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Submission

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

David Richardson

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Table of Contents

Introduction 2

Earlier work on banking and superannuation 3

Superannuation 7

Fraud and other malfeasance 9

Consequences of increasing financial/corporate power 11

Big banks 14

PROFITABILITY 16

Too big? 19

Common ownership 19

Trade off: Competition v stability 21

Recommendations and conclusions 24

References 27

Introduction

The Australia Institute welcomes the opportunity to make a submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

We expect the Royal Commission to be swamped by submissions that relate to specific examples of misconduct. Our submission tries to take a step back and consider the extent to which undesirable outcomes are inevitable in the Australian financial system as it is today being characterised by serious imbalances of power and knowledge between the industry's institutions and their customers. Alfred Eichner (1976) coined the term 'megacorp' to describe the modern large business corporation common in advanced economies and found in oligopolistic industries in particular. It is big enough to plan its own environment and tends to exemplify the separation of ownership from control with control vested in a professional manager class. It is characterised by planning its growth and scale rather than passively responding to the needs of the market.

We attempt to ask how society might address the implications of the present structure of the industry and its dominance by megacorps. The Australia Institute has written a good deal on topics that involve the banking and finance sectors. We wish to have the earlier papers treated as part of this submission and hyperlinks are provided to assist.

Much has been written on the specific instances of misbehaviour on the part of the banks. However, a critically important question is whether or not those specifics indicate systemic issues that need to be addressed. Most of what follows is a summary of The Australia Institute's (TAI) earlier work. Apart from some new material in the present brief, references, footnotes and further discussion can be found in the papers referred to.

We would expect that the Commission will want to ask a lot more on the role of banks in society and questions that probe such matters as the incentives to dupe customers in the present environment. That is the focus of the present submission.

Earlier work on banking and superannuation

In 2010 TAI published *A licence to print money: bank profits in Australia* (Richardson 2010) which found that the underlying profits of the big four megacorp banks were then around $35 billion or just under three per cent of GDP. Of that some $20 billion was likely to be the result of monopoly power over the financial system. That report quoted a former Governor of the Reserve Bank of Australia (RBA), Ian Macfarlane, who in 1999 said he had 'often wondered why banks are so profitable—and they certainly have been extremely profitable in Australia'. Australians have been pondering the same question for well over a century.

The consequence of banks aiming for high rates of return (18 to 20 per cent is quoted by Macfarlane) is that 'they are failing to invest in a lot of things which are reasonably profitable and socially very useful'. So banks use their monopoly power to achieve high rates of return and try to retain high rates by refusing to invest in less profitable things. At the time there were concerns about banks closing branches that were profitable but not profitable enough.

Concern about the exploitation of market power by Australian banks goes back to before Federation as do the efforts by policy-makers to counter it. Policy makers tried to generate competition by establishing some of the early state-owned banks in colonial times and the Commonwealth Bank soon after Federation in an attempt to offer better alternatives to the private banks. Building societies, credit unions and later the mortgage originators (for example, RAMS and Aussie Home Loans) were each supported as potential competition against the banks. Similarly, foreign banks were championed as the means of providing effective competition.

As *A Licence…* shows, the big four banks appear immune from competition and came through the global financial crisis stronger than ever with their share of the Australian financial market as high as ever. About the only things that seem to work against their might are the actions of the Reserve Bank of Australia (RBA) that effectively impose price controls on some of the banks' fees and charges or the types of controls operating before deregulation. As an example, when the Campbell inquiry reported in 1979 banks had 50 per cent of the finance market and various non-bank financial intermediaries had the other 50 per cent. By the time of *A licence to print money* the banks' share had increased to 83 per cent. Within those figures the concentration

among the banks themselves increased with the big four gradually increasing their shares of both banking and finance defined more widely.

While these comments go to the level of competition as a weak check against the exploitation of economic power they do not necessarily shine a light on the degree of wrong-doing in the Australian financial system. However, while there is no objective and quantitative evidence we venture the position that competition from not-for-profit institutions forces ‘good’ or at least ‘better’ behaviour on the private banks and other entities. While credit unions and building societies played the role of the honest alternative to some extent even more significant may have been the government owned banks dating from colonial times (eg The State Bank of Victoria, The State Bank of Tasmania etc) as well as the Commonwealth Bank of Australia in 1911.

Money and Power: The case for better regulation in banking (Fear et al 2010) argued that the power of Australia's big four banks is unmistakeable. Their underlying profits equate to almost three per cent of GDP, up from less than one per cent a quarter of a century ago. Of every $100 spent in Australia, nearly $3 ends up as underlying profit for the banks. Profits are so high because the banking market is highly concentrated. The big four banks controlled more than 75 per cent of all bank assets and banks accounted for over 90 per cent of all lending by financial institutions in Australia. This level of concentration has distorted competition, allowing the big banks to reap underlying profits of around $35 billion per year, including $20 billion in 'super-profits' attributable to their market power. Most Australians believe that the banking market is overly concentrated: three in four survey respondents (72 per cent) said that the big four banks in Australia have too much market power.

Against that is the argument that the extreme profitability of Australia's banks is in the public interest. Many workers hold shares in banks indirectly through superannuation, and therefore arguably receive a share of their profits. Yet the distribution of share ownership and superannuation balances means that the wealthiest Australians capture most of the dividends flowing from bank profits. And in other important respects the behaviour of the banks runs counter to the interests of the broader community. We discuss this below as the Farrell/Shapiro view.

Submission to the Senate Economics Committee inquiry 'Competition within the Australian banking sector' (Richardson and Denniss 2010). This submission argued that the role for government should be much greater than the mere provision of additional information to consumers. In short, government should ensure that banks behave in ways that are consistent with the public interest rather than simply 'leaving it to the market'. This submission suggested a number of detailed policy prescriptions which are included in the recommendations below.

The profit in home lending (Richardson 2012a) estimated the profit earned on mortgages by the big four banks. The method here is to estimate the average profit margin on bank home loans and then to apply that to the amounts people were borrowing at that time.

The rise and rise of the big banks: Concentration of ownership (Richardson 2012b) updated some of the data in *A licence to print money* but was also the first to question the common ownership of the main players in a concentrated industry in Australia. The Australian banking industry is the most concentrated in the world and also the most profitable. In fact the 'big four' Australian banks make up four of the eight most profitable banks in the world. The big banks have conceded that they are not highly competitive but have argued that their market power provides benefits in the form of 'financial stability'. Yet in other contexts the big four banks argue that they are highly competitive. The evidence shows clearly that this is not the case. This paper finds that the degree of common ownership seriously challenges the idea that the big four banks are engaged in fierce competition.

Since TAI published that paper *The Economist* has examined the common ownership phenomenon and reported the higher profits in industries with common ownership among the main corporations (Economist 2016).

New research supports need for extra bank regulation (The Australia Institute 2016) In some of the most comprehensive polling ever released into attitudes to the banks in Australia, polling of over 1,400 Australians finds:

- 68 percent of respondents supported a Royal Commission or similar inquiry. Only 16 percent were opposed. Support was similar across states and incomes.
- 76 percent agreed that big four banks should put customers ahead of shareholders; 64 percent disagreed that the banks do this.
- 77 percent agreed that banks "should have to pass any reductions in the RBA cash rate on to customers". Only 11 percent disagreed. Major party voters were most likely to agree.
- 59 percent disagreed that the banks have been truthful about what they knew about scandals revealed by whistleblowers.
- Should banks be able to own financial planning businesses? More disagreed (44 percent) than agreed (32 percent).
- 52 percent agreed Malcolm Turnbull is protecting the banks by refusing to call a Royal Commission. Only 21 percent disagreed.

- What is the strongest action the government could take against the banks? 42 percent said a Royal Commission. 27 percent nominated a bank tribunal, and only 9 percent said making bank CEOs front an annual government-controlled committee.
- 52 percent said the Liberal Party was the party closest to the banks.

In 2014 TAI made a Submission to the financial services review (Richardson 2014) in which we discussed many of the topics raised in earlier papers as well as some new material. In one of the arguments relevant to the present Royal Commission we said:

> Government-owned enterprises and the promotion of member-owned alternatives are worth pursuing as bulwarks against the exercise of private power. In addition there is a good case for splitting the banking system into the utility functions related to the payments system and the lending functions which are less likely to favour large uncompetitive conglomerates.

We have commented that competition has failed in the sense that monopoly profits are still too high and customers are being ripped off. However, we need to look at much more than price. Quality is equally important and the issue is to guarantee quality when there is a huge power and information imbalance between the customer and seller. Such things as honesty and protecting the customer may be impossible to regulate but competition from a genuinely trustworthy source is bound to have the impact of improving standards across the board. We think there is a very strong case for a new publicly owned competitor with a charter to provide a sound and honest banking service. Or at the very least the promotion of member-owned banks and other deposit taking institutions. There is also a case for banking with the government or the central bank as argued below.

In Levy on the Major Banks: Submission to the Inquiry into the Major Bank Levy Bill 2017 and the Treasury Laws Amendment (Major Bank Levy) Bill 2017 TAI again drew attention to how our financial institutions are trying to dupe us (????). We there observed:

> Australian Banking Association CEO Anna Bligh has vowed that 'every Australian is going to have to pay the bill' for the new levy. Her promise of revenge goes to prove that the Australian big banks have too much economic and political power. We can only hope the government empowers the ACCC to respond effectively to Bligh's revenge. The ABS household expenditure survey

shows that low income groups pay higher proportions of their incomes in bank fees.

TAI also drew attention to the very high annual advertising expenditure ($1.2 billion) on the part of the banks about to be subject to the bank levy. Despite the billion dollars of advertising expenditure it is very difficult to extract much information from the advertising. Advertising is justified as a means of conveying information but clearly it relies on emotive appeals.

Consumer protection in the banking, insurance and financial sector (Richardson 2017) was a submission to the Senate Economics Legislation Committee's inquiry into consumer protection in the banking, insurance and financial sector. Our main concern in this submission was to look at the deeper issues and ask what are the forces that drive 'bad behaviour' in the finance and insurance sectors. We started with some general and theoretical considerations following the views of eminent Professor of Finance at Harvard University and President of the American Finance Association, Luigi Zingales. This will be addressed below. This discussion provided a useful framework for considering the Australian debate and the abuses that have been highlighted in the Australian debate.

Our aim in this submission is to give a theoretical perspective that can form something of a framework in which to view the many and varied experiences that the committee is likely to confront in this inquiry. The Australian discussion has dwelled on particular cases. When that occurs it is always possible to dismiss those anecdotes as one-offs caused by rogue staff and so on. Australian academics who specialise in finance economics have not been of much assistance.

SUPERANNUATION

The Australia Institute has written extensively on the subject of superannuation. While the focus was not necessarily on the issues of concern to the Royal Commission many of the issues discussed are relevant to the Commission's work.

In May 2008 we published Choice Overload: Australians coping with financial decisions (Fear 2008). That paper documented the limited information super members have and the lack of engagement with their funds. The implication is that people did not have either the financial literacy or interest to make rational decisions. Hence they were unlikely to do well out of the earlier policy of offering greater choice to consumers. It also implies members were ripe for exploitation by private funds.

Choice overload was followed by Choosing not to choose: Making superannuation work by default in November 2008 (Fear and Pace 2008). That paper developed the critique of the Choice of Fund policy for failing to protect those consumers who were disengaged from superannuation issues while generating additional income for fund managers and financial planners. This paper also argued strongly for a default super system, a policy that was elaborated upon in The case for a universal default superannuation fund in September 2009 (Ingles and Fear 2009). Those arguments were ultimately reflected in the Cooper Review (Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System 2010) and subsequently in new superannuation arrangements.

Can the taxpayer afford self-funded retirement? (Denniss and Richardson 2012) examined the tax expenditures that are spent on subsidies for superannuation with the bulk of those subsidies going to the very rich. Self-managed super funds (SMSFs) are now firmly entrenched as the vehicle of choice for tax avoidance by high income earners and high wealth individuals. At the time, June 2013, a total of 509,362 SMSFs had total assets of $506 billion; the average assets of SMSFs was $993,000 while tax office figures show their average income was $86,000 in the 2010-11 financial year. Ten SMSFs had reportable income of $5 million or more. The extreme bias in super tax concessions towards high income earners was addressed in Super for some: Who wins and loses from $30 billion worth of tax concessions for superannuation? (Denniss 2013).

There is a strong gender bias in the superannuation system with males able to accumulate much higher balances and subsequently receive much higher payouts compared with the experience of women in Australia. Essentially men get the money but women have the higher 'survival risk' as the actuaries put it. The issue was addressed in What's choice got to do with it? (Cameron 2013) in August 2013. Aspects of the governance of superannuation were addressed in Time to get engaged with super? which found that many members thought their funds should take greater account of ethical and environmental considerations in managing their investments (Denniss 2013).

Fraud and other malfeasance

TAI has not produced any research that examines specific instances of actual bank wrong-doing in any detail. However, we have noticed that managers have tended to deny involvement and put it down to a few errant staff. But we find that unconvincing. For example the former CEO of Westpac knew exactly what she was doing by fraudulently allowing customers who wanted to bank with someone other that the big four to pretend parts of Westpac were independent community-based organisations. For example the then CEO of Westpac, Gail Kelly, when giving evidence to a Senate committee on bank competition, explained the strategy very well. Kelly said:

> *In the Westpac Group …our strategy is one of offering customers choice through our multi-brand model, our key retail brands being Westpac, St George, Bank SA and RAMS. Each designs and implements their own customer strategies and plans. They have different marketing approaches, and it has become increasingly clear to us that they attract different types of customers.*
>
> *[W]e find that customers who choose St George are not the customers who would choose Westpac. There is very little overlap there.*
>
> *It is more different attitudinal approach. The customers who have chosen St George do not want to bank with a major bank* (Kelly 2011).

Kelly repeated this view saying:

> *There are a range of customers, as we know, that choose St George over Westpac. If we didn't have a St George, they wouldn't choose to bank with us… It gives us an opportunity to win more customers* (Johnston 2012).

Now St George is just a group within Westpac[1] and we believe it is improper to present St George as a genuine alternative to those who do not want to bank with the big four. The only reason Westpac pretends St George is distinct is that it can thereby increase its profit. Note that Westpac also operates the Bank of Melbourne and BankSA in a similar way. The Annual Report also refers to Westpac Institutional Bank which undertakes specialist business services and appears to have its own identity.

Westpac is not alone in this but our point is that if the CEO admits to such a level of duplicity to the Senate without seeing anything wrong then surely there is a rotten culture that starts at the head.

[1] In fact the St George group also includes the Bank of Melbourne and BankSA.

In addition to these comments we have written quite often about the incentives in finance for the duping of customers. We have cited Harvard Professor of Finance, Luigi Zingales, especially his presidential address to the American Finance Association (Zingales 2015). We might almost suggest that paper should be required reading for the Commission.

Consequences of increasing financial/corporate power

There is a view that increases in concentration, the economic power of the remaining firms, and the consequent monopoly profits may be a benefit to society. We can refer to this as the Farrell-Shapiro view after their contribution that showed that while there were costs to consumers through mergers there were efficiency benefits such that the owners of the merged corporations had higher incomes that more than offset the losses to consumers (Farrell et al 1990). This is equivalent to saying that after a robbery there is no change in total wealth there has just been a redistribution of the wealth holding. Fortunately this view no longer seems to be a widely held view among professional economists but it is worth raising here as it does find echoes in the views held in some business quarters as will be evident below. The problem with the Farrell-Shapiro view is that generally the benefits accrue to high wealth/income groups while the costs go to ordinary consumers and tend to be very regressive.

Information imbalances give corporations a powerful weapon for extracting profits from unwitting consumers. For example, Zingales notes that 'From Libor [London interbank offered rate] fixing to exchange rate manipulation, from gold price rigging to outright fraud in subprime mortgages, not a day passes without a news of a fresh financial scandal' (Zingales 2015). Zingales continues: 'If the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension'. The fact that 'market forces cannot bring [the finance sector] in check' is a very serious concern. But perhaps that should not surprise us; the market has no solution to crime for example and many cases of market failure in banking and finance are just additional examples of crime.

Zingales discusses a number of specific problems with the finance sector as a whole beginning with 'duping unsophisticated investors' which involves two types of duping:

- 'straight' duping 'where investors are sold a product they do not understand and would have never wanted had they understood it' and
- 'indirect' duping 'where investors are attracted to product bundles that are very convenient for sophisticated investors (who buy the cheap part and disregard the expensive one), but turns out to be extremely costly for unsophisticated ones, who buy the whole bundle'.

Most of the Australian examples seem to be of the first type – straight duping in which unsophisticated investors are sold complex investment products that are not

understood until they fail, and often not even then. There is academic evidence that more complex products have higher mark-ups and are sold to less sophisticated investors (Celerier et al 2013 cited in Zingales 2015). Moreover, complexity seems to be a deliberate strategy used by the finance industry to prevent consumers shopping around. People cannot shop around if they do not understand the products they are buying. In the meantime bank and other finance sector sales people cultivate an honest 'trust me' image. This type of behaviour on the part of large corporations in oligopolistic markets has spawned a growing literature on the economics of obfuscation.

In Fear et al (2010) the problem of the incentive structure facing staff was addressed in some detail. It basically concluded that the Australian banks included incentive structures that could well have been designed to dupe customers. Many of the arguments relevant here will be taken up by the submission from the Centre for Future Work.

Just as the internet, which made price search more efficient encouraged investment in obfuscation, so it seems more education on the part of retail financial investors has the effect of inducing greater efforts at obfuscation in the retail financial products industry (Carlin et al 2011). The obfuscation seems deliberately aimed at disorienting financial investors. One of the strategies is to offer several classes of investment products to price discriminate among investors of various sophistication. As some recent researchers put it 'discrimination through such purposeful distortions in transparency is an important source of value to providers' (Carlin et al 2011 p 755) albeit at the expense of the financial investors. The authors caution that efforts at raising the financial literacy of customers may be counterproductive if it only marginally improves financial literacy—it may just cause providers to increase their efforts to further obfuscate their offerings. Moreover Carlin et al make the point that the disparity between the sophistication of the customers and complexity of the product offerings applies in other areas of the financial market which, especially in the US, have been involved in the build up to the global financial crisis. They have in mind here credit card financing, life annuities, mortgages, life insurance and education savings plans. 'Indeed, participation without sophistication is frequently cited as a root cause of the recent financial crisis' (Carlin et al 2011 p 757).

While education is important to overcoming obfuscation so too are default options: 'default options would in essence make more investors experts (by proxy) and may decrease obfuscation, especially when used on a grand scale or in markets in which people learn on their own' (Carlin et al 2011 p 758). Australian governments have assisted in this objective with, for example, the requirement that banks offer no frills

deposit accounts, industry super funds and default options. Note how the for-profit super funds try to argue that there are benefits in competition for customers.

The financial sector provides much greater opportunities for abuses, thanks to the flexibility provided by financial engineering. Yet these distortions are present in almost every sector, not just in finance. The recent and prominent Australian example is electricity with its bewildering array of consumer options (ACCC 2018).

Big banks

"When corporations open their wallets to politicians, the public loses" (Economist 2018).

The big four banks have come in for particular criticism by the Royal Commission and so it is worth devoting a section to look at the big four in particular. The big four are able to offer very attractive post-retirement packages to influential public servants, former mandarins from the Reserve Bank and Treasury now occupy or recently occupied plum positions among the big four banks. That includes former governor of the RBA, Ian Macfarlane on the ANZ board, Andrew Mohl former senior official of the RBA on the board of the Commonwealth Bank, former head of Treasury, Ken Henry chair of the board of the National Australia Bank, Westpac had on its board Ted Evans, another former Treasury head. Henry jointed the National Australia Bank just after being instrumental in the drafting of the government's bank competition policy. Sometimes there is movement in the other direction with David Murray a former CEO of Westpac appointed to chair the Future Fund which he did until recently. Former Queensland Premier, Anna Bligh, is now CEO of the Australian Bankers' Association which was engaged in a powerful advertising campaign against a proposed South Australian bank levy. Fairly quickly the state government conceded defeat and the ABC reported 'The bank tax was met by a chorus of opposition from business groups and the banking industry, which funded polling and advertising campaigns against the levy'.

Recently we learned that Glenn Stevens, another former head of the Reserve Bank of Australia, had been appointed to the board of the investment bank Macquarie Group. One of Macquarie's activities is its role as Australia's biggest dealmaker—interposing itself between corporate buyers and sellers and making a good deal of money for itself. It has become known as the 'millionaires' factory' but has been involved in allegations such as abuse of trust with personal investments. 'An internal audit in 2010 — which was suppressed by Macquarie — found that 80 per cent of files breached legislation by failing to provide statements of financial advice or otherwise failing to properly document advice and the relationship with the client'. As to the millionaires' factory, Macquarie has long been known for the huge 'generosity of the bank's executives towards themselves' (Long 2015).

Speaking of the banks we are forcibly reminded of the Medici style (see Zingales 2017)[2] when we learn that in the midst of the AUSTRAC investigations the Commonwealth Bank—the subject of the investigations—hired key AUSTRAC staff. Indeed, one observer is reported to have said that 'the revolving door with ASIC and the banks has facilitated regulatory capture' (Ferguson 2017). Regulatory capture refers to the capture of the regulator by the industry players. People with certain skills such as in parts of banking face two main options; working for the regulator or the regulated and their career path may involve periods of each. Sensible workers in the field will not be inclined to offend any potential employer. This is of course more evident when we see Treasury heads and others move into the private sector and when private sector players perform tasks for government. But the movements at more junior levels may be just as serious while not so obvious. Former head of ACCC Graeme Samuel has the issue of 'anticipation of that post career opportunity' for regulators and the 'vulnerable regulator feeling the need to be liked' as well as feeling they are 'mixing it with the big end of town'. He said 'the most serious risk for regulators is industry capture' and that 'industry is adept at implementing regulatory capture strategies' (Kehoe 2018).

We hope the Royal Commission will examine the staff movements between the regulators and the finance sector and back again.

There is an increasingly influential view that says big business can expand through innovation and other orthodox mechanisms or through gaining political influence. Political/government connections can bring:

- preferential access to credit,
- preferential treatment by government-owned business,
- benefits for procurement,
- relaxed regulatory oversight,
- stiffer regulatory oversight of competitors,
- lighter taxation,
- subsidies for (eg) R&D, and
- government bailouts when necessary (Akeigit et al 2018).

Om effect companies exert considerable influence over law-making. Companies that can sustain themselves through political connections do not need to innovate and the costs in lower economic growth are spread throughout the economy (Economist 2018). It is also possible that Australia's financial system would have been 'better

[2] Medici refers to the 'signorias' of the middle ages in Italy in which rich and powerful families ran the city states in their own commercial interests.

behaved' if they were less politically connected. Ken Henry (formerly head of Treasury now chair of the board of the National Australia Bank) has been calling for Australian companies to take more responsibility for misdeeds and said 'Corporate leaders have responsibility for the culture of organisations and they all kind of know it, but they're struggling with how to do it and how to be effective'. In addition the NAB executives signed the banking and finance oath, a pledge by individual finance professionals to behave ethically (Gray 2016). While all of that sounds laudable it does not appear to have been effective and one wonders if the actions of someone like Henry had the effect of little more than postponing government actions.

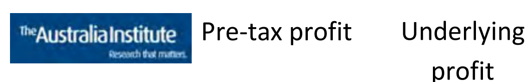
Australia's big banks, particularly the 'four pillars' control so much of the nation's economy, yet the banks have been duping people into buying wealth products that do not suit them, overselling home mortgages and other debt and their insurance arms are rejecting legitimate claims while their traders have been manipulating interest rates. Everyone – even their own CEOs are shouting at the banks to clean up their culture. But you cannot blame the culture when it is the incentive structure within the banks that puts the banks against the wellbeing of the rest of society. Instead of sacking crooked staff the whistle blowers are sacrificed. But the institutions themselves operate as profit maximisers without sufficient checks from competition or regulation.

PROFITABILITY

Meanwhile banks are extremely profitable, which might leave you asking: why would they feel the need to resort to that sort of behaviour?

As mentioned earlier, in 2010 TAI published A licence to print money: bank profits in Australia (Richardson 2010) which found that the underlying profits of the big four megacorp banks were then around $35 billion or just under three per cent of GDP. In the year to June 2018 we calculate the big four banks earned pre-tax profits of 2.9 per cent of GDP. If we use the concept of underlying profit which excludes provisions for bad and doubtful debts then underlying pre-tax profits were 3.1 per cent of GDP; for every dollar spent in Australia 3.1 cents become underlying profit of the banks. A good part of that comes from their recently exposed practices. In Table 1 we present a time series of two profit concepts as a share of GDP.

Table 1: Big four banks profit as share of GDP (%)

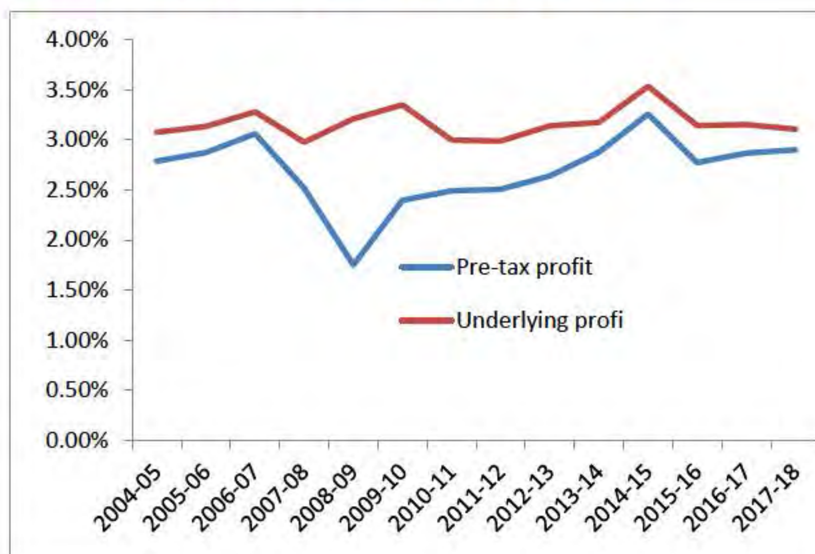
	Pre-tax profit	Underlying profit

2004-05	2.79	3.08
2005-06	2.87	3.13
2006-07	3.06	3.28
2007-08	2.52	2.98
2008-09	1.75	3.21
2009-10	2.40	3.35
2010-11	2.49	3.00
2011-12	2.50	2.99
2012-13	2.64	3.14
2013-14	2.88	3.17
2014-15	3.26	3.54
2015-16	2.77	3.14
2016-17	2.87	3.15
2017-18	2.90	3.11

Source: APRA (2018)

Table 1 suggests that underlying profit in particular has shown little if any trend in the data. Over the period covered the figures appear to be reasonably stable, although the pre-tax profits are somewhat less stable. When the figures in Table 1 are shown graphically another important feature is clearly visible as we show in Figure 1.

Figure 1: Big four banks profit as share of GDP (%)



Source: APRA (2018).

Figure 1 suggests that there was a bit of a slump in pre-tax big bank profit around the time of the global financial crisis. However, underlying profit was barely affected. The gap between pre-tax and underlying profits is the value of provisions for bad and doubtful debts.

As Richardson (2010) shows, the big four banks appear immune from competition and came through the global financial crisis stronger than ever with their share of the Australian financial market as high as ever. About the only things that seem to work against their might are the actions of the Reserve Bank of Australia (RBA) that effectively impose price controls on some of the banks' fees and charges or the types of controls operating before deregulation. As an example, when the Campbell inquiry (Australian Financial System Inquiry) reported in 1979 the banks had 50 per cent of the finance market and various non-bank financial intermediaries had the other 50 per cent. By 2010 the banks' share had increased to 83 per cent (Richardson 2010). The latest figures show banks had 91 per cent of housing loans, credit cooperatives were just 2 per cent and building societies under one per cent. The remainder (6 per cent) was accounted for by securitisation vehicles (ABS 2018b). Within those figures the concentration among the banks themselves increased with the big four gradually increasing their shares of both banking and finance defined more widely. Those large market shares seem to have insulated the banks from reputational risk.

Too big?

In the UK, the Bank of England has expressed concern that larger banks are becoming too complex. It complains that 'some large, complex banks have over 2,000 distinct legal entities across different countries' and, as a result, it has called for the breakup of large banking groups (Bank of England 2009). Some commentators have suggested that the banks need to be trimmed down to their core functions. Former Managing Director of the International Monetary Fund, Strauss-Kahn, has said:

> [I]n the wake of the crisis, it is now widely accepted that in some countries, the financial sector has grown too large. It has gone well beyond its core function of financial intermediation, and devoted much energy to financial engineering—generating products that have been profitable for the industry, but of more doubtful value to the economy as a whole (Strauss-Kahn 2009).

Similar concerns could be expressed about the Australian banking system especially in the context of figures cited above suggesting Australia's is the most concentrated banking industry in the world.

Common ownership

Common ownership issues were apparent when NAB had tried to break away from the other big banks and set its mortgage rates below the others. The NAB said in its press release that 'we broke up with the other banks' (Maley et al 2014) in order to offer lower interest rates to customers. However, according to a newspaper report, Cameron Clyne, the then CEO of the NAB, was pressured to increase interest rates by some of the NAB's biggest shareholders who wanted to see NAB raise interest rates in line with the other banks (Kehoe et al 2012). That allegation was repeated when it was alleged that 'some of Clyne's biggest shareholders have leaned on him to raise rates' to effectively undermine the NAB's strategy when it sacrificed revenue but grew market share in its home loan book and deposits and set itself apart from the three other majors at a time when cynicism about the banks was at record highs (Smith 2012). While this incident was reported there may well have been a large number of other instances of similar sorts of pressures on the part of common owners who would not appreciate attempts by companies to engage in serious competition with each other.

Table 2 updates the earlier TAI paper, which discussed the tight control of the banks by a small number of nominee companies (Richardson 2012). It shows the top owners of the banks as they appear in their respective annual reports.

Table 2: Top owners of the big four banks

Owners	ANZ %	CBA %	NAB %	WBC %	Average %
HSBC Custody Nominees	26.3	21.1	24.4	24.6	24.1
JP Morgan Nominees Australia Limited	14.1	13.0	11.9	12.4	12.8
Citicorp Nominees Pty Limited	8.2	5.6	6.9	6.4	6.8
National Nominees Pty Limited	3.9	3.3	4.3	4.2	3.9
Other top 20 owners	5.8	5.7	6.0	5.8	5.8
Total top 20	58.4	48.6	53.5	53.3	53.5
All other shareholders	41.6	51.4	46.5	46.7	46.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

The Australia Institute Source: Banks' Annual Reports.

The latest figures on common ownership in Table 2 shows that there is a substantial amount of common ownership among the big banks. Indeed, each of the owners has a roughly similar share in each of the banks. One of them, National Nominees Limited, is part of the NAB Group. As far as we are aware the ACCC does not take into account any common ownership when examining takeover proposals and seems not have done so in the specific instance of the Commonwealth's takeover of BankWest. Nonetheless common ownership is certainly going to blunt competition.

An examination of the banks' annual reports shows that the big banks are more than 50 per cent owned by their top shareholders. The exception is the Commonwealth Bank and its ownership by its top 20 shareholders may well be lower as a result of its history of public ownership then privatisation and public offerings targeting small shareholders.

Since the TAI research was published there has been some overseas research examining the implications of common ownership in the US banking system and showing that more common ownership implied higher profits for the companies concerned. The authors of that report concluded that:

> Who owns the banks matters for how the banks compete...we provide analyses that suggest a causal link from...[a concentration index] to prices by using index

> funds' ownership of banks as a source of variation in bank ownership patterns across geographical markets (Azar et al 2016 p 34).[3]

The authors go on to argue that their findings indicate that firms' objectives may 'not necessarily coincide with its individual profits'. If a firm is involved in a full merger with another then the original firm may see its role as contributing to the group's profit rather than its own. Moreover, 'decreased competition due to common ownership concentration has the potential to explain the rising capital share of income, increased inequality, reduced aggregate output, and sluggish macroeconomic growth amid record corporate profits' (Azar et al 2016 p 34-5).

In the particular US market studied by Azar et al concentration varied across the continent given the historic restrictions on bank branching and that allowed the authors to examine profits and charges in different regions with different banking concentrations. Australia by contrast has to be considered a unified market although there may well be slight variations between a particular bank's market share across state borders. Nevertheless the more we think about common ownership, interlocking directorships, the exit and egress of staff and similar issues we really have to question the role of competition in the Australian economy.

Trade off: Competition v stability

The Australian Bankers Association denies there is any evidence the banking sector lacks effective competition. However, as we have argued before (Richardson 2010), the banking sector is a concentrated industry that earns much higher profits than would be expected in a competitive environment. We noted above the extent of the political and economic power of the banks and mentioned the exercise of the banks' political power with the strong campaign against the proposed South Australian bank levy. We could go into much more detail concerning the bank's behaviour and their super profits. However, it is enough to mention their South Australian campaign as evidence they will fight against any challenge to that power while their behaviour with regard to consumer issues and AUSTRAC suggests a lack of accountability and contempt for business norms, rules and regulators .

Following the global financial crisis we noticed that both the Reserve Bank and the Australian Bankers Association appeared to be giving the same message when they introduced concepts of 'effective' and 'safe' levels of competition. The argument is

[3] Note that the US banking system is characterised by a comparatively very large number of banks operating in small and/or regional markets. This reflects a history of prohibitions on interstate and branch banking. Wikipedia says there were 6,799 commercial banks in the US in 2014.

that the more intense the competition is the more risky is bank behaviour and so the more precarious is the banking system. Hence there is now talk of a trade-off between competition and the stability of the banking system.[4]

This notion raises more questions than it answers. There is no evidence that small deposit-taking institutions at the fringe of the Australian market have any more inclination to take on excessive risk than the big uncompetitive banks. Nor is there any evidence that the incentive structure is different in the more competitive part of the industry which might cause the greater willingness to incur risk in that part of the industry. But we do know that there is a strong incentive for large incumbent firms to want to stifle competition including through non-market means.

We think the thesis of a trade-off between stability and competition is a furphy if not a self-serving delusion. However, the link between deregulation and instability is clearer. It is worth quoting Stiglitz who claims that 'making markets more flexible may exacerbate the disequiibrating [sic] dynamics' (Stiglitz 2012).

We also need to address the tendency for businesses to grow so large in the first place. One of the reasons why Australia's big four banks grew so large is that they were permitted to buy smaller rivals such St George and BankWest in recent times. In years gone by the present big four grew to dominate the market by acquiring other competitors. Takeovers/mergers generally should be banned among companies in the same market/s. Companies that wish to grow should attempt to grow organically rather than taking over or merging with their competition. Policy on mergers should include a public interest test.

Banks seemed to have been better behaved when they had competition from a government-owned bank. Cooperatives and other member-owned entities seem to perform a similar function in the markets they operate but are much less well known. We should also revisit proposals to move the Post Office towards more banking functions. In addition as we point out below there are proposals to allow anyone to bank directly with the central bank (see below).

The banks themselves have argued that the charges of profiteering are largely irrelevant because these profits go back to ordinary Australians through the dividends banks pay to shareholders including superannuation funds. As the Australian Bankers' Association expressed it:

[4] In the case of the Reserve Bank see the evidence by Glenn Stevens (2010) to the Senate Economics Committee. For the bankers' view see Munchenberg, (2011).

> An estimated eight million Australians hold shares, either directly or indirectly, in an Australian bank. So you are probably one of the owners of our banks.
>
> Over one and a half million Australians have invested their savings directly in bank shares. These shareholders include tens of thousands of retirees, many of whom rely on the dividends from their bank shares for support income.
>
> Then there are the estimated eight million Australians who, through their superannuation schemes or managed funds, are saving for retirement *(Australian Bankers' Association 2004)*.

Individual bank executives also followed a similar theme and point to the shares held by super funds and therefore what the customers may lose through monopoly pricing they get back as shareholders either directly and indirectly (Richardson 2012). Almost any bad behaviour can be justified if this logic is accepted. This is effectively a restatement of the Farrell-Shapiro view but it falls down on the distribution of shareholdings which is highly skewed towards the rich while the costs are borne disproportionately by lower and middle income earners.

Recommendations and conclusions

No one can deny that the big banks and other finance megacorps have an enormous imbalance of power and information vis-à-vis their customers. That has probably been the case since the establishment of the first bank in 1817 (Bank of New South Wales now Westpac).

Economists have long appreciated the dangers of unchecked greed on the part of business. Adam Smith described the self-interest of the baker and other producers but argued it was competition between bakers that would ensure we get our daily bread at a reasonable price without being ripped off. However Smith also warned about businesses acting in concert to increase their market power. To provide a check against the greed of business economists would also add knowledge; that the customer knows what is in the bread and how it compares with other bakers' offerings. When knowledge is lacking there is again a potential for rip off. Sticking with Smith's bakers we note that Engels reported the almost universal of the adulteration of bread with alum of which people were unaware (Engels 1891).

The Australian financial system fails on both counts; it is dominated by megacorps and there is a vast power and knowledge imbalance between the suppliers and customers.

Then there is the thorny question of establishing the 'rules of the game'. All economic activity takes place within a legal, social and institutional framework that defines to a large extent what and how economic transactions take place. TAI has not addressed this directly but would point to the work of Dr Evan Jones who we understand has made a submission to the Commission on the failings of the legal system in particular.

The implication we obtain from Adam Smith and economists since is that business will rip us off if given half a chance but that generally the market environment holds them in check provided there is sufficient competition, knowledge and protection. Clearly that is not always the case especially in markets dominated by megacorps.

We recommend the Commission acknowledge the power and information imbalances and the potential for unchecked financial institutions and their staff to rip off their customers.

There are certainly arguments for breaking banking and other large finance companies into smaller units. Moreover, the banks' power to a large extent reflects their control of the payments system.

We recommend the Commission consider means of breaking up large financial institutions and putting the operation of the payments system in the hands of the Reserve Bank or some independent alternative institution not involved with banking.

We recommend the Commission address the issue of common ownership among the banks and other financial institutions.

We recommend an independent body be established to consider fraud and deception in the finance industry and continue the invaluable work of the Royal Commission.

We recommend some mechanism to restrict or limit the movement of public servants into the finance sector as well as the movement in the opposite direction.

Other policy changes that would contribute to a better banking outcome include:

- **reducing the one-sided ability to vary interest rate margins by, for example, legislating to ensure that interest rates charged by banks move in line with changes to the RBA cash rate and are set and advertised as a mark-up over the cash rate**
- **capping certain kinds of bank fees at a level sufficient to cover costs, including a reasonable return on assets**
- **mandating that all financial institutions offer a no-frills, low-cost everyday savings/transaction account to every customer as the default option**
- **restricting the interest rates that can be charged on unsecured credit to levels that reflect the underlying risk to the lender—at the moment lending rates seem to be much higher than objective measures of bad and doubtful debts would suggest**

Such initiatives would help bring profits back to a reasonable level, but it is also important that banks do not use their privileged position to exploit the vulnerabilities of individual customers. Something more is needed to ensure that banks behave in socially responsible ways that contribute to the wellbeing of the broader community. We have discussed initiatives in Fear et al (2010) that address the imbalance between banks and their customers but those are revisited and expanded upon in the submission by the Centre for Future Work.

However, in addition to all of the above

- **establish a means of addressing excessive bank profits by returning them to the community through such devices as a super profits tax on economic rents generated in finance. That might include a mechanism that would return excessive income from mortgages back to the borrower.**

- **either expand the APRA mission to include the surveillance of all bank fees, charges, and commissions including interest rates or charge the Australian Competition and Consumer Commission with those functions.**

We reommend the Commission consider forcing financial institutions to divest themselves from financial planning and related businesses that conflict with banks' core businesses.

In Australia at the moment there is no longer a publicly-owned and trustworthy financial institution that might assist in keeping the others honest as well as providing customers with that choice.

We recommend the Commission examine the potential role of a publicly-owned financial corporation with a charter to provide a sound and honest banking service.

In the event that the company tax cuts go ahead and include highly profitable entities such as the banks then:

We would recommend either the banks be quarantined from the proposed tax cut or become subject to an excess profit tax along the lines of the Petroleum Resource Rent Tax. The revenue would be earmarked in the first instance to compensate victims of financial misconduct.

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