SUBMISSION ON POLICY ISSUES IDENTIFIED IN THE INTERIM REPORT

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Structural separation of the banks is necessary and straightforward

Citizens Electoral Council (CEC) submission on Financial Services Royal Commission Interim Report

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Dear Commissioner Hayne,

The most important question posed in your Interim Report is: "What can be done to prevent the conduct happening again?"

The Citizens Electoral Council (CEC) maintains that the only answer to that question is the full structural separation of commercial deposit-taking banks from all other financial services, including investment banking, financial advice, wealth management, stock broking, superannuation, and insurance.

The integration of normal banks with these activities has created conflicts of interests that your inquiry has shown have not been "managed", as the banks claim they are able to do.

These conflicts of interest are the root cause of almost all of the misconduct and abuses highlighted in the public hearings.

Putting aside the regulators' unwillingness to enforce the law, the conflicts of interest entrenched by the vertical and horizontal integration of the banks make the financial system complex and difficult to regulate.

Full structural separation of the banks will end the conflicts of interest and simplify the financial system, making it easier to regulate and the regulation simpler and more difficult for banks to "game".

The CEC is a registered political party which is committed to banking reform, and has the most expertise in Australia on the issue of banking separation. Since the 2008 global financial crisis we have participated in a worldwide effort to restore the Glass-Steagall principle to the financial system, collaborating with expert advocates of Glass-Steagall in the United States, United Kingdom, and many EU countries. The CEC drafted the Banking System Reform (Separation of Banks) Bill 2018, which the Member for Kennedy Bob Katter, seconded by the Member for Denison Andrew Wilkie, introduced into the House of Representatives on 25 June 2018; the legislation is modelled closely on the original US *Glass-Steagall Act* of 1933 and the updated 21st Century Glass-Steagall Act bill currently before the US Congress to restore banking separation, but adapted for Australia's financial and regulatory system.

Therefore, while your inquiry has looked at the entire financial system, this submission will focus on the banks, for which structural separation is the clear solution to their misconduct. The principle of ending conflicts of interest, however, should apply to all parts of the financial system, including the large, vertically integrated non-bank financial institutions such as AMP and IOOF which control retail superannuation funds.

Conflicts of interest

The conflicts of interest are obvious in almost all of the misconduct highlighted by the royal commission:

* In mortgage lending, because the banks have investment banking operations which trade in residential mortgage backed securities (RMBS) and derivatives contracts such as interest rate swaps based on their loans, they are able to profit from writing bad mortgages. This, and [redacted] reckless risk-weighting of mortgages, clearly incentivised the banks to lower their lending standards. This is a conflict between their fiduciary duty to their customers, and their obligation to make a profit for their shareholders on which the bank executives' bonuses depend.

It is worth noting that the rise of both mortgage securitisation and over-the-counter (OTC) derivatives trading in the USA beginning in the 1980s first required the bank regulator, the Office of the Comptroller of the Currency (OCC), to exempt those instruments from the *Glass-Steagall Act*'s ban on commercial banks trading in securities. If the OCC had not granted that exemption, the reckless subprime lending that led to the 2008 financial crash and derivatives meltdown would not have happened; likewise, if Australia's banks were not able to do investment-banking securities and derivatives trades on their mortgages they would not have been able to profit from lowered lending standards.

* In financial advice, vertically integrated banks have a greater interest in directing their customers into their other businesses, than in the best outcome for the customer. This was confirmed by ASIC's 24 January 2018 report, "Financial advice: Vertically integrated institutions and conflicts of interest", which revealed that despite other institutions supplying 80 per cent of the investment products that bank staff were authorised to sell, nearly 70 per cent of the investments that staff advised went into in-house products sold by divisions of the same bank.

Since the royal commission's hearings on financial advice, some banks such as [redacted] have made moves to divest themselves of their financial advice businesses, but this is disingenuous. [redacted] intends to keep the in-house financial advice service which has been the source of most of its financial advice scandals. Unless separation is legislated, banks can demerge partially or temporarily, which mean there is nothing to stop this structure from reappearing.

This specific conflict of interests was one of the drivers of the *Glass-Steagall Act* in the United States. The so-called Pecora Commission hearings of February 1933 exposed how banks exploited their customers on a massive scale; for instance, National City Bank had packaged up its risky loans to South American countries as bonds and employed an army of aggressive bond salesmen to sell them to National City's unsuspecting depositors. The *Glass-Steagall Act* consciously separated depositors from such investment practices to stop it from happening again.

* In lending to small and medium enterprises, and farms and remote communities, one of the factors in the banks' conduct "below community standards and expectations", a.k.a. bastardry, is their preference for mortgage lending over business and farm lending. This is due to [redacted] risk-weighting of mortgages and the banks' trading activities making mortgage loans far more profitable than other lending, as referenced above. Historically the major banks always loaned more to businesses than for mortgages, but the banks' recent obsession with mortgages has come at the expense of businesses lending, which is now around 30 per cent of their business, compared with more than 60 per cent for mortgage lending. Banks play hardball with business customers because they are not a priority.

* In superannuation, as in financial advice but with captive customers, the banks have managed their retail funds not to maximise returns for the clients, but profits for the banks. The large difference between the returns of retail superannuation funds and independent funds, such as industry funds, is entirely due to the banks keeping the provision of services to those funds, such as wealth management, stock broking and insurance, "in house". In 2010 APRA research head Dr Bruce Arnold and his colleague Kevin Liu revealed that the Big Four banks and financial services giants [redacted] and [redacted] which own the majority of retail superannuation funds, charged two and a half times the market rate for services to the clients of the funds they owned; [redacted] ignored the research—as it tends to do when such research is inconvenient to the banks—and the banks have been able to merrily gouge their super clients in the subsequent eight years to the tune of tens of billions of dollars. Superannuation expert and former APRA Principal Researcher Dr Wilson Sy has estimated that for an average worker the difference in superannuation nest egg between being in a bank-owned retail fund and an industry fund is $1 million.

Structural separation

In response to your questions:

* Is the law governing financial services entities and their conduct too complicated?

* Does it impede effective conduct risk management?

* Does it impede effective regulatory enforcement?

* Is the regulatory regime too complex? Should there be radical simplification of the regulatory regime?

* Do the events that have happened raise any issue about business structures?

* Do the events that have happened invite consideration of whether structural changes should now be made?

* Do the events that have happened suggest that manufacturers of financial products should not be permitted to provide, whether by employee or authorised representative, personal financial advice in relation to products of a kind it manufactures?

* Are changes in law necessary?

* Should the financial services law be simplified?

* Should the regulatory architecture change?

* Is structural change in the industry necessary?

The answer to all of these is yes. The conflicts of interests arising from integrated banking are not manageable. Regulation is too complex and hard to enforce, even if the regulators are willing, and the threat of criminal and civil sanctions are not enough to ensure good behaviour because the banks have the legal resources to exhaust court actions against them. Structural separation simplifies regulation, is easy to comply with, easy to enforce, and, above all, effective.

It is important to understand that integrated banking is a recent phenomenon. It should be recognised as a disastrous experiment and consigned to the dustbin of history.

While Australia did not have a legislated separation of banking, like the United States, we always had a natural separation between commercial banks and so-called merchant banks, like the United Kingdom, because the types of banking were very different. The financial deregulation of the 1980s broke down these natural barriers; in fact, former UK Chancellor of the Exchequer Lord Nigel Lawson in 2010 acknowledged that mergers between commercial and merchant banks was an unintended consequence of the Big Bang deregulation of the City of London that he oversaw in 1986, and this UK development increased pressure on the United States Congress to repeal the *Glass-Steagall Act*. Lord Lawson now regrets this development, and is trying to have the Glass-Steagall separation reinstated in the USA and UK.

The move to vertical integration in Australia's banks coincided with the 1996 privatisation of the Commonwealth Bank and the 1998 Wallis Inquiry reforms, which included the fateful decision to establish APRA as the bank regulator separate from the Reserve Bank. The acknowledged pioneer of vertical integration was ███ general manager David Murray, whose 2014 Financial System Inquiry ignored the problems that vertical integration had caused and recommended against structural separation.

The banks will claim that structural separation will be too disruptive, but that is not true. It is a straightforward process.

After all, as noted above, some banks are moving to demerge their operations, without any difficulty. The problem is, without it being legislated, such voluntary demergers will likely be partial and temporary. Legislation is necessary to make the separation complete and permanent, but it will not be any more onerous.

The legislation that the CEC drafted for Parliament, the Banking System Reform (Separation of Banks) Bill 2018, allows the banks two years to demerge their operations. This was the time frame allowed by the original *Glass-Steagall Act*. Moreover the CEC consulted a banking expert and Glass-Steagall advocate from Japan, Daisuke Kotegawa, a former deputy director of the Ministry of Finance and Japanese representative to the International Monetary Fund, who is experienced in banking operations with and without the Glass-Steagall division (Japan also had Glass-Steagall until 2000). He confirmed that two years would be sufficient time for banks the size of Australia's Big Four to demerge.

The objective must be full separation. You noted in your Interim Report that the *Glass-Steagall Act* and the UK's 2013 ring-fencing law demonstrate that structural separation is not novel, but those two laws are not equal. Glass-Steagall, a full separation, was in place for 66 years and was an unqualified success. More than 4,000 US banks failed in the three years following the 1929 crash before it was enacted, and only nine years after its repeal hundreds of US banks failed in the biggest financial crash since 1929, but for the seven decades it was in force there were no systemic banking crises in the USA.

On the other hand, the UK's ring-fencing law, the *Financial Services (Banking Reform) Act 2013*, is not full separation, because it allows the ring-fenced operations to remain under the same bank holding company. It is also does not come into force until next year, 2019. When it was debated in Westminster, many MPs tried to have it amended to become a full separation, on the basis that ring-fencing would not be sufficient to stop banks from exploiting commercial bank deposits and customers for speculative purposes. In fact, this was proven in the United States prior to Glass-Steagall, when the arrangement was identical to ring-fencing: commercial banks got around the prohibition on trading their own shares and securities by establishing "securities affiliates" that were ostensibly separate but under the same roof. In the

debates in the House of Lords former banker Lord Forsyth of Drumlean memorably insisted that only full separation would work because "investment bankers are extremely adept at getting between the wallpaper and the wall". 445 MPs and Lords ended up voting for an amendment that would have turned the bill into a full Glass-Steagall separation, which was only narrowly defeated after intense lobbying by the banks.

Conclusion

Despite the limitations of the terms of reference for the royal commission, the same politicians who for years denied the problems in the banks are now looking to you to recommend solutions. They know that structural separation is on the table, as do the banks, which are already lobbying the major parties against it. This means that as with other royal commissions, there is no guarantee that the government or opposition will implement the recommendations in full. However, your inquiry has shown up the failings of not just the banks, but the regulators and major parties, so you have a moral authority to demand change that the public will support, and the vested interests will find difficult to oppose. Just as the *Glass-Steagall Act* was a product of the 1933 Pecora hearings which laid bare the criminality of Wall Street, your inquiry can be the catalyst for lasting structural change that reorients the banking system to again serve, rather than exploit, the people of Australia.

The CEC respectfully urges you to recommend the full structural separation of Australia's banks.

Yours sincerely,

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