The Australia Institute
Research that matters.

Submission

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

David Richardson

March 2018

ABOUT THE AUSTRALIA INSTITUTE

The Australia Institute is an independent public policy think tank based in Canberra. It is funded by donations from philanthropic trusts and individuals and commissioned research. We barrack for ideas, not political parties or candidates. Since its launch in 1994, the Institute has carried out highly influential research on a broad range of economic, social and environmental issues.

OUR PHILOSOPHY

As we begin the 21st century, new dilemmas confront our society and our planet. Unprecedented levels of consumption co-exist with extreme poverty. Through new technology we are more connected than we have ever been, yet civic engagement is declining. Environmental neglect continues despite heightened ecological awareness. A better balance is urgently needed.

The Australia Institute's directors, staff and supporters represent a broad range of views and priorities. What unites us is a belief that through a combination of research and creativity we can promote new solutions and ways of thinking.

OUR PURPOSE – 'RESEARCH THAT MATTERS'

The Institute publishes research that contributes to a more just, sustainable and peaceful society. Our goal is to gather, interpret and communicate evidence in order to both diagnose the problems we face and propose new solutions to tackle them.

The Institute is wholly independent and not affiliated with any other organisation. Donations to its Research Fund are tax deductible for the donor. Anyone wishing to donate can do so via the website at https://www.tai.org.au or by calling the Institute on 02 6130 0530. Our secure and user-friendly website allows donors to make either one-off or regular monthly donations and we encourage everyone who can to donate in this way as it assists our research in the most significant manner.

Level 1, Endeavour House, 1 Franklin St
Canberra, ACT 2601
Tel: (02) 61300530
Email: mail@tai.org.au
Website: www.tai.org.au
ISSN: 1836-9014

Table of Contents

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[1] 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.

[1] See in particular Eichner AS (1976) *The Megacorp and Oligopoly: Micro Foundations of Macro Dynamics*, Cambridge University Press.

The Australia Institute papers

BANKING

In 2010 TAI published *A licence to print money: bank profits in Australia* 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. They 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 This publication 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.

Submission to the Senate Economics Committee inquiry 'Competition within the Australian banking sector' 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 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 in 2012 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.[2]

New research supports need for extra bank regulation 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).

[2] The Economist (2016) 'Stealth socialism', *The Economist*, 17 September.

- 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 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 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, this is just the narrow arguments often used by economists when they concentrate on 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.

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.

Consumer protection in the banking, insurance and financial sector 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 is to look at the deeper issues and ask what are the forces that drive 'bad behaviour' in the finance and insurance sectors. We start 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 discussion provides a useful framework for considering the Australian debate and the abuses that have been highlighted in the Australian debate.

Our aim in this submission was 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. We began our submission with an outline of the views of Luigi Zingales.

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. 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. 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. Those arguments were ultimately reflected in the Cooper Review[3] and subsequently in new superannuation arrangements.

Can the taxpayer afford self-funded retirement? 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 June 2013 a total of 509,362 SMSFs had total assets of $506 billion[4]; 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?

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? 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.

[3] Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (2010)

[4] APRA (2014) Statistics: Annual Superannuation Bulletin, June 2013, 8 January.

Fraud and other malfeasance

TAI has not produced any research that examines 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 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.*[5]
>
> *[W]e find that customers who choose St George are not the customers who would choose Westpac. There is very little overlap there.*[6]
>
> *It is more different attitudinal approach. The customers who have chosen St George do not want to bank with a major bank.*[7]

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.*[8]

Now St George is just a group within Westpac[9] 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

---

[5] Kelly G (2011) 'Transcript of evidence', *Senate Economics Committee Inquiry into competition within the Australian banking sector*, Sydney, 21 January, p. 55.

[6] P 86

[7] P 88

[8] Johnston E (2012) 'Kelly rejects multi-branding critics', *Sydney Morning Herald*, May 4.

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

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.

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.[10] We might almost suggest that paper should be required reading for the Commission.

[10] Zingales L (2015) 'Does finance benefit society?' *2015 American Finance Association Presidential Address*.

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.

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. 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.

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.

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 perhaps beyond the scope of the current submission. However, some that are relevant to the present inquiry include:

- **restricting or banning sales targets and commissions for bank workers**
- **providing bank workers with a decent ordinary wage independent of salesbased commissions**
- **preventing banks from claiming money spent on the advertising of credit products as tax deductible business expenses.**

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 Recommend 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.

UNPUBLISHED OP ED, 13 APRIL 2016

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.

Meanwhile banks are extremely profitable, which might leave you asking: why would they feel the need to resort to that sort of behaviour? Before-tax underlying profit of all banks was $55.3 billion, or 3.4 per cent of Australia's national income, in the year to December 2015. That is, for every dollar spent in Australia 3.4 cents become underlying profit of the banks. A good part of that comes from their dirty practices.

Ken Henry (formerly head of Treasury now chair 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', ASIC head, Greg Medcraft, was also reported as wanting to make boards criminally responsible for bad conduct.

On Thursday the Australian Financial Review lead story was 'PM puts huge pressure on banks to end scandals'. That 'huge pressure' was further described: 'Prime Minister Malcolm Turnbull slammed what he said was the banks' culture of greed'. The Prime Minister, with all of his authority to make laws and regulations, elected to tell the banks to fix themselves, pretty please.

All this is fairly mild compared with the message from the American Finance Association president, Luigi Zingales, who said 'I fear that in the financial sector fraud has become a feature and not a bug'. Part of the responsibility, in his view, was the instruction in universities where finance faculties 'teach our students how to maximize the tax advantage of debt and how to exploit any arbitrage opportunity. Customers are often not seen as people to respect, but as counterparties to take to the cleaners'.

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'.

These sorts of comments could apply equally to Australia. Staff in the big banks have all been turned into sales staff. Every interaction with the bank is seen as an opportunity to try to sell other products. Incentives are provided to staff who make sales and, at the same time, there is disapproval of those staff that do not make their quotas.

Staff who sell 'wealth products' have an incentive to sell a lot as well as directing the customers towards the banks' own products and/or those paying the staff some sort of commission. Probably staff that 'play fair' can make a reasonable living selling those products. But those who are willing to cut corners and sell products with the biggest commissions are going to do very well.

Loan managers are similarly likely to be 'incentivised' to maximise their loans and, as a result, APRA has voiced concerns about some of the loan contracts that customers have entered. APRA claims to have worked hard with banks over the last year to improve lending standards.[1] Along with the incentive to sell unsuited products the banks themselves have developed ways of presenting their loan and deposit offers that are difficult to understand let alone compare against their competition.

The Commonwealth Bank's insurance arm has been in the news for knocking back reasonable claims and/or trying to hold out until the death of the claimant. What is a claims manager supposed to do? We can imagine how an insurance company (or a branch of a bank) would feel about a claims manager who willingly agreed to all the claims that came in. There is no incentive structure that guarantees an outcome will be fair.

We expect to see banks as solid, staid and very conservative institutions who are motivated by much more lofty concerns than making money. But the banks have allowed, or encouraged the development of an incentive structure that now lures those who see a banking career as selling wealth management products, rather than serving customers and as Zingales says 'fraud is a feature'.

How we clean up this industry is a more difficult question. David Murray was speaking for the banks when he strenuously objected to proposals to prescribe bank culture. But a bad culture has to be addressed by changing the incentive structure, not least by stronger sanctions against those who rip us off.

[1] Richards H (2016) 'A prudential approach to mortgage lending', address to *Macquarie University Financial Risk Day*, Sydney, 18 March.

BANK CULTURE; SYSTEMIC FAILURE OR JUST A FEW BAD EGGS

AUTHOR: David Richardson

PUBLICATION: AFR

PUBLICATION DATE: 12/04/16

LINK tba

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.

The big banks have been in the news a good deal in recent times and for all the wrong reasons. The issues include allegations of interest rate fixing, refusing to honour insurance claims, selling dud wealth management products and overcharging. Meanwhile banks are extremely profitable, which might leave you asking: why would they feel the need to resort to that sort of behaviour? According to APRA figures and TAI calculations, before-tax underlying profit of all banks was $55.3 billion, or 3.4 per cent of Australia's national income, in the year to December 2015. That is, for every dollar spent in Australia almost three and a half cents become underlying profit of the banking system.

This extremely profitable industry is now the subject of intense discussion about how to reform it. Ken Henry (formerly head of Treasury now chair 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', ASIC head, Greg Medcraft, was also reported as wanting to make boards criminally responsible for bad conduct.

On Thursday the Australian Financial Review lead story was 'PM puts huge pressure on banks to end scandals'. That 'huge pressure' was further described: 'Prime Minister Malcolm Turnbull slammed what he said was the banks' culture of greed as political pressure mounted for a royal commission into the scandal-plagued industry'. The

Prime Minister, with all of his authority to make laws and regulations, elected to tell the banks to fix themselves, pretty please.

All this is fairly mild compared with the message from the American Finance Association president, Luigi Zingales, who said 'I fear that in the financial sector fraud has become a feature and not a bug'. Part of the responsibility, in his view, was the instruction in universities where finance faculties 'teach our students how to maximize the tax advantage of debt and how to exploit any arbitrage opportunity. Customers are often not seen as people to respect, but as counterparties to take to the cleaners. … If the only goal is enrichment, there is a risk that abuses and fraud become not a distortion, but a continuation of the same strategy by other means'.

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'.

These sorts of comments could apply equally to Australia. Staff in the big banks have all been turned into sales staff. Every interaction with the bank is seen as an opportunity to try to sell other products. Incentives are provided to staff who make sales and, at the same time, there is disapproval of those staff that do not make their quotas.

Staff who sell 'wealth products' have an incentive to sell a lot as well as directing the customers towards the banks' own products and/or those paying the staff some sort of commission. Probably staff that 'play fair' can make a reasonable living selling those products. But those who are willing to cut corners and sell products with the biggest commissions are going to do very well.

Loan managers are similarly likely to be 'incentivised' to maximise their loans and, as a result, APRA has voiced concerns about some of the loan contracts that customers have entered. APRA claims to have worked hard with banks over the last year to improve lending standards.[1] Along with the incentive to sell unsuited products the banks themselves have developed ways of presenting their loan and deposit offers that are difficult to understand let alone compare against their competition.

The Commonwealth Bank's insurance arm has been in the news for knocking back reasonable claims and/or trying to hold out until the death of the claimant. What is a claims manager supposed to do? We can imagine how an insurance company (or a branch of a bank) would feel about a claims manager who willingly agreed to all the claims that came in. There is no incentive structure that guarantees an outcome will be fair and it is probably not possible to design one that would overcome the employer's profit motive.

We expect to see banks as solid, staid and very conservative institutions who look at financial arrangements very seriously and are motivated by much more lofty concerns than making money. But all the financial incentives are aligned towards staff who are indeed motivated by grubby motives such as making money. The banks have allowed, or encouraged the development of an incentive structure that now lures those who see a banking career as selling wealth management products, rather than serving customers. These are the areas where Zingales says 'fraud is a feature'.

How we clean up this industry is a more difficult question. David Murray was speaking for the banks when he strenuously objected to proposals to prescribe bank culture. The Prime Minister can wave his finger and ask the banks to be good, and he can simultaneously hear David Murray's call and give them whatever they want. But a bad culture has to be addressed by changing the incentive structure not least by stronger sanctions against those who rip us off.

David Richardson is the Senior Research Fellow at The Australia Institute