More Regulation Is Not The Solution To Westpac Revelations

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Yet another scandal among Australia's banks suggests the industry is in dire need of a clean-out. Westpac has committed one of the most startling failures of corporate governance in Australian history. After a year-long investigation, the bank stands accused of failing to report, as required by law, 23 million transactions that it had facilitated, and, in particular, failing to notice a series of suspicious transactions originating from South-east Asia that have been implicated in child exploitation.

The consequences for Westpac continued to mount. The bank is expected to be fined more than $1 billion. It lost $6 billion in market capitalisation, or 7 per cent of its value. Its chairman and chief executive have both resigned. All of this is fair enough. The allegations are extremely serious and, if proved, demonstrate an almost-incredible negligence.

Inevitably, these facts raise the question of whether a policy response is required, and what kind. Given the recent Hayne inquiry into various kinds of malfeasance by Australia's banks, it would be understandable if the first recourse that comes to political minds is more legislation or regulation.

But this would be a mistake.

Banks, as unsympathetic as they are, already labour under the weight of a substantial regulatory burden: apart from the various civil and criminal laws to which they are subject, Institute of Public Affairs research has shown that banks and the finance industry are governed by 76,000 pages of regulatory dark matter, referring to legislative instruments and bureaucratic guidance. An earlier report by Deloitte found that one in 11 Australian workers is employed in compliance, with the number in finance estimated to be even higher.

None of this amounts to a defence of Westpac, but it suggests that Australia's banking industry does not suffer for a lack of rules. Instead, the better question is: why are Australia's banks so bad? We ought to consider whether all of these scandals point to a systemic problem.

To begin to answer this question, note first that the big banks, and big business generally, welcome regulation and actively co-operate in its creation. For example, the act under which Westpac was charged was passed in 2006 after extensive consultation with the sector, and in particular with the then Australian Bankers' Association. For big businesses, it is well understood that compliance can be useful for limiting competition from smaller rivals that are less able to bear the associated costs. They have little incentive, then, to adopt an adversarial approach to regulators.

For this reason, it is not surprising that a 2018 Grattan report found businesses in heavily regulated industries put more effort into lobbying than other businesses. It might be thought that this effort is towards deregulation. But if that is the case, then it is the least successful lobbying operation in history. The simpler explanation is that this effort is towards self-interested regulation.

In the case of banking, the most obvious self-interest is the perpetuation of Australia's anti-competitive cartelisation of the industry. The "four pillars" policy prevents mergers between Australia's biggest four banks. Despite the Productivity Commission last year advising that the policy be dropped, it has the support of the now Australian Banking Association. Its chief executive, former Queensland Labor premier Anna Bligh, told the ABC after that report came out that the policy had contributed to stability, which necessarily has to be traded off against competition in the marketplace.

This aversion to competition can also be attributed to the growing role of institutional investors, such as super funds. Super funds value stability over growth because their product is low-risk guaranteed returns to members. Not coincidentally, the removal of Westpac chief executive Brian Hartzer reportedly followed a meeting with Australian Council of Superannuation Investors chief executive Louise Davidson. Her organisation represents all of the major super funds, which control $2.2 trillion of capital, much of which is invested in blue chip Australian companies like the banks. Super funds own an average of 10 per cent of every ASX 200 company.

The banking industry, then, has been deliberately constructed – by government, its practitioners and its investors – to prefer regulation and stability to competition and dynamism. This is the context within which the recent scandals have occurred. It is an industry that knows that no matter what it does, it has the protection of its powerful friends. So it feels at liberty to behave badly, or negligently. As risk analyst Nassim Taleb would say, Australia's banking industry has no "skin in the game" – and its performance is worse for it.

Any policy response should target this insularity by instilling some competitive discipline into the industry. The alternative is more regulation and more compliance costs. But if the root cause of Australia's banking problems is that the banks, the regulators, the government, the lobby groups and so on are all in it together, then further regulation should be seen for what it is: the ruling class closing ranks.

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