# RECENT DEVELOPMENTS - DEREGULATION OR REREGULATION

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## INTRODUCTION

The topic for this session lends itself to as many possible interpretations as did the capital gains tax provisions which recently bemused members of the High Court in **Hepples** case. I was glad, therefore, to be assigned the task of commenting on Mr Aitken's paper, which has so clearly defined the boundaries.

Mr Aitken's theme, sustained by apt references to Kipling's lines, is that we should beware of turning away from deregulation towards reregulation, as a panacea for the ills that have beset the financial and commercial world in the last decade. In that regard, his comparison of the experience in Hong Kong and Australia is particularly instructive. Neither reregulation nor deregulation, it seems, can be considered either a guarantee against, or an aider and abettor of, corporate collapse or commercial malfeasance. Whichever path is taken, mismanagement and peculation will continue to beset us "as surely as fire will burn". That cautionary note is not to be taken as a counsel of despair. Some things can be done. Mr Aitken's paper invites comment on a number of issues of a regulatory nature, which need to be addressed.

## BEFORE DE-REGULATION

Before accepting that invitation it may be useful to consider, in brief, some of the perceived benefits flowing from deregulation, and what, if any, disadvantages have accompanied them.

In a submission made to the Martin Committee in January 1991, the Reserve Bank of Australia described the "erosion of the regulated sector" as one of the pressures which led to deregulation: "The major beneficiaries of the restrictions on banks were finance companies, which increased their market share from 2% in 1953 to 9% by 1960, and permanent building societies, which grew from 2% in 1968 to 7% by 1978. In the late 1970s and early 1980s merchant banks also increased their share quite sharply, as did cash management trusts although their absolute size was a lot smaller".

The submission went on to point out that this shrinkage of the "controlled sector" had weakened the capacity of monetary policy to affect the economy, and meant that many borrowers had to go outside the banking system to obtain credit even though they were obliged to pay higher rates of interest than a bank loan. Depositors had also gradually moved more savings outside the banks in pursuit of higher interest rates, and investment and building society deposits, credit union deposits, bank-owned finance company debentures and cash management trust investments were increasingly

perceived by the public, rightly or wrongly, as offering virtually the same security as bank deposits.

Under a system of regulation, where interest rates on loans were controlled, it was understandable that banks would allocate their funds to the lowest risk borrowers. This conservative approach by banks to lending led to the rueful jibes that banks would only lend to people who did not need to borrow the money. It also resulted, of course, in the banks themselves diverting customers to bank-owned finance companies, which were not subject to the same borrowing and lending interest rate controls, both to retain the customer and to improve the banks' overall profitability. Hand in hand with that method of tempering the artificial effect of regulation went the payment of so-called "implicit interest", by subsidising transactions on customers' accounts, where those customers maintained large credit balances with the banks.

Despite these measures, it was still true to say that prior to deregulation the artificially low ceiling on interest rates that could be charged and paid by banks on loans and deposits, as well as quantitative controls, created a vacuum, which was filled by other financial institutions such as finance companies, building societies and merchant banks.

Deregulation removed these artificial constraints. As a result, bank lending policies became less conservative, it now being open to banks to charge higher rates for the riskier category of loans.

## CONSEQUENCES OF DE-REGULATION

This, I think, had several consequences.

First, not only did the removal of arbitrary interest rate restrictions enable banks to compete with other financial institutions for business, which they did; it also enabled them to compete, in the true sense of that word, with each other. That area of competition was considerably increased when, as part of the deregulation process, 16 foreign banks (twice the number recommended in the Campbell Report on the Australian financial system) were admitted into what has been described recently by *The Economist* (April 4, 1992) as "a sleepy commercial banking system". This, observed *The Economist*, "set off a bloody battle for market share" and, in the words of Senator Peter Walsh, banks lent hundreds of millions "without any mortgage security, without even asking how much was owed to other institutions, and without checking whether income streams could service borrowing costs".

Second, it is notorious that the aftermath of this aspect of deregulation was massive bad debts accumulated by most banks in the late 1980s. Professor Valentine, in an article (February 1991, *The Australian Banker*) questioned whether those bad debts "would not have arisen, in large part at least, even if the regulations had been left in place". I would have thought that to be unlikely. Under a regulated system, which virtually compelled a conservative lending policy, bad debts were a comparative rarity for the banks. After deregulation, the level of bad debts dramatically increased. This was due not only to the increase in real competition between domestic banks as between themselves, and with foreign banks and other financial institutions; it also arose from the relative inexperience of some bankers with new types of lending, of greater risk, which the banks now proceeded to court; coupled with something akin to a panic mentality, as management vied with each other to hold existing business and attract new customers. In the Reserve Bank's submission of January 1991 it commented that:

> "It is fair to say that the increase in the availability of credit was greater than was foreseen, and banks would concede that they made many loans that they now

> regret. This is part of the learning phase for banks (and others) which is still underway."

Third, the effect of that "learning phase" on banks had little direct impact, at least of any disastrous nature, on most depositors or shareholders in established banks. Of course, as Liza Carver points out, it has certainly had an impact on retail bank customers who have met, in the form of increased charges, at least some of the losses incurred as a result of poor management and credit control. The consequences were much greater for other financial institutions and in turn, it should be added, for taxpayers who bailed some of them out, through Government intervention. Examples in Western Australia are the two Rothwells "rescues", and the Teachers Credit Society. Faced with unprecedented competition from domestic and the new foreign banks, and therefore a considerably reduced "vacuum" to fill, many were forced into areas of ever increasing risk lending which they were unlikely, in a regulated era, to have ever embarked upon. As *The Economist* observed, in its recent Australian Survey (April 4, 1992):

> "Good business sense and good business ethics were in short supply everywhere in the 1980s; but Australia took the biscuit. Even now it is hard to credit how investors and bankers threw such enormous sums of money at such implausible optimists."

Not that this was unforeseen. In an address by the Deputy Governor of the Reserve Bank in August 1987, with the title "Deregulation - Is the Honeymoon Over?", it was acknowledged that:

> "Undoubtedly the risks are increased. Deregulation has meant that the volume of transactions and the average size has increased in virtually all segments of the market. The range of products has grown exponentially, and it is not always clear that the nature of the risks involved is fully understood. The extra competition has led to narrower spreads and, on the average I suspect, a rise in the credit risk attached to transactions."

He referred to a newspaper article in which it was stated:

> "To put it mildly, deregulation can only work if Governments get their houses in order and if banks are allowed to go bust".

That view was not shared by the Deputy Governor, who thought it to be "a very poor reflection of community attitudes". But it does provoke the question of what market forces or sanctions operate, in practical terms, to ensure that reckless or inefficient management and lending policies are effectively deterred. Much publicity has been given to the "smooth-tongued wizards", but what of those officers who were so easily persuaded to lend so much of their institutions' money to them; or who themselves persuaded those who were poor credit risks that they could borrow?

## CAN THE LEGAL SYSTEM COPE?

Mr Aitken has questioned the capacity of the legal system to cope with the "smooth-tongued wizards". There is no doubt that certainty of punishment is a great deterrent to any crime, and perhaps in particular the so-called "white collar criminal". Nor is there any doubt that there is a perception within the community that many persons suspected of "gross peculation" (as Mr Aitken puts it) are not being brought to book.

The operative words, however, are "suspected of". We need to be reminded that a cardinal principle of our system of criminal justice is that all persons suspected of, or

charged with, a criminal offence, are presumed innocent until proven guilty. There is, on occasions, an alarming tendency discernible in some media reports and elsewhere, to reverse that presumption.

## "OVER-CHARGING" OF OFFENCES

Having said that, let me deal with some of the suggestions raised by Mr Aitken. First, the question of "over charging". That is, laying charges of such number and complexity that the whole trial process may become "bogged down". That is a problem which is well recognised, and from my observation and experience very frequently given practical recognition by prosecuting authorities, who sometimes have to tread a very careful path. On the one hand, the laying of what might be called excessive charges may be unnecessary and undesirable from a pragmatic viewpoint. On the other hand, the laying of only a few simple charges may be perceived as "going too easy", leading to suspicion of favourable treatment.

## STATUTORY OBSCURITY

Mr Aitken referred to the "sinuosities of the law itself". He makes a valid point. In an address given recently to the National Corporate Law Teachers' Workshop the Chief Justice of the High Court, Sir Anthony Mason, referred to the ever increasing complexity of corporate law, contrasting the Uniform Companies Act 1961 which he described as "a model of spartan simplicity compared with its present day counterpart" whose "Byzantine complexity is a testimony to the subtlety of mind of those who brought it into existence". There is a real need for review of many of our statutory provisions, to ensure that they are expressed in as simple and clear terms as possible. That will assist, not only in avoiding the mockery that sometimes attaches to the adage that everyone is presumed to know the law, but also in enabling prosecuting authorities to determine what offence has been committed, and in framing appropriate and easily understood charges. Finally, it will facilitate the conduct of the trials before juries. I referred earlier in this paper to **Hepples** case, which provides (in a different field) a recent example of unnecessary legislative obscurity. The provisions of that particular legislation were described, again by the Chief Justice, as "extraordinarily complex", observing "they must be obscure, if not bewildering, both to the taxpayer ... and to the lawyer who is called upon to interpret them".

## JURIES: CAN THEY COPE?

That brings me to the question of jury trials. Much has been said and written about the ability of juries to grapple with complex fraud trials. In the United Kingdom, the committee on fraud trials chaired by Lord Roskill (Fraud Trials Committee Report HMSO 1986 para 8.35) stated:

> "We do not find trial by random jury a satisfactory way of achieving justice in cases as long and complex as we have described. We believe many jurors are out of their depth. The breadth of experience of these cases of many of our witnesses leads us to accept their evidence."

A contrary view was expressed by Mr Ian Temby QC (then DPP for the Commonwealth) in an interesting and balanced paper entitled "The Pursuit of Insidious Crime", delivered in 1987 at the 24th Australian Legal Convention. His view then was that there was no evidence suggesting that the rates of acquittal or conviction were different in fraud cases as compared with crime generally and that "the case for the abolition of juries in fraud trials is unproven". The fact remains, however, that lengthy and complex trials impose

great demands on jurors, many of whom had no training whatever to fit them for the task.

There are some steps that may be taken to alleviate the problem. Mr Temby, in the paper that I have mentioned, suggested giving juries access to transcripts of the evidence, and "innovative measures" such as video presentations to explain complex transactions. Recent experience in Queensland has brought calls for review of the system of selecting juries, with at least some ability for prosecuting and defence counsel to question potential jurors, so as to determine fitness, possible prejudice etc. From time to time one hears "horror stories" about the decision-making process engaged in by jurors, particularly in cases of complexity, which fill one with disquiet about a system which entrusts to 12 people, drawn at random, a task which would strain the ability of most professionals. And I wonder whether Mr Temby, in the light of events of the last 5 years, would still hold to his "not proven" verdict on the question of jury trials. Certainly, the UK experience over that time would have done nothing to change the view of the Roskill committee. There is much to be said for a "special jury" system, comprised of professionals likely to comprehend the kind of evidence presented at fraud trials.

## THE LAW'S DELAY

One source of public concern, quite apart from the trial process itself, is the time taken for those suspected of corporate misfeasance to be apprehended, charged, and ultimately tried. The time taken to detect, and to charge, is very often unavoidable. When I embarked on the Rothwells investigation, as an Inspector appointed pursuant to the Companies Code, a decision was made at the outset that if and when evidence was unearthed which established a *prima facie* case against any person, then, as a matter of policy, charges would generally be laid against that person at once (rather than wait until the whole investigation had been completed and a report delivered) in accordance with the principle that "justice delayed is justice denied". Consistently with that approach, a number of charges were laid against former directors and officers, well before completion of the investigation and the publishing of a report. However, that brought with it a number of problems.

For example, several persons who were charged with offences thereafter resisted any attempt to question them further, even on matters which were not related to the charges, on the ground that there were criminal proceedings pending. One of the persons charged went as far as commencing proceedings in the Supreme Court (see [1990] 2 WAR 350) seeking (unsuccessfully) to obtain an injunction to restrain me from further questioning him in the course of the investigation, on matters unrelated to the existing charges.

Apart from that problem, the existence of charges raises a difficulty in connection with publication of a report. There is the real danger that widespread publicity will seriously prejudice the accused person's prospects of a fair trial. In Western Australia, that problem has been further compounded by the current ongoing Royal Commission. The publicity surrounding certain persons questioned before the Commission has been the basis of successful applications to the Supreme Court to postpone the hearing of criminal charges against them, at least until after the conclusion of the Commission. And there had been, I understand, the foreshadowing of an application for a permanent stay of some criminal proceedings, on the ground that excessive publicity emanating from the Royal Commission has created such prejudice as to render a fair trial impossible. Most of the major charges, laid well over 2 years ago, still await trial.

## THE DANGER OF OVER-REACTION

I mention those matters, simply to point out that the path for regulatory and prosecuting authorities is by no means easy. But public expressions of frustration with the legal process should not be allowed to submerge individual rights. Calls for the lowering of the standard of proof, and even for a reversal of the onus of proof, should be steadfastly resisted. As Mr Temby said in his paper in 1987:

> "Those who are inclined to change the balance between State and citizen, in this or any other area, will do well to remember that every one of us is a potential accused."

So we must not throw away, in outraged reaction, the important principles that protect accused persons from injustice, strong though the temptation may be. As Mr Aitken reminds us, these kinds of events are recurrent, and cyclical. Two hundred and seventy years ago, the South Sea Bubble precipitated a financial crisis in England of mammoth proportions. The real estate market collapsed. The government fell. Almost everyone of consequence was ruined or on the verge of ruin. Walpole masterminded a bailout reminiscent of the recent S and L rescue scheme in the USA, but with a difference. The directors, by Act of Parliament, had most of their wealth confiscated. In the result, some 2 million pounds so seized was distributed among the stockholders. For some time, the risk capital that had driven the British economy, and produced an era of inventiveness and entrepreneurial activity, was no longer there. But, eventually, it reappeared, as "the burnt fool's bandaged finger goes wobbling back to the fire".

No legislation can save a fool from his folly; and how far should we go, in imposing on the whole community the cost of regulation to protect people from their own greed, who may and do invest despite all warning signs, for the sale of a higher return which no prudential institution could or would pay?

## ADVISERS' LIABILITY

The same reactionary spirit should not be allowed to extend the liability of third party advisers to a point where independent objective advice from professionals becomes impossible to obtain through fear of being charged as an accomplice. The article written by Justice McHugh, referred to by Mr Aitken (1989, 5 *Australian Bar Review* 1) prompted a strong response from A J Meyers QC (*Australian Law News*, March 1990). Alex Chernov QC (Brief, February 1991) followed with a reminder to practitioners of the importance of preserving their professional independence. As Mr Chernov points out, the line between professional adviser and business participant or promoter may easily be crossed, and once that happens, the protection normally afforded to the adviser will be lost. The risks have been clearly pointed out in **Leary v FCT** ((1980) 32 ALR 221), and in **Forsyth's** case, in which a leading counsel was acquitted of a charge of conspiring to defraud the Commonwealth, the only evidence being that he had fulfilled his obligation as a barrister to advise on the legal effects of a proposed transaction.

Yet Mr Aitken suggests, with some historical justification, that we may well ultimately follow the American regulatory path, instancing the recent example of the RTC, which has handled the liquidation of about 550 "Thrifts" in the USA. The director of the Office of Thrifts Supervision contends that lawyers and accountants must bear responsibility for the actions of their thrift clients. This is not just talk. The RTC expects to have filed about 200 professional liability claims by the end of this year, seeking billions of dollars in damages. Aided by the powers given under the 1989 Thrifts Bail-Out Act to freeze financial assets of a defendant before trial, which it used to pressure the law firm, Kaye Schuler, into a settlement of $41 million, the OTS is a formidable regulator. Its actions

may result in a redefinition of the traditional relationship between professional advisers and their clients, in the USA.

## CONFISCATION OF PROFITS FROM CRIME

In Australia, legislation to confiscate profits derived from criminal activity, including of course "white collar crime", is being used on an increasing scale to ensure that wrongdoers are stripped of their gains. That, and a high likelihood of apprehension and conviction, are the most potent means of ensuring the observance of the law, and if not avoiding, at least reducing, some of the excesses of recent years.

## CONTROL OF NON-BANK INSTITUTIONS

There is no need for, and indeed no point in, a move away from the deregulation that has taken place. There may, however, be a need to move towards greater regulation of non-bank financial institutions. Merchant banks, so called, did not exactly cover themselves with glory during the last decade. Rothwells and Tricontinental are but two examples that spring to mind. One might seriously question the policy of permitting any non-bank to call itself a "merchant bank". To many members of the public, the name is quite misleading. So, too, is the tag of "trustee status", which carries an implied assurance which is sometimes found to be unwarranted.

There is, in my opinion, an argument for greater supervision and regulation of non-banking institutions, to ensure not only compliance with minimum prudential requirements, but also that they are not engaged in questionable lending practices. That is not just a matter of auditing the books, but ensuring that management entrusted with lending has sufficient training and skill for the task.

That, you may think, is a counsel of perfection. And where are the regulators themselves to be found? I referred to the S & L travails in the USA. The regulators have moved in, but already there are disturbing reports of gross inefficiencies in the realisation of S & L assets by those regulators. May I add to Mr Aitken's Latin motto of a fine police force, another, "*Quis custodes custodiet?*" - who regulates the regulators?

## REGULATION OF BANK PRACTICES

Liza Carver has criticised some current banking practices, from a consumer viewpoint. Banks need to consider and act on such criticisms, if they are to avoid, not "re-regulation", but new regulation to counter unacceptable practices. May I give one minor example? In March 1987 the Deputy Governor of the Reserve Bank, addressing the AIB, referred to regular customer complaints, about lack of information, including interest rates they were paying. Surely, he said, it is not beyond the wit of the technicians to show on statements the current rate charged? Yet it seems to be that massive technological improvements have not meant corresponding improvement in customer information. If anything, with EFTs and standard forms and conditions, there has been a decline. So, in these areas, as well as lending practices, it is perhaps for the banks to regulate themselves, rather than waiting for it to happen. If they take positive steps they are well on the way to preventing new regulations and legislation, of the nature apprehended by Professor Baxt, from being foist on them.