The Farce of Fake Regulation: Royal Commission Exposed Australia

Wilson Sy[1]

Abstract

The revelations from the *Hayne Royal Commission* (HRC, 2019), limited though they were by the terms of reference, have come as a shock to most people, including Australian politicians, officials, academics and the media. Their expressed shock indicates a high degree of ignorance about the Australian financial system. For decades, the public was led to believe that Australia has the best financial system in world, being one of the few countries to have avoided a recession in the global financial crisis (GFC).

This complacent view was contradicted by the HRC and this fact needs to be understood and explained. The *HRC Final Report* lacks an explanation for its major finding that the regulators had failed to enforce the law. The report merely recommended the regulators be more active, when it did not discover why the regulators had been so passive in the past. This paper provides detailed explanations for the observed failure to regulate based on published research, new or old empirical evidence and industry insider experience[2].

Key words: finance, regulation, financial system

[1] 29 March 2019. Investment Analytics Research. The author thanks Robbie Barwick, Richard Bardon and Jeremy Beck for comments.

[2] Insider experience consists of nine years of work with ASIC and APRA, including the Super System Review, and also information from past and present employees of the regulators.

Introduction

Few people see that the *Hayne Royal Commission* (HRC, 2019) has provided a glimpse that financial regulation in Australia is a farce because it is fake regulation. Some misconduct exposed by the HRC went back decades, and could have continued indefinitely unless exposed and stopped.

The HRC has largely spared the regulators from adequate scrutiny because the Government restricted the terms of reference only to examining the misconduct of the agents of service providers. The HRC final report was compromised by being written mostly by the Australian Treasury (Sy, 2019). The desultory HRC evidence is drawn together here to prove that fake regulation is deeply rooted in the global financial system.

For years, mainstream media financed by the major banks have propagated the myth that Australian regulators are "tough cops on the beat", who claimed credit for sparing Australia from the global financial crisis (GFC). One of the HRC's favourite words: "dissembling" also applies to the regulators. The misconduct exposed by the HRC is sufficient to suggest that Australia has fake regulation – that the watchdogs are actually lapdogs.

The purpose of this paper is to explain coherently how the Australian financial system has fake regulation by assembling apparently unrelated, but significant facts and by connecting them logically together. The evidence assembled is either self-evident as observed in the HRC or obtainable from official data sources or verifiable from insider experiences across all sectors both private and public.

The approach is scientific in so far as important assertions and statements made here should be factually falsifiable even though actual evidence or sources may not always be easily specified. Having established the most important facts about fake regulation, we propose a theoretical explanation for the observations based on the current economic paradigm, which is in turn based on assumptions accepted by governments and taught at universities. That is, the fake regulation exposed in this paper is not accidental, but deliberately founded on certain economic beliefs which are false.

The plan of this paper is firstly to collect and summarize the facts, many of which are now common public knowledge, though still they may appear unrelated and at times incredible. What seems unbelievable or inexplicable is given credibility by tallying with facts from insider experience which are rarely publicized for reasons explained below. Fake regulation is a unifying hypothesis which fits all these facts.

The final step in our plan is to explain how fake regulation is not a bizarre "conspiracy theory", but a natural outcome of decades of deregulation, which is based on the principles of economic rationalism that have driven the global economic agenda for the past several decades.

Enforcement Farce

The HRC has discovered that there has been little enforcement of regulation in the past decades. The reason regulators have been reluctant to enforce the law is that earlier attempts at enforcement have been failures. Successes have been minor and rare. The failures suggest regulations are too complex and ambiguous to enforce. Those failures impose heavy budgetary burden on the regulators without commensurate benefit of convictions and consequential deterrence. Historically, further enforcement was considered economically unjustifiable.

The *Australian Securities and Investments Commission* (ASIC) resorted to negotiating penalties and enforceable undertakings with wrongdoers instead of taking them to court because ASIC had typically lost its enforcement litigation. This explains why Rowena Orr QC at the HRC asked ASIC about penalty negotiations:

> *The parking inspector doesn't seek an indication from the person he's giving a parking fine to as to whether they will accept and pay it. He just does it. Why don't you just do that?*

James Shipton, being the new chair of ASIC, may be excused for giving a false answer that if infringement notices were not accepted, they would "*go straight to court*".

The *Australian Prudential Regulation Authority* (APRA) works "behind the scene" to persuade regulated entities to comply voluntarily with the law and has avoided enforcement altogether for many years.

The reality is: major banks are complex conglomerates which have so many lines of business that they are difficult for executives to manage and for regulators to supervise. Given this complexity, the regulatory system is based on the assumption that the "invisible hand" guides free markets to self-organize for the benefit of all, and therefore regulation is actually unnecessary. This extraordinary assumption leads to fake regulation, as will be discussed further below.

The system was never designed with enforcement in mind. Fake regulation was established as a façade to placate the detractors of deregulation. Deregulation has been implemented progressively by governments for decades, particularly in the finance industry. Deregulation implemented through fake regulation has resulted naturally in the misconduct revealed by the HRC.

Under immense pressure of criticism arising out of the HRC, the Government has belatedly provided APRA with special funding of $60 million, normally unavailable to the regulator's budget, to show an extraordinary intent of enforcement. After nearly twenty years, APRA has recently announced its first serious enforcement action against the senior executives of IOOF, a small service provider capitalized at $1.6 billion (after a 30 percent plunge in its share price) compared with *Commonwealth Bank of Australia* (CBA) at $125 billion. This may be a case of token enforcement action on a minnow.

Whether justified or not, Ken Henry, the former secretary of the Australian Treasury (2001-2011), has been credited with saving Australia in the GFC by advising the Government to "Go hard, go early and go to households". He took the stand in last days of the HRC as the chair of the *National Australia Bank* (NAB). His performance in answering the questions posed to him has been described as nonchalant and arrogant because he clearly displayed disrespect for the HRC.

Ken Henry, who understands well fake regulation in the financial system, was apparently mocking the regulators and the proceedings as he knows that a major bank is virtually untouchable – "too big to fail" and "too big to jail". This is typical of the contemptuous attitude major banks have to regulators and government in general. Even if a major bank is untouchable, he was not. He eventually paid the price of being explicitly censured by the HRC for his public display of arrogance; he and the CEO have since resigned under pressure.

In the forthcoming litigation, IOOF defendants could explain to their prosecutors that their misconduct exposed at the HRC merely emulated those of the major banks. However, IOOF may not understand that not being a major bank, it may be very risky to emulate what a major bank does – the special status of the major banks will be explained further below. It remains to be seen whether in the enforcement of IOOF, even if a minnow, APRA can avoid the same failures of the past.

Under serious public pressure from the HRC, ASIC has recently announced "investigations" into 13 specific referrals for possible criminal proceedings. The new commissioner Sean Hughes declared that the mantra at ASIC going forward will be "Why not litigate?" He appears to have a short memory because he should know well from his past experience working at ASIC how costly, unsuccessful and unpopular litigation has been for the regulator. What is the point of more litigation recommended by HRC, if it only ends in failures?

The HRC and the Government may understand the law and the legal processes, but do they really understand the industry? Laws based on false assumptions or misunderstandings of the industry will be contradictory or ambiguous relative to other laws and will therefore be impossible to enforce. A hint that nothing much will change at APRA was given recently by the chair Wayne Byres when he informed the *Senate Economics Legislation Committee*:

> *We will still be, at our heart though, a prudential regulator. We will not be all of a sudden a police force.*

Attempts to regulate a complex industry with complex laws have failed as evident in the GFC, where widespread and serious misconduct in many countries landed few people of any note in prison. The rest of this paper explains what the history of the finance industry has repeatedly indicated: enforcement is a farce.

Financial Trade Guild

Through industry consultation, guidance notes, compliance rules and prudential standards, APRA has been acting as a trade guild to harmonize trade practices. The key performance indicators (KPI) of APRA all relate to industry practice, making no explicit mention of protecting consumers. Those APRA standards for the industry act as a barrier to entry to discourage new entrants. The standards also serve as benchmarks to "level the playing field" for established players, but bank executives were never held accountable for those standards by APRA. The HRC has belatedly triggered awareness that there needs to be accountability for those standards.

Instead of increasing competition, harmonization through regulation led to *de facto* price fixing, because major financial institutions act uniformly and effectively as a monopoly. No major institution would operate too far out of line and take the risk of being different from the others. The financial trade guild notion is another way of expressing "regulatory capture" where the regulators work to benefit the industry rather than the whole community. There are good reasons and evidence, given below, for why the heads of regulators are chosen not to "rock the boat" of the industry. Clearly enforcement is totally alien to this trade guild philosophy of self-regulation.

By standardizing practice with its compliance rules, APRA has effectively eliminated competition from the financial system and consumers have been paying monopoly prices for many years. The *Australian Competition and Consumer Commission* (ACCC) which examined recently the activities of APRA and the major banks in relation to residential mortgage lending, has confirmed earlier evidence of anti-competitive oligopoly pricing (ACCC, 2018, p.6):

> *The accommodative and synchronised approach to pricing we have previously observed among the big four banks was again evident at this time. This behaviour was not unexpected and is enabled by the oligopoly market structure in which the big four banks collectively have about an 80 per cent share.*

The ACCC is a general consumer advocate across all products in the economy; it is not specifically a financial regulator to protect consumers of financial products. The main financial regulators, ASIC, APRA and the *Reserve Bank of Australia* (RBA) are focussed on financial institutions and the laws governing them, with little or no responsibility to protect consumers. Financial regulation in Australia is mainly to protect the system and its financial institutions.

The Australian financial trade guild is a member of a global financial trade guild with several international regulators. For example, the Bank for International Settlement (BIS) in Basel, Switzerland sets the regulatory framework with which APRA complies in setting prudential standards. The close relationship between BIS and APRA is cemented through APRA staff having lucrative secondments and important positions at Basel.

Just like trade guilds, the budgets of Australian regulators are largely funded by levies (mostly based on asset sizes) from the regulated entities in consultation with the Australian Treasury, in a "cost recovery" model based on agreed tasks and projects. This funding model virtually precludes enforcement. Since success in enforcement is generally not guaranteed, it is essential for budgeting that the funders accept and cater for failed litigation, which is at odds with the funding model. One does not budget for enforcement failures in self-regulation. Imagine that the regulators have to seek to recover funds from the regulated entities when the regulators have repeatedly failed in prosecuting the funders for their breaches of the law! This would be a farce.

Effectively without adequate funding for enforcement, Australian financial regulation has never been properly enforced which was one of the key findings of HRC. Regulation which is not enforced is fake regulation and this pretence at regulation is a farce. The HRC recommendation for greater enforcement will not stop the farce because it has not called for a stop to fake regulation by recommending structural changes to the system.

The farce will continue even when ASIC and APRA have been funded specially by the Government to step up enforcement action and to cooperate with each other more closely. To dissemble and forestall harsher recommendations from the HRC in the final report, the Government had created earlier a second deputy chair at APRA for John Lonsdale, an ex-Australian Treasury official of 30 years, to develop at APRA an enforcement strategy about which evidently it had never thought before. This is part of the farce.

What has changed to make enforcement more effective now than in the past? The "knee jerk" reaction to show toughness publicly may be a waste of public money, as has been the case in the past, because the idea of enforcement is at odds with the philosophy and the structure of the financial system which is based on fake regulation. Successful enforcement cannot come from fake regulation.

Fake Regulation

Fake regulation does not mean there is no regulation. Fake regulation gives the appearance that regulation is for the benefit of everyone, as the community expects, whereas fake regulation is actually for the benefit of the industry, with the premise that what is good for the industry is good for everyone. The false assumption is: an industry which serves customers will keep customers happy because it is irrational to destroy itself by being bad to customers. Hence on this assumption, the regulation which has been set up to work for the industry would hardly contemplate enforcement which represents external intervention and admission of failure of self-regulation.

The recent promises of enforcement and even making some lame attempts are merely to extend and pretend regulation. They will come to nought, because fake regulation was never meant to be enforced and has not been organized to do so, as explained further below. New attempts at enforcement by ASIC and APRA, even with special litigation funding, will meet with the same old road blocks and will likely fail as before. The Australian regulatory system, like the US system and others, has been designed to be weak and ineffective, as a step towards deregulation.

For the past several decades, deregulation has been the general policy direction pursued by governments in most developed countries. Regulation has effectively served to protect the free market system with its vested interests, and not directly to protect the consumers. The fake regulation is a dissembling to play a confidence trick on the public, including the media which are duped or compromised.

The HRC has provided a glimpse of the pressure put on front-line staff in major banks to do unethical or unconscionable things. Everyone in big institutions is expected to follow orders. Psychopaths and bullies among the management ranks are over represented in financial institutions compared with other professions. Staff surveys by consultants and by financial sector unions have provided evidence of this pathology whenever they have been leaked to the public. Such leakages are actively stemmed by managers and passively contained by workers' fear of losing their relatively well-paid jobs in the financial sector. Organizational dysfunction does not seriously affect the regulators because eventually fake regulation is recognized by every insider who either quits or accepts the situation as normal in the industry.

With fake regulation, there is no real need for extensive knowledge or expertise about financial products, conduct and operations. People and employees, who understand the industry and know what is wrong with the system, are redundant and unhelpful to the work of the fake regulators. Would-be reformers among employees are considered misguided and are avoided by the regulators. Competence may be a career liability.

Indeed, ASIC and APRA may not even care to understand broadly or deeply about the financial services industry, because their own knowledge is never required to challenge the data or information submitted by the regulated entities. More knowledge is undesirable because it creates more trouble, more onus and greater obligation to regulate and censure which is inconsistent with fake regulation or self-regulation by the institutions.

With respect to bank misconduct and remedy, James Shipton, the chair of ASIC let slip at the HRC:

> *We sent the strongest message we could have which was a public expression of disappointment, and also a private expression of disappointment.*

This is an inadvertent admission by the regulator of fake regulation – a watchdog which is unwilling and unable to bite.

The special inquiry by APRA following the money laundering scandal at CBA found that CBA management was unaware that money laundering was going on through their ATM machines between 2012 and 2015. The scandal was attributed by the APRA inquiry to a long list of management failures involving inadequate oversight, over-confidence, unclear accountability, inadequate reporting of complaints, overly complex and bureaucratic processes, deficient operational risk management and so on.

However, all those failures identified by the APRA inquiry are issues of oversight and supervision for which APRA has full responsibility as the institutional regulator. The issues should have been recorded by APRA supervisors in their PAIRS[3] and SOARS[4] databases which should have been audited in the inquiry. Even if its supervisors were asleep, senior management at APRA must have known about the glaring compliance failure at CBA from the money-laundering watchdog, because there was a 2007 memorandum of understanding (MOU) with AUSTRAC[5] to exchange important information in a timely manner. The tolerance for law breaking by Australia's largest financial institution is further evidence of fake regulation.

No one has called out that APRA investigating its own failure in supervising CBA is a farce. The special inquiry did what APRA should have already done in routine supervision. If APRA did not know about how CBA is managed and how the largest financial institution in Australia has breached regulation for years, what does APRA know about other institutions? The 68 days of hearings at the HRC appear to have taught APRA a lot about the institutions which it is supposed to be supervising with its extensive insider knowledge.

The truth is APRA and ASIC both work for their paymasters who decide how they want to be regulated in an arrangement of self-regulation, approved by Government policy.

Fake Knowledge

The regulators passively collect data and publish the raw data only when required by the law. They publish little research in any depth to validate the data or to distribute the knowledge to inform their staff, other regulators and the public. The Productivity Commission (2019) found major deficiencies in APRA data which would have been evident if the data were

[3] Probability and Impact Rating System (PAIRS)
[4] Supervisory Oversight and Response System (SOARS)
[5] Australian Transaction Reports and Analysis Centre (AUSTRAC)

actually used. In its *Financial Sector Assessment Program* (FSAP) for Australia the *International Monetary Fund* (IMF) reported data and analysis deficiencies in the regulators (Frost, 2019):

> *Relative to international experience, the assessment identified shortfalls in the granularity and consistency of data to support the analysis of supervisory and systemic risks and the formulation of policy.*

External reviews have no way of discovering that within the agencies, everyone is kept deliberately in the dark about the content of the data. Even supervisors are restricted in what they know. Staff members, who while doing research on the data, raise questions or alarm about errors in the data, or challenge established views and practices, are considered a nuisance, a "loose cannon". They are shunted for "rocking the boat" – a career terminating transgression. The regulators do not want known that they know what they don't want to know – the inconvenient truth.

Over time, the databases of regulators have become a shambles, because they have not been properly used and maintained. It is important to realize that an organization does not know, or have knowledge; only individuals within the organization can know or have knowledge. If the individuals are prevented or discouraged from investigating available data, the regulators have only fake knowledge and everyone is kept in the dark.

Clearly, fake knowledge eventually leads to a fake senior management which is ignorant of basic facts of the industry (CEC, 2017). Public performances of senior staff at conferences and inquiries have to be properly stage-managed by public affairs experts within the regulators. Direct contact and unrehearsed communication with the public, particularly with journalists, are forbidden and at lower levels of the organizations, severely punished. As a result, few know much about how the regulators work and cannot interpret many of their utterances.

A glimpse of fake knowledge is evident at the HRC and at various Parliamentary committee inquiries when relatively simple impromptu questions are asked by politicians about operations at the regulators or about the industry in general. Many questions have to be "taken on notice" to be investigated when even approximate or vague answers would have sufficed. Few can define a derivative or know how to evaluate one. At the HRC, it is seen that at the senior management levels of regulators and banks, ignorance has often been accepted as defence for their lack of response to misconduct.

APRA Lacks Experts

The regulators have realized that it would be a waste of resources to acquire real knowledge when it is not needed for fake regulation. Whenever they are exposed publicly for their lack of knowledge, for example about derivatives, they make the excuse that they cannot afford to compete with the industry and to pay high bonuses to attract the expertise. In an International Monetary Fund (IMF) assessment report, APRA admitted that in specialist areas such as risk management "*it could not pay, say, bonuses available in the private sector*". This was perhaps why the IMF reported that "*it did form the impression that certain staff, particularly in the specialist areas referred to above, was somewhat overstretched*". Specialists are not overstretched – they are mostly non-existent.

The inability to pay sufficiently is merely a lame excuse for not hiring experts, some of whom are prepared to work for lower pay for the public good rather than for higher pay for questionable private gains. Self-interest alone does not entirely explain human behaviour as assumed by current economic theory of economic rationalism. Since APRA believes it cannot compete for the "quant" talent, APRA is not organized to use the expertise even when "*some such people actually want to work in regulation*".

Should such experts be hired accidentally, they will be ostracised and will find eventually that their skills, even though proven on the job of regulation, are not appreciated. They also run the risk of showing up the ignorance of senior management. They are pushed out for "rocking the boat" when they challenge the data or the risk models submitted by the major banks. APRA treats mathematical and technical people as boffins, eggheads and geeks who are too naive to understand how the game is played.

Consistent with self-regulation, the major banks prefer to encourage and fund "rubber stamping" regulators who are too ignorant to challenge them in risk management. No one in authority seems to be aware or care that lack of knowledge by the regulators in innovative risk products is a serious systemic vulnerability. The truth is that fake regulators do not have the resources or the desire to hire people with real knowledge. Without the necessary expertise, $40 trillion of derivatives in the Australian financial system remain a data black hole and being unregulated, poses extreme risk to the economy.

An example of APRA's complacency about its ignorance of derivatives was evident in November 2007 even when the debacle of mortgage securitization was unfolding in the US. APRA gave a speech to the industry on mortgage securitization, concluding:

> *…the capital and transparency required by regulators now seems somewhat second order relative to the capital and transparency required by the market.*

This is an affirmation of the efficient market which "knows" more than the regulators could possibly know; that is, regulator knowledge is redundant and its ignorance is justifiable.

APRA used to publish some research to enhance industry engagement, but has found that inconvenient facts uncovered hinder its cosy relationship with the industry. Articles published in *Insight*, now its only publication for the general public, are uninformative to identify risks for the public and with nothing substantial enough to explain policy. Facts from serious research may hinder the way APRA formulates policy, as will be discussed below.

APRA shut down its research unit several years ago to extract an "efficiency dividend", as if efficiency is undesirable – the research budget was eradicated because research was too efficient. In funding for regulation, nothing fails like success, because success leads to funding cuts and conversely, nothing succeeds like failure. When regulation fails publicly and demonstrably, the consequence is a reward of more funding for the regulators, because the standard accepted explanation for failures is a "lack of resources", rather than a lack of genuine regulation. Regulators are incentivised perversely to fail. For example, decades of regulatory failure exposed by the HRC were rewarded with more money, more power and more responsibility for the regulators.

To cover trails of past research successes, APRA research papers which may have been too revealing, are now made difficult to access on its current website. Instead of demonstrating knowledge and competence through published research, APRA considers that its public affairs unit is much more useful for managing its media image. Public image and appearance are paramount for the regulators. Some senior managers have even said often enough, and in all seriousness, "appearance is reality". As explained below, this has some basis in economic theory. However, fake regulation leads to fake knowledge and vice versa.

Secrecy and lack of knowledge sharing within the regulators mean that important knowledge residing in individuals who can only gain their specific knowledge through work experience routinely disappear from the organization when they change jobs. This was the explanation given for APRA's failure to anticipate the HIH collapse in 2001. The "revolving door" works against the competence of the regulators. Experts and experienced supervisors who have accumulated substantial knowledge over time can easily be poached with lucrative job offers from regulated entities. Their loss would be a serious blow to genuine regulation, but not to fake regulation, which does not want employees, in any case, to "know too much".

ASIC Has Silos

ASIC is organized into separate silos, where staff in one silo does not communicate with those of another. For example, there are over 30 separate databases or "data islands" or "data lakes", called ASIC registries, which are disconnected from each other and are separately "owned" or controlled by different individuals. ASIC is overpopulated with lawyers, certainly in all senior positions. Lawyers tend to treat information as their own prized possessions to be used at critical moments to their own advantage, not to be shared freely.

Getting data from any database normally involves bureaucratic procedures of getting permission through submitting requests to layers of managers. The database owner eventually gets someone to extract the precise data requested and pass them back through a chain of command to the individual needing the data, with lengthy delays of weeks, even months. With disorganized data, one needs to examine the data before one knows precisely what is useful. Hence data access at ASIC is effectively a Catch-22 conundrum – one cannot ask for the precise data of which there is no metadata and which one has never seen.

The system of separate databases ensures that ASIC works in silos. For example, under the *Financial Services Reform Act 2001* (FSRA), financial service providers were required to apply for and obtain licences to operate. In 2002, a licence was being granted to an applicant who was simultaneously being taken to court by the enforcement directorate. Most staff have little idea of what others do. Licencing staff have little knowledge even of the broad statistics of the licensees they deal with, because information is generally suppressed on a "need to know" philosophy as curiosity is discouraged.

The HRC recommended greater cooperation, particularly in enforcing superannuation law, between ASIC and APRA. Is that possible when ASIC does not even cooperate between its many silos? At most, regulators work in small groups isolated from other groups, with little sharing of data or information.

Over the years, numerous victims of fake regulation have made copious complaints to the regulators, particularly to ASIC, but the information has been trapped in their databases, which are inescapable black holes. ASIC has few clues even on a statistical basis about the many thousands of complaints. Ken Henry said at the HRC that as far as he knows the best measurement of customer outcomes is customer complaints. It would have helped NAB management to have the data on complaints lodged by NAB customers with ASIC.

The regulators pretended that they knew about the complaints, whereas they do not because the sheer volume of data requires high expertise and enormous computer resources to analyse. Such basic information is not valued because of fake regulation, because only public image and pretend knowledge are important to the fakers. The HRC has exposed a little of this charade.

ASIC tries to divert financial complaints firstly to service providers to resolve, then to tribunals for dispute resolution, but because ASIC is supposed to be the watchdog with bite, it is realistically the primary destination for serious complaints. The volume of complaints can be inferred from the huge volume collected even by small specialist consumer advocates such as the *Banking and Finance Consumers Support Association* (BFCSA).

Yet ASIC has published little data or information on broad industry sector statistics to inform other regulators and to help the public to identify potential financial services risks, to enable the practice of *caveat emptor* ("let the buyers beware") to work. How could "buyers beware" when buyers are kept in the dark about other buyers' complaints? The simplest way to prevent wrongdoing is to alert potential victims, but the regulators do the opposite.

For example, the number of complaints received against any institution should be disclosed, even if the complaints may not involve actual breaches of regulation, because it may mean that the institution needs to fix communication problems, something which is useful for everyone to know. Consistent with IMF findings (Frost, 2019), the lack of data and analysis of complaints at ASIC prevents effective regulation and informed markets. Poorly informed buyers do not make efficient markets.

ASIC does not deal with resolution and compensation of individual financial complaints. They were dealt with disparately, confusingly and severally by the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO) and the Superannuation Complaints Tribunal (SCT). Since the merger of these agencies into the new "mega ombudsman", the Australian Financial Complaints Authority (AFCA) in November 2018, AFCA has received over 23,000 complaints in a few months. There has been little published information yet about what sorts of complaints are being lodged by consumers.

Fake knowledge or lack of knowledge at the regulators leads to enforcement failures, because with fake knowledge, the regulators have no informational advantage in prosecution. In fact, information asymmetry in specific cases strongly favours the defendants on whom the regulators depend, almost exclusively, for information. The regulators have no alternative sources of information on breaches of the law except through self-reporting by the entities which also have total control of other relevant information surrounding the circumstances of those breaches. Fake knowledge explains the lack of enforcement success of the regulators.

Fake Management

Fake management is needed to manage hundreds of staff at each regulatory agency to produce fake regulation, fake knowledge and a fake façade. Mainstream media propaganda often projects the image that the agencies are managed efficiently to fulfil their missions. The image projected is not based on any facts. Information and facts about how the regulatory agencies are managed are often deliberately kept from the public due to secrecy provisions and sensitivity of potential enforcement actions. For years, the level of public respect has been unreasonably high and is unwarranted by the reality, but helped by positive media propaganda.

The main way of controlling hundreds of employees, keeping them busy and preventing them straying outside their narrow areas is through copious documentation, otherwise known as “paper work” or their electronic equivalent these days. Planning and documentation are essentially aspects of bureaucracy. A substantial amount of one’s work is documenting what one plans to do for tasks relative to the job description of one’s position; how one is going to perform stated tasks; how one is going to be measured or assessed against the stated objectives at regular intervals.

It is also necessary for an employee to document anticipated training required to acquire new knowledge or skills needed to do their specifically agreed tasks. They need to know just enough to carry out orders, but not too much. Training refers to professional seminars, conferences, in-house courses or external university courses. The assumption is that formal training and book learning are adequate ways of finding out how the financial services industry actually works. The assumption is seriously false. Little acknowledgement is granted to staff who may have real knowledge gained from years of experience working inside the industry, because this would threaten many senior managers who have risen through the ranks of bureaucracy without such real knowledge or experience.

All documents have to be read and approved by the immediate supervising manager and they have to be revised and updated quarterly in consultation. The documents are used to control, and if necessary, to intimidate staff through regular performance assessment which provides the opportunity for feedback to keep employees in line.

The “red tape” within the organization hinders responses to any externally emerging issues in regulation. The whole process of job description and performance agreement is designed to prevent initiative and rapid responses. Bureaucratic management eliminates spontaneous team work and discourages cross-fertilization of ideas. Most work is fake work to keep everyone busy.

Generally employees do not know about the other employees whom they may be working with. Usually, no one knows others’ backgrounds and qualifications, which are not published within the organization. There is no possibility of taking the initiative to consult an in-house expert who may be available. The general ignorance about each other among employees prevents challenges and allows senior management to promote their cronies and to block the advancement of more “troublesome” but capable employees.

Information about almost everything within the organization is made available only on a need-to-know basis. Most employees do not know what others are really doing. Typically, employees do not even know what their own regulators have done as an organization until they read about it in the daily newspapers. The management must hope that no one reads newspapers or that the management’s insensitivity to its staff has no impact on morale. Fake management, particularly in the financial industry, is particularly adept at inventing weasel concepts such as “Chinese wall”, “self-regulation”, “self-assessment” and “culture” which is the “new” concept of regulatory reform discussed below.

Employees are made to feel that they are just another brick in the wall of fake regulation and it is difficult for them to feel that they are really making a difference in public service. It is difficult for anyone to sense any urgency or purpose working with the regulators. Perhaps if they see the full picture, they may see the farce. Most are kept in place by “silence money”, by being relatively well paid in their fake jobs, so long as they “toe the line” and keep their mouths shut. The alternatives are career-terminating. Such passively controlled subordinates make life much easier for fake managers whose remuneration mainly depends on how large are the numbers of subordinates they can control under their charge.

Government bureaucracies including the regulators pay the highest graduate salaries to attract some of the largest numbers of high academic achievers leaving universities. There are many reasons for this practice which dates back hundreds, if not thousands of years of public administration in many countries. Graduates with the highest marks are those who are most willing to accept and regurgitate accurately what they have been taught. They are less likely to question authority, since they have already proven docile to academic authority by learning what they have been told. However, after disappointing experiences, many do not stay in the public sector, but those who stay, are eventually promoted to the highest ranks in the bureaucracy. Fake regulation does not need talent and does not keep talent.

Much of these practices revealed here merely confirm what many consider as common in the government bureaucracy which is well-known and has been documented (Mises, 1944; Crozier, 1963). The bureaucratic organization limits the capability of regulators to regulate in a changing environment, because the bureaucracy has inherent limitations to learn or acquire new knowledge about changes in the financial services industry. Indeed, stability of public administration is one of the key objectives of a government bureaucracy which is designed to have little flexibility and can perform well only very clearly defined simple tasks. Unfortunately, not so easily defined are the tasks of regulating a rapidly changing industry in financial services, but this is not a problem for fake regulation.

Self-reporting Farce

Fake regulation depends on self-reporting of breaches of the law by the regulated entities. Without real knowledge of the financial services industry, the regulators have no way to regulate efficiently or effectively. Even with new reporting or new procedural changes arising from new rules and regulation, the entities can delay compliance citing impracticality or unreasonable demands by regulators who are ignorant of real-world operations. New regulations, such the reporting of new types of breaches, generally take a long time to implement.

Without forensic information from extensive data and real knowledge of the industry, the regulators have no way of knowing, suspecting or anticipating, breaches of regulation. For example, without confessions, the regulators do not know or suspect that fees have been charged to the dead. As the HRC found, reliance on self-reporting of breaches by the regulated entities put the regulators at great disadvantage if they were serious about regulation and enforcement of regulation.

Often corporate boards do not report breaches because they have no awareness of the operational risks in the management, as the HRC noted (2019, p.395):

The evidence before the Commission showed that too often, boards did not get the right information about emerging non-financial risks; did not do enough to seek further or better information where what they had was clearly deficient; and did not do enough with the information they had to oversee and challenge management's approach to these risks.

Ignorance of risks by the boards has been a defence for not reporting breaches of the law in a timely manner. The boards are kept in the dark, because what they do not know, they cannot report.

Obviously, there were lengthy delays (possibly more than a year) in self-reporting of breaches and further delays in regulatory response because the regulators must collect more information about the circumstances surrounding the breaches, to assess the implications of breaches and to find suitable remedies. Each case is like a separate research project. Under such circumstances, damages to victims would have been prolonged. Delays make prosecution more difficult and remedies are unlikely to involve enforcement actions due to trails having gone cold.

For example, after "fees for no service" was exposed as a systemic scandal by the HRC, a process, started in 2015 (ASIC, 2016), of remediation and compensation was accelerated by requesting major financial institutions to complete overdue reviews to identify cases of "fees for no service". Four years and a royal commission later, ASIC has complained recently that six major banking institutions have yet to complete properly their reviews, citing issues with record keeping, legal issues with customers, etc. Most are unable to give estimated dates for completion of their reviews.

Self-reporting is an inevitable consequence of fake knowledge from fake regulation. The only major US conviction of Ponzi fraud in the GFC, despite much earlier warnings by a whistle-blower to US regulators, was a self-reported crime described by Taibbi (2011):

Harry Markopolos, a certified fraud examiner best known for sounding a famously unheeded warning about Bernie Madoff way back in 2000, says the SEC's practice of asking suspects to investigate themselves is absurd. In a serious investigation, he says, "the last person you want to trust is the person being accused or their lawyer." The practice helped Madoff escape for years. "The SEC took Bernie's word for everything," Markopolos says.

The *Securities and Exchange Commission* (SEC) is the US equivalent of ASIC. The SEC, like most regulators, had no procedure or resources to deal with whistle-blowers who are assumed not to exist in supposedly well-organized and efficient markets.

In Australia, for decades, misconduct in unconscionable lending involving mortgages and businesses, bank fee gouging, conflicted financial advice, superannuation theft and so on, has been growing largely unhindered. The regulators have reassured governments and the public that Australia has the best financial system in the world. The reassurance is not based on any real knowledge of the financial system, but on the low level of self-reported breaches and on regulators' ignorance of their own complaints databases. The regulators are able dissemblers.

Because everyone is in the dark, the reassurance of a sound system was widely accepted for many years – the myth that misconduct was due to just "a few bad apples" persisted. Eventually, public protests by so many victims were so loud and so strong that the

Government was forced to concede that a royal commission was needed to calm public concerns. Of course, it was the Government which was misled into complacency. The HRC has since exposed the myth promulgated by the regulators that there was no systemic misconduct. Perhaps, the regulators have since learned for themselves so much about the system which they did not know or did not want to acknowledge before.

Tip of the Iceberg

The 68 days of hearings of the HRC were sufficient to overturn the misplaced complacency about the Australian financial system, as many expressed or pretended shock and horror at the initial revelations. Yet the revelations have come from only a tiny fraction of the complaints known even to small consumer advocates such as the BFCSA. The tiny selection of cases is only the tip of the iceberg with many complainants expressing anger that their more serious grievances were not heard at the HRC.

The deficiencies of the financial system run much deeper than can be exposed by limited public hearings of the testimonies of consumers and service providers. The policy assumptions behind the design of the financial system and its regulation need to be understood to explain how the system works. The HRC was not given the brief to question more thoroughly the regulators whose roles may not be fully understood. The misconduct exposed is certainly just the visible tip of the iceberg, 90 percent of which relates to the structure of the financial system, which the HRC was not able to investigate. Only some of the symptoms of the disease have been exposed.

It is difficult to know the true extent of the failure of the financial system to serve the nation when regulators collect most of the data and complaints and do not inform the public in any useful way. The public and the journalists assume the regulators are well informed and are "working behind the scene". Yet this assumption has been proven false by the HRC. That those enormous databases have not given rise pre-emptively to any serious regulatory action suggests further evidence of fake knowledge.

There is a real need to discover the size of the iceberg. As the HRC has found, law breaking can go on for many years before the breaches are reported, assessed and addressed. Imagine the sufferings of large numbers of victims who are assumed not to exist, as will be explained below. Also, law breaking typically does not lead to criminal prosecutions by the regulators who want to avoid incurring the cost of litigation as mentioned above. In the name of saving public money, this also reduces public awareness of misconduct from the lack of media exposure of wrongdoings.

Self-reported breaches typically lead to negotiations between offenders and the regulators to desist from further breaches, sometimes with enforceable undertakings and occasionally with civil penalties. There is no public visibility in the process. All these factors conspire to hide the problems of the financial system from view, creating a misleading impression and an unwarranted complacency in innocent consumers that regulation is effective. This "behind closed doors" approach to regulation is invisible and is therefore neither a deterrent to would-be wrongdoers nor a warning to potential victims.

Regulators are incompetent due to fake knowledge. The HRC has provided glimpses of the substantial knowledge deficiency in the regulators, with ASIC and APRA admitting on occasions to their lack of expertise or lack of information. For example, APRA recently admitted it lacks sufficient knowledge about who is accountable and what is good industry practice in challenging the policies of bank-boards when it comes to enforcing the *Banking Executive Accountability Regime* (BEAR). Is this further evidence of a misguided attempt at more fake regulation?

Profit Competition

The very idea of holding bank executives accountable with BEAR is probably another farce of fake regulation, because executives are legally accountable (including remuneration and bonuses) under the *Corporations Act 2001* only to their board and shareholders. According to Milton Friedman, "*the social responsibility of business is to increase its profits*", which is a view accepted by the Australian Treasury under economic rationalism or neoliberalism. In fact, regulation has been designed to help bank profitability and to ensure financially sound banks, as discussed below.

Whenever the public complains that bank fees and charges are too high because there is insufficient competition in the system, the major banks deny this by indicating that the "four pillars" provide strong competition. Of course by "competition" they mean competition to make the most profits for shareholders, not competition to lower prices and serve their customers. The two types of competition are completely different and potentially in conflict. The major banks feel obliged to make as much profit as the regulators allow, otherwise their shareholders would be relatively disadvantaged compared to their competitors. Profit competition does not necessarily lead to lower prices to benefit consumers.

To balance the interests of shareholders with those of the consumers is so unnatural to the existing philosophy that the HRC suggested a major overhaul of corporate "culture" among banking staff. Ken Henry may have been flippant or optimistic when he predicted at the HRC hearings that it could take a decade to overhaul NAB's culture, which is mainly a culture driven by profit. Greed is merely a vague expression for profit-making beyond what the public commonly perceives as reasonable, but it is not necessarily illegal.

Many uninformed suggestions for management to change individual behaviour are misguided. It is easy to say that banks need more honesty and morality, but it may be logically impossible to change the profit driven culture within a bank and between banks. The law and its enforcement are often used to define the envelope of what is acceptable conduct. In the finance industry, risk-taking or making money belongs to the front-office or the profit centre, whereas risk management and customer service belong to the back-office or the cost centre. Obviously, the culture is to maximize profits and minimize costs and employees are remunerated accordingly.

Just like cheating in sport, unless competition is properly regulated with adequate punishments, the doping cheats, for example, would have such a great advantage that doping would eventually become so rife in the sport that there would be no real competition at all. A competition without effective regulation but with many cheating participants is fake competition. Profit competition culture within a bank is fake competition.

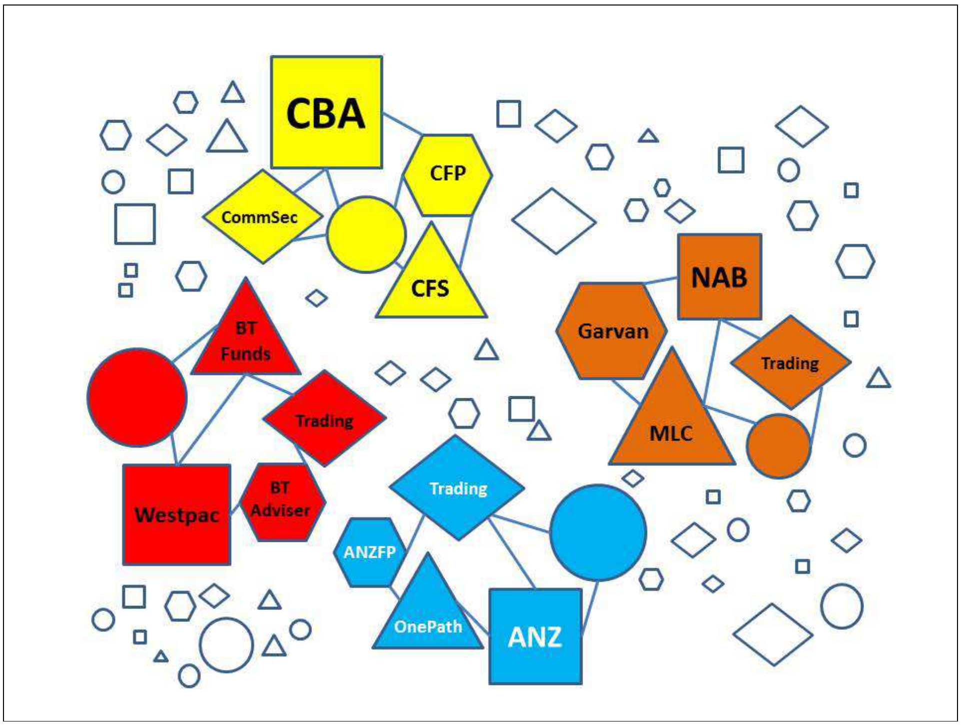
Also, for the community, the profit competition between major banks is fake competition. The oligopoly competition is not the market competition of the economic textbooks which preach free markets with many genuine competitors benefiting consumers with lower prices. The Australian Treasury also protects the banking oligopoly by pretending that there is no structural concentration in the Australian financial system. It has misinformed and misled the Parliament with false statements such as:

> ***…our financial system already exhibits a high degree of structural separation**. **Foreign bank branches play a major role in investment banking** but only have a small presence in retail and commercial banking. By contrast, **Australia's major banks** have a significant presence in retail and commercial banking, but **do not have large investment banking businesses.***

The false or misleading assertions are in bold for emphasis. The major banks (including Macquarie Bank) have nearly 80 percent of total financial system assets, 83 percent of housing assets and over 80 percent of investment banking. Since the HRC, APRA has responded by issuing a few new banking licences to prove the absence of barriers to entry. It made little difference to the fact that the Australian financial system has a highly concentrated and integrated conglomerate structure.

The conglomerate structure of major banks operating the gamut of financial services businesses allows them to extract invisibly high fees and costs from consumers through vertical and horizontal integration of the businesses. Self-referral of services within conglomerates shields individual business units from open market competition, entrenching oligopoly as Figure 1 illustrates schematically.

Figure 1: Schematic Illustration of the Integration of Major Banking Conglomerates



In Figure 1, different shapes represent different lines of financial service and their sizes provide an impression of their market shares. Conglomeration and vertical integration apply not only to the major banks, but also other large institutions such as AMP.

The argument for conglomeration and allowing the creation of "too big to fail" banks is often based on the false assumption that economies of scale lower costs, therefore lower prices benefit consumers. Instead of economies of scale benefiting consumers from lower prices, the cost savings are used to boost shareholder profits, because the oligopolistic structure provides inadequate competition for lowering prices. That is, size or scale leads ultimately to monopolies increasing profits and hurting consumers. The rent-collecting structure also obviates and therefore prevents genuine innovation.

Yet the HRC in its final report (2019, p.196) was "*not persuaded that it is necessary to mandate structural separation between product and advice"*, within Australian financial conglomerates with high degrees of vertical and horizontal integration. In the Cuffelinks' survey of 850 industry professionals (Bell, 2019), "*71 percent thought Hayne had erred in not addressing vertical integration*". This was also the view expressed by many notable individuals, including well-known journalists, past regulators and politicians such as ex-Prime Minister Paul Keating.

Most people understand that monopolies and oligopolies are uncompetitive and consider them as undesirable in the free markets described by Adam Smith. The existing situation is therefore inconsistent with the free-market neoliberalism espoused by the Australian Treasury which largely wrote the HRC final report. Regulation has the intended or unintended consequence of organizing competitive looting by the major banks and other conglomerates.

Competitive Looting

Profit competition in the Australian financial system does not lead to price competition as taught in economics textbooks. The oligopolistic system of conglomerates is a perfect regulatory arrangement for competitive looting of consumer wealth. Oligopoly is probably worse than a monopoly which has no competitive incentive to loot consumers for the greatest profit. Nowhere is the conglomerate structure more clearly damaging to consumers than in Australian superannuation. Over the decades, hundreds of billions of dollars have been transferred excessively, without economic justification, from workers' savings to the financial institutions, particularly the major banks.

The *Retail* funds run by the major banks use the conglomerate structure to extract fees as indirect costs from the investment processes which involve multiple intermediaries. These indirect costs are "invisible" to superannuation regulation because only costs paid directly by superannuation funds are considered as costs reportable to the regulator APRA. However, the inconsistency between reported costs and the net returns to beneficiaries was noted from APRA data as early as 2006.

In a first major review, "Celebrating 10 years of superannuation data collection 1996-2006", APRA (2007, p.14) has already noted:

> *…there were **systematic differences in return** by functional classification during the 1996 through 2006 decade. Corporate funds performed a little better, and **retail funds and ERFs much worse, than public sector and industry funds**. This performance is calculated after expenses and taxes.*

Emphasis has been added. In 2006, retail funds, managed mostly by the major banks, had about a third of all superannuation assets.

The systematic differences were further investigated and confirmed. They were found to originate from conflicted governance where many trustee directors of *Retail* funds had associations with related-party service providers (Sy et al., 2008). The directors had conflicts of interests between making profits for shareholders and servicing the beneficiaries of their funds. The preference was given generally to the interests of shareholders who were able to reward their directors.

APRA did not act on this research which indicated a breach of the *SIS Act* which is supposed to protect the interests of beneficiaries. Instead, APRA "shot the messengers" and eventually closed down the research unit. More than a decade later, the looting of superannuation by the major banks is still continuing. The *status quo* has been maintained and real change has been prevented or delayed by a sequence of fake inquiries and reviews which were limited by their terms of reference.

Most recently the HRC was similarly limited in being able to expose fake regulation. The HRC final report saw no problems with superannuation trustees who are seeking to make profits while having the fiduciary duty of looking after the money of their funds. The HRC final report (2019, p.237) recommended no action:

> *The most radical response to address difficulties encountered by the trustees of for-profit superannuation funds would be to prohibit, or at least inhibit, the carrying on of a superannuation fund for profit. For the reasons that follow, I do not favour proposals of that kind.*

The reasons given are superficial: "*most radical*", "*a very large step*", "*reduce competitive forces*" etc. They do not adequately address its admission: "*I accept that the trustees of for-profit funds encounter particular difficulties in the performance of their duties*". Decades of violating superannuation law elicited no response, because system structure was not properly investigated by the HRC.

Wilful Ignorance

The annual transfer of tens of billions of dollars from superannuation generates abnormal profits for bank shareholders, even after paying well for the financial services industry. In wilful ignorance, funding for named professors of banking and finance, for selected academic research projects and for prestigious journals for publication, ensures that university graduates are indoctrinated with a belief in economic rationalism, free and efficient markets.

Academic research in superannuation is based on finance theory which assumes efficient markets with perfect information and costless transactions. Theoretically, the differences in investment performance are explained entirely by risk-return trade-offs of different asset allocations, according to individual investor preferences. Fraud, misconduct, high fees and indirect costs are irrelevant in academic research because rational markets are assumed to behave "as if" misconduct does not exist.

Consultants regularly publish the "best in show" beauty parades of superannuation product performances, creating a selection bias and a misleading impression. Generally, the public has had an erroneous perception of good performance of the superannuation system. The Government and the Australian Treasury have encouraged this false confidence. For decades, the poor performance of Australian superannuation has been masked by biased research that the system is considered unquestionably good, until recently when the fake image was tarnished by the fraud and misconduct exposed in the HRC.

An example of the general ignorance of how superannuation works can be seen in a misguided attempt by ASIC (2017) to enhance disclosure of fees and costs of superannuation products through the requirements of Regulatory Guide No.97 (RG 97). As mentioned above, many fees and costs of *Retail* funds are invisible because they are incurred through deducting from investment returns by service providers inside the conglomerates. Major Banks can therefore declare misleadingly low costs for their superannuation funds. Other funds, such as *Industry* funds, without associated service providers, have to declare accurately much higher costs. Hence through RG 97 disclosure, ASIC regulation misleads the public.

After years of self-delusion, it would be too big a shock for the recent inquiry of the Productivity Commission (2019) to report that Australian superannuation, instead of being "one of the best" systems in the world, may be "one of the worst", at least in terms of investment performance. The typical evidence for the optimistic assessment is the $2.8 trillion of accumulated total assets, which are one of highest relative to GDP in the world. However, this amount is mainly due to the enormous amount compulsory contributions made over the past twenty years, not due to good investment performance, despite several periods of high asset price inflation over the period.

Rigging the Laws

Many billions each year are extracted by fee gouging and other forms of financial misconduct in superannuation, which are against the law. In just ten days of public hearings on superannuation, the HRC exposed some misconduct leading to indirect costs for investors. For example, an investment in the superannuation cash option of a major bank may provide substantially lower returns than from a simple bank deposit in the same bank. Internal operations of conglomerates are structured to pass transactions from one business unit to another, racking up indirect costs which are invisible externally. Charges are made silently and automatically by computer algorithms.

Not only did the regulators not stop the law breaking as evident from the lack of enforcement, the regulators and Australian governments actually attempted to change the laws to facilitate the competitive looting. Regulation has been rigged to damage public interests. All sorts of attempts have been made to pass laws which favour the big banks and prevent genuine competition, including:

- Maintaining oligopoly by requiring sufficient size as a criterion for managing money of superannuation, thus excluding new competitors;
- Giving bankers control of superannuation trustee boards which must have "independent" directors with financial and investment expertise;
- Saving insolvent banks by legally allowing the conversion of bank deposits (bank liabilities) to common shares (bank assets) when needed.

Time and time again, economies of scale have been used as arguments in favour of mergers and acquisitions to create corporate monsters, yet it is well-known in textbooks and in life that monopolies and oligopolies are detrimental to price competition and harmful to consumers. There was an attempt to prohibit smaller funds from offering default MySuper products for workers' superannuation. However, the attempt to introduce a scale criterion in the *Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012* failed because it was revealed that some of largest *Retail* funds operated by major banks have consistently and persistently performed poorly over long periods of time.

Despite being the largest sector, *Retail* funds have gradually lost relative market share to *Industry* funds which have had consistently better investment performance. However, the trustee boards of *Industry* funds are populated mostly by directors representing blue-collar employers and employees. Hence the big banks and the financial services industry do not control the trustees of *Industry* funds, which is an important reason why they perform so much better than *Retail* funds.

To pry open the boards of *Industry* funds, APRA and the Government declared that *Industry* fund directors are not "independent" because their interests are aligned with the members of their own funds. Instead, "independent" directors are defined as non-aligned investment experts such as those on the boards of *Retail* funds populated mostly by bankers and related-party service providers. Even though APRA's own research (Sy et al., 2008) had shown that *Retail* directors have multiple conflicts of interests between themselves as agents, and shareholders, and beneficiaries, it did not stop the Government from trying to put "foxes in the henhouse".

Against sound governance principles, APRA and the Government proposed in November 2017 the *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017* which requires a trustee of an APRA-regulated superannuation fund to have an "independent" chair and at least one-third "independent" directors. Fortunately, the Bill was shelved when the HRC was called soon after the introduction of the Bill. The subsequent findings of the HRC on superannuation have shown how unsound and corrupt is the proposed legislation. The HRC final report (2019) should have recommended banning for-profit superannuation trustees due to proven unmanageable conflicts of interest of "independent" directors.

A successful attempt at rigging the law to save insolvent banks occurred when the *Financial Sector Legislation Amendment* (*Crisis Resolution Powers and Other Measures*) *Act 2018* was enacted in February that year in an empty senate chamber, where most senators were absent and unaware that such a law was passed. In the name of financial system stability, the legislation allows APRA discretionary powers to act secretly to save an insolvent bank. The provisions include the power to convert bank liabilities to assets in the form of common bank shares. The liabilities are a range of financial instruments, defined broadly enough to include bank deposits. This action of confiscating bank deposits to save an insolvent bank is commonly referred to as "bailing-in a bank" or a "bank bail-in".

While the Government officially denied the legislation includes "bail-in", Senator Amanda Stoker, a legal expert explained later in a letter to one of her constituents:

> *The legislation facilitates bail-in as a type of resolution power which is available for dealing with financial institution distress. This was done after the G20 leaders endorsed a new Financial Stability Board standard for Total Loss-absorbing Capacity. Specifically, it builds on the Key Attributes which specifies that Financial Stability Board jurisdictions should have in place legally enforceable mechanisms to implement a bail-in. The purpose of the Total Loss-absorbing Capacity standard*

ensures there are mechanisms in place to stop the 'domino effect' and reduce loss on [sic] bank shareholders, creditors and the Government.

The regulatory system was never designed specifically to protect the consumers or the community at large. It was designed to protect and to organize the industry to ensure a stable financial system. The rationale is that without a prosperous industry, a stable financial system cannot be guaranteed and without a stable system, consumers and the community would suffer.

Ripping off consumers to have a stable banking oligopoly has become justifiable and the Government has been actively rigging the laws to facilitate the looting. The increasing wealth inequality in Australia is not due to capital accumulation from economic production, but due to looting in the financial system. Regulation has led to "bail-ins" and "bail-outs" as mechanisms for systemic looting which exploits the lack of risk separation in the flawed structure of the financial system. The HRC was forbidden by its terms of reference to recommend structural changes to the system, such as breaking up the major banks in the manner of the US *Glass-Steagall Act*.

Flawed Systems

The Australian regulatory system is a flawed system, like others. Fake regulation or Clayton's regulation is the regulation you have when you are not regulating. Fake regulation is worse than "honest to goodness" overt deregulation, because the regulators actually serve, by making deals with big banks, to hide misconduct and fraud from public view. The HRC has exposed this to a limited extent – but much more serious problems beyond HRC have yet to be exposed.

The fatal flaws in the global financial system were demonstrated in the GFC, suggesting failures of the Bank for International Settlement (BIS), the IMF and other global financial regulators. Yet governments and regulators have ignored those important lessons and pretended that nothing fundamental has gone awry. There have been only piece-meal fake reforms, such as the Basel III framework and the US *Dodd-Frank Act* which do not address the fundamental flaws.

As if to emphasize that the *status quo* approach to regulation is sound, the Nobel committee awarded a third of the 2013 *Sveriges Riksbank Prize* in economic "sciences" to Eugene Fama for the efficient market hypothesis (EMH) for explaining asset prices. Essentially, EMH asserts that market prices fully reflect all available information. The implication for regulation is: if all markets have fair prices which automatically adjust to all available information, then all transactions at market prices are fair – regulation is unnecessary.

Therefore, under the finance taught at universities, investor complaints are baseless, probably due to regret that they have taken calculated risks which did not pay off. For example, as mentioned above, the poor performance of *Retail* superannuation funds was explained by the assumption that it was due to investors in those funds being more conservative, taking less risk. This was the accepted explanation for decades and the academic solution was to educate more investors to overcome their behavioural biases. Changing investor behaviour is now a major area of research called "behavioural finance".

More “Nobel Prizes” were awarded to cement this behavioural interpretation which has only recently been challenged in Australia by the findings of the Productivity Commission (2019) and the HRC (2019). Victims of fraud and misconduct were not necessarily uneducated and market prices did not reflect all available information, some of which had been held back deliberately by the regulators.

The EMH and much of economics and finance taught at universities are based on erroneous interpretations of the workings of the free markets of Adam Smith (Sy, 2018). The EMH together with the fall from grace of Keynesian economics in the stagflation of the 1970s led to the creation of neoclassical economics (Lucas and Sargent, 1978) which is a revival of classical economics with mathematical modelling.

The Australian System

Neoclassical economics underpins economic rationalism or neoliberalism which is the paradigm embraced by the Australian government and particularly the Treasury. Neoclassical economics is the intellectual foundation for globalization and financial deregulation since the 1980s. The fake regulation discussed above is a step in the process of deregulation started in Australia with the Campbell Inquiry (1981, p.1) which stated:

> *The Committee starts from the view that the most efficient way to organise economic activity is through a competitive market system which is subject to **a minimum of regulation** and government intervention.*

Emphasis has been added. The assumption continued later in the Wallis Inquiry (1997, p.18):

> *Where industry standards and performance suggest that the most practicable method involves **self-regulation** or coregulation, such methods should be preferred.*

Ignoring the potential cost of regulatory failure, the Wallis Inquiry (1997, p. 21) used lower cost as the rationale for less regulation and for structural separation from the RBA of a regulatory entity which later became APRA:

> *Such an entity will be better placed **to reduce the intensity of regulation, and so lower its cost**, in the likely event that new technologies or other developments facilitate a reduction in systemic risk.*

Emphasis has been added. The current *Department of Finance* was called the *Department of Finance and Deregulation* until 2013 with a special deregulation group to implement the government’s deregulation agenda of reducing cost or “regulatory burden”.

Regulation is seen as a “friction cost” which hinders the workings of free markets. The Australian system has been designed with weak regulators. Australian economic policy is determined by where the major banks make the most profits, with limited government intervention dictated mostly by politics.

The US System

Given that neoclassical economics originated in Chicago, it should not be a surprise that the US is the leader in the system of fake regulation. For example, his nomination as chair of the US Federal Reserve in 1987, Alan Greenspan (2007, p.372) confessed:

> *Avid defender though I was of* ***letting markets function unencumbered****, I knew that as chairman I would also be responsible for the Fed's vast regulatory apparatus. Could I reconcile that duty with my beliefs?*

Emphasis has been added. As it happened, his "*libertarian opposition to most regulation*" did not cause conflicts, because regulation was widely accepted as unnecessary. On taking charge of the Fed, Greenspan (2007, p.373) later confirmed:

> *What I had not known about was the staff's free-market orientation, which I now discovered characterized even the Division of Bank Supervision and Regulation*.

That is, fake regulation was well entrenched in the US system by 1987. For thirty years, Alan Greenspan was the "top dog" regulator in the global financial system and nearly everyone admired him and emulated him. Everyone loved the asset bubbles he created, but to Greenspan (2007, p.367) it was the miracle of the market:

> *As I saw it, from 1995 forward, the largely unregulated global markets, with some notable exceptions, appeared to be moving smoothly from one state of equilibrium to another. Adam Smith's invisible hand was at work on a global scale.*

In his *mea culpa* speech before the Committee on Oversight and Government Reform of the US House of Representatives in 2008 to explain the GFC, Alan Greenspan held firm:

> *My judgment is that free, competitive markets are by far the unrivalled way to organize economies. We have tried regulation, none meaningfully worked...*

However, he admitted that his model was flawed:

> *I found a flaw, I don't know how significant or permanent it is, but I have been very distressed by that fact…*
>
> *I found a flaw in the model that I perceived is the critical functioning structure that defines how the world works, so to speak.*

More than ten years on, nothing much seems to have been done to correct the flaw found by Alan Greenspan who presided over much of the era of financial deregulation. The financial services industry pretends that the GFC never happened and the regulators introduced cosmetic reforms. The universities continue to lobotomize future leaders with the same economic fallacies. The economic paradigm enabled a fraudulent global financial system (Sy, 2014), because the paradigm is not the system.

Conclusions

Alan Greenspan was never explicit about what was the flaw he found in his model. One thing is clear: today's complex financial markets bear little resemblance to the simple markets of Adam Smith, 250 years ago. Economists have never understood that there was a moral presupposition for free markets (Sy, 2018). Simple markets require little regulation and behave *as if* they are moral, because simple markets require limited information to operate efficiently. Financial markets are different because they require complex information which investors often struggle to comprehend. The government bureaucracy cannot continue to pretend to regulate complex financial markets with its current system.

Australian financial markets are evidently not the competitive markets of economic textbooks, as they are dominated by monopolies and oligopolies. Instead of breaking them up to improve competition, the Government and the regulators have rigged the laws in favour of major banks to entrench oligopoly, apparently to ensure financial system stability. Perhaps, this is the way regulators have sought to simplify regulation for stability which has come at heavy economic costs.

All the while, regulators use the concept of working "behind the scene" or "behind closed doors" to hide fake regulation and fool the public. Government bureaucracies have inherent limitations as described above. The recommendations of the HRC, even if all implemented, will not make sufficient difference. For regulation to be effective it must be simple, open and public, not complex, secretive and private, as is required by well-informed free markets. Everyone needs to know the law clearly and have confidence that the regulators are deterring wrongdoers and warning potential victims.

Fake regulation is a farce because the regulators appear publicly to be either inactive (from complainant experiences) or highly effective (from media propaganda), depending on your preferred view. Neither conclusion is correct or helpful to the community. If the regulators were believed inactive then there is no deterrent for the would-be wrongdoers. If the regulators were believed to highly effective, then consumers could lower their guard and forget "*caveat emptor* still exists in the system", as Wayne Byres reminded the Australian Senate: "buyers beware"! Fake regulation has neither deterred wrongdoers nor protected consumers – the worst possible outcome.

There has been little serious acknowledgement that regulation has failed badly for decades and that the new attempts at regulation will make no fundamental difference. Just because the regulators have promised to be more active in doing this or that, does not mean they will do so or that they will succeed. It took decades to have a royal commission to show that there has been little regulation, but the politicians have not understood the farce of fake regulation described in this paper. Fundamentally, Australian regulation has put the interests of the system ahead of the community which it is meant to serve. This needs to change. The Australian Treasury played a "dirty trick" in the HRC final report in recommending against structural changes (Sy, 2019) which are demanded by popular opinion (Bell, 2019).

The evidence provided above indicates that complex regulation is either impossible or impractical. The Australian regulators have little independent knowledge of the Australian or the global financial system and are incompetent by design. The easiest and most effective step to take now is to separate structurally the financial system in the manner of the US *Glass-Steagall Act*. The separated system worked well before 1999 when the Act was mistakenly repealed. Operationally, it is not difficult for conglomerates to separate by spinning off business units because they are already run as separate businesses any way. Indeed, following HRC, some have already sold off business units. Three important benefits can be recovered by banking separation:

- Trust in traditional commercial banks can be restored and bank deposits can be protected at financial institutions, as were the original intentions of the *Banking Act 1959*.

- Economic stimulus can be targeted accurately to traditional banks for the real economy, rather than indirectly to investment banks for financial speculation. Australia can reclaim economic sovereignty by decoupling economically important banking from financially speculative banking controlled by international bodies.
- Financial regulation will be simplified and effective because it will be enforced. Separation will encourage financial innovation in investment banking without jeopardizing the whole economic system.

Fake regulation is a farce; it needs to stop. The failure of the global financial system has been seen wrongly as a failure of capitalism and the world is being pushed misguidedly towards socialism, particularly in the UK and the US. These failing systems including that of Australia are not really capitalism, because they are capitalism for the few and socialism for everyone else. The failures are due to government sanctioned oligopolies which have captured the regulators.

References

APRA (2007): "Celebrating 10 Years of Superannuation Data Collection 1996-2006", *APRA Insight* Issue 2, 2007 (Special Edition); available at: http://www.gtm.apra.gov.au/Insight/Documents/07-Insight-issue-2.pdf

ASIC (2016), "Financial advice: fees for no service", *Report 499*, October 2016; available at: https://download.asic.gov.au/media/4054607/rep499-published-27-october-2016.pdf

ASIC (2017), "RG 97 Disclosing fees and costs in PDSs and periodic statements", available at: https://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-97-disclosing-fees-and-costs-in-pdss-and-periodic-statements/

Campbell Inquiry (1981), *Australian Financial System, Final Report of the Committee of Inquiry*, September 1981, The Treasury Library; available at: https://treasury.gov.au/publication/p1981-afs/

Crozier, M. (1963), *The Bureaucratic Phenomenon*, The University of Chicago Press, Chicago.

Bell, L. (2019), "Royal Commission survey: 12% very satisfied", *Cuffelinks Survey*, 20 February 2019; available at: https://cuffelinks.com.au/royal-comm-survey-responses/

Frost, J. (2019), "IMF says ASIC and APRA should lift their game on data and analysis", *The Australian Financial Review*, 22 February; available at: https://www.afr.com/business/banking-and-finance/imf-says-asic-and-apra-should-lift-their-game-on-data-and-analysis-20190222-h1bl3b

Greenspan, A. (2007), *The Age of Turbulence*, The Penguin Press, New York.

Greenspan, A. (2008), "The financial crisis and the role of Federal regulators", Transcript of Hearing before the *Committee on Oversight and Government Reform, House of Representatives*, 23 October, 2008; available at: http://www.gpo.gov/fdsys/pkg/CHRG-110hhrg55764/html/CHRG-110hhrg55764.htm

HRC (2019), *Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, Commonwealth of Australia; available at: https://financialservices.royalcommission.gov.au/Pages/reports.aspx#final

Lucas, R. and Sargent, T. (1978), "After Keynesian macroeconomics", presented at a conference sponsored by the Federal Reserve Bank of Boston, June 1978) and published in *Quarterly Review of the Federal Reserve Bank of Minneapolis* , Vol.3, No.2, 1979; available at: https://www.minneapolisfed.org/research/qr/qr321.pdf

Mises, L. v. (1944), *Bureaucracy*, Editorial Edition, Liberty Fund, Inc., Indianapolis, 2007.

CEC. (2017), "How can Australian government make policy without accurate data on mortgage lending?" *Australian Alert Service (Citizens Electoral Council Publication)*, Vol.19, No.39, pp.4-5.

Production Commission (2019), *Superannuation: Assessing Efficiency and Competitiveness*, *Productivity Commission Final Report*, Commonwealth of Australia; available at: https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf

Smith, A. (1776), *The Wealth of Nations*, Fifth Edition, Bantam Dell, New York, 2003.

Sy, W., Inman, C., Esho, N. and R. Sane. (2008). "Superannuation fund governance: trustee policies and practices", *APRA Insight*, Issue 1, 2008: 1-17, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2050348

Sy, W. (2014), "Implications of the global financial crisis", *Journal of the Economics and Business Educators NSW*, Issue No. 2, 2014, pp. 26-34; available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2520661

Sy, W. (2018), "A science of markets: the moral dimension of the invisible hand"; available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3254087

Sy, W. (2019), "Treasury's dirty trick in Hayne's report", *Australian Alert Service*, Vol. 21, No. 6, p.5; available at: http://cecaust.com.au/releases/2019_02_07_Wilson_Sy_Treasury.html

Taibbi, M. (2011), "Is the SEC Covering Up Wall Street Crimes?", *Rolling Stone Magazine*, 17 August, 2011; available at: https://www.rollingstone.com/politics/politics-news/is-the-sec-covering-up-wall-street-crimes-242741/

Wallis Inquiry (1997), "The financial system: towards 2010", *Overview and Recommendations of the Financial System Inquiry Final Report*; available at: http://fsi.treasury.gov.au/content/downloads/FinalReport/overview.pdf