

Mr John Lonsdale  
Head of Secretariat  
Financial System Inquiry  
The Treasury  
Langton Crescent  
Parkes, ACT 2600  
3 December 2013

**Re: Submission to The Financial System Inquiry regarding its Draft Terms of Reference**

Dear Mr Lonsdale

Professor O'Brien is Director of the Centre for Law Markets and Regulation (CLMR) at UNSW Law, The University of New South Wales and Dr Gilligan is a Senior Research Fellow at the CLMR. Please find below our joint submission which is made in a personal capacity, regarding the draft terms of reference for the Financial System Inquiry to be chaired by Mr David Murray AM.

We hope that this submission assists the Committee in their deliberations. If you require further information please contact us.

Yours sincerely

Justin O'Brien and George Gilligan

Professor Justin O'Brien & Dr George Gilligan  
Centre for Law, Markets and Regulation, UNSW Law, The University of New South Wales

## Submission to the Financial System Inquiry re its Draft Terms of Reference

We welcome the establishment of the Financial System Inquiry in November 2013 through the publication of its Draft Terms of Reference (TOR) and we hope that this submission assists inquiry members, the secretariat and the government as they finalise the inquiry's TORs. This inquiry follows the highly influential Wallis Inquiry of 1996-1997 which laid out the framework for Australia's largely successful (in comparison to many overseas counterparts), *Twin Peaks* approach to financial regulation.<sup>1</sup> Preceding Wallis was the Campbell Inquiry, which recommended substantial financial deregulation within Australia.<sup>2</sup> The current inquiry has been established as the world economy slowly recovers from the damage wrought by the Global Financial Crisis (GFC). The GFC illustrated dramatically that poor operational culture in business organisations, especially banks, can have devastating impacts beyond business bottom lines and across social and political structures. It is questionable just how robust the contemporary global economy would be if faced with another GFC any time soon and that possibility is by no means a far-fetched scenario. So, a key challenge for all associated with, and affected by, the financial sector, which in this day and age is just about everybody, is what potential is there to re-cast operational cultures in business, especially in the financial sector?

Culture can be simultaneously local and general. Similarly the financial inquiry's draft TORs have both a local and general focus, because the Australian financial sector is so integrated with, and dependent upon, the international financial sector. So for example, improvements in Australia's growth and competitiveness (TOR 1), efficiency, risk management, innovation and financial regulation (TOR 2), technological impact, international integration, corporate governance capital sourcing and distribution (TOR 3), systemic financial stability and productivity (TOR 4) can only be made locally in Australia if they have synergy with market realities internationally. Similarly, those market realities internationally, especially normative influences such as prevailing operational cultures within financial sector actors shape how financial business is carried out in Australia and what benefits such financial business can bring to Australia as per the inquiry's draft TORs specified above. Australia as a jurisdiction with not only a robust financial regulatory infrastructure, but also an economic profile which has allowed it to survive and deal with the GFC's effects better than most other nations, so it is well-placed to make a substantial contribution to discourses on how operational cultures in financial sectors can be improved both nationally and internationally.

We would strongly recommend to the inquiry that it examines how operational cultural norms within the financial services sector determine the levels of integrity, manageable risk and accountability that may be achieved in capital markets.<sup>3</sup> In doing so the inquiry would be responding to the challenge of Melbourne University's Professor Ian Ramsay that such inquiries: '...should look at how to create the right sort of culture - one that encourages innovation but not at the cost of mis-selling financial products.'<sup>4</sup> It is hard to argue against

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<sup>1</sup> Treasury, *Financial System Inquiry, Final Report*, 1997, <http://fsi.treasury.gov.au/content/FinalReport.asp>

<sup>2</sup> Treasury, *Australian Financial System: Final Report of the Committee of Inquiry*, September 1981, Australian Government Publishing Service, 1981

<sup>3</sup> See J. O'Brien and G. Gilligan, 'Regulating Culture: Problems and Perspectives', (2013), Introduction in *Integrity, Risk and Accountability in Capital Markets: Regulating Culture*, J. O'Brien & G. Gilligan (eds), Hart Publishing, Oxford, pp.xv-xxx, <http://www.hartpub.co.uk/pdf/samples/9781849465670sample.pdf>

<sup>4</sup> R. Gluyas, 'Ramsay says that proposed financial inquiry should look at bank culture', *The Australian*, 17 June 2013, <http://www.theaustralian.com.au/business/financial-services/ian-ramsay-says-a-proposed-financial-inquiry-should-look-at-the-banking-culture/story-fn91wd6x-1226664710509>

the innate good sense and truth in such a statement and we hope that the inquiry will give this issue due consideration.

Professional, structural and cultural embeddedness condition the interplay of regulatory authority and regulatory responses and contemporary regulatory conditions shape future regulatory structures. Consequently, ingrained cultural forces can distort perceptions within organisations about risk and incentives, especially in the hyper-competitive environment of finance which may adapt ever-increasing matrices of risk as the norm.<sup>5</sup> Moreover, the complexity of modern finance and globalized, fragmented chains of command governing the production and dissemination of specialized knowledge increases the information asymmetry risk. As a consequence, the risk that the unscrupulous will take advantage of what the economist David C. Rose has termed the ‘golden opportunities’ of deception is increasing.<sup>6</sup>

If countries such as Australia are going to have a sustainable and efficient financial sector it is essential to build the governance of that sector on an explicit normative foundation. This is not merely a matter of ethereal academic debate or conceptual modelling. It is a truism recognised, if not implemented by senior financial regulators. For example, in March 2010, then Chief Executive of the UK Financial Services Authority (FSA), Mr Hector Sants stated:

‘We need to answer the question of whether a regulator has a legitimate focus to intervene on the question of culture. This arguably requires both a view on the right culture and a mechanism for intervention. Answering yes to this question would undoubtedly significantly extend the FSA’s engagement with industry. My personal view is that if we really do wish to learn lessons from the past, we need to change not just the regulatory rules and supervisory approach, but also the culture and attitudes of both society as a whole, and the management of major financial firms. This will not be easy. A cultural trend can be very widespread and resilient—as has been seen by a return to a ‘business as usual’ mentality. Nevertheless, no culture is inevitable’.<sup>7</sup>

Mr Sants left the FSA before meeting the culture challenge within and without the UK financial sector. The FSA has also disappeared as an entity, a casualty of post-GFC financial regulatory re-engineering within the UK and it has been replaced by the Financial Conduct Authority (FCA). The culture challenge has not disappeared though, as acknowledged in a speech in November 2013 by FCA Chief Executive Mr Martin Wheatley, who also serves as joint chair of the IOSCO taskforce on benchmark regulation:

‘The FCA is firmly at the heart of the global regulatory landscape, and is here to drive forward a changing global agenda that emphasises conduct and culture. A lot of the work since the crisis has focused on strengthening the resilience of our institutions and infrastructure. As

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<sup>5</sup> DC Langevoort, ‘Chasing the Greased Pig Down Wall Street: A Gatekeeper’s Guide to the Psychology, Culture and Ethics of Financial Risk Taking’ (2011), 96 *Cornell Law Review*, 1209.

<sup>6</sup> DC Rose, *The Moral Foundations of Economic Behavior* (New York, Oxford University Press, 2011) 16; see also P Pettit, ‘Republican Reflections on the Occupy Movements,’ in F O’Toole (ed), *Up the Republic* (Dublin, Faber & Faber, 2012), 169–81 (noting ‘it is a sad fact of human nature that while not many of us might be corrupt, not many are incorruptible; when opportunity offers not many are capable of resisting the temptation to make a quick buck. The timber may not be rotten but it is crooked.’ at 177).

<sup>7</sup> See H Sants, ‘*Annual Lubbock Lecture in Management Studies*’ (Speech delivered at Said Business School, University of Oxford, March 12, 2010).

this work nears completion, the spotlight is shifting. It is shifting towards market practices, industry culture, and individual behaviour.’<sup>8</sup>

The above quotes demonstrate that the thorny normative challenges presented by the inter-dependent relationship between market integrity and industry culture are acknowledged in both national and international fora. The financial system inquiry is an opportunity for Australia to acknowledge the inextricable links between delivering *a well-functioning financial system* (TOR 2) and the prevailing industry behaviours and standards that in reality will, as they always have done, constitute that financial system. Importantly this inquiry is an opportunity for Australia to articulate normative benchmarks for organisations and individuals operating in the financial sector that will substantively improve the stability, risk management and governance of the Australian finance sector that in turn will promote its competitiveness and efficiency in capital allocation (TORs 1,2,3,4). We hope that the inquiry to be chaired by Mr David Murray takes up this opportunity through its inquiry processes and final report scheduled to be delivered to the Treasurer by 1 November 2014.

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<sup>8</sup> Modelling integrity through culture, *Speech by Martin Wheatley, Chief Executive of the FCA, at the FCA Markets Conference*, 19 Nov 2013, <http://www.fca.org.uk/news/firms/modelling-integrity-through-culture>