Hayne, ASIC, banks, penalties and the price of shifting risk

Richard Harris on the impact of the preoccupation with banking mistakes

History abounds with examples of problems to which a disproportionate solution creates unintended collateral or new problems.

Anti-bank sentiment in Australia in the wake of the 2018 Hayne Royal Commission into Financial Sector Misconduct seems likely to continue in that tradition, with the effect that the cure from the collective preoccupation with bank mistakes over the past few years might well be worse than the disease.

The difficulty, in part, stems from an overstatement or mischaracterisation in some quarters of the nature of the problem to be addressed. Of course, the issues considered by the Banking Royal Commission were serious, in many instances harmful to customers and rightfully the subject of attention and rebuke from the Commission. That said, of the issues considered by the Commission involving the major banks, only a small proportion were apparently deliberate and fewer still involved dishonesty. It's not that there were not problems, it's just that the issues were mostly something other than intentional. Despite the true nature of most of the issues considered, much of the political and regulatory response assumes that somehow the Royal Commission categorically established some overarching immorality within banks. It did not.

A confluence of that rhetoric with a number of other factors, in particular:

- Commissioner Hayne's advice to the Australian Securities and Investments Commission (ASIC) to the effect that ASIC should pursue litigation as a first response to issues that arise. In essence, when a breach arises ASIC should ask itself 'why not litigate?'; and
- recent amendments to the regime of penalties applicable to breaches of the banking and corporations laws which significantly increase the consequences of engaging in misconduct,

seems likely to have profound unintended impacts on the sector and the economy and will fall hardest on the economy and parts of the community least able to bear it.

First, there is the theme throughout the Royal Commission to the general effect that ASIC has been insufficiently tough on the banks and that they should adopt a 'litigate first' approach to enforcement. While ASIC was initially and justifiably incredulous at the suggestion (given the cost, complexity and uncertainty of litigation and an inherent understanding of the lack of utility of using penalty litigation to address inadvertent misconduct), ASIC's public statements tend now to indicate that it has come around to the Hayne enforcement model.

Second, earlier this month, off the back of perceived issues arising in the Royal Commission, an omnibus parcel of amendments to a number of acts passed Parliament under a bill titled 'Strengthening Corporate and Financial Sector Penalties'. Importantly, the Hayne Royal Commission into Financial Sector Misconduct did not identify laxity as a cause of the misconduct it observed and did not make any recommendation that penalties be increased. That is not surprising given there was no evidence

before the Commission that would justify such a conclusion or recommendation.

Despite the lack of any need being identified through the Commission process, the augmented penalties legislation passed in March 2019 very significantly alters that landscape. For individuals, civil penalties are now over AUS$1m per contravention. For corporates, maximum fines are the higher of AUS$10.5m, three times the value of any benefit gained or (significantly) 10% of the company's turnover (up to a maximum of AUS$525m). That is, the maximum fine for a contravention of a civil penalty provision has gone from AUS$1.8m to over half a billion.

Prison terms for some contraventions like dishonestly breaching directors' duties have now moved from five to 15 years (for perspective, assault causing death in New South Wales is 20 years).

Two other particularly important amendments to the law also came in through that process. First, the obligation that financial service and credit providers ensure that their services are provided 'efficiently, honestly and fairly', is now the subject of civil penalty. That is, the maximum fine has moved from zero to over half a billion dollars – per contravention. Second, the definition of dishonesty, which relates to a number of offences, has been amended to remove the need to show that the person was actually aware that they were being dishonest.

In short, an invigorated regulator, encouraged by the Commission to take a more adversarial approach to banks and pursue litigation as a default, is now armed with exponentially higher potential penalties and a lower bar to pursue those outcomes.

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In other words, banks and bankers are now exposed to much higher risks than ever and a greater probability of the risk eventuating. Banks understand that there are two responses to risk, either put a price on it or remove it. The rational response to a materially increased risk environment for banks is to manage or abandon areas of additional regulatory risk or charge more for taking it. That can only mean constraining credit decisions and abandoning more marginal segments. Economists will tell you (if any had been asked), that you don't need to do too much of that in an already slowing economy before it can create a big problem.

The next period in bank regulation will be a particularly challenging one, not just for banks but for regulators and legislators too. Great skill and restraint will be necessary on the part of all parties to make sure that rhetoric and misplaced or manufactured indignation do not inadvertently cause a retreat by financial institutions from risk that the economy depends on them assuming.

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