice, perhaps at the trigger points in life that Paul was mentioning.

PAUL CLITHEROE
It’s a biggie though, isn’t it, because the—and this is such an important question for everyone in this room. There’s a million-odd contact points I’ve had over the last 30 years with people who are really interested, and it’s fascinating where they end up. Because, to be quite blunt, about 15% of those enquiries—a lady wrote to me, Elaine, and said, ‘I cannot afford a blanket for my child’—about 10–15% of those enquirers end up with fabulous people like the Smith Family.
You know there is good fee-based advice out there, and people with high income can find it, but Tony, what the real people, the great rump of Australians want to ask, is this the question they ask me at barbecues, ‘I’ve done a budget and I’ve got a spare ten bucks a week, do I use the ten bucks a week to top up my super or do I use it to pay down my mortgage?’ And how can I say, ‘Go and see a financial planner who’s going to end up giving you a 60-page document that’s going to cost you $3,000 to find out where to put your ten bucks a week’?

So that’s where this generic advice model we’re talking about is really fundamentally important, because I think we’re making this harder than it really is. Most of the real questions that real people ask, any of this panel, anyone in this room I hope, can answer in about three minutes, providing you don’t need to do it professionally and spend three hours doing analysis, because a lot of it is, ‘Do I pay off my mortgage?’ or whatever. A system that allows us to answer that would be—and I know we’re trying to tackle it, Tony—would be of high value to consumers.

ELAINE HENRY
Let’s go back to the good example of a particular bank. They wanted to do something for the disadvantaged and they had a good scheme, but you know the first thing they had to do was work with their own staff, because their own staff thought, ‘I don’t know these people, they’re disadvantaged, they don’t understand the language I talk, I can’t deal with them’. And what’s more, they would stigmatise the people if they just went in to open a bank account and put $10 in, if you remember that.

So it’s not just that the disadvantaged have to get literate about what we’re talking about, it’s also that the rest of us have to change and understand. These people are outside their comfort zone. They’re not going to do the right thing, because they don’t understand what the right thing is, and we’re not very good at working with them. But if we—and I’m harping on this—if we saw this as a business opportunity, we would put ourselves in their position, their shoes, perhaps get to understand what their needs are, and start supplying the end product that’s going to be of benefit to them.

There are masses of people out here in this situation, and it is a fact in Australia that our education system in public education moved completely away from this as the market started to produce very expensive products that are complex and hard to understand. As people became wealthier, they didn’t know the very basic difference between a want and a need, so when we run workshops—and there’s no reason why the financial planners here can’t get involved, and many of our corporate partners do provide opportunities for their staff to get involved.

And all of a sudden they realise there’s a world out there that they had never even conjured up. They wouldn’t be able to understand, as Paul was indicating, someone can’t afford blankets for their child, but there’s a whole raft of people who we deal with, lone parent families, where the kids don’t get any education—around the dinner table, for example, and Paul will tell his story about that—but from the very earliest time we don’t talk about money as a family. You might talk with your children and so forth but, you know, there are a lot of people out there who are frightened of money, they’re frightened to talk about, they don’t know anything about it, they don’t know about it.
TONY D’ALOISIO
From a superannuation perspective, access to advice and assistance, what’s the practice there, what are your thoughts about improving—

IAN SILK
I think there are a couple of ways to improve it. One is we need to reduce—it might seem a bit odd from my perspective—but reduce the regulatory burden around advice and put in place a better architecture. Paul’s case is a classic case; everybody here would know, even if they’ve not themselves experienced it, people who want relatively simple advice and the cost of it is just prohibitive, and the document they received is so difficult to navigate. They often just want to know, for example: ‘Do I pay money off my mortgage or put some more money into super?’

So that’s one side of it, but the other side of it is that it’s not a problem that can just be sheeted home to the regulators. Rather, it is a creature of the industry itself and it goes to the issue that has attracted some controversy over the last two years, the issue of conflicted advice.

It is not that advisers are innately personally conflicted. It is the remuneration structures and, in particular, the issue of commissions. It now seems pretty much the accepted wisdom that commissions should go. Everybody is saying it. Virtually nobody is doing it, but everybody is saying they are doing it. The Ripoll Inquiry suggested that a fiduciary obligation should apply in the instance of the provision of financial advice, and I think the government will be announcing some sort of response to that relatively shortly, but I think what does emerge out of this debate about commissions will be incredibly important.

If commissions are simply replaced by asset-based fees and nothing else changes, well nothing at all will have changed. So there does need to be a move towards fee-for-service and an obligation to act in the best interests of members or a fiduciary obligation of some sort, and importantly that the regulator, probably ASIC, is appropriately resourced to ensure that that change happens on the ground.

I can just see the sort of public policy changes occurring where audience members today are delighted and fanatically interested, but out there in consumer-land if it doesn’t actually apply out there, then this whole debate for five or six years will have been for nought.

TONY D’ALOISIO
I want to get to the important issue of financial literacy, particularly with Paul here as Chairman of the Board.

You and the Board, you have been very passionate about this and you’re pushing it through. You have got an audience that I think is, I would have thought, by and large on your side. What are your messages about financial literacy and its importance? What should we all be doing? Importantly, what should the big players be doing out there in this sort of issue?

PAUL CLITHEROE
It is an on-again issue. The work is going well. Obviously we have now made solid progress, with financial literacy being taught in schools to year 10. There is solid progress and we are now converting it into the national curriculum. That is moving well.
We have now got universities offering financial literacy or personal finance or business skills as first year subject matter. Obviously we need 1.63 million kids in the VET and TAFE system getting more financial literacy as part of their training to become electricians, plumbers and all sorts of important people in the community.

Businesses—I do agree with the point someone made about one of our banks that when they were talking about financial literacy some years ago, I think it was John McFarlane, and we said to John, ‘How are your 45,000 staff at ANZ? How are they with money?’ They did a survey and, apart from the teller staff, which were pretty good, the rest of the bank staff had no more idea than any other Australian, so one of the most valuable things that ANZ put into place was a workplace program for staff.

So I think, as corporate leaders, one thing you can do is not just sit there and whinge about the general state of the community, let’s take it home. So I think good progress has been made. Obviously financial literacy is now based with ASIC since the change of government a couple of years ago, and we have got some really good programs going.

You have also got to be a little patient. For those who think we are going to get behavioural change overnight, you are just kidding yourselves. It took us nearly two decades to get drink-driving implemented in an effective sense. I still see, I am Chairman of the youth drink-driving body and I still have journalists say to me, ‘Drink-driving is failing. Someone was caught drink-driving the other day’. My point to that is, when I was 18 or 19 we were killing 2,000 a year on the roads. We have now got three times as many cars and we are killing 1,000 a year on the roads. Are we winning or losing? It isn’t perfect, but we are winning.

The first step is awareness. The words ‘financial literacy’ had no meaning at all seven years ago. Did you know, folks, this past New Year’s Eve the second most made New Year’s Resolution, I am advised, the second was, ‘I will do better with my money’. That is good awareness.

TONY D’ALOISIO
What was the first?

PAUL CLITHEROE
Number 1 was, ‘I will lose weight’. No one is losing weight, okay? And do I think many people are actually behaving better with their money today? No I don’t, Tony, but what I am excited about is we have got the subject matter being discussed. Elaine is right, it has got to be discussed doesn’t it, Elaine?

ELAINE HENRY
Absolutely. You can do nothing if it is in the closet, you have got to bring it out and we know that from smoking control, from sunbaking control, you name any of the big behavioural changes that we have made in Australia. We used to be pretty good at this, so don’t give up hope, folks, I think we can crack this one. But it is a 20-year journey, it is a comprehensive journey, it is a whole of community journey. It starts with the home, the parents. It goes into the schools, it goes into the educational institutions, into the workplace, and all of us belong to a community. It really behoves all of us to get involved in this and not to lose sight of the gain that we can all make as a society if we get this right.

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108 Recording Artists and Athletes Against Drink Driving
We have survived this GFC, or whatever you want to call it, quite well, but we are living through a transition and we have got the catalyst from many things that have happened, whether we go back a couple of years or not, to make this secure for future generations. If everyone wants to get involved there is a way for them to get involved and that is a very positive thing.

PAUL CLITHEROE
Look at ourselves very quickly. Tony. I am as big an idiot as anyone. If you want to find financial illiteracy, go to high-income families, where most of us in this room belong. I get all this behavioural psych stuff over my desk and I did a little test recently. I have got a 23-year old, a 20-year old and a 15-year old. The two older kids share a car and they are going to uni and stuff and I said, ‘Guys, how much do you think our family spends on road tolls?’ The two older kids said, ‘What is a road toll?’ I said, ‘Are you really kidding?’ They said, ‘No Dad, we know we pay road tolls, but that little white bleeping thing on the car window goes back to your credit card’. So what have I done? Our family spends $500 a month on road tolls—this is the Sydney road system. We spend $500 a month and my two adult children, one studying a Masters of Economics and one in the middle of a law degree, had no idea, and guess who’s stupid, the children or Dad?

SPEAKER
Dad.

PAUL CLITHEROE
I’m stupid. Do something about it.

TONY D’ALOISIO
Or you live in lower north shore.

ELAINE HENRY
No, no, the point he’s making is, one part of our population has cocooned the kids from every risk you could imagine, so goodness knows what they’re going to be like in 20 years time.

TONY D’ALOISIO
Can we have a final comment from each of you on financial literacy or retail investor protection?

LINDA ELKINS
So my final comment on financial literacy would be, it’s a responsibility of all of us as participants in this sector to do what we can towards building the life skills that are necessary for the people who participate in the products and services we offer.

IAN SILK
I would say that, recognising the very large number of people who are disengaged, there is a very substantial responsibility on product providers and product manufactures and intermediaries. Also important is elevating their sense of responsibility and their accountability to their clients’ or members’ clients.

ELAINE HENRY
Low socioeconomic-status citizens are the same as everybody else, they can be assisted through trusted intermediaries to asset accumulate and we should make it our societal response to do so.

DIMITY KINGSFORD SMITH
I am just delighted it’s now so on the table and we’re all working towards it and I think it is a good vehicle for giving us more material to consolidate the gains that we are already making in relation to evidence-based regulation.
CATRIONA LOWE
You asked the question, ‘What can the businesses in particular, in this room do to help with financial literacy?’ I’d suggest two things: reduce complexity at every opportunity you get; secondly, get the people who write your ads to talk to the people who write the risk page in your prospectus and get them to match a little bit better than they do at the moment.

PAUL CLITHEROE
Very quickly, three pillars—we love our pillars in this country—three pillars to financial literacy: firstly, regulation, where the risk is clear and the sales pitch is on page 61—give me pictures if I can have them; secondly, education—let’s not pretend people are dumb, they’re not dumb, give people the knowledge; and finally, the third pillar is corporate responsibility—if it isn’t capital stable, don’t tell them it is.
WEDNESDAY The crisis and retail investors and financial consumers

Meet the ASIC Commission

Panel discussion
Moderator Mr Peter Couchman, former ABC journalist and TV presenter
Mr Tony D’Aloisio, Chairman, ASIC
Dr Peter Boxall AO, Commissioner, ASIC
Mr Michael Dwyer, Commissioner, ASIC
Ms Belinda Gibson, Commissioner, ASIC
Mr Greg Medcraft, Commissioner, ASIC

PETER COUCHMAN
Hello everybody. Those of you who’ve been here through the full three days of the Summer School have had a pretty solid time absorbing a lot of information and discussion about issues, underpinned of course by the role of the regulator right through.

So we thought for this session what we should do is to let you have a chance to (a) find out who and what the regulator is and how it works, and (b) have an opportunity to, face-to-face, raise any issues that you might have with the individual Commissioners. It seems to me that, if we went outside this precinct and we asked anyone out there with any kind of knowledge of financial affairs at all—and after the session we’ve just heard, it seems we’d be hard pressed to find somebody—and you ask them about ASIC, they would probably say that’s Tony D’Aloisio, because Tony is the public face and voice of ASIC.

The ASIC Commission is in fact a five-headed creature—you will notice I said creature, not monster—and so I think there’s a lot of confusion out there about (a) what the role of the regulator is and (b) how it actually arrives at its decisions. This session is to give you a chance to talk to the Commissioners, all of them or one of them individually as you wish, and I will simply be moderating that discussion.

I wanted to start by just giving the Commission a human face. Do you all know the Commissioners, for a start? Perhaps not. We have here Peter Boxall, Michael Dwyer—Tony of course you know well now—Belinda Gibson and Greg Medcraft. We will start with Greg, what has been your professional background?

GREG MEDCRAFT
I spent nearly 30 years in investment banking, including nearly 10 years on Wall Street, and before that I was in chartered accounting. So, on Wall Street I was the Global Head of Securitisation at Société Générale. So my background is capital markets and banking.

PETER COUCHMAN
When you were invited to take a position on the Commission, why did you take it, what did you want to do?

GREG MEDCRAFT
From being on Wall Street I had a view—and having seen the sub-prime crisis—that markets do work and they do adjust, but
when they do adjust often the victims of that adjustment don’t recover. Markets recover but individuals don’t. So I had a philosophical view that this was a great opportunity to get in there and help reshape things and, hopefully, make a difference. I came back to Australia two years ago when I retired from Wall Street, and I really saw this as an opportunity to do something different and make a difference.

PETER COUCHMAN
You’ve been on the Commission for about—

GREG MEDCRAFT
One year.

PETER COUCHMAN
Belinda, what about you? You’re the longest serving Commissioner, I think, aren’t you, apart from Tony?

BELINDA GIBSON:
After Tony, yes. I was a lawyer for 20-plus years. I was a partner at one of the big law firms—I was involved in mergers and acquisitions, corporate governance advice, securities raising, and a little bit of litigation. It was one of the last of the general practices, I think.

When I was approached to join the Commission I thought, ‘Well, it’s time now to also do some public good’. It was a fairly benign setting in November 2007 when I made the move, and I thought it would be just about making a few tweaks here and there to the regulatory framework. But in January 2008, we had the collapses of all these companies and a major takeover, and my co-Commissioners were on holidays, and I thought, ‘Oh my Lord, what have I done?’

Now I’m enjoying the public good aspect of the role, making some difference. Really, to try and make sure that next time there is a crisis, it’s less dramatic than it was this time.

PETER COUCHMAN
Tony, what range of talents do you hope to have on the Commission to make it work at its best? What kind of backgrounds would you hope to have?

TONY D’ALOISIO
When I became Chairman we had a Deputy Chairman, at that stage Jeremy Cooper, and Belinda. An increase in workloads was the first driver in recommending to government an increase in the Commission size. We needed to ensure that at the strategic and tactical levels—whether it’s major cases or major initiatives—that we did have Commission time and ability to deal with the matters. When we really analysed that and talked to government, it was felt that a skill set along the lines of what we have—that is, economics, accounting, insolvency, audit, legal, securitisation, investment banking, and public sector expertise—were the sort of skills that would better position the Commission to make better decisions in terms of the issues that it confronts.

Now we have been operating with this structure for the last year or two, the last couple of years, and I must say I am very pleased with the way it is working; I think the different skills are working well. Clearly, we are also complemented significantly by the senior executive leaders that sit under us.

The government has indicated that it’s looking probably to appoint an additional Commissioner at some point, to add skills more in the consumer, financial literacy area; and again, that sort of skill set would complement us quite well.
PETER COUCHMAN
The US Securities and Exchange Commission (US SEC), as I discovered through our meeting with Roel Campos the other day, is essentially made up of corporate lawyers. You obviously hope to have a much broader base than that on ASIC.

TONY D’ALOISIO
I think when you look at our mandate, our responsibilities, and the areas we regulate, we have a much broader mandate than the US SEC. For example: we run the real economy and the registration aspects, we oversight auditors, we oversight liquidators, and we oversight financial planners. And that means we need a broader skill base; however, you definitely need the legal skills, such as mine and Belinda’s and many of our senior leaders, including in the Office of the Chief Legal Officer. Lawyers clearly are needed, particularly for the myriad of enforcement issues, administrative law issues and so on that we need to deal with.

PETER COUCHMAN
What about you, Peter Boxall?

PETER BOXALL
I am an economist. I have a PhD in Economics from the University of Chicago and my background is in the public sector. I was in the international public sector, at the International Monetary Fund (IMF) for seven years in Washington DC, but also I was in the Australian Public Service for about 20 years. Prior to joining the Commission I was the Secretary of a number of government departments in Canberra and also the Secretary of the Treasury in South Australia, so I came to—

PETER COUCHMAN
So you have got a pretty fair understanding of government.

PETER BOXALL
That’s right, so I am not going to make a statement that I came to ASIC to make a difference, because I have been in the public sector for a long time. I was a Secretary of a government department for 14 years, including Finance, Employment and Workplace Relations, and Resources, Energy and Tourism. So I come to the Commission with a background in economics, public policy and public sector management.

I joined ASIC because my family and I wanted to move to Sydney and I needed the money—because I have worked in the public sector my whole life, I need the money.

The other reason why I joined ASIC is that I believe in a liberal market democracy, and I think one of the few roles of government that can be really seriously defended is the rule of law, and in my view, ASIC has a very important role to play because it’s prime reason for being is to
enforce very important laws—the Corporations Law, now the National Credit Law, and Tony mentioned a couple of others. So basically, we are here to enforce these laws, because the parliamentary system has said, ‘Put in place these laws so that we can operate in a market-based economy, so that people can have faith in a market-based economy’. Without the rule of law there it would just degenerate into chaos.

The other aspect is that the law requires companies, auditors and others to register, and they register with ASIC; so a very important role in ASIC is the registry.

PETER COUCHMAN
I want to take some questions from the floor, but I will first ask the Commission, how do you all see your role? How do you see your role as Commissioner? In the press you are generally referred to as the corporate plod and that is generally in the context of Tony and what he has to say publicly. How do you see your role, Michael?

MICHAEL DWYER
Well, managing our people and being involved with our people and working with our senior leaders to perform those functions.

PETER COUCHMAN
Belinda, how do you see your role as Commissioner?

BELINDA GIBSON
At ASIC we have six overarching strategic objectives, and the area I work in is focused on the capital markets—market integrity, improving market integrity and protecting retail investors, and they both overlap with disclosure.

Now, to do that we have an array of tools aimed at influencing behaviour—one of them is policy and guidance about what we think the position should be, and another is surveillance, which is about being out in the market and looking at what is happening and watching what is happening and letting it be known we’re watching.

And then the other end is the deterrence activities—it’s the investigations and the prosecution or civil proceedings or bannings, which actually say, ‘You’ve overstepped that mark and some sort of penalty is needed’. So it’s far more than being a policeman—the policeman part is probably more towards that enforcement end.

PETER COUCHMAN:
Yes. What about you, Greg?

GREG MEDCRAFT
I’ve got a pretty similar view to Belinda. Basically, I see my role as bringing my skills and experience to help us achieve our objectives.

More specifically, in terms of the areas that I’m responsible for, I’ve got three priorities in
the next 12 months. The first one is about making sure that we have a consistent framework for risk-based assessment and surveillance and enforcement.

I think, when you have limited resources, it’s important to be sure that you are very focused and really targeting those things that, in terms of your objectives, have the highest risk, and then doing something about them. I am a big believer in engaging with industry, making sure that we have informed regulation, and I think you get that from working closely with industry and this means you get a much better outcome.

Secondly, in the area of disclosure, which is obviously one of our tools, there are a number of areas that have come out of the crisis that we believe we probably need to reshape.

Then thirdly, I am focused on some of the things that are coming out of the government that affect areas I’m responsible for, and we have teams looking to implement these.

So they’re the three specific things that I’m focused on.

PETER COUCHMAN
Tony, how does your role as Chair fit in with all of this?

TONY D’ALOISIO
I will try to draw the discussions a little bit together. If you look at ASIC, in terms of our role, it’s a bit like we turn up—there’s a car accident and we turn up—and the first role, clearly, is to see what’s happened, put people in jail or recover damages for people injured, see what’s happened. It’s sort of got that enforcement role in really enforcing the law.

You then step back from that and you have a look at the scene and you say, ‘Well, actually the safety barriers are in the wrong place, there could be further things that could be done and can we work with the community or industry to improve those things?’ Then, if you step further back, you could say, ‘Well, we should be able to see a lot earlier that that road is in the wrong spot or that curve is in the wrong spot and work with government to look at legislative changes that may be needed’.

So the ASIC role—in a sense it’s got all these facets, and I think as you’ve heard the Commissioners pick up different aspects.

The role of a Chairman is interesting. Certainly you’re right that the media focus tends to be very much on the head of an organisation, but the Chairman, in terms of ASIC under the ASIC Act, is the head of the agency, so it’s actually a statutory Chairman’s role. And with that, my role is certainly much more outward-focused in terms of what’s going on. You know, appearing at Senate Estimates, Parliamentary Joint Committees and so on, and keeping the strategic issues in the organisation at the forefront, and continually pushing to see that we’re achieving outcomes for the community.

PETER COUCHMAN
Now, as you know only too well, the broadest criticism of ASIC comes after the accident and you’re being asked, ‘Why didn’t ASIC stop the accident in the first place?’ Are you in a position to do that, or are you in a position to simply pick up the pieces afterwards?

TONY D’ALOISIO
I think what we’ve said, and what we’ve said at Parliamentary Joint Committees—at the
end of the day, the way that the Corporations Act is framed and the underlying philosophy of it is that we are the oversight, as I described it earlier, we’re not really the preventative body or the guarantor of last resort.

You need to go back to that not very good analogy, but there are a lot of other safety things that are in place in addition to ASIC. The role of the gatekeepers that we discussed yesterday, the role of the auditors, the role of the asset managers, the role of the lawyers, the role of the accountants, and a lot of the people in this room, financial advisers. We all have a responsibility to try and foresee where the big crash may occur and try and deal with it.

ASIC does as well, but we’re not resourced; and nor is it the underlying policy of the Corporations Act that ASIC is the guarantor of last resort. Indeed, as Peter said, the terms of the enterprise system we operate under, success and failure are part and parcel of what our economy, our markets are about.

PETER COUCHMAN
Okay.

BELINDA GIBSON
We’re working a lot together, particularly in the financial advisers and brokers areas. As Greg mentioned, the risk-based surveillance is what’s critical. You can’t possibly—I don’t know how many financial advisers there are, there are—

SPEAKER
18,000.

BELINDA GIBSON
Yes, there are 120 broking firms, so you can’t possibly visit all of them, you can’t possibly speak to all of them, but you can be a presence. And there are some that might require more stringent visits more often, and so it’s a part of being in that investment community to understand where the problems might lurk. It’s like speeding cars.

PETER COUCHMAN
Sorry to interrupt you, but how do you even know? Do you wait for a complaint to be made? Are you after it like a bloodhound?

BELINDA GIBSON
Complaints are one source, certainly. Market discussion is another source. We stay very close to industry groups and participants. We’ve all come from industry and so we all know people in industry and everyone knows just where the slightly smelly egg might be in the corner. We also have a dialogue with a
lot of participants, it’s not a one-to-one dialogue but it’s a written dialogue.

There are various obligations to report breaches. Financial services licensees, if they go sadly awry, do have to tell us about it, they don’t always, but that is another source. So the challenge for us is to get close to the market to know what’s there. It’s not good enough—and this is the big change that we wanted from our restructure in 2008—to sit and wait for the car crash and then pontificate to the world about what it should be.

**PETER COUCHMAN**
Yes. You’re in there trying to make sure that it is a licensed driver in the car and that the car was in fact in a roadworthy condition, and if there is a crash—

**BELINDA GIBSON:**
To do the best we can. Like the police, you can’t monitor every car and so on, so you have to try and take your settings to those where perhaps the problems are more likely, the speedy bend.

I just want to mention one other area where we have a lot what we call BAU, ‘business as usual’, work. Certain corporations—emerging mining and resources corporations, and investment managers—come to us when they need relief for example, when they need a blessing to do certain things in a certain way, or they need a waiver, and quite a large part of ASIC in that area is responding to these requests.

So the law is clear—or sometimes not so clear in a certain area—and you give them a steer and some relief. So that also is a way for us to be a presence in the community and see where the settings should be. And I think one of the things you’ll see—you might comment on, if you were generous, those corporate advisers out there—that we are being much more engaged with what the business outcome should be, and much more engaged with the quality of the documentation. So that’s another area where we have influence.

**PETER COUCHMAN**
As you all know from experience, inevitably when there’s a crash in which retail investors get burnt, we hear, ‘Where was the regulator?’

**GREG MEDCRAFT**
In terms of surveillance, what we are looking at doing, for example for financial advisers, is taking that population of 18,000 and really looking at what the risk characteristics are of that population by segmenting it down.

Clearly with the adviser population, if you take the top 100 dealer groups, about 9,000 deliver 80–90% of advice for financial products in the country. So, we can use a filter to narrow that population down in terms of analysing risk characteristics. The ultimate thing we’re looking for is inappropriate advice, so basically our surveillance approach is to fine-tune the risk characteristics and then zone in on those where we think there might be inappropriate advice being delivered. So that’s an example in financial advisers where, basically, we zone in on the population.

The one thing that I should mention is that, when something goes wrong, we set up taskforces across ASIC to look at it. We have a taskforce looking at hedge funds. We have one looking at the mortgage trust sector. We had one looking at infrastructure and complex products. We have one looking at agricultural schemes.
And what these taskforces do is look at what can be done about what’s gone wrong—really trying to protect investors, this is top priority. We look at whether there’s anything to do about past behaviour and whether we need to take enforcement action. Then, given the behaviour we saw, we look at what we can do to try and stop it occurring in the future, which is about reshaping it, or changing the law, or improving disclosure, or something else.

PETER COUCHMAN
What is your success rate? Do you ever get to measure it? Publicly we never hear about cases unless it has involved the road crash, we never hear about the cases that you’ve investigated and somehow got a resolution on before it ever came to a crisis point.

GREG MEDCRAFT
By way of example, on the agricultural investment schemes, with the collapse of Timbercorp, we were in the court and gave advice about what we thought was the most appropriate action to protect investors’ interests. Likewise, with Brisbane Connections, we went into the court and we gave advice about what we thought was the most appropriate disclosure to investors.

There are many cases where you can read about us taking action to protect investors—you can read about what we have done in relation to Westpoint to recover money for investors.

After 30 years in investment banking, I find it amazing that I still have to read the paper every day, because there is always something about Tony or ASIC or both. I think, despite what you’re saying, a lot of people do know what we do, and there is obviously a lot we can’t tell people about what we’re doing, in terms of just giving natural justice. I do think there is a lot of evidence about what we do.

TONY D’ALOISIO
If I can follow on from that, the ASIC Annual Report sets out the key outcomes measures that we use to assess and report on our achievements. We are very clear about wanting to deliver outcomes and to be measured against these outcomes.

I think there is a difference between that and what is in the media and what the media thinks is a good story. So you do get—as all regulators do globally, it’s not just ASIC—you do get a mismatch between what is reported in the media and what you feel are your achievements. The achievements often don’t get the same recognition as some of the areas where you might have problems, but I think we are quite comfortable with that because the Annual Report speaks for itself—we will continue to measure and report on our achievements against the outcomes and targets set for the things that we take on.

So I agree with you that our public profile tends to be around the more difficult issues, but there is no issue about that, that’s the way life is and we deal with that, as do all other regulators globally—it’s not a peculiar Australian issue.

PETER COUCHMAN
It’s amazing how universal it is. Peter, did you want to add something here?

PETER BOXALL
Yes, one of the things that ASIC has been doing is—given that this session is about what ASIC has been doing—when the federal government decided to take over the regulation of credit providers and credit intermediaries as brokers, ASIC began work to establish a registration and
licensing system and to set up a deterrence area for credit. Registration starts on April 1, and we are planning to go around the country, where we will be interacting with industry, to make sure it goes as smoothly as possible—and we have already had some very successful roadshows in Queensland and Adelaide. It is a huge task, and it’s a task that is being done by our Credit and the Real Economy teams.

Another big issue, which a lot of people may not be aware of, is that the government has decided to move the responsibility for registering business names from the states and territories to the Commonwealth, and ASIC will need to establish and maintain the registry for national business names. Again, this is a very big task and, in my view, a key area of responsibility for ASIC.

PETER COUCHMAN
Michael, yes.

MICHAEL DWYER
Peter, without detracting from anything the others have said about the outcomes of enforcement, I think another important issue is the deterrence effect that the threat of enforcement action has on behaviour. A good example of that are the insolvent trading provisions of the Act—people quite rightly say there have been no convictions, but if you speak to directors in the street, they do take notice. I think that awareness of the provisions leads them to be more concerned about ensuring their obligations are met as directors, so we shouldn’t underestimate the deterrence effect of our work.

PETER COUCHMAN
Okay. I am simply getting the Commissioners to open up a bit about how they operate and what the processes are. You may have much more specific issues, please feel free to raise them, because it’s not often that you get a chance to have all five Commissioners up here ready to take questions on any topic for anybody who wants to ask. Does anybody want to raise an issue? Please go ahead.

QUESTION
I was interested, Greg, in asking you about the recent request that has gone out to the industry, asking for 800-plus responses from licensees on a range of financial planning questions. Is that really the best and most effective use of industry’s time? And also, what will you do with that information?

GREG MEDCRAFT
What we’re trying to do is be more efficient and risk-based with industry, so we are using the survey as an alternative to coming to a dealer, selected at random, and spending a fair bit of time looking at their advices as part of our routine surveillance activities.

So it really was trying to be more efficient and focused and make sure in fact that you’re not spending time with us, undertaking a surveillance exercise on you, when there really are no high-risk characteristics within your dealership, for example. So the whole objective was to be more efficient and to identify those who have high-risk characteristics so that we could zone in on them.

QUESTION
A question for all the Commissioners: are there some things that you’ve heard and found out during these three days that you want to go away and think about very carefully?

TONY D’ALOISIO
I think we will talk about the Summer School and what came out of it as part of our review. For me personally, I think there
have been a significant number of things that have come out over the last three days, for example: the issues around financial literacy; the role of advice; the issues of whether we should be more proactive in restricting products, or how we might handle that; and the issues in relation to the problems around responsible lending. As you listen and as you participate in the debate, these are the things you’ve got in the back of your mind and that you are going to continue to think about. I could go back to the Monday morning, on the big picture issues, such as the ‘too big to fail’ issue and the implications of that, so I think for me certainly, there have been a number of significant issues that will influence, or continue to influence, my thinking.

PETER COUCHMAN
Has somebody else got a point they would like to raise with the commissioners, while we’ve got them here? Please go ahead.

QUESTION
Minutes of board meetings—boards could use a little bit more guidance on minute taking.

PETER COUCHMAN
Belinda, are you going to respond?

BELINDA GIBSON
We have board meetings, as it were, at the Commission, and I think it is a personal preference about how detailed you like minutes to be. From my own view, I don’t think a set of minutes that say ‘he said, she said’ is useful to anyone.

I agree that there should be enough in the minutes to say that these were the topics that were at issue, these were the pros and cons. I must say I would expect the pros and cons to be in the papers that come to the board, and the big issue for the board is to make sure those papers are succinct enough so it is realistic to expect the directors to have read them. Sometimes lawyers prepare the board pack and the board pack is so large that it is asking a lot for all directors to read and recall all of the material.

There has always been this little side debate about directors making annotations and who keeps the copies. I think we all go through the minutes and tick and cross and highlight a bit, or a lot in some cases, and it’s hard to go back and remember down the track why it is you highlighted a particular point—for example, was it because you thought it was a good point or because you thought it was a shocking point?

So, it is very hard to give guidance about board minutes. It really depends on the quality of the board papers and it depends on the competency of the minute-taker who prepares the minutes, and so on. I don’t favour a long set, but I suppose if you were in trouble, if you were facing a really difficult discussion, you might tend to the long side.

Ultimately the decision of the board is a decision of the board collectively. It doesn’t help particularly to say, ‘Well I want to write down my dissent here’.

PETER COUCHMAN
But that is an issue, though, that does in a sense get to the heart of many of the difficulties you face as regulator when it comes to looking at compliance, because I can see board minutes can become evidence if there is an issue. I can also see that it is possible to write a set of minutes that will comply with what is expected without actually committing you to anything and won’t be incriminating if they were ever to be looked at in an investigative way. Do you have any sort of minimum requirements?
BELINDA GIBSON
Against that, board minutes can be incriminating but they can also be exculpatory. If your board minutes show that a matter was well-considered, that you were acting reasonably with due diligence, which is what the Act requires, then they are a big help, so it is not just—

PETER COUCHMAN
Yes, but I can see the temptation to make minutes as vague as possible, so that you are not really producing anything that can be looked at afterwards. As you say, it can work both ways.

BELINDA GIBSON
Yes, then not exculpatory. I would think most boards believe they are doing the right thing, and might tend to think that their board minutes are a useful record of discussion that shows they have been diligent, as indeed I think most boards are.

PETER COUCHMAN
They use the minutes to say, we will cover ourselves.

BELINDA GIBSON
Yes.

TONY D’ALOISIO
At the end of the day it is a matter for the chairman and the directors about how they structure their meeting and how they decide to record their decisions. They take the risk of it getting them out of trouble or into trouble, so it is not really a role for a regulator to be prescribing a form of minutes.

QUESTION
It occurs to me that there is an enormous reform agenda facing ASIC that has come from a number of quarters, not the least of which is the federal government. I just wonder if you have got adequate resourcing to implement a lot of this stuff. I know that you work closely with the Australian Prudential Regulation Authority (APRA) and also with industry, but are there enough people in the stable to help you get this done?

TONY D’ALOISIO
I think as regulators you are always using resources to a maximum. I think, when you look at the additional responsibilities that we have been given in credit, in surveillance, this has been coupled with government recognition that additional resourcing is needed. Each year we discuss with government what our resourcing should be for the next so many years, so where we are sitting at the moment, I think the issue for us is to get on and get these things done with the resources we have. Having said that, as a regulator, you will always have more than you can do in a given time and so you have got to prioritise and remain focused.

PETER COUCHMAN
Yes, because you are in fact taking on significant new responsibilities, aren’t you, with registration of companies, Australian Securities Exchange Limited (ASX), supervisory—to name just a couple of the more obvious ones.

PETER COUCHMAN
Yes, because you are in fact taking on significant new responsibilities, aren’t you, with registration of companies, Australian Securities Exchange Limited (ASX), supervisory—to name just a couple of the more obvious ones.

TONY D’ALOISIO
But generally government does recognise that additional resources are needed for additional responsibilities and the two do go together, so you do negotiate what you need to—

PETER COUCHMAN
As a matter of interest, what is the workforce now that ASIC has at its disposal?

TONY D’ALOISIO
ASIC, prior to I think—these won’t be precise numbers, we can get those—but prior to
credit and surveillance, I think we were about 1750, and I think with those—

**PETER COUCHMAN**
Nationally.

**TONY D’ALOISIO**
Nationally, and we have got nine locations and with credit and with surveillance I think we will grow to around 2000.

**PETER COUCHMAN**
Has somebody else got something they would like to raise with the Commissioners? How do you arrive at your decisions?

**TONY D’ALOISIO**
We burn paper, put it that way. At the formal level the Commission makes decisions in the same way as boards do, as Belinda explained.

Depending on the issue there is delegated authority to Commissioners, delegated authority to the senior leaders and to the managers; so there is, if you like, a delegated authority structure. So decision making can be at Commission level, it can be at individual Commissioner level, and so on. So far as the Commission itself is concerned, we meet on average once a month and it’s a formal meeting with formal papers and formal processes, and we work by consensus.

**PETER COUCHMAN**
So decisions tend to be unanimous do they?

**TONY D’ALOISIO**
They are hotly debated and, generally speaking, they actually do agree because they are unanimous. There will always be issues where there may not be unanimity, but the Commission and the Commissioners with the minority view accept, if you like, ‘That is the decision, I support that, move on’. It is a vigorous discussion.

**PETER COUCHMAN**
Is it a bit like the Cabinet process where once a decision has been made all Commissioners are locked into that decision?

**TONY D’ALOISIO**
Yes. But we have a lot of debate at times.

**QUESTION**
With ASIC’s focus mainly being on the ‘big end of town’, or a perception that it is, what can and is ASIC doing to stop, or try and protect consumers and suppliers, some of these small companies that have phoenix situations, and particularly with some wind back and some stimulus for example, where it might lead to some further development?

**TONY D’ALOISIO**
I will ask Michael to comment on the phoenix issues more specifically, but can I pick up your ‘big end of town’ comment? It’s wrong. When you look at our resources and how we allocate them, in the areas you just mentioned we have considerable resources allocated to retail investor and financial consumers matters, to the small to medium enterprise (SME) sector that we look after. So we do take that part of our oversight seriously; but because they tend to have a narrow compass and they are dealing with small companies, you don’t see that.

But again, if you look at our Annual Report you will see considerable work, such as bannings of companies that have been involved in two or more failures. Directors of

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109 A phoenix company is a commercial entity which has emerged from the collapse of another through insolvency. The new company is set up to trade in the same or similar trading activities as the former, and is able to present the appearance of ‘business as usual’ to its customers. (Source: Wikipedia)
companies in two or more failures tend to be at that lower end that you are talking about, and if you look at what we do there, there is a significant team that works in that area to push better behaviour and to deal with banning.

So we do—when you look at our operation as a whole, we have got considerable resources devoted to the ‘smaller end of town’, if you like, but with that I will ask Michael to comment on the phoenix company activity, which, I agree with you, is extremely important, particularly in this climate.

MICHAEL DWYER
Thanks Tony. Just briefly, we have got to look at phoenix activity being either legal phoenix activity or illegal phoenix activity, and it’s the illegal phoenix activity, or the intent to defraud creditors or other parties through a phoenix activity, that is ASIC’s focus.

We have had a number of investigations ongoing in this regard, for example we had a successful prosecution some five or so months ago of an adviser and a lawyer who was an adviser of phoenix. This was successful at fining that adviser and is subject to appeal. Again, as I said earlier, there is a deterrence effect here, it’s an awareness that illegal phoenix activity is not an acceptable activity from ASIC’s perspective, and in fact from the law’s perspective.

We have also provided feedback to the Australian Taxation Office’s proposals in relation to phoenix and given quite detailed explanations there. So as Tony said, it is very much on our radar and a very important issue in the business community.

PETER COUCHMAN
I would like to just finish off by asking Greg, who said one of his motivations for accepting the invitation to become a Commissioner was he you wanted to make a difference. Greg, do you think—you have only had a year so far—but do you think you have made a difference?

GREG MEDCRAFT
You know, watching some of the things we did with investment managers last year, I think we did make a difference and some of the outcomes of that, that we hope to bring in this year in terms of reshaping things, I think are very important to me, because they are one of the reasons I joined ASIC. So this year will be important. Last year was a bit of a learning year, so in terms of that reshaping I think this year will be very important.

PETER COUCHMAN
What about you Michael, do you feel you are making a difference and getting to what you hoped you would achieve when you became a Commissioner? Having come out of the profession yourself, have you had any personal ethical difficulty dealing with former friends and colleagues that you were dealing with as an equal before you became a corporate plod?

MICHAEL DWYER
Maybe you should direct that one to the Chairman. We don’t get any social invitations.

It has made a difference to me, Peter, my golf handicap’s gone out five shots. I think once you jump the fence and you move from being a leader within your profession—knowing all the stakeholders and working with the profession and ASIC from the professional side—clearly your focus needs
to change. But I think if you asked my colleagues, my ex-colleagues who are on the other side of the fence, they see it as a very positive thing to have somebody who understands the issues, and brings some experience that assists our people to understand the issues. So I think from that perspective, it’s been very beneficial and quite rewarding for me to be able to add some content to ASIC’s strength in that regard.

PETER COUCHMAN

Peter, having come from such a long background in government, you are obviously used to dealing with the art of the possible—how have you felt about the role as Commissioner? Have you had frustrations, have you had difficulties you didn’t anticipate, or has it been very similar to the kind of work you were doing before within the government sector?

PETER BOXALL

No, it’s not similar. It’s a good question, because in the government sector I managed larger departments with much more diverse programs. ASIC is, relatively, a single-purpose government agency. It’s not completely single-purpose, but compared to the larger departments in Canberra, it is.

The other thing is that ASIC has a small ‘p’ policy role. It’s really Treasury and the Treasury portfolio that has the prime carriage for policy advice. ASIC is very much an enforcer and implementer of the legislation and of the government policy, so in that respect it’s been a bit different, but it’s very interesting—a lot of the work and intellectually stimulating. A lot of the work—things like projects, like introducing credit, national business names—those are quite large implementation programs and I’ve enjoyed that.

The other thing for me was, now I’m part of a commission, there’s a five person commission—there were six before Jeremy left—and so now I’m part of, in a sense, a commission team, whereas when I was head of a government department I was the CEO.

PETER COUCHMAN

You called the shots.

PETER BOXALL

Yes.

PETER COUCHMAN

Belinda, you’re obviously getting an insight into corporate law that you wouldn’t have had in your previous career, what insights has it given you, being a Commissioner?

BELINDA GIBSON

In corporate law you see it from the other side, but the law is the same, and as an adviser, the principles are the same. For me, there were some big things where I had to go from zero to learning a lot in a very short amount of time. I think of the short selling and the issues that were there, and then the decision that really we had to ban short selling over a space of a weekend, well, we all had the books out that weekend. The whole of ASIC was poring over them.

This change to market supervision, for which I’ve got primary responsibility, is an enormous learning curve for all of ASIC and for me. In that area, the market has always hitherto been ‘ASX is and ASX does’—and we’ve learnt a lot, and I’ve learnt a lot, in the supervision of it. But now, to take those rules, and to come to them—it has stretched my mind a lot more in the last two years than I have in the previous, probably 10 or so, anyway, I think would be fair to say. And it is the decision making that is the difference. As an adviser, I think those that I advise would always say, ‘Belinda, you never just said, “It
could be this or it could be this” in your decision’, but the actual, ‘Here’s the call’—and some of them are big calls—was a change.

PETER COUCHMAN
Thank you so much to all of you for making yourselves available today, for being so open and for being so prepared to explain yourself and your roles publicly. Much appreciated. Thank you.

TONY D’ALOISIO
Thank you, Peter.

We are now at the end of the Summer School and I will be quick in my remarks. Summer School is an important event in ASIC’s year and, as I said earlier, it is very much about us sharing with you and discussing with you the key issues of the day, and then sharing that with our people across ASIC. This is an important part of us being at the leading edge of opinion setting on really significant issues.

I think, if one thing came out of the program for this Summer School, is just how difficult and complex some of the issues are that we are confronting, and will confront us, as the reform agenda unfolds—both at the big-picture prudential liquidity leverage, as well as at the smaller end, in the sense of the financial literacy, the issues around credit and so on. So really, the two-and-a-half days has been very much about getting a feel for those issues, and as I said—I’m sure I speak for my fellow Commissioners and ASIC staff—we are very, very pleased with how the Summer School has gone.

It is important, I think, having said that, to now thank a lot of people. First and foremost, I would like to thank the speakers, the presenters, the workshop leaders and those that participated. We are extremely fortunate that we were able to bring together such outstanding people with outstanding credentials, not only from Australia but also internationally. And particularly with Guillermo Larrain—with what had happened in Chile—his desire, notwithstanding that, to stay and see the Summer School through is really an indicator of just how ASIC is seen much more globally as an institution.

Secondly, and just as importantly, it’s really to thank you. Really, at the end of the day, it’s because you come and you come back each year that we’re able to put on the Summer School and we’re able to run it. I would like to thank you for the directness of the questions, the way that you have participated and we hope that you got as much out of it as we did, and we’ll come back next year.