Consumer protection in the banking, insurance and financial sector

Submission to the Senate Economic References Committee

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Summary

This submission attempts to isolate some of the systemic problems in the banking, insurance and finance markets. it makes that point that private for-profit organisations face an environment in which there is a strong incentive to dupe customers and the complexity of financial instruments combined with the lack of knowledge on the part of the customers provides the perfect opportunity for duping customers.

There are many suggestions raised by others for reforming the players in the market and their modus operandi. For example the banks are looking at changes to their culture. It is suggested that things like cultural change can change behaviour. Moreover, it is often suggested that there are only a few bad examples that spoil the reputation of the whole of the sector. However, we would make the submission that there are deeper forces that drive anti-social behaviour which happens to be endemic.

There is a more critical literature on finance and Prof Luigi Zingales from Harvard University has recently drawn many of those threads together. Zingales says ‘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’. This is an area where the incentives are strong and there is not a market solution to prevent antisocial behaviour. By ‘duping’ Zingales has in mind selling something to people who don’t understand it and would not have wanted it if they did. Australia provides a host of examples of exactly that sort of behaviour in relation to loans and investment products.

Zingales warns about the political economy of finance and how it neutralises the political reaction to bad behaviour and how the academics are subtly bought off. We do not provide specific Australian evidence on that but we point to disturbing trends.

Australian banks provide a useful case study and while there seems to be a semblance of competition between banks, competition is ineffective because customers tend to form one-on-one relationships with bank staff and it is in those relationships that duping takes place. Duping involves not just the fraud on the part of a bank officer but also when big banks pretend the customer is dealing with a small regional alternative like Westpac masquerading as St George. Then there is the billion dollar plus advertising budget of the big four banks which is designed not to inform but to persuade and promote an air of probity.

Of course initiatives such as the Banking and Finance Oath are welcome but in reality are little more than token gestures. We also submit that the expectation that boards

will take on cultural issues is naïve and there is now a good deal of discussion that puts severe doubt that any board can monitor or even understand the performance of an institution with tens of thousands of employees dealing in complex financial markets selling complex products.

This submission also discusses insurance. The insurance industry is an easier one to understand in lots of ways. Like banks the industry is incentivised to sell products to people who do not need them and may not even know they are buying them. Where insurance differs is that people present with claims against the insurance companies. The latter make bigger profits if they can come up with means of avoiding making payouts on a claim and so they attempt to frustrate claims. This is just basic incentives at work. Again it is naïve to think that a claims manager will be incentivised to act entirely fairly. That would put the claims manager at conflict with the aim of maximising profit.

There is interest in initiatives such as default funds that would be government-owned or not-for-profit institutions and would compete in the market by offering an honest alternative. The privatisation and de-mutualisation movements have severely weakened the competitive pressures coming from honest alternatives in Australia. But also the absence of such institutions has removed some of the choice that consumers used to face. It may be ironic that many of the advocates of choice in the market are also advocates of privatisation.

Another solution in the insurance market is to address the conflict of interest when the company paying the claim also assesses the claim. We think that especially in the case of disputed claims there should be an independent claims assessor which might well be a government agency.

This submission takes the strong view that a lot of proposals to date are just tinkering with the system while proper structural reform would address the problems by altering the incentives faced by players in the banking, insurance and finance sectors.

Introduction

The Australia Institute (TAI) welcomes this opportunity to make 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 mainly it 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. However we begin our submission with an outline of the views of Luigi Zingales.

Terms of reference

On 29 November 2016, the Senate referred the following to the Economics References Committee for inquiry and report by the last sitting day of the autumn sittings of 2018:

The regulatory framework for the protection of consumers, including small businesses, in the banking, insurance and financial services sector (including Managed Investment Schemes), with particular reference to:

a. any failures that are evident in the:
    i. current laws and regulatory framework, and
    ii. enforcement of the current laws and regulatory framework, including those arising from resourcing and administration;
b. the impact of misconduct in the sector on victims and on consumers;
c. the impact on consumer outcomes of:
    i. executive and non-executive remuneration,

    ii. incentive-based commission structures, and

    iii. fee-for-no-service or recurring fee structures;

d. the culture and chain of responsibility in relation to misconduct within entities within the sector;

e. the availability and adequacy of:

    i. redress and compensation to victims of misconduct, including options for a retrospective compensation scheme of last resort, and

    ii. legal advice and representation for consumers and victims of misconduct, including their standing in the conduct of bankruptcy and insolvency processes;

f. the social impacts of consumer protection failures in the sector, including through increased reliance of victims on community and government services;

g. options to support the prioritisation of consumer protection and associated practices within the sector; and

h. any related matters.

Prof Zingales's critique

It has to be said that the discussion in Australia has been fairly mild compared with the message from Zingales who said 'I fear that in the financial sector fraud has become a feature and not a bug'.

From Libor 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.[1]

Zingales makes it clear that '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'.

Zingales makes the point that economists and especially finance economists are prone to the 'belief in our profession…that all that we observe is efficient' (p 9) but without any evidence to justify that belief. By contrast Zingales argues that 'market forces cannot bring [the finance sector] in check' (p 4). Zingales discusses a number of specific problems with the finance sector as a whole beginning with 'duping unsophisticated investors' to which we now turn.

'Duping unsophisticated investors'

Zingales says there are 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 we hear about 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 evidence that more complex products have higher mark-ups and are sold to less sophisticated

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

investors.[2] 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 looking at. 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.

The internet, which made price search more efficient encouraged investment in obfuscation. It also seems more consumer education on the part of retail financial investors has the effect of inducing greater efforts at obfuscation in the retail financial products industry[3]. The obfuscation seems deliberately aimed at disorienting financial investors. One of the strategies is to offer several classes of investment products so as to 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'[4] 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 the authors 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, some of which, especially in the US, were 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'.[5] Of course Australia has some rules that try to ensure that consumers understand where they are putting their money. However, these are likely to be insufficient.

While education is important to overcoming obfuscation so too are default options in some contexts. It has been suggested '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'.[6] This important result

[2] Celerier C and Vallee B (2013) 'What drives financial complexity? A look into the retail market for structured products, A Look into the Retail Market for Structured Products' cited in Zingales *op cit*.

[3] Carlin BI and Manso G (2011) 'Obfuscation, learning, and the evolution of investor sophistication', *Review of Financial Studies*, Vol 24, No 3, pp. 754-85.

[4] Carlin and Manso *op cit*, p. 755.

[5] Carlin and Manso *op cit*, p. 757.

[6] Carlin and Manso *op cit*, p. 758. Note how the for-profit super funds try to argue that there are benefits in competition for customers. Competition has benefits in many industries but not necessarily finance.

the literature; that more competition from sound institutions is a useful antidote to obfuscation efforts.

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' [7]*Carlin and Manso, 2010, p. 758).*

Australian governments have assisted in this objective with, for example, the requirement that banks offer no frills deposit accounts, publish standardised 'comparison rates' on consumer loans, while industry super funds have been encouraged and default options made available. But more needs to be done. We used to have more default options that are now closed off with the privatisation of the Commonwealth Bank and state banks, Medibank Private and numerous other institutions that, at least in principle, should not have been as keen to 'rip-off' their customers. Despite that the Pensioner Loan scheme and Higher Education Loan Program remain as arrangements in which the Commonwealth Government acts as a financial intermediary.

Another example of duping is the sale of 'lemon securities' to unsophisticated buyers. Zingales refers to Italian banks dumping Parmalat and Cirio bonds on their depositors just before these companies collapsed.[8] Australian examples include Timbercorp and Great Southern,[9] Westpoint Property Group[10] and Allco and Centro.[11] These are some of the ventures that banks encouraged customers to buy into.

The ABC reported that a supressed internal audit at Macquarie Bank 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.[12] Apparently that lack of advice was later used to deny Macquarie had duped customers. Then there is the fiction that managed funds can outperform the market. S&P Dow Jones Indices 'found the majority of managers have consistently underperformed

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[7] Carlin and Manso, *op cit*, p. 758.

[8] Zingales *op cit* p 14.

[9] Bembridge C (2015) 'Hundreds without life savings', *ABCFirst,* 19 October at : http://tasmaniantimes.com/index.php/article/Hundreds-without-life-savings.-Burning-offs-limits.-#sthash.ogBIHmGG.dpuf

[10] Alberici E (2006) 'Investors begin legal action against Westpoint' ABC 7:30 Report, 23 Febrary at http://www.abc.net.au/7.30/content/2006/s1577149.htm

[11] Long S (2015) 'Macquarie Bank clients who lost life savings in scandal largely denied compensation, process 'farcical', critics say', ABC 7:30 Report, 23 November.

[12] Long S (2015) 'Macquarie Bank clients who lost life savings in scandal largely denied compensation, process 'farcical', critics say', *ABC 7:30*, 23 November.

against their respective benchmarks…For example, about eight out of 10 active managers of funds trying to beat the S&P/ASX 200 … underperformed, achieving an average return of 9.2 per cent against an 11.8 per cent gain by the index'.[13] Those who spruik managed funds are clearly seeking investments from people who do not know better.

The sorts of distortions and perversions described here may be present in every sector, not just in finance. Yet, the financial sector provides much greater opportunities for abuses, thanks to the flexibility provided by financial engineering.

Recommendation: Governments should recognise that there is not a market solution such as increasing competition that would eliminate bad behaviour on the part of the financial system as a whole. If there is a chance to profit at the expense of customers then someone will take up that chance.

Recommendation: Iin areas likely to involve duping customers, government should provide or arrange to be provided and promote a no frills and honest alternative.

Zingales raises another serious concern. Our academics who are supposed to be dispassionate researchers interested in objective analysis have been very quiet on the subject to bad behaviour in the financial system. Zingales suggests that researchers in housing finance in the US are all conflicted by the research grants and stipends coming from Fannie Mae in particular. The result is that there is little published that is critical of Fannie Mae and people find it very hard to get any 'expert' to do anything of a critical nature. The US of course has many more academics in any field and if Zingales sees a problem there we must expect it in Australia. Australia has a large number of academics interested in financial economics. There is also just one main research organisation interested in finance questions: the Australian Centre for Financial Studies (ACFS). In its blog there is mention of partnerships with at least two of the big four banks along with the Australian Bankers Association. In addition there are representatives from other sectors of the finance and insurance industries. Their representatives sit on various research committees. ACFS commissions research and provides grants to researchers.

We can be confident ACFS has never done anything that could be construed as blatantly biasing researchers. But more insidious is the possibility that its very presence causes independent researchers to self-censure. We would not be surprises if the committee receives few critical submissions from finance economists.

[13] Kaye A (2017) 'Lower fees are key to a fightback by active fund managers' *The Australian*, 28 February.

Aiding and Abetting Agency Problems

Aiding and abetting agency problems are also discussed by Zingales although in the main these tend to be very complex arrangements. But the agency problem refers to the parties to a transaction not being the ones who would bear the ultimate costs if things go wrong. Nick Leeson bringing down the venerable Bearings Bank is a case in point. As agent for the bank Leeson stood to gain a fortune if his 'bet' worked but instead the result was bankruptcy of the principle. The National Bank of Australia has also had experience with rogue traders. But it is the interaction with third parties, the customers, that is of concern here.

The role of complex financial instruments that even company boards cannot understand is implicated in many of the failures of the institutions that presaged the global financial crisis. Many other industries have similar problems but as Zingales points out:

finance stands out in all three dimensions: innovation happens very fast; financial engineering provides an extremely flexible tool to exploit agency problems; and the principles (be they shareholders in publicly traded companies or taxpayers) are dispersed and almost incapacitated to move. For this reason, financial products designed to prey on existing agency problems are very diffused.

We will have much more to say on this theme below.

Is fraud a bug or a feature?

Zingales points out that the Hippocratic Oath makes it socially unacceptable for a doctor to maximize income at the expense of patients but that is not true in finance. As he says:

We 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. It should not come as a surprise, thus, that – according to a whistleblower – investment bankers were referring to their clients as Muppets. 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.

Part of the responsibility, in his view, was the instruction in universities where finance faculties 'teach…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'.

This account of Zingales's Presidential Address to the American Finance Association is sobering if not disheartening. It suggests that an approach that leaves things for the market to decide simply cannot work. The incentives are lined up in a way that virtually guarantees fraud is a feature of finance. The only solace we can take is that the Australian environment seems better than the US and hopefully that is not just wishful thinking. Having considered some of the patterns of unwanted behaviour addressed by Zingales we are in a position to consider Australia's financial system and the main players.

Of course Zingales is far from alone in his critique of the financial system. It is also worth noting the comments by the authors of a recent study of the dysfunctions in the financial system as they developed in the US leading up to the global financial crisis. The authors point to the 'legally and ethically dubious behaviour in generating the current and past financial crises' and noted that 'most Americans engage in some law-breaking on a daily basis. We should not expect business people and financiers to behave any differently'. The examples listed for ordinary Americans include 'jaywalking, to hiring illegal gardeners and nannies, to not paying social security taxes on legal domestics, to doing drugs, to cheating on taxes, to getting disability benefits when there is no disability, to speeding, to insurance fraud, and so on'. And if business people are equally disposed to flirt with the law then the 'few bad apples' theory usually invoked to explain unsocial behaviour is vastly inadequate.[14] We note that the National Australia Bank disciplined 1,138 staff in the latest financial year for breaching the bank's code of conduct.[15] That contrasts dramatically with the view often encountered that government can safely deregulate the financial system confident in the knowledge that there are market forces that constrain participants to be 'good'.

The asymmetric knowledge of the buyers and sellers has meant there is a massive incentive to mislead buyers and disguise toxic assets as top-rated securities—which is exactly what led up to the global financial crisis in the first place. Where there is asymmetric knowledge there is an incentive to exploit it on the part of the party with the greater knowledge.[16] That is why some of the bankers and economists have blamed the global financial crisis on a failure in the regulatory regime. The bankers'

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[14] Quotes are taken from McCarty N, Poole KT and Rosenthal H (2013) *Political Bubbles: Financial Crises and the Failure of American Democracy*, Princeton and Oxford: Princeton University Press,

[15] Mather J and Eyers J (2017) 'NAB chief pledges to peel off the bad apples', *The Australian Financial Review*, 4-5 March.

[16] Admittedly banks are sometimes on the other side of the asymmetry when, for example, someone seeks a loan for a project they may know all about but the banks have no way of assessing its commercial potential.

complaint has been wittingly paraphrased as saying 'It's your fault: you let us do it!'[17] that seems to confirm the views of McCarty et al (2013) cited above to the effect that many in the industry are liable to flirt with the law if not break it and need to be controlled. Certainly the Stiglitz UN Committee has been scathing and essentially blames free market ideology. It is worth quoting in full:

…Both policies and economic theories played a role. Flawed policies helped create the crisis and helped accelerate the contagion of the crisis from the country of its origin around the world.

But underlying many of these mistakes, in both the public and private sectors, were the economic philosophies that have prevailed for the past quarter century (sometimes referred to as neoliberalism or market fundamentalism). These flawed theories distorted decisions in both the private and public sector, leading to the policies that contributed so much to the crisis and to the notion, for instance, that markets are self-correcting and that regulation is accordingly unnecessary. These theories also contributed to flawed policies on the part of Central Banks.

Flawed institutions and institutional arrangements at both the national and international level also contributed to the crisis. Deficiencies in international institutions, their governance, and the economic philosophies and models on which they relied contributed to their failure to prevent the crisis from erupting, to detect the problems which gave rise to the crisis and issue adequate early warning, and to deal adequately with the crisis once it could no longer be ignored. Indeed, some of the policies that they pushed played a role both in the creation of the crisis and its rapid spread around the world. All of this facilitated the export of toxic products, flawed regulatory philosophies, and deficient institutional practices from countries claiming to be exemplars for others to follow.[18]

Recommendation: The Committee takes note of the critique of Professor Zingales and others and note their observations on the ubiquity of fraud in a finance market unless it is heavily regulated. With such strong incentives to 'misbehave' it is recommended that sanctions be as strong as possible, including hefty fines and gaol terms combined with rigorous enforcement.

[17] Stewart cited in Morgan J and Sheehan B (2014) 'Information economics as mainstream economics and the limits of reform: what does the Stiglitz Report and its aftermath tell us?' *Real-world economics review*, Issue no 66, pp. 95-108.

[18] Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (2009) *Report*, NY: United Nations, 21 September at http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf accessed 22 January 2014.

In passing Zingales draws attention to political corruption which creates voter support for populist parties. That in turn encourages the financial industry to seek protection by increasing its political power. Big banks have been concerned about the moves to increase scrutiny over their cultures, address unethical practices, protect whistle blowers and, at the next level, to assist them against competition from industry super funds. In the meantime there is a good deal of fluidity among senior people in the Reserve Bank, Treasury, politics and the commanding heights of the finance sector. For example, Ken Henry's decision to join the board of the National Australia Bank makes one wonder about his commitment to some of the work on enhancing bank competition before he left his job as head of Treasury. The appointment of Anna Bligh to the head of the Australian Bankers Association has raised a number of eyebrows.[19] Perhaps even more significant in a way was the appointment of Mike Baird to an executive role in the National Australia Bank.[20] We don't want to make any specific allegations but would draw the Committee's attention to the conclusions of a project funded by the European Union which says 'weaknesses of prudential regulation may result from regulatory capture and regulatory arbitrage; from the incentive structure of the supervisors'.[21] If there is mobility between senior levels of government and big businesses and there is a promise of a board or other position for senior bureaucrats then we have a serious potential problem with conflicted interests.

Recommendation: The free and easy movement between senior government positions and big business should be severely discouraged if not banned.

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[19] Aston J (2017) 'ABA, Bligh collateral damage in ScoMo shocker', *The Australian Financial Review*, 20 February.

[20] Hewson J (2017)'More bankers should follow in Mike Baird's footsteps', *Canberra Times*, 2 March 2017.

[21] Notermans T (2013) 'Reforming finance: A literature review', *Working Paper Series, no 8, Financialisation, economy, society and sustainable developmen*t, p. 45.

Banks

Some years ago TAI published a survey which found 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.[22]

Australia's major banks, particularly the big four; the ANZ, Commonwealth Bank, National Australia Bank and Westpac, control much of the nation's economy. The advances extended by the big four amount to 145 per cent of GDP.[23] 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. Instead of sacking crooked staff the whistle blowers have been sacrificed. All of these allegations are on the public record and do not need repeating here in any detail. No doubt he Committee will hear many of the case studies in other submissions. Everyone – even their own CEOs are shouting at the banks to clean up their culture. But our submission is that you cannot blame the culture when it is the incentive structure within the banks and the rest of the finance sector that puts the banks against the wellbeing of the rest of society.

The whole ethos of our system encourages people to make money however they can. Adam Smith pointed out that we do not rely on the good will of the baker for our daily bread. The same can be said for the host of goods and services we purchase. We rely on the self-interest of the baker and the myriad of other suppliers. But we also rely on the competition between bakers and a bit of knowledge on the part of the consumer to ensure that we get quality bread at a reasonable price. Genuine competition between sellers is important. At first sight banking seems to be reasonably competitive. However, problems arise in taking out loans, dealing with insurance or putting savings into a wealth management product. The common factor here is that the customer is usually dealing one-on-one with a member of the staff in a close personal relationship. However, the staff member knows much more about what is going on than the customer. That means there is much more scope for duping the customer who is not in a position to contrast the deal being offered with other possible offers. If you don't like a loaf of bread you can switch suppliers next time. But

[22] Fear J, Denniss R and Richardson D (2010) 'Money and power: The case for better regulation in banking' *The Australia Institute Paper No 4*.

[23] Figure calculated from APRA (2016) *Statistics: Quarterly ADI performance*, 29 November and ABS (2016) *Australian System of National Accounts, 2015-16,* Cat no 5204.0, 28 October.

a deal with a bank is rarely easy to reverse. That means the greed of the supplier is no longer held in check as it is in the other market types.

Ken Henry 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'.[24] This at least acknowledges that thing go awry without any checks and only the board can really do that. The head of ASIC, Greg Medcraft, was reported as wanting to make boards criminally responsible for bad conduct.[25]

A year ago The Australian Financial Review had a lead story: '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'.[26] That description seems to nail it but has not been pursued as far as well can see. Moreover, the Prime Minister elected to tell the banks to fix themselves. Yet many staff in the big banks have 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. This seems a deliberate strategy to align staff greed with the motive of maximising profit for the banks.

Staff who sell 'wealth products' have an extra 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 much better financially. We cannot rely on their own consciences as evidenced by past behaviour. Of course we do not blame all bank staff but the 'bad apples' most likely self-select into positions where they can most exploit customers.

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.[27] Along with the incentive to sell unsuited products the

[24] Gray J (2016) 'NAB chairman Ken Henry says boards should talk often to all staff, not just executives', *The Australian Financial Review*, 5 April.

[25] Gray J (2016) 'NAB chairman Ken Henry says boards should talk often to all staff, not just executives', *The Australian Financial Review*, 5 April.

[26] Coorey P and Durkin P (2016) 'PM puts huge pressure on banks to end scandals', *The Australian Financial Review,* 6 April.

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

banks themselves have developed ways of presenting their loan and deposit offers that are difficult for consumers to understand let alone compare against their competition.

It is fair to say the consumer is hardly aware of much of this. We all expect to see banks as solid, staid and very conservative institutions who are motivated by much more lofty concerns than making money. Indeed that it the impression they try to cultivate. But the banks have allowed or encouraged the development of an incentive structure that now lures those who see a banking career as getting rich selling wealth management products, rather than serving customers.

How we clean up this industry is a more difficult question. David Murray was once CEO of the Commonwealth Bank and seemed to be 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. Recent events suggest that the ‘bad’ bank culture can start at the top. For example Westpac in particular seems to have a strategy of buying up branded competitors and continuing to pretend they are separate identities and pretend they provide an alternative to Westpac itself. The CEO of Westpac, Gail Kelly, when giving evidence to a Senate committee on bank competition, explained the strategy and said:

There are a range of customers… 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.[28]

Now St George was formerly a building society but converted to a banking license as did many credit unions and building societies in the 1980s and 1990s. But following Westpac’s takeover of St George is just a group within Westpac and we question the propriety of presenting St George as a genuine alternative to those who do not want to bank with the big four. That sounds very much like duping customers. 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. But the essential point is that the deliberate strategy is to trick people into thinking they are not banking with one of the big four.

Recommendation: The banks should declare their interest in subsidiaries so as not to deceive customers into thinking they are dealing with a small ‘friendly’ bank when dealing with the likes of St George.

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[28] Johnston E (2012) ‘Kelly rejects multi-branding critics’, Sydney Morning Herald, 4 May.

APRA has been pushing bank directors to 'assume responsibility for improving bank conduct in the wake of a series of damaging scandals'[29] 'These include allegations Westpac Banking Corp and ANZ Banking Group manipulated the key benchmark interest rate, and earlier revelations that Commonwealth Bank of Australia, National Australia Bank, Macquarie Group and ANZ dudded customers with bad financial advice as they chased larger profits'.

Reflecting on the culture question a Commonwealth Bank board member, Harrison Young told The Australian Financial Review Banking & Wealth Summit that 'there are no right answers to those questions, but the prudential supervisor is entitled to insist on a thoughtful response'.[30]

Ken Henry said:

Running a bank successfully means having a good sense of shareholder expectations. It means attracting, motivating and retaining high-performing staff. And it means knowing what it takes to attract reliable funding from depositors, institutional pools and other banks…But most importantly, it means having a very good understanding of what the banking customer wants[31].

This seems very naïve compared to the obvious culture of trying to manipulate customer wants. Between them the latest annual reports show advertising spending of $1.1 billion with the Commonwealth Bank alone spending $491 million.[32] A moment's reflection and a word with the NAB marketing people would convince Ken Henry that the advertising effort is designed to persuade customers to do business with that bank. Meantime it is reported that Steve Sedgwick who is heading a review into remuneration in banking said he had 'tentatively identified some practices of some banks that have high risk of incentivising poor selling practices leading to poor customer outcomes, which those banks should consider changing'.[33] Sedgwick pointed to incentives, bonuses or product-based payments or sales commissions that are directly or indirectly related to product sales to some of their retail staff, or to third parties acting on their behalf – such as mortgage brokers. He said he 'concur[s] with those who believe it is appropriate to reduce the emphasis on product-based

[29] Eyers J (2016) 'APRA pushes bank boards to define, improve risk culture', *Sydney Morning Herald*, 11 April at http://www.smh.com.au/business/banking-and-finance/apra-pushes-bank-boards-to-define-improve-risk-culture-20160409-go2n36.html

[30] Eyers J (2016) *op cit.*

[31] Eyers J (2016) *op cit.*

[32] These are TAI calculations based on each banks' annual report.

[33] Eyers J (2017) 'Bank "accelerator payments" to staff amplify risk: Sedgwick', *The Australian Financial Review*, 17 January.

payments whenever possible. This will reduce risk and help to rebuild public trust'.[34] In a separate review, [the Australian Prudential Regulation Authority is investigating the pay structures of senior banking executives] as it increases its focus on bank risk culture.[35]

Each of the CEOs of the big four banks have now signed the Banking and Finance Oath which 'proponents hope will become like the Hippocratic Oath for doctors'.[36] The last on board was Ian Narev CEO of the Commonwealth Bank. The oath is chaired by John Laker the former chair of the Australian Prudential Regulation Authority who said Narev's commitment to the oath 'sends a strong signal to employees, and the industry more generally, that the leaders of Australia's largest bank assign a high personal priority to ethical behaviour'.

Despite all the good intentions there remains a major principle-agent problem between senior management and certain sets of employees who are paid in relation to short term performance which creates an incentive to put the long term health of the company at risk.[37]

In an earlier paper we raised issues to do with the 'tricks' often used against consumers and recommended some measures to address those.[38] The use of emotional techniques in advertising and marketing financial products is common and clearly effective. However, marketing that relies solely on such techniques without providing any helpful information or guidance to consumers is misleading and manipulative and contributes to widespread public mistrust of banks. Banks should promote their products in ways that contribute to, rather than undermine, broader public understanding of financial concepts and imperatives. If they choose not to do this, it is the responsibility of government to monitor and regulate their communication with customers, particularly in the marketing of credit. This can be achieved in various ways as suggested in the following recommendations:

Recommendation: That the government:

• establish national laws to ensure that credit is not extended to people who do not have the capacity to repay

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[34] Eyers J (2017) 'Bank "accelerator payments" to staff amplify risk: Sedgwick', *The Australian Financial Review*, 17 January

[35] Eyers J (2016) 'APRA to determine whether banker pay is increasing risk', *The Australian Financial Review,* 18 October.

[36] Eyers J (2017) 'Narev last of big four chiefs to sign oath', *The Australian Financial Review*, 20 February.

[37] Notermans T *op cit*, p52

[38] Richardson D (2014) *Submission to the financial services review*, The Australia Institute, March.

• prevent banks and debt collectors from pursuing debts for loans made to people who did not have the capacity to repay when the money was originally loaned

• restrict or banning sales targets and commissions for bank workers

• provide bank workers with a decent ordinary wage independent of sales-based commissions

• ban the practice of 'pre-approving' credit-card offers and/or credit extensions

• prevent banks from claiming money spent on the advertising of credit products as tax deductible business expenses.

These reforms should constitute part of a formal social contract between individual banks and government; ratifying the social contract would then become a condition of maintaining a banking licence.

There is also a case for setting up an honest default option to keep the private sector honest. There have been proposals for the establishment of an institution like the Kiwibank in New Zealand.

Recommendation: The government consider the establishment of an honest alternative to the existing private banks.

Bank profitability

Banks are extremely profitable, which might leave you asking: why would they feel the need to resort to the sort of behaviour that is reported in the media? 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.[39] That is, for every dollar spent in Australia 3.4 cents become underlying profit of the banks. Perhaps a good part of that comes from their dirty practices. But clearly there is an incentive to maximize the return from every interaction with a customer. Each member of staff is a profit centre. So while the bank as a whole makes a lot of money each small part of the bank is also programed to maximize the profit outcome of its interactions with customers.

Banks in the past have stated that they aim to generate returns on equity of 20 per cent or more. In 1999 former Governor of the Reserve
Bank, Ian Macfarlane said:

[39] APRA (2017) *Quarterly Authorised Deposit-taking Institution Performance*, December 2016, 1 March and TAI calculations.

I, like you, have often wondered why banks are so profitable—and they certainly have been extremely profitable in Australia… They always were very profitable, let's face it. They were very profitable in the regulated phase, and some of us thought that those profit rates would go down in the deregulated phase, as competition heated up. So you can understand why people are very interested in profits and very surprised that profits or rates of return on equity have remained so high…

Any business, whether it is a bank or any other business, if it is aiming for extremely high rates return on equity—if it is aiming for 18 or 20 per cent in an environment of two per cent inflation—it seems to me there are an awful lot of very useful things that could be done which are profitable, but they are not quite that profitable.

If they are literally doing what they are aiming to do they are failing to invest in a lot of things which are reasonably profitable and socially very useful.[40]

All banks report return on equity figures prominently in their profit announcements.[41] ANZ describes one of its management targets as a return on equity in the range 17 – 20 per cent.[42] If banks operate rate of return targets at about 20 per cent then we can assume all of their pricing, investment and other decisions will reflect that target. NAB's 2008 annual report mentions that the return on equity is one of its main internal evaluation criteria. It says that the Group evaluates operating segments performance on the basis of cash earnings and return on equity.[43]

Westpac was forced to announce a reduction in its return on equity to below 20 per cent for the first time in its 2009 interim results. The Commonwealth Bank has highlighted a return on equity of 15.8 per cent in its 2009 results which was down by 460 basis points but still, it claims, a good result in the circumstances.[44] In its influential review of the major Australian banks KPMG uses return on equity as perhaps its most prominent performance ratio.[45] Of course even the figures reported

[40] Transcript of evidence, Standing Committee on Economics, Finance and Public Administration: Reserve Bank of Australia annual report 1997-98: Discussion 17 June 1999.

[41] The measure they use is an after-tax cash rate.

[42] ANZ Bank (2004) *Annual General Meeting* Repot at http://www.anz.com/Documents/AU/Investor/agm/CEO%20Final.PDF accessed 2 March 2017.

[43] National Australia Bank Ltd (2008) *Annual Report, 2008*

[44] R Norris, CEO Commonwealth Bank, *Annual Results Media Presentation*, 12 August 2009 available at http://www.commbank.com.au/about-us/shareholders/pdfs/results/2009_Full_year_results_media_presentation_12_August_2009.pdf

[45] KPMG (2009) *Major Australian Banks: Half Year 2009: Financial Institutions Performance Summary* available at http://www.kpmg.com.au/Portals/0/Major%20Banks%20Half%20Year%202009.pdf

here are biased downward because they are allowed to include 'good will' in their equity measures. For example Westpac includes 'good will' worth $8.8 billion in its balance sheet mainly resulting from the acquisition of St George, BT Financial Group and others.[46] Adjusting for that would significantly increase the rate of return on equity reported by the relevant banks. Note too that these figures are after-tax and pre-tax returns are almost half as much again—a 15 per cent post tax rate of return is up to 21.4 per cent pre-tax.

An important factor in the banks' profitability is the increasing concentration in the banking industry and, indeed, the financial sector generally. For example, the top four banks now control over 75 per cent of all bank assets and banks account for over 90 per cent of all lending by financial institutions in Australia.[47]

We do not need to pursue this theme much further. Clearly banks act in their own self-interest and given the power and information asymmetries with customers there is clear scope for the former to take the latter 'to the cleaners'. But the important point is that extraordinarily high bank profits are at the expense of the rest of society. Borrowers are paying more and/or depositors are getting less than they should under more competitive conditions. Putting that differently, measures that might affect bank profitability should not worry us too much as the banks can easily afford lower profitability.

Recommendation: Governments need to address the super profits that the banks are reaping from the rest of society.

Too big?

We often hear complaints that modern financial institutions are too big to fail because the consequences would be too severe. And so government effectively underwrites the risks involved in financial systems. However underwriting risk creates the moral hazard problem: if banks are insured against downside risk they will most likely want to take more risks. But there is another concern. We have seen in the previous section that banks are trying to change their culture with CEOs and board chairs and members expressing strong concern that these issues are cleaned up. There are a number of researchers now concerned that big companies are too big to monitor and ask whether a group of around a dozen people in 12 monthly meetings can monitor a bank such as the Commonwealth Bank with 45,129 full-time equivalent workers. Directors

[46] Westpac (2016) *Annual Report*.

[47] See Fear J, Denniss R and Richardson D (2010) *Money and power: The case for better regulation in banking*, Institute Paper No. 4.

typically face substantial problems in monitoring, which can stem from basic issues like firm size, firm complexity, outside job demands, complexity of those job demands, dissimilarity of those job demands, size of the board, frequency of board meetings, diversity of the board, norms of deference of the board, and power of the existing CEO.[48]

One group of researchers have put it:

> *most academic research, popular press accounts, and even U.S. legislation all echo the sentiment and deeply held belief that boards should be able to actively monitor and control management. ... Given the research reviewed in this article, we are pessimistic about the possibility of boards being able to effectively monitor managers on an ongoing basis in many circumstances. ... Given the size and complexity of many modern firms, we believe some firms may effectively be 'too big to monitor', and that successful monitoring by boards may be highly unlikely in many large public firms. It might be time to concede that our conception of boards as all-encompassing monitors is doubtful ... Consequently, we believe that future research and theorizing needs to focus on boards as advice-giving bodies, or bodies that get involved in punctuated events, and look to other corporate governance mechanisms to secure monitoring.*[49]

If there is so little accountability in one direction and control in the other we have to regard the internal workings of the big company as somewhat anarchistic. Boards may not be 'really equipped to catch or stop misbehavior'. What often seems like directors shirking their responsibilities may instead just reflect the impossibility of really managing big companies. That of course raises very fundamental questions about the proper role of one of the cornerstones of our economy – the modern corporation.

With particular regard to the financial corporation the former chair of the Federal Reserve System, Paul Volker, has made the point that none of the boards of the firms using financial innovations are likely to understand them and that imposes huge problems for financial governance.[50] In that regard it is also worth mentioning that there is already cause for concern with rogue traders using sophisticated instruments and we recall the problems imposed by staff members who brought down Barings

[48] Taylor T (2016) 'Corporate boards: Stop expecting the impossible?' Conversable Economist Blog at http://conversableeconomist.blogspot.com.au/2016/06/corporate-boards-stop-expecting.html

[49] Steven Bovie, Michael K. Bednar, Ruth V. Aguilera, and Joel L. Andrus (2016) 'Are Boards Designed to Fail? The Implausibility of Effective Board Monitoring', *Academy of Management Annals*, vol. 10, no. 1, pp. 319–407.

[50] Notermans T (2013) 'Reforming finance: A literature review', *Financialisation, economy, society and sustainable development*, No 8 working paper series.

Bank and caused grief for the National Australia Bank. We can be sure all the board members do not understand all the financial products their companies deal with.

There has been a proposal that new financial products should require authorisation by the regulators before they can be sold.[51] They would be treated much like new pharmaceuticals and have to show that they are useful as well as safe for both the buyers and for the stability of the financial system as a whole.

Recommendation: government investigate governance issues generally and report on whether some companies are indeed too big to govern and whether there is an appropriate size for finance companies in particular.

Recommendation: New financial products should be treated like new pharmaceutical products and require authorisation before being marketed .

[51] Cited in Notermans T (2013) 'Reforming finance: A literature review', *Financialisation, economy, society and sustainable development, No 8 working paper series, p* 7.

Insurance

This is an area that has received a good deal of media interest. Life insurance is a good example of an industry with strong incentives for duping and obfuscation, especially in the event of a claim against an insurance company. The Commonwealth Bank's insurance arm, Comminsure, has been in the news for knocking back reasonable claims and/or trying to hold out until the death of claimants (see below). Unfortunately insurance is an area fraught with difficulty. The industry sells insurance against some adverse event. The insurer has a strong incentive to get out of payment if the adverse event does happen. Common strategies seem to be redefining the event in a way that does not accord with the understanding of the other party, denying the event happened or claiming there was some contributory action on the part of the insured and so on. Another strategy is to wait for the claimant to die.

It is clear that many claims were never made when the insured event happened and that business models were built on the assumption that many beneficiaries of insurance would never make the claims. ASIC has given evidence to the Senate that a large number of life policies lapse. This is taken as evidence that a large number of policies are simply wrong for the people who have taken them out.[52] That is made clear in the following observation:

The crunch came in 2013, when life insurers were caught by surprise by a jump in claims for TPD payouts. Various reasons have been given for this spike – a rise in mental health claims related to redundancies and retrenchments, changes to workers compensation laws, greater awareness by members of their right to claim (often due to the advice of medical support groups and peak bodies) and the increased involvement of plaintiff law firms.[53]

Because so few people had previously claimed, insurers didn't properly budget for what would happen if more people did claim. The resulting impact on industry profitability was so dramatic that it alarmed APRA, which chided the industry for being too aggressive in chasing new business. It was reported that 'ASIC … put the industry on notice that it was watching advisers with poor lapse and switching rates, companies

[52] ASIC (2016) *Senate inquiry into the life insurance industry (as part of the Inquiry into the scrutiny of financial advice):Submission by the Australian Securities and Investments Commission*, April.

[53] Ferguson A and Williams R (2016) 'Devils are in the detail in super life insurance', *Sydney Morning Herald*, 6 August.

with high claims denials, insurers with low levels of goodwill payments and call centres selling unneeded and inappropriate policies'.[54]

Anything that increases consumers' use of their entitlements is seen as a threat. Hence the losses incurred by the industry mentioned above were ascribed to a number of factors by APRA including:

increased plaintiff solicitor involvement drove an increase in lump sum total permanent disability (TPD) claims. The resulting increase in claims has been seen, in part, as a correction of a rate of claims which may not have accurately reflected the industry's underlying exposure. For instance, prior to targeted marketing by plaintiffs' firms, individual members may not have been aware of their available cover. An increase in the number of TPD claims related to mental illness and other complicated injuries, and changing community standards as to what conditions give rise to claims, has also resulted in more claims payments and requires greater claims management and resourcing.[55]

This of course implies that there had been a large under-claiming of entitlements that the insurers had expected to persist. Another account puts it:

> *Litigious lawyers are being blamed for a big round of premium increases that are almost doubling the cost of life insurance, disability cover and income protection policies for millions of members of superannuation schemes. Insurers are attempting to battle billion-dollar annual payouts by tightening the terms and conditions of their total and permanent disability (TPD) policies to make it harder for members and their lawyers to make claims. IOOF claims it has been forced to increase insurance cover for a wide range of super products from 1 July because of increased litigation, recent court decisions in favour of individuals and scheme members' rising awareness of their rights.*[56]

In announcing increases in its premiums BT Business Super told its members 't*he increase in insurance premium rates is due to a substantial rise in the number of*

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[54] Roddan M (2017) 'ASIC seeking tougher penalties against company directors', *The Australian*, 8 February.

[55] North M (2016) 'Life Insurance Industry In Review – APRA', *Digital finance analytics Blog*, 28 April http://www.digitalfinanceanalytics.com/blog/life-insurance-industry-in-review-apra/

[56] Hughes D (2015) 'Insurance premium increases coming, lawyers blamed', *The Australian Financial Review*, 1 May. http://www.afr.com/news/insurance-premium-increases-coming-lawyers-blamed-20150430-1mxgy6#ixzz4XawTuZ00

insurance claims over the last three years, together with the increased cost in meeting and managing these claims.[57]

One report referred to the life insurance that comes packaged with superannuation policies. Many people know little about their superannuation and, perhaps, even less about their life insurance policy. She observed 'one of the scandals of life insurance is that many Aussies don't even know they're doing it [that is paying for] premiums for life insurance policies, including for death, total and permanent disability and income protection'.[58]

Part of the strategy then is selling policies that will never have claims made against them. Of course when a claim is made the insurers fall back on their plan B which involves rejection and/or delay of claims. Some companies reject a third of death benefit claims according to one report.[59] A newspaper investigation claims to have uncovered evidence suggesting the mishandling of cases by some insurance claims agents is systemic.[60] That brings us back to APRA's suggestion that finance sector sales people dupe (our word) people into taking on inappropriate policies.

In October 2016 the House of Representatives Standing Committee on Economics held its first of the new 'Annual review of Australia's four major banks'. The Chair of the Committee David Coleman asked the CEO of the Commonwealth Bank, Ian Narev, about some of the practices at Comminsure; in particular 'allegations that you delayed making payments to terminally ill policy holders in the expectation that they would die [and] that doctors were pressured to change medical opinions in order to deny claims'. The response included 'we have done wrong by some customers in that business and other businesses…We have gone over more than five million documents. We have had a number of different independent experts in EY, KPMG, DLA Piper looking at different aspects of this. …the goal is to put things right'.[61] One can only hope!

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[57] Klijn W (2015) 'More super funds lift insurance premiums' *TheInstoreport* 28 May http://www.theinstoreport.com.au/articles/more-super-funds-lift-insurance-premiums#sthash.CQLTRlEW.dpuf

[58] Irvine J (2017) 'Many of us don't even know we have life insurance. Often it's worthless', Sydney Morning Herald, 27 February.

[59] Williams R (2016) 'Australia's super funds scrambling to fix super life insurance', *The Sydney Morning Herald*, 15 October.

[60] McKenzie N et al (2016) 'Dirty tactics by insurance companies make injured workers miserable', *The Age*, 11 September.

[61] Senate Standing Committee on Economics (2016) 'Past Public Hearings and Transcripts' Review of Australia's four major banks at http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Four_Major_Banks_Review/Public_Hearings

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. To err in the other direction is to increase profit and enhance the reputation of the manager. There is no incentive structure that guarantees an outcome will be fair. Our view is that while there is a case for market provision of insurance, the market is the wrong place for deciding if an insurance event has been triggered. We suggest remedies below.

There is a large literature on the economics of insurance but most of it examines issues such as moral hazard and adverse selection on the assumption. Those refer to the problems the insurer has in insuring an individual who may or may not be a good risk. The upshot is generally an acknowledgement that there is substantial market failure and a case for government intervention. Hence we have a heavily regulated health insurance sector in particular.

While there has been little academic attention given to the issues in which we are presently interested: there are some good first hand accounts. The following is a good account by a legal practitioner discussing the practice of insurers and attributes those practices to the incentives structure.

> *Many of the insurance giants deny claims or offer meager (sic) settlement proposals in an effort to become more profitable. Insurance company claim's adjusters find creative reasons to deny valid claims or to offer low settlement amounts. Common reasons for denial include paperwork errors, assumption of facts contrary to the findings of witnesses and expiration of time periods for the submission of documents. Common reasons for low settlement offers include claims of contested liability and the adjuster not taking in to account all of the relevant facts to properly make a fair valuation of the claim.*
>
> *Insurance companies have two major reasons to delay reasonable payment of claims. The first is, if the settlement is delayed long enough, there is a chance the injured party may become in great need of the funds and suffer some type of economic duress thereby making an otherwise unacceptable offer something they are forced to take. The second reason is the longer the insurer delays in making payment, the more time the insurance company has to hold onto premiums and earn money on their investments.*
>
> *Not only do insurance companies delay making reasonable offers and payments, they also attempt to delay court proceedings once the case is put into suit. The insurer hopes the net result will be you give up in continuing the*

fight due to the stress and aggravation and settle your claim for less than full value.[62]

Two things stand out from this account. The author is clearly describing fairly common practice and secondly there is a clear incentive to underperform the contract on the part of the insurer. By contrast the consumer would normally expect the insurer to perform according to the letter of the contract.

The important thing is that the present system involves massive economic distortions. Effectively those who suffer at the hands of the insurance industry are subsidising both the insurance companies themselves and possibly also those who do well and have their claims honoured. Economists generally assume that contracts, the law etc work such that an agreement to buy or sell something, including insurance and similar contracts will be honoured and both sides go in with their eyes wide open. However, just a moment's reflection is enough to show that the incentives in finance and insurance work against a win-win outcome for both the buyer and seller.

One solution with insurance might be to separate the sale of insurance from the handling of claims. The latter could be handled by an independent government owned tribunal funded by a cost recovery program on the former. The aim is to ensure that the decision as to whether the insured event has happened and the compensation due is completely independent and not conflicted by other incentives. The decision should be objective and based on evidence. We envisage claims being put to the independent assessor who would seek an answer from the insurer.

- In the event the insurer accepts the claim the assessor's job would be very simple and involve little more than rubberstamping the decision.
- In the event the insurer disputes the claim it must indicate as soon as possible and provide reasons within another short period. The assessor would then rule.

Evidence should reflect the latest science and modern best practice rather than outmoded understandings as is alleged in some of the Comminsure cases. This model would reflect the view that a conflicted organisation should not be the one that decides the merit of a claim. However, we expect that such a model would involve much reduced legal expenses.

Recommendation: That the government examine models for the separation of claims management from conflicted insurance companies. Our favoured model would involve a government body assessing claims which are to be honoured by the

[62] Hastings RP (no date) 'Strategies for dealing with insurance company claim's adjusters', https://www.hg.org/article.asp?id=21585 accessed 6 February, 2017.

insurer. The work of the assessor would be funded on a user pays basis through charges on the insurer.

Recommendation: That insurance fraud be particularly punished but also that institutional behaviour designed to frustrate a claim be severely punished.

We saw in the section on banks just how profitable they have been. A recent article brought attention to the remarkable profitability of the health insurers. It suggested rates of return much higher than even the banks and that in an industry that is supposed to be highly regulated. It compared the big four banks' rates of return on equity of 15 or 16 per cent while 'NIB just scored 32 per cent'. Medibank was described as having a mediocre result though it still had a return-on-equity of nearly 29 per cent.[63] The author continued:

I have heard the chief executive of MLC Life – now 80 per cent owned by a Japanese mutual – argue that life insurance is properly the realm of mutual structures. That argument can very easily be applied to health insurance, with its surging costs and rich pickings for no apparent societal benefit by private investors.

The committee would do well to ask the question as to why we allowed the mutuals to disappear and whether policies might be developed to encourage the return of the mutual.

Recommendation: The profits of insurance companies be addressed.

Recommendation: The government develop policies that would introduce honest competition through government-owned and mutual enterprises.

[63] Pascoe M (2017) 'Forget the banks – health insurance makes them look like amateurs', *The Sydney Morning Herald*, 28 February.

Conclusions

The present submission has touched on some of the main issues in banking and insurance and even then barely scratched the surface. In other aspects of finance the Committee should keep in mind that we are dealing with profit motivated companies, or in less polite terms, greedy companies with a strong incentive to 'take the customers to the cleaners' as Luigi Zingales might put it. Moreover, they are making deals with customers where they know a lot more than the customer. Indeed, the difference in knowledge is often why trusting customers approach the finance sector in the first place but it then becomes the means of duping the customers.

There is a long history in Australia of trying to find competitors to pit against the powerful banks. One of the early examples followed the crisis in 1841-3 which saw banking collapses and banks forcing borrowers into insolvency. Existing banks were seen as avaricious and incompetent. The NSW Legislative Council established a Select Committee on Monetary Confusion. This committee actually proposed a NSW central bank that would compete against the private bank with its own notes issue. In those days even private banks issued their own currencies. [64] Around the same time and for similar reasons we had the establishment of the state-owned banks in Victoria and SA. At the Commonwealth level the government established the government-owned Commonwealth Bank of Australia in 1911.

We think the time is ripe for discussing the best way of providing genuine competition to the private finance sector through not-for-profit or government owned bodies. Those competitors would provide new standards of propriety. However, there are other suggestions here that might be taken up. For example our suggestion that the insurance company that must honour a claim be independent of the body that decides the claim.

List of recommendations

Recommendation: Governments should recognise that there is not market solution such as increasing competition that would eliminate bad behaviour on the part of the financial system as a whole. If there is a chance to profit at the expense of customers then someone will take up that chance.

[64] Butlin SJ (1953) *Foundations of the Australian Monetary System*, Sydney University Press. As it happened, the legislation that followed the Committee's report was refused assent by the King's representative in NSW.

Recommendation: in areas likely to involve duping customers, government should provide or arrange to be provided and promote a no frills and honest alternative.

Recommendation: The Committee takes note of the critique of Professor Zingales and others and note their observations on the ubiquity of fraud in a finance market unless it is heavily regulated. With such strong incentives to 'misbehave' it is recommended that sanctions be as strong as possible, including hefty fines and gaol terms combined with rigorous enforcement.

Recommendation: The free and easy movement between senior government positions and big business should be severely discouraged if not banned.

Recommendation: The banks should declare their interest in subsidiaries so as not to deceive customers into thinking they are dealing with a small 'friendly' bank when dealing with the likes of St George.

Recommendation: That the government:

- **establish national laws to ensure that credit is not extended to people who do not have the capacity to repay**
- **prevent banks and debt collectors from pursuing debts for loans made to people who did not have the capacity to repay when the money was originally loaned**
- **restrict or banning sales targets and commissions for bank workers**
- **provide bank workers with a decent ordinary wage independent of sales-based commissions**
- **ban the practice of 'pre-approving' credit-card offers and/or credit extensions**
- **prevent banks from claiming money spent on the advertising of credit products as tax deductible business expenses.**

Recommendation: The government consider the establishment of an honest alternative to the existing private banks.

Recommendation: Governments need to address the super profits that the banks are reaping from the rest of society.

Recommendation: government investigate governance issues generally and report on whether some companies are indeed too big to govern and whether there is an appropriate size for finance companies in particular.

Recommendation: New financial products should be treated like new pharmaceutical products and require authorisation before being marketed.