

The Senate

Economics
Legislation Committee

Banking System Reform (Separation of Banks)
Bill 2019

May 2019

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Chapter 1

Introduction

1.1 On 14 February 2019, the Senate referred the Banking System Reform (Separation of Banks) Bill 2019 (the bill) to the Economics Legislation Committee (the committee) for inquiry and report by 13 May 2019.¹

Overview of the bill

1.2 On 12 February 2019, Senator Hanson introduced the bill in the Senate. According to the Explanatory Memorandum (EM), the bill seeks to:

- protect deposits;
- end vertical integration, to protect depositors from banks trying to lure them into buying services from the banks' other business;
- ensure deposits are only used for normal lending, which will keep more money in the real economy and available for banks to lend to productive enterprises; and
- stop banks from securitising mortgages—meaning on-selling them to other banks to be bundled into risky derivatives—which will put a brake on mortgage fraud and excessive mortgage lending to risky borrowers.²

1.3 The EM stated that the effect of the bill will be:

- to re-establish public confidence in the banking system;
- to reduce risks to the Australian financial system by limiting the ability of banks to engage in activities other than socially valuable core banking activities;
- to limit conflicts of interest that arise from banks engaging in activities from which their profits are earned at the expense of their customers and the national interest;
- to remove explicit and implicit government guarantees for high-risk activities outside of the core business of banking;
- to regulate Australian Banks;
- to strengthen Parliamentary oversight of the activities of the Australian Prudential Regulatory [Authority] (APRA) as the banking regulator; and
- to separate retail commercial banking activities involving the holding of deposits, from wholesale and investment banking involving risky activities.³

1 *Journals of the Senate*, No. 140, 14 February 2019, p. 4667.

2 *Explanatory Memorandum*, p. 1.

3 *Explanatory Memorandum*, p. 1.

1.4 In her second reading speech, Senator Hanson, drawing on the banks' behaviour as exposed by the Hayne Royal Commission, stated:

The Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has highlighted the necessity for banks to be limited to their core industry. The vertical integration of the banks providing additional services including financial advice, insurance and superannuation have been shown to be the root cause of rorts, over charging and profit gouging...

The Banking System Reform (Separation of Banks) Bill 2019 will put in place a banking system that, I hope, will prevent a repetition of the history being aired before the Hayne Royal Commission.⁴

Regulatory Impact Statement

1.5 The bill will, according to the EM, have a moderate impact as the regulatory authority and powers already exist in respect of the existing regime of regulation of authorised deposit-taking institutions (ADIs).⁵

Financial Impact Statement

1.6 The bill according to the EM, has no significant impact on Commonwealth expenditure or revenue and is intended to operate within the existing regulatory framework subject to Parliamentary oversight of the regulator, APRA.⁶

1.7 The EM argued that there will be a transitional cost for banks in the separation of the elements of their businesses, and as they adjust to the operation of the new regime as provided for in the bill. The EM also argued that the compliance cost in relation to the new regime will be minimal, as the regulatory authority and powers already exist in the current regime of ADI regulation.⁷

Human rights implications

1.8 The EM stated that the bill does not engage any of the applicable rights or freedoms and does not raise any human rights issues.⁸

Legislative scrutiny

1.9 The Senate Standing Committee for the Scrutiny of Bills made no comment in relation to the bill.⁹ The Parliamentary Joint Committee on Human Rights found that the bill did not raise human rights concerns.¹⁰

4 Senator Pauline Hanson, *Senate Hansard*, 12 February 2019, pp. 9894–5.

5 *Explanatory Memorandum*, p. 3.

6 *Explanatory Memorandum*, p. 3.

7 *Explanatory Memorandum*, p. 3.

8 *Explanatory Memorandum*, p. 9.

9 Senate Standing Committee for the Scrutiny of Bills, *Index of Bills*, 28 March 2019, p. 1, https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Scrutiny_of_Bills/Index_of_Bills (accessed 15 April 2019).

Conduct of the inquiry

1.10 The committee advertised the inquiry on its website and wrote to relevant stakeholders and other interested parties inviting submissions.

1.11 Following the call for submissions to the inquiry, the committee received a significant amount of correspondence from individuals across the country.

1.12 Over 900 items of correspondence, both electronically and in hard copy, were received. Due to the large number of submissions, the committee has decided not to publish every submission it received on its website.

1.13 The large public response was prompted by an email campaign organised by the Citizens Electoral Council of Australia (CEC), which is a national political party.¹¹ The CEC ran a co-ordinated appeal to its members to lodge submissions with the committee, outlining why they believed the bill should be passed by the Parliament. As a result, the received documents repeatedly focussed on the same themes with little variation.

1.14 Accordingly, the committee has published a selection of submissions which represent the recurring views expressed in those documents. In total, the committee published 54 submissions, which are listed at Appendix 1.

1.15 All correspondence and submissions were considered by the committee during the course of the inquiry. The committee appreciates the efforts of all stakeholders who contributed to the inquiry.

10 Parliamentary Joint Committee on Human Rights, *Report 2 of 2019*, p. 169.

11 Citizens Electoral Council of Australia website: <http://www.cecaust.com.au/> (accessed 15 April 2019).

Chapter 2

Views on the bill

2.1 As discussed in chapter 1, the committee received over 900 pieces of correspondence of which 54 were accepted as submissions to the inquiry.

Support for the bill

2.2 The mail campaign organised by the Citizens Electoral Council of Australia (CEC) was responsible for all but a small handful of the received correspondence and accepted submissions. The correspondents and submitters consistently made the following points:

- the recently completed Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ('the Royal Commission') demonstrated conclusively that Australian banks, and in particular the four major banks—Commonwealth, ANZ, Westpac and NAB—were not to be trusted;¹
- the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 gave power to access customer deposits should a bank find itself in financial difficulties;²
- the existing financial regulators, such as the Australia Prudential Regulatory Authority (APRA), were ineffectual as exposed by the Royal Commission;³
- international agencies such as the Bank of International Settlements (BIS) and the International Monetary Fund (IMF) had or are in the process of usurping Australia's sovereignty with regard to banking laws;⁴ and
- separation of bank activities between retail-deposit banking and investment banking was necessary to safeguard customer deposits and this was best achieved through new legislation based on the now repealed 'Glass-Steagall'⁵ legislation that was in effect in the United States between 1933–1999.⁶

1 For example, see Mr Adrian Giacobetti, *Submission 9*, p. 2.

2 For example, see Mr John Terenzini, *Submission 2*, p. 2.

3 For example, see Dr Wilson Sy, *Submission 49*, pp. 2–4.

4 For example, see Mr Anthony Allison, *Submission 29*, pp. 10–11.

5 The Glass-Steagall Act was passed by the U.S. Congress in response to the Great Depression as part of the Banking Act of 1933. Sponsored by Senator Carter Glass, a former Treasury secretary, and Representative Henry Steagall, chairman of the House Banking and Currency Committee, it prohibited commercial banks from participating in investment banking and vice versa. Glass-Steagall lost its relevance in subsequent decades and was effectively repealed in 1999. See *Federal Reserve History*, webpage, 'Banking Act of 1933 (Glass-Steagall)', https://www.federalreservehistory.org/essays/glass_steagall_act, (accessed 16 April 2019).

6 For example, see Mr Michael Swain, *Submission 10*, p. 1.

2.3 Accordingly, all these correspondents and submitters strongly supported the bill as proposed. Many expressed the deep concern that their life savings and superannuation accounts were under threat through the existing banking arrangements and what they believe to be an oncoming financial crisis of the same proportion as that which occurred during 2008–09.⁷

2.4 The CEC itself, in its own submission to the committee's inquiry, summarised its support for the bill:

Separating banks is not a panacea, but it will address many of the problems in the system. It will stop banks from being too big to fail and therefore make them more prudent as they will be accountable for their own actions. It will remove the conflicts of interests of vertical integration and force all financial services companies to serve their customers again, instead of fleecing them. It will stop banks from speculating with other people's money, which will reduce speculation and encourage credit into productive activities that create jobs and grow wealth and ensure that debt is repayable and not a growing burden and drag on the economy. It will simplify the financial system so that it is straightforward to regulate and for regulations to be enforced. And it will protect deposits, and therefore the confidence that underpins the banking system, far better than any government guarantee by ensuring that banks with deposits do not engage in the risky activities that put the savings of their customers at risk.⁸

Qualified support for the bill's intent

2.5 The Australian Institute for Progress (AIP) expressed support for some aspects of the bill's intent, but had reservations about the bill's wording and unintended outcomes. The AIP observed:

The bill as currently drafted is confused, and will not achieve the results that it seeks. All parts of it should be removed, except those that require banks to only be involved in the business of banking.⁹

2.6 The AIP went on to say that the bill in its current form 'would actually damage the efficiency of Australia's financial services'.¹⁰ The AIP concluded:

While the Hayne Royal Commission revealed deficiencies in the banking sector, it is important not to over-react and put Australian banks in a position where they are over-supervised and innovation is difficult.

This can be achieved by structural separation of the financial services sector so that retail banking is not polluted by being mixed with other activities. To the extent the bill achieves this, it is good. To the extent it tries to be prescriptive as to who and on what terms banks may lend, it is not helpful,

7 For example, see Ms Beate Lerchner, *Submission 26*, p. 1.

8 Citizens Electoral Council of Australia, *Submission 51*, p. 4.

9 Australian Institute for Progress, *Submission 48*, p. 5.

10 Australian Institute for Progress, *Submission 48*, p. 5.

nor in attempting to ban the securitisation of mortgage backed securities etc.¹¹

Opposition to the bill

2.7 The Australian Shareholders' Association (ASA) opposed the bill. ASA argued that new laws were not required; rather that existing laws should be reformed and properly enforced, and cited the Royal Commission's outcomes as support for its position:

ASA particularly supports the reaffirmation that new laws are not required, but current laws need to be enforced and a better outcome would be achieved by having clearer laws. We support the proposal to reduce the number and area of operation of special rules, exceptions and carve-outs. As such, ASA does not support the Banking System Reform (Separation of Banks) Bill 2019, which runs counter to these recommendations by Commissioner Hayne.¹²

2.8 The Australian Banking Association (ABA) also opposed the bill for essentially the same reasons; that is, that existing laws should be reformed and better enforced. They too cited Commissioner Hayne's conclusions to support their position:

The ABA does not support this Bill and has concerns with the drastic regulatory intervention it proposes. The banking industry is undergoing substantial reform and the ABA is of the view that these reforms will achieve the objectives of the Bill in a manner that is more efficient, and less costly and disruptive to the economy and community.

This was the view of Commissioner, the Honourable Kenneth Hayne AC QC, in his Final Report of the Royal Commission into misconduct in Banking, Superannuation and Financial Services Industry (Royal Commission), where he stated that such form of regulatory intervention will likely be costly and disruptive, and it remained unclear that the benefits of structural separation would outweigh the costs.¹³

2.9 The Finance Sector Union of Australia (FSU) was of the view that vertical integration was not, in itself, a problem and that separation was not necessary. The FSU stated:

The Union does not believe that the solution to conflicts that arise from vertical integration is to ban it or to separate the entities. Rather, the solutions involve a range of measures including:

- prohibition of conflicted remuneration defined as all variable or contingent pay;
- elimination of the general advice exception (in terms of consideration of the customer best interest and an assessment of

11 Australian Institute for Progress, *Submission 48*, p. 6.

12 Australian Shareholders' Association *Submission 2*, p. 1.

13 Australian Banking Association, *Submission 30*, p. 1.

customer needs) under the FOFA [Future of Financial Advice] provisions;

- avoiding incentives or drivers that promote sale of a product or class of products;
- improved education, training and professionalisation in the industry to promote a customer centric culture in the sale of financial services products;
- requiring licensees to disclose conflicts, including vertical integration and commercial relationships, in a clear and comprehensible manner to customers; and
- creating a standards and training framework that ensures that staff are appropriately trained and empowered to resist conflicted sales drivers.¹⁴

Committee view

The Royal Commission and its findings

2.10 The committee, like many Australians, was disappointed and indeed shocked at the outcomes of the Royal Commission. The Commission's recommendations are now being considered and the regulators are examining whether criminal charges should be pursued.¹⁵ The committee recognises that confidence in the banks has been lost, and that the banking and finance industry will need to make a great effort over a long time period in order to regain that trust.

Safety of Australian bank deposits

2.11 The committee understands that the outcomes of the Royal Commission may have resulted in individuals questioning the safety of their deposits and recognises that Australians want their savings and superannuation accounts to remain safe—particularly those older Australians who are no longer in the position of being able to 'start again' financially should the worst befall them.

2.12 An important and lasting benefit of the US Glass-Steagall Act reforms was the introduction of the Federal Deposit Insurance Corporation (FDIC) in 1933. The FDIC is an independent agency of the US federal government. All national US banks are required to be members of the FDIC with voluntary membership available to state banks. The FDIC preserves and promotes public confidence in the U.S. financial system by insuring deposits only [not securities, mutual funds or similar types of investments] in banks and thrift institutions for at least \$250,000 per depositor, per insured bank.¹⁶

14 Finance Sector Union of Australia, *Submission 54*, pp. 1–2.

15 See 'Banks may face criminal charges after final royal commission report', *The Guardian*, 4 February 2019, <https://www.theguardian.com/australia-news/2019/feb/04/banks-may-face-criminal-charges-after-final-royal-commission-report> (accessed 16 April 2019).

16 Federal Deposit Insurance Corporation, Who is the FDIC?, <https://www.fdic.gov/about/learn/symbol/>, (accessed 17 April 2019).

2.13 The Reserve Bank of Australia (RBA) explains the protections afforded to Australian depositors on its website:

Depositors in authorised deposit-taking institutions (ADIs) in Australia benefit from a number of layers of protection designed to ensure that their funds are safe. At the broadest level, Australia has a strong system of prudential regulation and supervision which, together with sound management at individual institutions, has meant that problems in ADIs have been rare. In addition, depositors benefit from strong protections in the unlikely event that an ADI fails. They have a priority claim on the assets of a failed ADI ahead of other unsecured creditors, known as 'depositor preference'.

Depositor protection arrangements were further strengthened in 2008 with the introduction of the Financial Claims Scheme (FCS), under which the Australian Government guarantees the timely repayment of deposits up to a predefined cap. This cap was temporarily set at \$1 million per person per ADI when the FCS was introduced and is scheduled to be set on a permanent basis at \$250,000 per person per ADI from 1 February 2012.¹⁷

2.14 In addition to the RBA's explanation, the Australian Securities and Investments Commission (ASIC) website further explains the Government guarantee on deposits:

The Australian Government has guaranteed deposits up to \$250,000 in Authorised Deposit-taking Institutions (ADIs) such as your bank, building society or credit union. This means that this money is guaranteed if anything happens to the ADI.

The cap applies per person and per ADI. So if you have \$250,000 with one ADI and \$250,000 with another, then both of your deposits are guaranteed... The guarantee applies to all ADIs incorporated in Australia, including Australian-owned banks, foreign subsidiary banks, building societies and credit unions...

The types of accounts covered by the guarantee are: savings accounts; call accounts; term deposits; current accounts; cheque accounts; debit card accounts; transaction accounts; personal basic accounts; cash management accounts; farm management deposits; pensioner deeming accounts; mortgage offset accounts, either 100 per cent or partial offset that are separate deposit accounts; trustee accounts; and retirement savings accounts.¹⁸

Concerns about 'bail-in'

2.15 The committee would also like to clarify that the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* does not allow

17 Reserve Bank of Australia website, 'Depositor Protection in Australia', <https://www.rba.gov.au/publications/bulletin/2011/dec/5.html>, (accessed 15 April 2019).

18 Australian Securities and Investments Commission (ASIC) website, 'Moneysmart: Banking', <https://www.moneysmart.gov.au/managing-your-money/banking>, (accessed 15 April 2019).

for customer deposits to be 'bailed-in'. The committee would like to reiterate the conclusion it reached for the inquiry it conducted into that legislation:

The committee believes that the protection of depositors' interests is paramount and does not consider that the [Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017] would allow the 'bail-in' of Australians' savings and deposits. The stability of the financial system depends on its depositors having confidence in its financial institutions. By ensuring the security of depositors' savings, the overall protection of the financial system can be ensured.¹⁹

The bill itself

2.16 As the AIP remarked in their submission, the bill itself does not appear to have been well drafted and if passed in its current form may do more harm than good. Such a profound change to the Australian banking and financial system would require a more detailed bill to properly implement such a change.

Conclusion

2.17 The committee is confident that current legislative protections are sufficient to ensure that the money of Australians held in bank deposits are safe. In support of that conclusion, the committee notes that during 2008–09, no Australian bank collapsed and no Australian deposits were lost despite the worst financial crisis since the Great Depression of 1929–33. While individuals may have lost money during that crisis, this was the result of falls in share prices and other markets, (primarily in the equity markets) and not the result of bank failure or confiscation of deposits.

2.18 While the committee acknowledges the concerns of correspondents and submitters, we do not believe that the full separation of the banks is necessary as has been advocated in the bill and by its supporters.

2.19 The committee also notes the concerns raised by AIP into the wording and structure of the bill. Even if the committee were convinced that banking separation was necessary, it would not be possible to support the bill as it currently stands.

2.20 For these reasons, the committee recommends that the bill not be passed.

Recommendation 1

2.21 The committee recommends that the Senate not pass the bill.

Senator Jane Hume
Chair

19 Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017 [Provisions] Report, 9 February 2018, p. 22, https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/CrisisResolutionPowers/Report, (accessed 15 April 2019).

Additional Comments from Labor Senators

1.1 Labor Senators do not support the *Banking System Reform (Separation of Banks) Bill 2019*.

1.2 Labor fought for the Royal Commission to shine a light on misconduct in the banking and financial services industry, and to provide a blueprint for how we can fix the deep-rooted issues at the heart of that misconduct.

1.3 The Hayne Royal Commission made 76 recommendations and a swathe of additional comments and observations about possible future action, but it did not recommend any structural separation of banks or any Glass-Steagall style legislation.

1.4 The Productivity Commission in its report *Competition in the Australian Financial System* also looked at separation policies in Chapter 9 and rejected them, stating:

FINDING 9.2 FORCED SEPARATION IS NOT A PANACEA

Forced structural separation is not likely to prove an effective regulatory response to competition concerns in the financial system, specifically not in either home loan or wealth management markets.¹

1.5 The Reserve Bank of Australia, APRA, ASIC and Treasury have responsibility for ensuring the stability and strength of the Australian financial system. Labor Senators have confidence in the ability of these institutions to manage financial stability risks and are therefore not considering Glass-Steagall style legislative measures.

1.6 Labor Senators are determined to ensure that the banking and financial sector is held to account for their actions wherever there has been misconduct or unethical behaviour.

1.7 Labor Senators are committed to reforming financial services in Australia to prevent the scandals and rip-offs exposed by the Royal Commission from ever happening again. To achieve this, Labor is focussed on implementing the recommendations of the Royal Commission to deliver lasting, comprehensive change to financial services.

1.8 In contrast, we have a Government who shows time and time again to be only for the top of town. The Government never wanted this Royal Commission to happen. They voted against it 26 times. The current Prime Minister fought against it for 600 days, calling it a 'populist whinge' and a 'reckless distraction'.

1.9 The current Prime Minister and his Government cannot be trusted to crack down on financial services misconduct, and they cannot be trusted to implement the recommendations of a Royal Commission that they never wanted in the first place.

1.10 Labor will fully implement 75 of the 76 recommendations, and will implement the final recommendation, Recommendation 1.3—Mortgage Broker

1 Productivity Commission, *Competition in the Australian Financial System*, p. 272.

Remuneration, in a manner that achieves the objectives but without harming competition in the retail mortgage market. We are sticking to our tougher, fairer and faster plan to implement its recommendations.

1.11 Labor called for the Royal Commission, Labor fought for the Royal Commission and only Labor can be trusted to implement its recommendations.

Senator Chris Ketter
Deputy Chair

Senator Jenny McAllister
Senator for New South Wales

Greens Dissenting Report

Make banking boring again

1.1 The problem with banking and finance in Australia is the same problem that exists in most of the western world. Through globalisation, technology and blind faith in the wisdom of markets, the financial system has become too big, too complicated and too interwoven to properly serve the interests of individuals and society. Banking has become a master of the economy, rather than its servant.

1.2 Australia has embraced financialised capitalism as much as any other nation. The banking and finance sector is the largest single industry sector, and accounts for 9 per cent of GDP,¹ which makes us one of the most heavily financialised economies in the world.²

1.3 But the increase in the size and scope of banking has not been matched by an increase in financial stability or a more even distribution of economic prosperity. Overwhelmingly, financial complexity has been of more benefit to the finance industry than it has been to individuals or society.³ Beyond a certain point, an oversized banking and finance sector actually constrains the real economy.⁴ In part, this is because no-one really understands the interconnectedness between complex financial products and everyday life. Risk is everywhere and it's everyone's problem, whether you signed up for it or not.

1.4 At the heart of modern banking and finance is the rise of universal banking, where everything from saving accounts to derivatives trading is under the one roof. This has been characterised in Australia by the development of the major banks into vertically and horizontally integrated institutions over the last twenty-odd years.⁵

1.5 This privatised and deregulated model has failed in banking for the same reason it has failed in so many essential services: it is built on the fallacy of the efficient-market hypothesis. This is the idea that well-informed individuals will act rationally and seek out the best deal for themselves. And, in doing so, these individuals will bring discipline to the market and ensure that asset prices reflect their underlying value. In other words, the system will be self-regulating.

1.6 This has proven to be nonsense. In the case of individuals, most people don't have the time, wealth or inclination to warrant spending their evenings poring over

1 ABS 5204.0 - Australian System of National Accounts, 2016–17.

2 Maddock, *Is the Australian financial sector too big?*, ANZ Bluenotes, 16 April 2014.

3 See: Kay, *Other people's money: masters of the universe or servants of the people*, 2015.

4 See: Cecchetti & Kharroubi, BIS Working Papers No 490, *Why does financial sector growth crowd out real economic growth?*, February 2015.

5 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Volume 1.

product disclosure statements and making price comparisons. Even if they do, in the words of the Productivity Commission:

What often is passed off as competition is more accurately described as persistent marketing and brand activity designed to promote a blizzard of barely differentiated products and 'white labels'.⁶

1.7 Instead, universal banking has allowed banks to prey upon customers' trust and loyalty by talking them into buying products they don't understand or don't need.⁷ As noted by Commissioner Hayne:

...there is always a striking asymmetry of power and information between bank and customer that favours the bank.⁸

1.8 In the case of those on the inside, universal banking has failed to provide much in the way of market discipline or protection against the build-up of systemic risk. Instead, with the government compelled to act as a lender of last resort, universal banking encouraged market concentration and gave rise to institutions that are 'too-big-to-fail', riddled with moral hazard, and blithe to the risks they are taking on. That was the Global Financial Crisis (GFC).

1.9 For all of the reasons outlined above, the Greens led the charge for a Royal Commission, the first of its kind since the 1935. We were the first party to call for such an inquiry, and we maintained pressure on the government and the opposition by pursuing the matter in parliament through motions, senate estimates and private member's bills.

1.10 The way banks treat consumers should improve over coming years if and when the recommendations of the Royal Commission are legislated by the next parliament. But, the great failing of the Royal Commission—in its terms of reference, in its time frame and in its operation—was the absence of detailed consideration of the problems that stem from market concentration, the structure of institutions, and associated prudential regulation.⁹ As a result, the Greens believe the job remains unfinished, and that the root cause of the problem—universal banking—needs attending to, as is proposed by this Bill.

Basic banking

1.11 When considering the structure of banking, the Greens believe that it is helpful to make a distinction between the simple and essential products and services that the vast majority of Australians use (retail banking, superannuation and

6 Productivity Commission, *Competition in the Australian Financial System—Final Report*, June 2018.

7 See: Akerlof & Shiller, *Phishing for phools: the economics of manipulation and deception*, 2015.

8 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Volume 1.

9 This is in contrast to the Terms of Reference proposed by The Greens in Banking and Financial Services Commission of Inquiry Bill 2017.

insurance), and the more complex and selective activity that is the domain of big business, the wealthy, and the adventurous.

1.12 Simple and essential products—basic banking—should come with a high level of consumer protection. As the providers of an essential service, banks, superannuation funds and insurance institutions should be obliged to make all reasonable efforts to ascertain customers' circumstances and the suitability of the products offered to them. People should be able to deal with banks, superannuation funds or insurance firms with confidence that their best interests are being attended to. This is not to say that individuals and small business should be absolved of responsibility. But there should be limitations on what they are expected to understand when consuming basic banking products. *Caveat vendor* to a greater extent, and *caveat emptor* to a lesser extent.

Structural separation

1.13 Vertical integration refers to the provision of basic banking, financial advice, insurance and wealth management by a single entity. Over the course of the last twenty years, the four major banks in Australia became vertically integrated, through the acquisition of existing firms and by establishing new services in-house.

1.14 Vertical integration has been at the heart of most of the misconduct uncovered within the sector in recent years. Yet, despite the vast bulk of instances of misconduct revealed at the Royal Commission being within vertically integrated institutions, the Commissioner did not recommend structural separation. Instead, as others before him have done, he placed faith in better management of conflicts, and suggested that the ACCC regularly review the issue.¹⁰

1.15 The Commissioner also noted that banks were looking to sell their wealth management arms anyway. Yet, only a month after the Royal Commission final report, the Commonwealth Bank 'put on hold' the sale of its wealth management arm. Former ACCC Chair, Allan Fels, forecast this occurring when, in supporting structural separation, he said:

I'm not sure that we can rely at this point on the market to deliver the result we want.¹¹

1.16 The Greens believe that the conflicts and the incentives to cross-sell and subsidise within vertically integrated institutions cannot be sufficiently regulated so as to prevent the myriad ways in which consumers can be unfairly or unknowingly disadvantaged. It is simply too difficult for legislators and regulators to identify, and act to prevent, all of the opportunities that arise within integrated institutions to do something other than act in the best interests of consumers, be it by subtly but consistently directing existing customers towards in-house products, or by exploiting the loyalty and inertia of customers with excessive fees and charges. The profit motive

10 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report*.

11 ABC AM, Thursday 9 August 2018.

is simply too strong and structural separation is necessary to curb an institution's worst excesses.¹²

1.17 The Greens propose that financial institutions should be constrained through ownership to being one of the following:

- an authorised deposit-taking institution (bank);
- an APRA regulated superannuation fund;
- an insurance provider, including life insurance and general product insurance; or
- a provider of other financial services, including wholesale and retail wealth management, investment banking, shadow banking, hedge funds, self-managed super funds, financial markets, and auditors and liquidators.

1.18 This model would remove the inherent conflicts for the cross-selling of these products within vertically integrated institutions.

1.19 However, this is not intended to prevent these institutions from selling other products altogether, only to stop them from manufacturing and selling in-house products. For example:

- Banks could still sell investment into (retail-grade) unit trusts (managed investment schemes).
- Banks could still offer mortgage insurance.
- Superannuation funds should still include group (life) insurance within default funds.

Counterparty risk

1.20 The model proposed by the Greens also addresses the issues associated with banks issuing derivatives, and residential mortgage-backed securities (RMBS) in particular. The GFC showed the world what can go wrong when too-big-to-fail universal banks get knee deep in complex securitisation. In the immediate aftermath of the GFC, serious consideration was given to the wisdom of retail banking and investment banking being run out of the one institution. Glass-Steagall was back on the table and being backed by people from 'respectable' organisations, like the OECD. For example:

The main hallmarks of the global financial crisis were too-big-to-fail institutions taking on too much risk with other people's money while gains were privatised and losses socialised. It is shown that banks need little capital in calm periods, but in a crisis they need too much – there is no reasonable ex-ante capital rule for large systemically important financial institutions that will make them safe. The bank regulators paradox is that large complex and interconnected banks need very little capital in the good times, but they can never have enough in an extreme crisis. Separation is

12 See: Akerlof & Shiller, *Phishing for phools: the economics of manipulation and deception*, 2015.

required to deal with this problem, which derives mainly from counterparty risk.¹³

1.21 Unfortunately, having got through the GFC in far better shape than most other western countries, a narrative has taken hold in Australia that our banks are immune from this problem. While securitisation is a much smaller component of bank funding in Australia, this narrative is blind to the role that RMBS and accommodating prudential regulation¹⁴ has played in helping make Australia one of the most heavily mortgaged countries in the world. Thirty years ago banks lent twice as much to businesses than they did for housing. Now it's the other way around.¹⁵ Banking is now more about property speculation than it is about facilitating productive investment. Bank issued RMBS are part of this equation.

1.22 The Murray Financial System Inquiry identified the end result of this trend in two of the four systemic risks that were identified for the economy and financial system:

Australia's banking system is highly concentrated, with the four major banks using broadly similar business models and having large offshore funding exposures. This concentration exposes each individual bank to similar risks, such that all the major Australian banks may come under financial stress in similar economic and financial circumstances.

Australia's banks are heavily exposed to developments in the housing market. Since 1997, banks have allocated a greater proportion of their loan books to mortgages, and households' mortgage indebtedness has risen. A sharp fall in dwelling prices would damage household balance sheets and weigh on consumption and broader economic growth. It would also reduce the quality of the banking sector's balance sheets and the capacity of banks to extend new credit, which would compromise the speed of a subsequent economic recovery.¹⁶

Views on this Bill

1.23 The Greens support this Bill, in principle. Its stated aims largely reflect our policy outlined above. However, we are reticent to give unequivocal support at this stage. Unfortunately, this Bill has not been scrutinised to the extent that is necessary given the importance and complexity of the subject matter concerned. It proposes bold and holistic reform to the banking system. As a result, this Bill should be subject to a rigorous and thorough examination before being put to the parliament.

1.24 Issues that require further examination include, but are not limited to:

13 See: Blundell-Wignall, Atkinson & Roulet, *Bank business models and the separation issue*, OECD Journal: Financial Market Trends, Volume 2013/2, 2014.

14 In particular, prudential rules regarding mortgage-risk weights.

15 Productivity Commission, *Competition in the Australian Financial System—Final Report*, June 2018.

16 Murray, *Financial Systems Inquiry—Final Report*, 2014.

- Whether more explicit transition arrangements need to be provided for, and what the role of government might be in managing any 'stranded assets'.
- The effect these changes would have on bank funding and liquidity, and whether these changes would disproportionately impact upon bigger or smaller banks.
- If and by whom covered bonds or securities would be issued in the event of structural separation, including the role of government.¹⁷
- Whether the proposed 10 per cent cap on investment by banks in securities is the 'right' number.
- Whether structural separation of banks and intermediaries (e.g. mortgage brokers) would also be provided for.
- Whether a new Joint Parliamentary Committee on Prudential Regulation is required; or whether the responsibilities of the existing Joint Parliamentary Committee on Corporations and Financial Services—which has oversight over ASIC—might be expanded to include prudential matters and APRA.

Recommendation 1

1.25 That the committee continues its inquiry into this Bill to enable consideration of further evidence.

**Senator Peter Whish-Wilson
Senator for Tasmania**

17 See, for example: National Housing Act Mortgage-Backed Securities and Canada Mortgage Bonds.

Appendix 1

Submissions

Submissions

- 1 Mrs Jan Pukallus
- 2 Mr John Terenzini
- 3 Australian Shareholders' Association (ASA)
- 4 Mr Matthew Turen
- 5 Mr John Bird
- 6 Mr Gus Brogan
- 7 Mr John Philp
- 8 Dr Nathan Wilson
- 9 Mr Adrian Giacobetti
- 10 Mr Michael Swain
- 11 Mr Richard Gloyne
- 12 Name Withheld
- 13 Mr John Lawton
- 14 Name Withheld
- 15 Allan and Jayne Lane
- 16 Name Withheld
- 17 Name Withheld
- 18 Mr John McNaught
- 19 Name Withheld
- 20 Ms Alphecca Muttardy
- 21 Mr Sunny Cheng
- 22 Ms Kerrie Ifield
- 23 Mr Joseph Burns
- 24 Ms Bronwyn Tillman
- 25 Mr John Dahlsen
- 26 Ms Beate Lerchner
- 27 Mr HENRY ASHTON
- 28 Mr Tom Jordan
- 29 Mr Anthony ALLISON
- 30 Australian Banking Association
- 31 Mr & Mrs Rob & Lesley McCormick
- 32 Name Withheld
- 33 Mr Christopher Hill

- 34 Ms Faye Harris
- 35 Mr Dante Kemp
- 36 Mr Anthony Herbert
- 37 Mr Stacy Dennis
- 38 Ms Carole Hubbard
- 39 Ms Heidi van Schaik
- 40 Name Withheld
- 41 Ms Katherine Eagles
- 42 Mr Les Stimson
- 43 Mr Tim Walshaw
- 44 Mr Glen Isherwood
- 45 Mr Alexander Kozlow
- 46 Mr Graeme Chapman
- 47 The Critical Thinkers Society
- 48 Australian Institute for Progress
- 49 Dr Wilson Sy
- 50 Digital Finance Analytics
- 51 Citizens Electoral Council of Australia
- 52 Mr Alan Cummine
- 53 Mr Scott Rowe
- 54 Finance Sector Union of Australia