

# FUNDING AUSTRALIA'S FUTURE

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## REGULATING THE AUSTRALIAN FINANCIAL SYSTEM

ALEX ERSKINE

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## Funding Australia's Future

The Australian Centre for Financial Studies (ACFS) instigated the project Funding Australia's Future in late 2012 to undertake a stocktake of the Australian financial system, and its role in facilitating economic growth within the wider economy.

In an economy which has enjoyed 21 years of consecutive economic growth and shown a resilience through the Global Financial Crisis (GFC) which is the envy of many nations, the financial sector has played a strong and pivotal role. The past decade, however, has been one of significant change. The impact of the GFC and the subsequent wave of global re-regulation have had a profound effect on patterns of financing, financial sector structure, and attitudes towards financial sector regulation. Identifying the extent to which these changes are transitory or likely to be more permanent is crucial to understanding how financing patterns and the financial sector will develop over the next decade or so.

Stage Two of Funding Australia's Future drills down into the key issues identified in Stage 1 of the project culminating in a set of recommendations aimed at placing Australia's financial system in a position to best meet the challenges presented by a rapidly changing and increasingly globalised economy.

In undertaking this analysis, ACFS has worked with a group of financial sector stakeholders, including the Australian Bankers Association (ABA), the Australian Finance Conference (AFC), the Australian Financial Markets Association (AFMA), the Association of Superannuation Funds of Australia (ASFA), the Australian Securitisation Forum (ASF), the Australian Securities Exchange (ASX), Challenger Limited, the Customer Owned Banking Association (COBA), the Financial Services Council (FSC), the Financial Services Institute of Australasia (Finsia) the Insurance Council of Australia (ICA), KPMG, National Australia Bank (NAB), the SMSF Professionals' Association of Australia (SPAA) and Vanguard Investments, as well as Treasury and the Reserve Bank of Australia (RBA).

This paper is one of four in Stage Two, which include:

1. Financing Australian Business:  
*Associate Professor Sam Wylie, Melbourne Business School and the University of Melbourne*
2. Australian Household Sector Finances:  
*Professor Michael E. Drew, Griffith University and Drew, Walk and Co*  
*Dr Adam N. Walk, Griffith University and Drew, Walk and Co*
3. International Linkages: Financial Markets and Technology:  
*Professor Deborah Ralston, Australian Centre for Financial Studies and Monash University*  
*Mr Martin Jenkinson, Australian Centre for Financial Studies*
4. Regulating the Australian Financial System  
*Mr Alex Erskine, Erskinomics Consulting*

All Funding Australia's Future papers can be accessed through the Funding Australia's Future Website: [www.fundingaustraliasfuture.com](http://www.fundingaustraliasfuture.com)

## Notes on the Author

**Mr Alex Erskine:** Alex Erskine is Managing Director and Founder of Erskinomics Consulting Pty Limited, focused on promoting economic and financial development, both national and international. Mr Erskine can draw on lessons from 4 decades of economic and financial cycles, reforms and crises, seen in government, in financial markets and as a regulator. Most recently he served 6 years as head of research with the Australian Securities and Investments Commission (ASIC), responsible for its economics and consumer market research team. With ASIC he helped lead some rethinking of the approach to securities regulation after the Global Financial Crisis. He started employment at the Reserve Bank of Australia in Sydney, then worked in progressively more senior roles with the Economist Intelligence Unit Limited in London, the Department of the Prime Minister and Cabinet in Canberra when the response to the Campbell Inquiry was being framed and implemented, and then Citibank (in Sydney and then Singapore) in the era of financial deregulation, before he launched Erskinomics, undertaking development assistance projects in post-Asian-crisis South East Asia. Mr Erskine was a Visiting Fellow of Macquarie University Applied Finance Centre from 1999 until 2008, teaching his course on 'the economics of financial markets' in Asian and Australian financial centres to aspiring Masters of Applied Finance. He has a BA in economics and an MA from the University of Cambridge. He has been a Fellow of the Australian Institute of Company Directors and a member of the Executive Committee of Australian Business Economists since 1999, and was President of the NSW Branch of the Economic Society of Australia in 1993–94. He is also a former Board member of Diabetes Australia NSW and Australian Diabetes Council.

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## Executive Summary

Questions on the regulation of Australia's financial system remain unanswered after the Global Financial Crisis (GFC), especially relating to the boundary of prudential regulation, the balance between safety and risk and any trade-offs that may exist. The Financial System Inquiry (the Murray Inquiry) reporting this year will be making important recommendations to government on these topics.

This paper may help inform those considerations. Chapter 1 sets out some key questions on the way Australia regulates the financial sector and Chapter 2 provides some perspective on the financial system and its importance in the economy. Amongst other observations it finds an absence of a trade-off between competition and efficiency on the one hand and stability on the other. It also finds a disappointing short-termism in the financial system, which regulation may have contributed to. Chapter 3 then reviews the philosophies that have underpinned Australia's approach to financial sector regulation in light of the GFC and the challenges and uncertainties that lie ahead. Its main focus is the implications of ever-present threats to financial stability, the need to recognise the threat this poses to taxpayers and the need to contain that risk. Amongst other improvements, changes are put forward that might encourage the availability of longer-term investment capital. Finally Chapter 4 canvasses proposals to add macroprudential policy to the set of regulatory tools available and to reform the regulatory architecture so that regulatory agencies have clear objectives, effective tools and can be held to account.

The 'efficient markets' regulatory philosophy that was the centrepiece of the Wallis/Costello approach to regulation of the Australian financial system failed in the GFC. The philosophy had depended on banks and their investors fearing they can go bust and consumers fearing they will lose their deposits, creating sufficient incentives to manage their risks and in doing so, aided by prudential regulation, perpetually nudging the financial system towards equilibrium even while permitting individual failures. This unreality was made obvious in the systemic financial shock of the GFC. In Australia every prudentially regulated entity became too-big-to-fail, key borrowings were guaranteed by government, and deposits are now largely insured through the Financial Claims Scheme (FCS), all in contradiction to the Wallis Inquiry intellectual underpinnings.

The GFC showed beyond doubt a determination from governments, including the Australian government, to limit through policies and regulations the risk and damage of systemic crises. In doing so, taxpayers were put at great risk, though fortunately in Australia the cost of support measures remained contingent and were not drawn on. It is time now to recognise the reality of this support and to devise a regulatory system that limits the risk to taxpayers in future crises. Financial system regulation, especially prudential and macroprudential, needs to be reassessed in this 'systemic stability' light, and the risk to taxpayers appropriately managed.

Nevertheless the most basic premises of 'efficient markets' philosophy, that no one knows the future and that market-based adaption is the least costly and quickest means of adjusting to changing expectations, are more clearly correct than ever. Though there is greater awareness of behavioural and psychological biases and of procyclicality in finance, there is no comprehensive alternative philosophy on which to base Australia's approach to regulation.

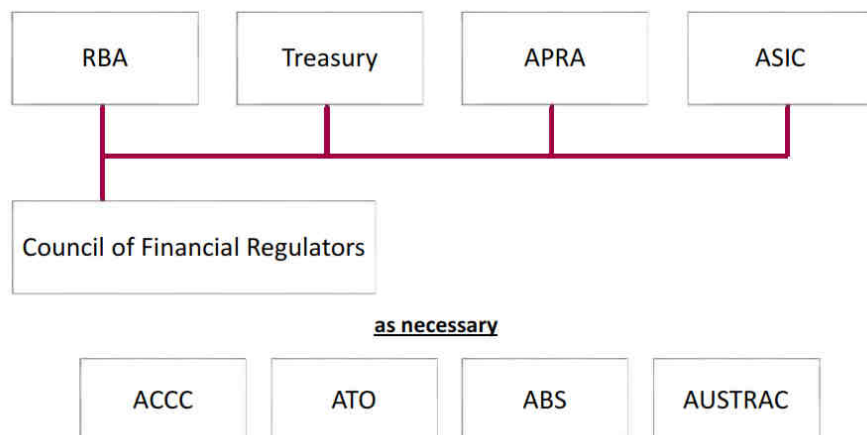
What has fundamentally changed is our understanding that the financial system is (and was) more complex and interconnected than envisaged, the systemic shocks more severe and potentially frequent and the public's expectation of stability more acute. Other countries, hit harder in the GFC, have had to make much more massive regulatory reforms. Australia by comparison needs a relatively modest rearrangement of what has been overall a successful approach to regulating the financial system and a renewed determination to protect taxpayers from the safety net created to support prudentially regulated financial activities.

The Tinbergen Principle, that the number of achievable policy goals cannot exceed the number of available policy instruments, has led to many practical rules including that, if you want something done, you give it to an agency that has it as its sole mission. Wallis got this uniquely right, separating bank regulation out of the central bank, the Reserve Bank of Australia (RBA), grouping all prudential regulation into a prudential regulator, the Australian Prudential Regulation Authority (APRA), and at that time correctly entrusting all market conduct regulation to what became the Australian Securities and Investments Commission (ASIC). The world has been envious of these 'twin peaks'. But Australia's financing is now more complex, systemic risks are ever-present, regulatory gaps are emerging and the status quo increases risk of the next crisis. This creates important issues for the Murray Inquiry.

Where Wallis failed was in not sufficiently recognising the wisdom of Hyman Minsky's 'financial instability hypothesis', which identified the systemic proclivity of financial crisis. Once financiers (let alone the public) come to believe that stability lies ahead, they gear up speculatively and inexorably bring on instability. Australia's regulatory focus on instability is informal and unaccountable: this needs to be improved, or Australia risks being taken unawares.

The main change proposed in this paper is an elevation of the role and responsibilities of the Council of Financial Regulators (CFR). This Wallis inspiration relies on clubby cooperation, is not necessarily proactive and is unaccountable. It has worked well so far, but the future is likely to be more testing.

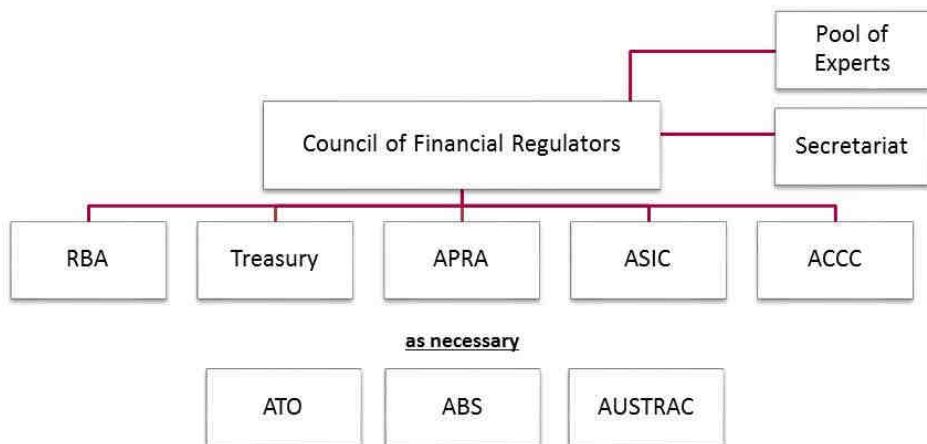
**Figure 1 Current Australian financial system regulatory architecture**



Recreated as a statutory body with an independent non-executive Chair, publishing an agenda and minutes for regular meetings and accountable half-yearly to parliament, the CFR should have two roles, one to oversee the effectiveness of regulation, and the other to be perpetually paranoid about

systemic financial instability and make decisions on the conduct of macroprudential policy. The Council could contract the RBA and other regulatory agencies as appropriate to implement its macroprudential policy decisions, resolving the confusion between the RBA and APRA over macroprudential policy.

**Figure 2 Proposed Australian financial system regulatory architecture**



Turning to the regulators themselves, there are some consequential changes proposed if the CFR takes ultimate responsibility for financial stability and macroprudential policy, and there are other changes proposed because the present regulatory structure either is failing or is unlikely to cope with the pressures of the future.

The Reserve Bank of Australia. The RBA currently has three objectives, financial stability, low inflation and an effective payments system but only two tools, monetary policy and payments system supervision/regulation. Its financial stability and inflation goals already clash: surges in housing lending and house prices have taken monetary policy hostage. Shifting the RBA's responsibility for financial stability to the CFR and the CFR determining macroprudential policy actions on a pre-emptive basis will allow monetary policy to focus on inflation.

The Australian Prudential Regulation Authority. APRA has almost the right prudential regulatory boundary (Approved Deposit Institutions (ADIs), most insurers and large superannuation funds) but needs to have a mandate of protecting Australia's taxpayers from risk of bail-outs made explicitly part of its objectives. It should be required to prepare a risk appetite statement, agreed with the government, and set capital and liquidity standards for prudentially-regulated institutions to protect taxpayers from all except a periodic 'unavoidable' financial crisis (the probability frequency can be pre-set – it could be as frequently as once every twenty years with relatively low capital and other requirements or as infrequent as once in a hundred years with relatively higher requirements). To clarify its role and responsibilities, APRA's competition mandate, which it has largely overlooked, should be transferred to the Australian Competition and Consumer Commission (ACCC).

The Australian Securities and Investments Commission. ASIC is the predictable failure of the Tinbergen Principle, with confused legislation giving it six objectives and often inadequate instruments, and since then its responsibilities have only grown. Systemic risks and globalization

mean more emphasis should be put on market integrity. There is focus already on taking away ASIC's registry operations: the National Commission of Audit (NCOA) suggested its transfer to the Australian Taxation Office (ATO) and the Budget is funding a scoping study for its possible privatisation. ASIC's several other functions, including licensing, market integrity and surveillance, consumer protection and financial literacy, also need review. To enable ASIC to focus, competition and consumer responsibilities should be transferred to the ACCC, where they fit. This would leave ASIC with one objective, market integrity, and it can be equipped with effective data, analysis, policy and regulatory tools. Funding for market integrity regulation should remain with taxpayers to limit risk of regulatory capture.

The Australian Competition and Consumer Commission. The competition regulator, the ACCC, has been almost irrelevant within the finance sector, undermined by the government's four pillars policy and swept aside in the post-GFC scramble to avoid prudential failures. A vigorous competition regulator will be more important for Australia's future: key competition questions will arise from the increasing vertical integration of the dominant banks into all aspects of finance and the implications of the emerging international trend to ring-fence core banking from riskier trading businesses. The ACCC should receive the competition mandates currently held (and generally ignored) by APRA and other regulators. The ambiguity in the border between the consumer responsibilities of ACCC and ASIC can be removed by transfer to ACCC of ASIC's consumer responsibilities. Responsibilities regarding consumer financial education can be simplified by making clear that the FCS has made ADI deposits safe, and that there is a safety net for consumer exposures to prudentially regulated entities, and everything else is more complex, less safe and not as protected.

To best protect the public interest, the Murray Inquiry will have to recommend improvements beyond just the regulators. The immediate trends are not encouraging.

The devil is in the detail of regulation and in the availability of quality data. As adviser to government, Treasury will be more deficient on detail and capacity to respond quickly after the staff cuts now in train. The ATO has an objective of promoting confidence in administration of the superannuation system as well as the tax system. It has fared well as regulator of the fast-growing Self-Managed Superannuation Fund (SMSF) sector, even in face of the superannuation system's persisting complexity, but it could usefully host a superannuation funds transfer exchange. Better regulation and forward-looking actions to handle systemic shocks also depend on better data. The ABS presides over data collections on funds management and superannuation that need significant improvement.

Finally, in the quest to avoid regulatory overload, industry needs to pre-emptively identify and deal with emerging problems before they explode into divisive political issues leading to complex legislation and regulation, costly to implement and yet often ineffective in execution. Effective industry self-regulation might promote and restore bipartisanship. And parliament itself will need to divert scarce resources to more effectively hold regulators to account.



## 1. The main regulatory questions

### 1.1 Introduction – the prudential boundary and other concerns

This paper seeks to stand back and assess whether the way the financial system has been regulated in Australia is appropriate for the future and lay out the options for reform. In comparison to some other countries which had very severe outcomes in the Global Financial Crisis (GFC) and are engaged in radical reform of the regulation of their financial systems, Australia fared comparatively well, in part because of differences in financial system regulation, and reform of regulation thus far has been incremental, though no less drawn out.

Nevertheless in Australia the approach to regulation remains contentious, and there is an underlying unease that the present approaches are not the best settings for Australia's future. There is an opportunity for reform: the entire approach to financial system regulation is under review this year by the government's Financial System Inquiry chaired by David Murray (FSI 2013).

One of the key questions for the FSI is whether regulation should create a fail-safe system or a system with a balance between risk and stability and, if a balance is appropriate, how that balance might be achieved while still protecting taxpayers and keeping financial system costs down. Davis 2013 and Maddock and Munckton 2013 both saw the persistent demand from the public and government for financial system stability as potentially having an adverse impact on the prospects for funding Australia's future, and posing a set of as yet unanswered regulatory dilemmas.

"The emergence of an international financial regulatory agenda emanating from the G20 and international organizations such as the BIS, Basel Committee, IOSCO, FSB, and the IMF" led Davis 2013 to foresee an "increase [in] the cost of intermediation relative to capital market funding" and "a likely increase in activity outside the prudentially regulated sector – including capital market innovations".

Finding the most significant features of Australian financing arrangements being issues of prudential regulation (relatively few significant sized financial institutions are outside the [prudential] regulatory perimeter and [prudentially-regulated] banks and superannuation funds dominate the financial sector in scale), Davis recommended that "identifying the appropriate perimeter of prudential regulation and designing appropriate investor protection arrangements outside of this perimeter remains a major issue".<sup>1</sup>

Davis also drew attention to segments outside that perimeter: "SMSFs are a rapidly growing savings/investment vehicle outside the prudential perimeter, while managed fund and direct investments in equities and debt instruments also escape prudential regulation".

He conjectured:

"This raises the question of investor protection in the non-prudentially regulated sector and in terms of arrangements for direct issues of securities by firms to investors. Both disclosure issues and issuance requirements are important in this regard. We have seen both attempts at reducing costly disclosure requirements and ability of companies to have more discretion in issuance

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<sup>1</sup> Recommendation 8 in Davis 2013.

arrangements (such as placements) which reduce the transaction costs of issuance, but create greater risks for investors. The net effect on the availability and cost of such finance is thus unclear.

... There may be valid arguments, on the grounds of encouraging a greater degree of appropriate risk taking from an economic perspective, for a smaller proportion of financial sector activities being undertaken within the prudential net and more outside.

But to achieve such an outcome involves two substantive problems. One is that it may require some structural separation of some prudentially regulated institutions – in particular banks. Developments overseas, such as proposals for “ring fencing” of retail banking in the UK and Europe, and the Volker rule in the USA Dodd Franks Act, appear to be heading in this direction. .... The second problem is that while the concept of a significant, nonprudentially regulated, financial sector facilitating risk taking and investment is economically appealing, there is little evidence that participation in such a sector would involve only those who are able to appropriately assess, manage, and bear the risks involved. With an increasing amount of household wealth being accrued in SMSFs, this is an increasingly important concern. Policies focused upon disclosure, education, and advice as the pillars for reconciling freedom of choice and investor (and borrower) protection have had limited success.

Appropriately delineating the prudentially regulated sector and politically and socially managing the consequences of risk taking outside of that sector remain major unsolved regulatory and political challenges.”

Maddock and Munckton 2013 also reflected on the regulatory dilemma:

“Regulators face a difficult transition. The current approach has been to define key institutions, like banks and other aspects of the financial system (including payments), and to regulate them more tightly. This creates a natural tendency for more risk to be taken outside the regulated boundaries. It will be difficult to graduate regulation from the core to the periphery of the system.”

These are dilemmas being faced around the world. World Bank 2013 says somewhat optimistically:

“The global financial crisis has also triggered a healthy policy debate on approaches to regulation and supervision. This ongoing debate among regulators, policy makers, and academics has led to multiple reform proposals, highlighting the diversity of views. This is likely to inform the regulatory reform process and improve future outcomes.”

There is a vast array of related questions pertaining to Australia, some of which the paper will seek to respond to:

- Some ask, in light of the experience in the GFC, why there have been any heightened standards imposed in Australia. Seeing more onerous regulation as negatively impacting on Australia's future through raising the cost of finance and impeding competition and efficiency, they ask if regulation has overreached, and seek to wind back the coverage and extent of prudential regulation. Some ask if the financial system would operate better for Australia's future if there were more self-regulation rather than regulation imposed by agencies of government.
- Some question whether Australian regulations should continue to harmonise with the crisis-driven US and European repairs or whether they should be oriented more at ensuring

compatibility with regulation in emerging Asia, to facilitate participating in the flow of funds within the region on which Australia's future increasingly depends. Those favouring the latter may well also be concerned by the extraterritorial reach of steps in prospect in the US and some of Europe to 'ring fence' core banking activities.

- Others, observing a regulatory tendency to provide increasing protection to consumers of financial services, ask what has happened to the concept of caveat emptor. They, or yet others, regret what they see as a tendency for regulators, rather than legislators, to make the case for new regulations and restrictions without appropriate democratic authority.

The questions reflect significant uncertainty and an unhappiness with the lack of coherence in the narrative describing financial system regulation in Australia. This paper is an attempt to resolve some of the uncertainty and to provide some of the missing coherence.

Making the case for change in Australia is hard, because on the surface there is little that is demonstrably broken, but it is no less important for the future. What Reinhart and Rogoff 2009 said to their readers is particularly apt now in an Australia that easily lapses in to complacency: we all too readily believe "this-time-is-different", "financial crises are things that happen to other people in other countries at other times; crises do not happen to us, here and now. We are doing things better, we are smarter, we have learned from past mistakes." Instead we should reflect on James Maddison's wisdom: "If men were angels, no government would be necessary". As we all know, financiers and regulators are not angels.

## **1.2 Aims and shortcomings**

This paper seeks to give a high level view on these issues and on how regulation of Australia's financial system might be improved, highlighting some important changes in the regulatory architecture and approach.

Regulation itself is inherently detailed. The paper is not a comprehensive catalogue of the regulatory changes that would help remove often unintended barriers to most effectively funding Australia's future.

It is also not an attempt to provide the sort of 'holistic view of how the Australian and global financial system is being transformed by' ... 'implementation of the vast regulatory reform agenda', as sought by Debelle 2013. There are too many reforms yet to be settled, let alone implemented. But this is a dangerous circularity in this: the IMF suggests "reaching a better understanding of the implications of these reforms for financial services and their impact on different economies is key to the completion of the reform agenda" (IMF 2014). At some point, Debelle's request does need to be addressed.

Chapter 2 sets out some context, highlighting some often overlooked features of Australia's financial system; Chapter 3 then addresses the theories underpinning the regulatory philosophy that has prevailed from the 1997-98 Wallis Inquiry until now, reviewing the extent they have been undermined by the GFC, as well as other specific regulatory questions, including those pertaining to the prudential regulatory perimeter; and Chapter 4 outlines some proposals for reform of the regulatory architecture and the roles of the regulators.

## **2. The financial system funding Australia's future**

This chapter addresses the unique characteristics of Australia's financial system, which often differ from common perceptions, to help inform the key regulatory questions to be addressed in later chapters.

Australia's financial system stands out as a large, stable, highly profitable, hybrid financial system that is neither the most nor the least efficient and competitive of a same reference group of countries. One of its worst tendencies is its short-termism.

### **2.1 Funding and stability of services – what the economy needs**

Financial systems are engaged in provision of several services, though funding is perhaps the most indispensable. The full range of functions include:

- funding consumption and fixed capital spending through:
  - 'classic intermediation' (where the financier and its shareholders take the credit and other risk exposures, limiting their own debt funders' exposure to those risks); and
  - market-based funding (in which usually the intermediary – in effect an agent – has little credit or other risk 'skin in the game' but generally on-sells all or most of those risks to investors in securities);
- investing and managing residents' money (asset and liability management, acting as agents and advisers), which involves placing funds in both debt and equity and all hybrids in between, as well as providing term and life insurance;
- providing risk management services such as general insurance and derivatives;
- operating markets that produce relative price signals important for resource allocation; and
- operating the payments system, vital economic infrastructure.

The financial system in Australia is the result of a unique process of development, as is its regulation, which has made the Australian financial system and its regulation quite different to other countries. The same is true of each of the other countries across the world, which is what makes harmonisation and the imposition of common regulatory standards a very hard task.

Regulation of the financial sector has to consider the full range of activities, not just its funding activities. Proposals for regulatory reform have to be made with care, and must be regarded as a package: a lesson repeatedly learned before and since the GFC is that altering one parameter can lead to unintended and possibly undesirable consequences.

In the post-GFC context, the official mantra is that financial sector regulation is intended to help ensure, to the extent possible, that financial services are supplied on a sustainable basis, both efficiently and fairly, but not in such a way that there are no failures.

In fact, there have been many failures amongst non-prudentially-regulated financial services participants in recent periods, not only in the GFC, some resulting from commission-driven selling and fraud and almost always from business models involving leverage and illiquid assets. None of

these failures was systemic, essentially because households *in toto* had capacity to absorb the losses; none caused the financial system (as opposed to the individual customers, management and owners of the failing entities) significant grief.

But there has not been a significant failure in the prudentially regulated space since HIH Insurance. The public and political tolerance for failure in prudentially regulated entities is very low, even non-existent.

This intolerance of failure also applies to payments system failures: the smooth conduct of business requires confidence in the secure and efficient settlement of payments. The future will be challenging but potentially very rewarding. The mooted move to implement T+2 clearing and settlement of equity transactions will reduce risks. The regulatory perimeter will have to be extended as new payment media become available. The threats to established payments systems are evident: contactless payments technologies, providers such as PayPal and mobile innovators are already inside the door, or on the doorstep. Bitcoin, amongst other innovations, has shown how technological innovation and its potential rapid consumer adoption may be transformative and disruptive. To get appropriate balance between innovation and stability, there is reason to make the introducers of new payments mechanisms carry a burden of responsibility, require rigorous pilot exercises ahead of any wider roll-out, and ensure that any true shadow banking operations are regulated as banks.

Australians have high expectations of the financial system, which helps to determine the appropriate approach to regulation and the regulatory architecture. What Australians appear to seek is a financial system that is:

- dynamic, where financiers earn reward for quality services and failures occur;
- stable, and can weather more frequent volatile financial and economic shocks, no matter the source;
- adaptable, so that new technology is adopted;
- domestically competitive, so that the gross return on risk is not disproportionately consumed by operating expenses;
- internationally competitive, so there is an array of choices when raising or investing funds at home or abroad;
- fair, so consumers have reason to trust financial service providers;
- diverse, so there are specialists as well as generalists;
- complete, so there are no market gaps such as with long-term finance and annuities;
- efficient, in the sense that prices quickly incorporate all available information; and
- efficient, in the sense that services are perceived as value for money.

## 2.2 The financial system rising in importance to the economy

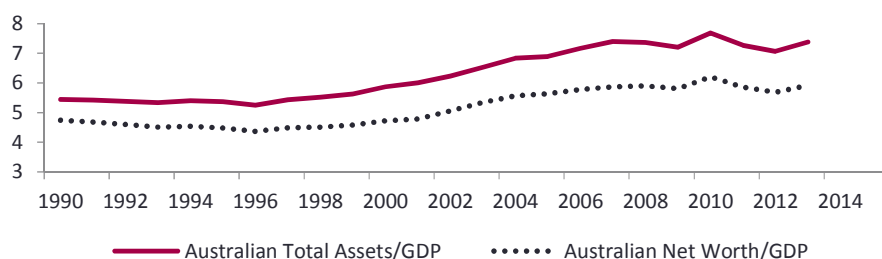
The financial system and its regulation are entwined in, and interact with, the economy. Perspective comes from 'big picture' national accounts balance sheet and income flows and their implications for the financial sector as analysed in the lifetime works of Raymond W. Goldsmith (eg Goldsmith 1985).

Following Goldsmith, Piketty 2014 recently has thrown a light on how wealth (net worth) as a multiple of annual income (GDP) has risen strongly over the decades once the destruction of the capital stock in WW2 had been paid for, and may rise further.

Bearing in mind that that wealth is a stock at a point in time and annual GDP is a flow of one year's income, a wealth to GDP multiple is very akin to a country's Price/Earnings (P/E) ratio. A higher multiple implies its reciprocal, a lower return on wealth.

ABS national balance sheet and national accounts data show Australia had recorded net worth of 7.4 times GDP by end-FY2012-13, up from 5.25 times GDP at end-FY1995-96, in line with Piketty's global observations. The setback represented by the GFC would appear to be temporary.

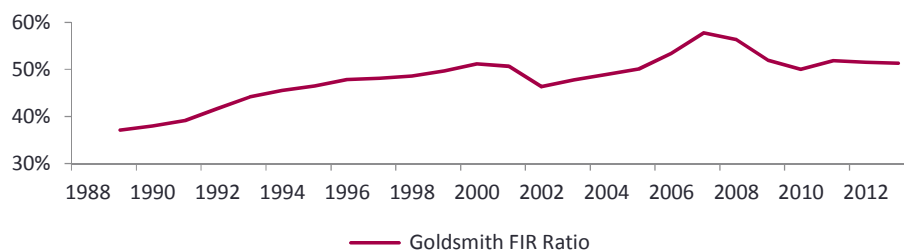
**Figure 3 Australian net worth divided by GDP, percentage**



Source: ABS 5204.0

In Australia, this increase in the wealth/GDP multiple is mainly the result of growth in land values/house prices above the rate of GDP growth and the rate of interest. Not surprisingly the rise in wealth has been accompanied by a rise in financial assets and liabilities. 'Financialisation' of the economy, as judged by the Goldsmith Financial Interrelations Ratio (FIR), calculated here by dividing financial liabilities (debt and equity) of the domestic non-financial sector by wealth (net worth), would still seem to be rising, notwithstanding a pause since the peak in 2007. The higher the FIR, the more financialised the economy.

**Figure 4 A 'Goldsmith' financial interrelations ratio for Australia**



*The Financial interrelations ratio (FIR is calculated as): debt and equity outstandings of the domestic non-financial sector as a percent of net worth*

Source: ABS 5232.0 and 5204.0

The FIR now stands at 51%, having risen from below 40% in the late-1980s/early-1990s to a peak of 58% in 2007. A FIR of 100% would imply every asset (or the income stream that flows from it) has been borrowed against or securitised through the financial sector. In theory almost all assets can be used as collateral for loans or securitised as equity, and a FIR of 51% means there still is as much as 49% of assets to utilise to secure financing (in the form of either debt or equity).<sup>2</sup>

Proxies in several other developed countries suggest their FIRs are higher than those presented for Australia above.<sup>3</sup>

Despite concerns in the media and elsewhere regarding overleveraged households, rising government indebtedness, increasing scale in the finance sector and rising volumes of market transactions, it appears there is a high likelihood of further increases in the financialisation of the Australian economy, especially if superannuation assets accumulate and are invested in debt and equity of the domestic non-financial sector. An ageing Australia is saving to finance spending and consumption in retirement. The regulatory system needs to be oriented to cope with the pressures that will emerge as wealth accumulates. Key regulatory issues – in addition to prudential regulation – will continue to be the principal-agent problems and information asymmetries that are endemic when the financial sector interacts with the household sector.

Another important development that seems very likely is a continuation of the trend towards economic and financial globalisation, with further increases in interdependence ahead (Ralston and Jenkinson 2014).

Over the decades Australians have been gathering more international exposures as borrowers and lenders and as investors from capital inflows and outflows:

- in terms of gross international liabilities through inflows (often intermediated through Australia's banks, though now also more directly from government bond issues) and during the resource investment boom the inflows counted from non-repatriation of dividends to foreign owners of mines and other projects;
- in terms of gross international assets largely through investment of a proportion of superannuation savings in foreign assets (equities, bonds and property); and
- in net terms, more inflows than outflows so that the current account deficit is financed.

These developments (net and gross) are likely to continue while-ever Australians in aggregate spend more on fixed capital expenditure than is saved from income and remain in the retirement savings accumulation phase, increasing savings for later consumption. These increasing international

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<sup>2</sup> Consider a house: if it is owned outright, there is no loan attached, so it can be used to secure a borrowing, though often not quite to 100% of the value of the house. If it is currently mortgaged on a loan-to-value ratio of 60%, there is still equity equivalent to 40% of the value of the house that could be offered as security for a further loan.

<sup>3</sup> International comparisons are always difficult, in this instance hampered by inconsistencies in compiling balance sheet data. This shortcoming is being addressed: after the GFC, the G20 asked the Financial Stability Board (FSB) and the International Monetary Fund (IMF) to identify data gaps shedding light on economic and financial vulnerabilities, and make recommendations whose implementation by countries would close those gaps. The FSB and IMF made 20 recommendations, the 15th being that G-20 member economies extend their national accounts by compiling financial and nonfinancial stocks and flows by economic sector, see Shrestha et al 2012.

exposures will be a source of activity for the financial services sector and for regulators, while regulators will also be obliged to make clear the regulatory protections to those engaged in the international transactions. As the cross-border financing flows increase, there will be more cross-border regulatory issues, requiring cooperation with foreign regulators in enforcement actions and in data sharing.

### **2.3 Competition, efficiency and stability – no trade-off**

There is still a widely-held belief that there is a trade-off between competition, efficiency and stability (most recently see as a prime example FSI TOR 2013). It was certainly the conventional wisdom in Australia at the time of the Wallis inquiry. Nevertheless, it seems a very pre-GFC way of thinking, as Chapter 3 will address in greater depth. This section of Chapter 2, by contrast, sets out some practical facts from a cursory inspection of the international data since the GFC. It questions the reality of such a trade-off in the light of what has happened.

Though international comparisons are fraught with difficulty, it is a task that must be done. Data to 2011 from the World Bank Global Financial Development Database<sup>4</sup> on bank competition, efficiency and stability measures for Australia and 5 reference countries (Canada, the Netherlands, New Zealand, the United Kingdom and the United States of America) shows Australia at the more financially stable end of the reference group (with Canada), but Australian banks are middling overall for competitiveness and efficiency. Interestingly, on some measures of competition and efficiency Australian banks are the best of the reference group, on others the worst and on others in the middle. Stability certainly seems to have helped investors, by maintaining high pre-tax profitability.

#### **Competition measures – mixed**

Australia is not exceptional in having a handful of major banks with a dominating share of banking sector assets. Comparing two concentration ratios and three estimates of the degree of competition and market power, Australia ranks in the middle of the group of countries, on one measure the least competitive of the six (the Boone Indicator of the elasticity of bank profits to marginal costs), on another the most competitive (the Lerner Index comparing output pricing and marginal costs) and on concentration and a measure of the elasticity of revenues to input prices in the middle.<sup>5</sup>

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<sup>4</sup> Version 17, updated 5 November 2013

<sup>5</sup> Bank concentration ratio (%) GFDD.OI.01. Assets of three largest commercial banks as a share of total commercial banking assets. Total assets include total earning assets, cash and due from banks, foreclosed real estate, fixed assets, goodwill, other intangibles, current tax assets, deferred tax assets, discontinued operations and other assets. USA is the least concentrated, then the UK. Then Canada and then Australia. Netherlands and NZ are the most concentrated.

5-bank asset concentration GFDD.OI.06. Assets of five largest banks as a share of total commercial banking assets. Total assets include total earning assets, cash and due from banks, foreclosed real estate, fixed assets, goodwill, other intangibles, current tax assets, deferred tax, discontinued operations and other assets. Similar results.

H-Statistic GFDD.OI.03. A measure of the degree of competition in the banking market. It measures the elasticity of banks revenues relative to input prices. Under perfect competition, an increase in input prices raises both marginal costs and total revenues by the same amount, and hence the H-statistic equals 1. Under a monopoly, an increase in input prices results in a rise in marginal costs, a fall in output, and a decline in revenues, leading to an H-statistic less than or equal to 0. When H-statistic is between 0 and 1, the system operates under monopolistic competition. However, it is possible for H-stat to be greater than 1 in some oligopolistic markets. Very limited data (for Australia only 2010, for Canada, Netherlands, UK and USA only 2010 and 2011). For the one year for which there is data for Australia, Canada was the closest to perfect competition, then the Netherlands. Australia, UK and USA were broadly similar, least like perfect competition.



What would seem to matter more than concentration is the concept of market contestability. According to World Bank 2014, "The behaviour of banks in contestable markets is determined by threat of entry and exit. Banks are pressured to behave competitively in an industry with low entry restrictions on new banks and easy exit conditions for unprofitable institutions—even if the market is concentrated". Local experience bears this out: competition – and the threat of competition – from non-bank sources, such as securitisers and other shadow banks, clearly made a difference in pre-GFC Australia. In the foreseeable future heightened contestability is more likely to stem from a technology upstart or retail industry entrant than from an established foreign financial entrant (most are weak after the GFC).

### **Efficiency measures – mixed**

A comparison of efficiency measures provide a ranking somewhat similar to the competition measures: Australian banks are the most efficient of the group of countries on one measure (a cost to income ratio), least efficient on another (a lending-deposit spread) and in the middle on a third (an overhead cost ratio).

In terms of profitability measures against assets and equity, the performance of Australian banks is exceeded only by Canadian banks, though economic adversity and financial instability clearly has held back the US, UK and Netherlands in this ranking.<sup>6</sup>

### **Financial stability measures – the key**

The stability measures that are compared are an estimate of the probability of default, the extent that bank credit is funded by deposits, bank capital ratios and whether and when a bank crisis occurred. In terms of financial stability, Australia not surprisingly ranks towards the stronger end of the countries, consistent with having not had a banking crisis in the GFC. Nevertheless, a key

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Lerner Index GFDD.OI.04. A measure of market power in the banking market. It compares output pricing and marginal costs (that is, markup). An increase in the Lerner index indicates a deterioration of the competitive conduct of financial intermediaries. Australia and the Netherlands seem more competitive than Canada and NZ which again are generally more competitive than UK and USA.

Boone Indicator GFDD.OI.05. A measure of degree of competition based on profit-efficiency in the banking market. It is calculated as the elasticity of profits to marginal costs. An increase in the Boone indicator implies a deterioration of the competitive conduct of financial intermediaries. On this measure, NZ is the most competitive, followed by Canada, the USA, the UK and the Netherlands. Australian estimates are the only ones with a positive sign – the least competitive.

<sup>6</sup> Bank cost-to-income ratio (%) GFDD.EI.07. Operating expenses of a bank as a share of sum of net-interest revenue and other operating income. Australia and New Zealand have become the most efficient on this criteria, sustainably achieving ratios of less than 50% whereas Canada, Netherlands, UK and US could not hold onto such gain and now record ratios of 60%.

Bank lending-deposit spread GFDD.EI.02. Difference between lending rate and deposit rate. Lending rate is the rate charged by banks on loans to the private sector and deposit interest rate is the rate offered by commercial banks on three-month deposits. On this measure, Australia is the least efficient, with the widest spread, followed by Canada. The Netherlands has the narrowest spread. There is no data for the UK and US.

Bank overhead cost to total assets (%) GFDD.EI.04. Operating expenses of a bank as a share of the value of all assets held. Total assets include total earning assets, cash and due from banks, foreclosed real estate, fixed assets, goodwill, other intangibles, current tax assets, deferred tax assets, discontinued operations and other assets. Australia ranks in the middle, the US and Canada have the highest overhead cost ratio, the least efficient, and the UK and Netherlands, the lowest, the most efficient.

Bank return on assets (pre-tax, %) GFDD.EI.09. Commercial banks' pre-tax income to yearly averaged total assets. Returns vary according to the economic cycle as well as efficiency. Canadian banks in 2011 were the most profitable on this measure and the UK and Netherlands the least. Australian banks' pre-tax returns were 1.17% in 2011, in line with the US.

Bank return on equity (post-tax, %) GFDD.EI.10. Commercial banks' pre-tax income to yearly averaged equity. Similar to the rankings of pre-tax returns on assets – Australia and NZ ranking behind Canada.

deterioration in Australia, an increased risk of instability, is seen in the switch over several decades from deposits exceeding credit to credit exceeding deposits, but this rising threat of instability in practice would seem to have been ameliorated over the same period by a strengthening in capital positions.<sup>7</sup>

Though the World Bank measures of banking sector efficiency and competition give a mixed, rather than clear, ranking for Australian banks versus the reference group, on some other more local measures there must be some concern. For instance, the big 4 banks' market dominance is rising towards levels that in other industries the Australian Competition and Consumer Commission (ACCC) would regard as a concern if considering mergers (see Australian Bankers Association 2014 Appendix E). Furthermore, whereas there is widespread confidence in the degree of competition and contestability in the market for mortgage finance, such confidence appears less certain regarding the market for SME loans.

At this stage there do not appear to be ready estimates of the extent of additional market power that has been flowing to the major banks from their strategies of vertical integration into wealth management, stock broking and financial advice. This appears likely to be extending their influence over individuals' financial choices and gathering a greater share of total spending on financial services. Further research is suggested for the implications for competition, given that a small number of banks is reported to have ownership of 80 per cent of the financial planners.

## **2.4 Economies of scale – the benefits not readily apparent**

Around the world the industry of finance has had a tendency to size and oligopoly. Scale confers significant advantages. So it is legitimate to ask if the economy, the community, is paying more or less as scale increases. As with the global evidence on economies of scale in much of finance, the local answer is mixed.

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<sup>7</sup> Bank Z-Score GFDD.SI.01 It captures the probability of default of a country's commercial banking system. Z-score compares the buffer of a country's commercial banking system (capitalization and returns) with the volatility of those returns. The USA and NZ are furthest from default, and the UK and the Netherlands closest to default. Canada and Australia are between these extremes, with the Canadian system somewhat less risky.

Bank credit / bank deposits (%) GFDD.SI.04. The financial resources provided to the private sector by domestic money banks as a share of total deposits. Domestic money banks comprise commercial banks and other financial institutions that accept transferable deposits, such as demand deposits. Total deposits include demand, time and saving deposits in deposit money banks. On this measure, the US system is the most stable, with credit substantially less than deposits, whereas the Netherlands and Canada are the least stable. Australia is between these extremes, closer to the Netherlands and Canada. (There is no data for the UK.)

Bank capital to total assets (%) GFDD.SI.03. Ratio of bank capital and reserves to total assets. Capital and reserves include funds contributed by owners, retained earnings, general and special reserves, provisions, and valuation adjustments. Capital includes tier 1 capital (paid-up shares and common stock), which is a common feature in all countries' banking systems, and total regulatory capital, which includes several specified types of subordinated debt instruments that need not be repaid if the funds are required to maintain minimum capital levels (these comprise tier 2 and tier 3 capital). Total assets include all nonfinancial and financial assets. Australia on this measure is the most stable, slightly ahead of Canada and the UK, both of which saw precipitous declines in capital to total assets in 2008 before capital was rebuilt. (No data for the Netherlands, NZ or the USA.)

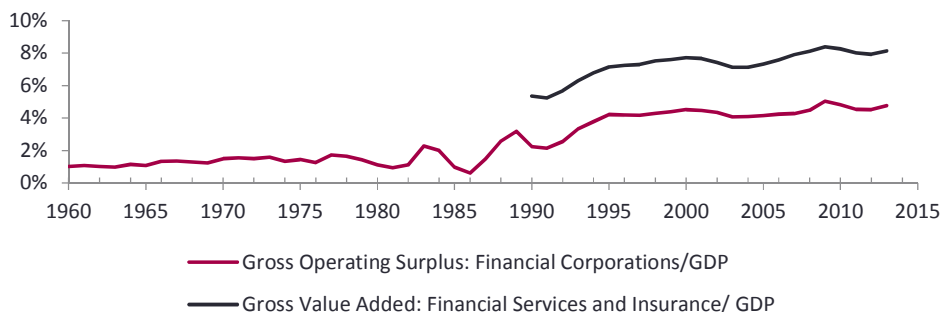
Bank regulatory capital to risk weighted assets (%) GFDD.SI.05. The capital adequacy of deposit takers. It is a ratio of total regulatory capital to its assets held, weighted according to risk of those assets. No data in the World Bank database for Australia, though locally available data suggests Australia ranks strongly.

Bank crisis dummy GFDD.OI.19 Dummy variable for the presence of banking crisis (1=banking crisis, 0=none). The UK and USA both recorded banking crises for five years (2007 – 2011) and the Netherlands for four years (2009 – 2011). Australia, Canada and NZ escaped crisis.

For Australia we present graphs of the Gross Operating Surplus of Financial Corporations (GOS) and the Gross Value Added of Financial Services and Insurance (GVA) as a proportion of GDP (Figure 5) and as a proportion of total domestic non-financial sector funding (Figure 6).

Compared to GDP it is clear the total incomes earned by the financial sector are rising faster over time than other incomes and the financial services sector has increased in size compared to the non-financial sector of the economy.<sup>8</sup>

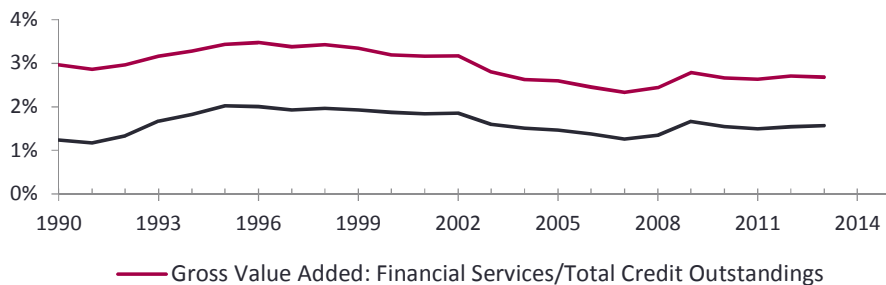
**Figure 5 Financial Sector Gross Operating Surplus (GOS) and Gross Value Added (GVA) as a percent of GDP**



Source: ABS 5204.0

Compared to total domestic non-financial sector funding, it is equally clear that the income earned by the financial sector per \$ of financing is below the peak levels of the mid-1990s, but has plateaued at a level above the low reached in 2007. This is in spite of an increase in funding that might have been expected to see some pricing benefits flow from some 'economies of scale'.

**Figure 6 Financial Sector Gross Operating Surplus (GOS) and Gross Value Added (GVA) as a percent of total credit outstandings<sup>9</sup>**



Source: ABS 5204.0 and 5232.0

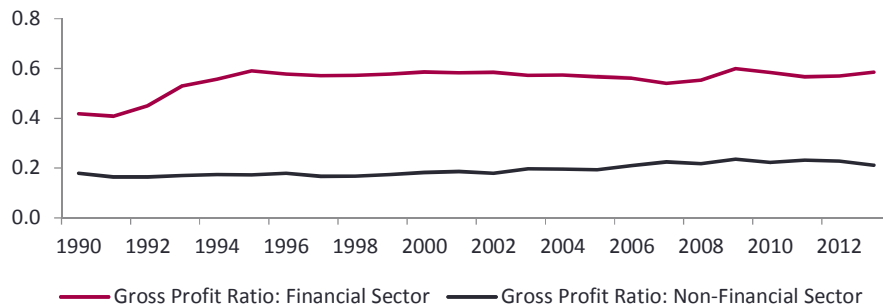
The 'gross profit ratio' (GOS divided by GVA), plotted in Figure 7 for both the financial sector and the non-financial sector, is an indicator of profitability showing the proportion of the value added created during the production process which remunerates capital. It confirms that the profitability of financial services increased in the mid-1990s (after the 'recession we had to have') and has since stabilised at a high level, barely disturbed by the GFC. There has been a less perceptible trend

<sup>8</sup> The growth of financial incomes relative to GDP is probably understated as value added does not include capital gains. See Bazot 2014.

<sup>9</sup> The Figure is an ABS aggregation of domestic non-financial sector funding through debt and equity.

improvement in profitability of the non-financial sector over the period, most visible in the immediate pre-GFC period.

**Figure 7 Gross Profit Ratios (Gross Operating Surplus (GOS) divided by Gross Value Added (GVA) for the financial sector and for the non-financial sector**



Source: ABS 5204

Especially in banking, the lack of apparent lower margins as the banking sector has grown (ie a lack of economies of scale) perhaps is not surprising. Notwithstanding a good record on operational efficiencies in Australia, the worldwide search for economies of scale in banking has come up with no conclusive evidence: complexities that come with scale (some doubtless regulatory) often seem to offset apparent economies.

There is clearer evidence that there are economies of scale in asset management, from overseas and domestic sources. From abroad, setting somewhat of a global benchmark, the operating cost (total asset management costs including performance fees) of the Norwegian Pension Fund Global (Norway's oil-funded sovereign wealth fund), which has assets now exceeding NOK 5 trillion (around AUD\$0.9 trillion, mostly invested offshore in debt and equity), have been in an range of 0.06 to 0.14 percent annually (6 to 14 basis points) since 1998 (Grande 2013), much less than the costs for this function of the individually smaller entities within Australia's superannuation industry.

From Australia, Chant West 2011 shows that there are economies of scale in superannuation asset management, with and even without what it found is a benefit to risk adjusted returns of asset diversification into unlisted assets that comes with size.<sup>10</sup>

Chant West estimates "large funds have outperformed small funds over the longer term within both the 'funds with a high exposure to unlisted assets' and 'funds with a low exposure to unlisted assets' universes".

<sup>10</sup> The Chant West analysis compared the performance of their multi-manager, growth investment options of 45 superannuation funds (32 not-for-profit funds and 13 master trusts), defining 'growth' as a 61 to 80% allocation to growth assets, the typical risk/return profile of most funds' default options. Performance was reviewed over one, three, five, seven and ten year periods to March 2011, with all the funds having a seven year performance history, but only 36 of the 45 having a ten year history. Returns are net of investment fees and tax, and do not include administration fees or any adviser commissions, to ensure that the comparisons are investment related, and that funds in the different market segments are evaluated equitably. 'Large funds' involved multi-manager assets of more than \$6 billion and 'small funds' multi-manager assets of \$6 billion and less.

**Table 1 Scale benefits: large funds outperformance of small funds (% pa)**

<b>Universe</b>	<b>5 Yrs</b>	<b>7 Yrs</b>	<b>10 Yrs</b>
High unlisted assets	1.1	1	1.1
Low unlisted assets	0.2	0.4	0.6

Source: Chant West 2011

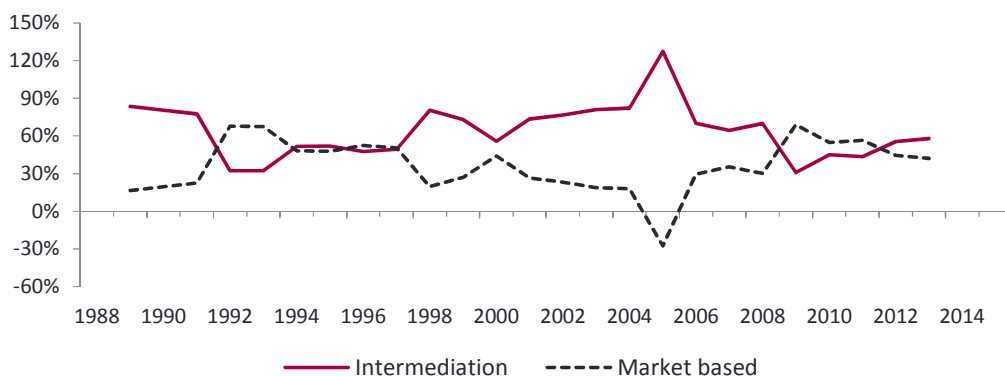
More recent data is soon becoming available, including from APRA. Preliminary indications discussed with some stakeholders suggest it may show a reduction in fees of retail funds over the period 2011 to 2013, suggesting a pricing benefit from MySuper.

## **2.5 Market-based funding – Australia to remain a hybrid**

The conventional wisdom is that over several decades the Australian financial system has become more market-based. There has been a rapid accumulation of assets in superannuation funds which, partly because of superannuants' access to 'choice', are invested largely in liquid, readily-marketable and frequently traded assets, especially equities. There have also been an increasing availability and use of interest rate risk management and other financial instruments, more trading on stock exchanges and Ralston and Jenkinson 2014 report a strong increase in corporate bond issuance. The exchange rate is flexible and heavily traded. In addition, interest rates on borrowing and lending are no longer determined by regulation.

However, if 'more market-based' means that the sources of funding for the Australian economy have shifted from 'classic intermediation' to 'market-based funding', then the perception is not yet reality. ABS data on the funding of the Australian economy (the domestic non-financial sector) reveals that 'classic intermediation', where the intermediary (typically a bank and its shareholders) stands between the borrower and the lender and assumes credit, market and liquidity risks in the transaction, remains the more important. This is so for both net transactions during periods and outstandings at the end of a period. By contrast, aggregating as 'market-based funding' the diverse instruments in which the investor takes the credit, market and liquidity risks in providing finance to the borrower/issuer, market-based funding has rarely been the dominant source of funds, and never for long.

**Figure 8 Net transactions: Intermediation versus Market-Based Funding<sup>11</sup>**



*(Domestic non-financial sector demand for credit, including equity and debt: loans and placements are 'classic intermediation', all other forms of financing are 'market-based', including bonds, bills, and equities)*

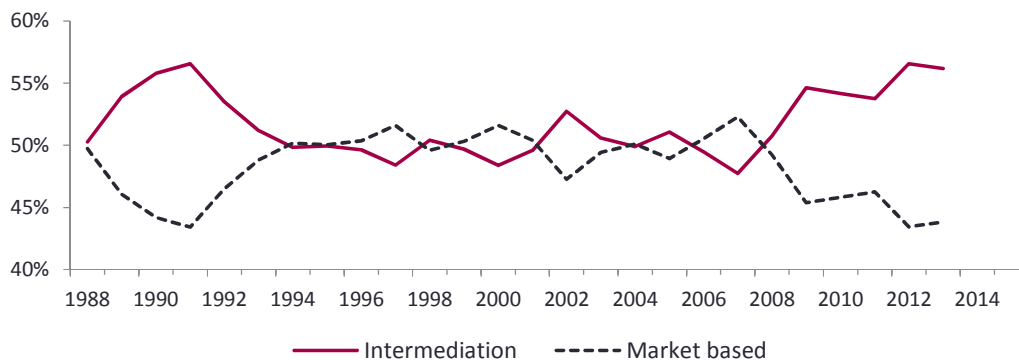
Source: ABS 5232.0

Twice in the period for which we have ABS Financial Accounts data the flow (net transactions) of market-based financing has exceeded classic intermediation, both times in periods of financial distress and slow growth/feared recession, which directly impeded classic intermediation. In the early-1990s, the rescue came from overseas funding. In 2009 and 2010, domestically-supplied market-based financing was the countercyclical source of funding supply (albeit at deeply discounted equity issue prices). The latter is an Australian phenomenon arising from the comparatively large and essentially unleveraged institutionally managed superannuation sector, and stands in contrast to the global experience of market-based financing reinforcing pro-cyclicality in the 'age of asset management' (see Haldane 2014 and Papaioannou *et al* 2013).

In terms of outstandings, there was a long period following the early-1990s 'recession we had to have' when market-based liabilities were as important as classically intermediated liabilities, presumably the result of the banking sector writing off loans and the corporate sector reducing its borrowings from banks. But the revived dominance of the stock of 'classically intermediated' finance over market-based finance has become clearer in the post-GFC period. This runs against the expectation (eg from Davis 2013) that the higher bank regulatory standards in the post-GFC period will cause demand to spill over into increasing use of market-based instruments. It certainly has not been seen yet.

<sup>11</sup> The recorded spikes upwards in intermediation and downwards in market-based funding in 2005 are atypical, due in large part to one large one-off transaction, being News shifting its domicile from Australia to the US. The surrounding years are more representative of the trend, which is that classically intermediated flows then comfortably exceeded market-based funding flows.

**Figure 9 Net Outstandings: Intermediation versus Market-Based Funding**



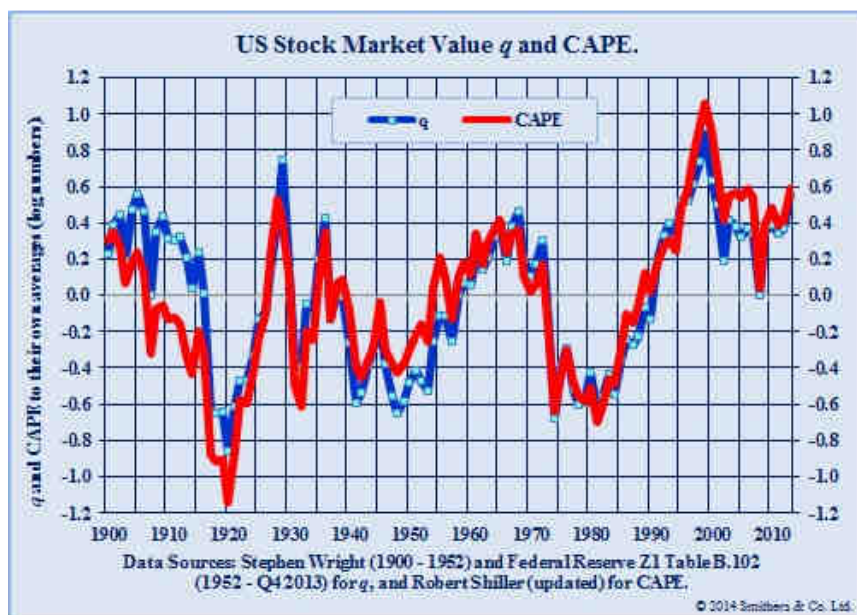
Source: ABS 5232.0

*Domestic non-financial sector credit, including equity and debt: loans and placements are ‘classic intermediation’, all other forms of financing are ‘market-based’, including bonds, bills, and equities*

Despite the growth of superannuation and lesser regulatory requirements, market-based funding seems quite unlikely to exceed ‘classic intermediation’ in funding the Australian economy during the next decade or beyond. This is largely because monies contributed from businesses and households to superannuation funds for deployment in diverse assets in aggregate do not leave the banking system, especially when they are used to purchase domestically-source financial assets. The funds diverted from household claims on banks (typically deposits) to superannuation funds are typically placed in short-term loans to banks, then exchanged for equities and the seller of those equities now has an increase in her deposits at the bank. Even if superannuation funds invest in assets abroad, the monies do not necessarily leave the Australian banking system, depending on foreign preference for Australian financial system exposures.

It is true that market-based instruments (especially equities) are subject to greater price revaluations, up and down on a daily basis, than are the loans and deposits that comprise the main assets and liabilities of the intermediaries involved in ‘classic intermediation’ (mainly the banking sector and other ADIs, who once a cycle or so may have to mark down or write-off some loans). But the same factor in the long-term – nominal GDP growth – drives both the flows and long-term asset pricing affecting superannuation funds and the flows and balance sheet size of banks. Though there are lengthy periods when the prices of equities move above fundamental, economy-driven values, the prices of equities in history have always reverted to fair value in the long run (see for instance Shiller 2000 and Smithers and Wright 2000 and the graphical update below).

Figure 10 US Stock Market Value  $q$  and CAPE



Source: <http://www.smithers.co.uk/page.php?id=34> downloaded on 20140605

There has been a significant rise in the volume of market-based transactions, for instance on exchanges. The effect of this volume of transactions in terms of the net provision of finance to the economy tends to net out over a period, suggesting the transactions are driven by factors other than the business of supplying long-term funds from long-term savers to long-term users of funds, such as 'active management', pursuit of liquidity, herding and momentum trading.

The implications would seem to be that rising market-based financing will increase as funds accumulate in superannuation but, unless superannuation funds allocate substantially more to Initial Public Offerings (IPOs), secondary raisings and other new corporate debt and equity financing (eg Private Equity (PE) and Venture Capital (VC)), 'classic intermediation' will continue as the bedrock of financial system provision of credit to the domestic non-financial sector. The implication is that we must plan for regulation to cater for both 'classic intermediation' and market-based financing: in effect a hybrid financial system.

## 2.6 Short-termism a defect – merit in a longer-term investment horizon

One finance-wide development over several decades has been an obsession with liquidity and an increasingly short-term investment horizon, and its counterpart, a diminution of longer-term investment horizons. The ever-increasing pursuit of liquidity across all aspects of finance (something John Maynard Keynes described as the 'fetish of liquidity' in 1936) is driving a preference for short-term instruments, shorter holding periods and increased transaction speeds and turnover, leading to herding and momentum at the expense of longer-term returns.

Overseas there has been a start made to identify the causes and costs of short-termism and to identify measures to encourage the adoption and pursuit of longer-term investment horizons, see Myners Report 2001, the Kay Report 2012, OECD 2013 and, for the IMF, Papaioannou et al 2013.



Research has been highlighting the pro-cyclical behaviour of institutional investors, sheeting home many of capital market failings to 'institutional herding'. Further research is progressing, especially from the London School of Economics and The Paul Woolley Centre for the Study of Capital Market Dysfunctionality in Sydney, into the drivers of increasing short-termism, with uncertainty, a decline in trust, behavioural incentives and regulations all contributing.

The capacity of the financial system to fuel asset price bubbles and procyclical economic volatility now stands out in sharp relief. Despite the apparent concentration in superannuation on active asset allocation strategies (RBA 2014), there has been and is still a paucity of genuine 'Friedman-ite stabilising speculators', prepared to 'buy low' and hold for long periods in line with the long tenor of superannuation fund liabilities before 'selling high' (Grenville 1998, Haldane 2014).

Matching the lack of long-term investors has been a quite surprising lack of financial services meeting longer-term needs – for instance for annuities, for infrastructure, for agriculture and for private equity and venture capital. Conversely, there has been an excess of financial services meeting shorter-term needs – for consumption, for equity market trading and asset allocation shifts. Market practices are becoming short-term, viz. high frequency trading and algorithmic trading, the short holding periods of equities and very liquid instruments such as ETFs etc.

The lack of capital for long-term investment has numerous deleterious effects on the economy, incomes, jobs and infrastructure, and distorts the development of the financial system, for instance channeling resources into facilitating herding, momentum-trading and volatility.

The implementation of policies and regulations that create a large and vibrant pool of long-term investment funds, and the removal of roadblocks that limit investment horizons, will improve the efficiency of capital allocation and increase productivity, jobs and incomes across Australia. This will make Australia a competitive destination for domestic and offshore investors and is critical to future economic welfare.

Some missing elements in the financial system include:

- a deep and vibrant corporate bond market;
- a ready funding market for quality infrastructure assets;
- a dynamic VC and PE industry; and
- the full set of instruments required for a deep and flexible annuities market.

The drivers of the low asset allocation to longer-term assets in Australia are partly regulatory, with regulations creating a bias towards liquidity. For instance:

- the requirement to provide 30-day portability biases trustees from investing in illiquid assets
- MySuper default funds, intended to "deliver a better deal for all default fund members, including through improving the simplicity, transparency and comparability of superannuation products", in practice have focused on high liquidity and low fees, limiting the range of assets they will invest in, in order to keep their implementation and compliance costs down, at the expense of longer-term returns. Data from FCS shows reduced fees for MySuper retail funds in 2013 compared to 2011.

One measure that might facilitate a longer-term investment horizon for superannuation funds, even while they maintain liquidity for operational purposes, would be creation of a liquidity back-stop such as access to a committed liquidity facility for qualifying superannuation funds, possibly provided by RBA. A liquidity backstop could allow qualifying superannuation funds to hold higher asset allocations of less liquid, longer-term assets, better matched to the duration of the funds being saved for funding retirement.

In providing this liquidity facility, it would of course be important to ensure that superannuation funds did not transform themselves into shadow banks, taking excessive credit risks, or market and liquidity/maturity risks. Data will be required for the provider of such a liquidity provider (as mentioned, potentially the RBA), to give it comfort that the asset quality was acceptable. In addition, requirements for prudential supervision of superannuation would have to be heightened to reflect such a change. The greatest merit of Australia's institutionally-managed superannuation system from a stability perspective is its lack of leverage, an attribute which should be maintained, even reinforced.<sup>12</sup>

## **2.7 Taxation and financing – better if distortions reduced**

Taxation is a significant determinant of the development of the financial system and a driver for its services, quite apart from the role of the Australian Taxation Office (ATO) as regulator of the administrator of SMSFs.

Four matters in tax policy stand out as having important financial system development and associated regulatory consequences, the first two concerning biases embedded in the current tax system (both contributing to short-termism) and the latter two reflecting Australia's international engagements:

1. The current structure of the capital gains tax (CGT) distorts financing and capital allocation, and is one factor promoting short-termism in investments. The distortion is the single step to a much reduced tax rate after a one-year holding period. It would be less distorting, and more supportive of longer-term investment horizons, if the rate reduction was smoothed and stepped down progressively over a longer holding period, for instance to a zero tax rate if assets are held for more than 10 years. While the present approach prevails, regulation has to focus on issues of short-term transactions and volatility: were a longer-term investment horizon to emerge, there would have to be increased requirements for, and surveillance of, appropriate disclosures of longer-term risks and uncertainties.
2. In aggregate, the tax system is biased in favour of consumption (due to the low rate of the GST relative to income tax rates) and borrowing (due to the deductibility of full nominal interest costs incurred for a business purpose) and against saving (due to taxing full nominal interest receipts). Some of the few offsets are the tax concessions favouring superannuation savings (bearing in mind these savings are intended to fund future consumption, not to fuel

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<sup>12</sup> Some leverage has long been permitted, for instance through instruments such as instalment warrants. Note however that the essentially unleveraged nature of the superannuation sector as a whole is being undermined by legislation explicitly enabling SMSFs borrowing for property or other asset purchases through non-recourse loans. At this stage the overall leverage incurred is relatively modest, and a long way yet from a systemic risk.

intergenerational transfers). Any reform to the tax system that reduces the bias against saving would add (appropriately) to the responsibilities of the financial sector regulators, as well as encourage a longer-term investment horizon.

3. As a result of company tax dividend imputation, the tax system is also biased towards business within Australia and against Australian businesses engaged in international trade and investment. In addition, according to industry, a key factor detracting from the international competitiveness of Australian fund managers is to do with taxation of international investors. There has been longstanding uncertainty and inconsistency over the tax rules that apply to foreign investors for foreign funds management services. Several inquiries (eg Johnson Report 2009) have recommended improvements to the tax regime applying to foreign investors investing through Australian funds managers, endorsing flow-through tax treatment of investment income so derived. Were there a way to give certainty for this (or for allowing imputation credits on company earnings taxed abroad) without opening options for tax avoidance, its introduction could be a catalyst for internationalisation of some Australian financial services providers (though some – eg Magellan Financial Group, according to Boyd 2014 – have already built such a business). Australia's financial regulators would have to internationalise further, cooperating more with foreign regulators in enforcing bilateral laws and regulations.
4. Other countries, at this stage in Europe especially, are considering introducing – and in some cases (France, Italy) have actually implemented – a financial transactions tax (FTT) at a low rate that, like the tax proposed by James Tobin in 1978, puts 'sand in the wheels of finance'. Australia has a long experience of such transaction taxes, in many formats, as assessed by the Campbell and Wallis Inquiries and, over time, has sought to abolish or reduce the coverage of such taxes. Were many countries, and especially the rest of the world, to plan to implement an FTT, Australia will confront a choice, whether to also implement an FTT (if all countries, including Australia, implemented an FTT, it might be reasonably non-distortive) or whether to stand aside and reap a competitive, tax-arbitrage-driven advantage. The policy considerations will be highly contested. Whichever way the decision goes will have regulatory consequences.

There are bound to be tax changes in future that will impact the domestic and international flow of finance and have consequences for the regulation of the financial system.

### 3. The regulatory philosophy

This chapter looks at the failure of the 'efficient markets' philosophy that underpinned the approach to regulation in the Wallis Inquiry and over the period until the GFC. It also addresses many of the regulatory conundrums current in regulatory debate in Australia, including what should be in the prudential regulatory boundary and what should be outside of that boundary.

There are devilish issues to address – globalisation increasing the likelihood of volatility, efficient markets theories going astray, Minsky keeping regulators permanently on edge, the success of Tinbergen's insights, protecting taxpayers if the prudential boundaries are kept as they are, and making it easier for consumers to know when they are protected and when they are not.

#### 3.1 Globalisation, the GFC and a state of ongoing crisis – recognise reality

After the GFC we cannot forget that our globalising world has made a collective decision to avoid future financial crises. Through the leadership of the countries meeting as the G20 (including Australia), the world has collectively determined to limit the risk and scale of future financial crises that could otherwise be systemic. These could be shocks from a build-up in risks overseas or they could be from Australian sources: the focus for the G20 is to lessen the risk of threatened spill-overs across borders.

The Global Financial Crisis (GFC) that started in 2006-08 was the third, but most costly, severe shock emanating from the global financial sector since the Wallis Inquiry, with the Asian Financial Crisis 1997-99 breaking soon after the committee had finished and the US 'Tech Wreck' following in 2000. The direct and indirect costs of the GFC were massive, many percentage points of GDP, in the most affected countries and the policy and regulatory measures taken to get back on track have been unprecedented and persistent.

The immediate realised cost of the GFC in Australia was limited because no financiers of systemic significance collapsed. However the Australian regulatory system was found inadequate in the face of the systemic shock from offshore. To avoid collapse of the Australian financial system when foreign funding markets froze, through government action taxpayers took on significant contingent liabilities and some financial markets were stopped from operating. Amongst the most decisive steps, all in contradiction to the leanings of the Wallis/Costello philosophy:

- banks' international borrowings were guaranteed by the government,
- deposits were guaranteed by the government and a Financial Claims Scheme was established as a form of broad deposit insurance, and
- short-selling was banned for a limited period for all listed equities and for a longer period for equities of financial corporations.

That said, it is important not to under-sell the financial strength and flexibility of Australia's financial system, supported by a strong fiscal position. The dominant financial sectors, banks and superannuation funds, helped Australia ride through the crisis without a recession. The banks were able to deleverage from then-unwanted corporate exposures when superannuation funds subscribed to new corporate issues of equity (albeit at discounted prices). This was in effect an on-

market debt-equity swap. Households provided the ultimate shock absorption capacity, underwriting the measures taken to shore up the prudential strength of the banks and accepting (through direct holdings and increasing exposures through superannuation funds including from continuing contributions) the markdown on equity prices.

In thought exercises to create a counterfactual, many senior policy makers, analysts and commentators consider Australia was lucky the GFC came when it did, rather than a year or two later when Australian asset and credit markets (and households) would likely have been more extended, and lucky that China stimulated when it did, keeping demand high and incomes flowing in Australia. The timing, the household sector resilience, the government's fiscal position and China's macroeconomic policy actions may be less supportive next time.

The G20 then kicked off a thorough improvement in the regulation of almost every component of the financial system on a global basis, encouraging domestic reforms in readiness. The more challenging issues, such as too-big-to-fail (TBTF), the designation of systemically important institutions and infrastructure and the whole approach (design and rules of engagement) to macroprudential regulation, remain works in progress. Despite pressure from G20 leaders, the progress with even the microprudential and market instrument reforms are not yet complete, hardly surprising in view of the breadth and complexity of the issues and the need to accommodate exceptions for the legitimate circumstances of some countries (including Australia).

The received wisdom in Australia (eg Macfarlane 2006 and Edey 2014) has for several years recognised that the financial system and regulation has to prepare for more frequent and more severe financial and economic volatility in future, as a result of two structural factors:

- the increasing use of market-based financial instruments, as they are inherently more sensitive to swings in sentiment as expectations change, reacting sharply and quickly, and
- the rapidly rising importance to Australian living standards of China and other Asian emerging economies, which are likely to experience greater business cycle fluctuations (because of high capital spending intensity) than more developed consumer-oriented economies such as the US, Japan and Europe.

The failures in the GFC affirmed the aphorism that most business is global but all failures are local. While some say the global financial system is safer now after the repairs to surviving institutions and regulatory reforms put in place since the GFC (Cunliffe 2014), this is a clearly a work in progress and much remains to be done. Not least, there is a need for resolution mechanisms that are compatible across borders. Completing the current suite of reforms is the focus of annual G20 leadership meetings.

### **3.2 The failure of 'efficient markets' theories – we are all Minskian now**

Comparing what was known at the time of Wallis/Costello and what is known as the Murray Inquiry proceeds, the basic problems with finance are unchanged but the experience of the GFC and other crises have heightened sensitivities to systemic risks.

The Wallis/Costello philosophy understood that finance is special, different from other services, because of the unavoidable inherent embedding of information asymmetries and principal-agent

problems. Taxes and other costs (including regulation) can add to these problems. Together, these problems lead to market failures, adverse selection, moral hazards and behavioural biases that do not have the characteristics of an 'efficient market'. These market failures warrant government intervention if the outcome of the intervention is cost-effective. Nevertheless Wallis/Costello invested considerable faith in the merits of efficient markets: the belief was that markets would self-correct, behaviours be disciplined, reputations valued and incentives adjust, in order to achieve what was perceived as an acceptable trade-off between competition, efficiency and stability. (Costello differed from Wallis on competition, banning mergers of the 4 major banks.)

The Wallis/Costello era embodied an official fiction that consumers behave as if even bank deposits are 'unsafe', to limit the government's exposure to moral hazard that a more realistic assessment (effectively an implicit guarantee for the banks) inexorably creates.

As things have turned out, the financial system in practice has fallen well short of hoped-for 'efficient markets' ideal, lurching towards systemic collapse.

It is true that those in finance (the markets, institutions, agents and customers) have not lived up to the tenets of efficient markets theories, not acting rationally or in a way that suggests a belief that the harsh disciplines of 'efficient markets' will be visited on them. There have been very clear evidence of information asymmetries, moral hazard and adverse selection, principal-agent problems, frictions and costs in transactions, apparent behavioural biases and incentives all distorting relative prices and leading to a misallocation of still scarce capital and other tendencies assumed away in the theoretical perfection of the underlying Efficient Markets Hypothesis. None of these observations however are actually new or especially unexpected (except perhaps to the most theoretical of the Wallis supporters).

Over time, behavioural economics research has highlighted biases that do not match the characteristics of actors as assumed in efficient markets. Learnings from behavioural studies have led to useful improvements in consumer interactions. However, there has been relatively little progress in identifying what – beyond defaults, where they are appropriate – can be done either to accommodate 'inefficient' or 'myopic' behaviours or to help those prone to behave 'inefficiently' to behave 'efficiently'. What we have also learned is that finance is easily misunderstood, that a little [or even a lot of] education can breed overconfidence and that having a regulator intervene in provision of education, licensing or even product information, may give the least informed a sense of unwarranted comfort. What would be best (or the least bad) in this very second-best environment (and has yet to be done) is to clearly delineate what is safe because the government will stand behind the investments – ie ADI deposits, life insurance contracts and, in the event of fraud, institutionally-managed superannuation – and any investments beyond those boundaries are riskier and are much less protected.

The prevailing philosophy in Wallis/Costello was undermined most by its misperception of systemic risk. Here the better insight comes from the 'economics theory and practice' fringe occupied by Hyman Minsky. Reviled by mainstream economics and finance, Minsky had long argued that financial crises are inevitable (see for instance Minsky 1982 and 1986) because of his 'financial instability hypothesis' drawn from the observed pro-cyclical behaviour of financiers and others

across the economy. Minsky is amongst the few economic theorists to have come out of the GFC with his reputation and relevance enhanced.

Minsky died in 1996. Were he alive today he would remind us that system stability is an illusory goal: like perfection it cannot be attained. If those involved in finance believe stability is in prospect, they would leverage themselves so much the financial system outcome would become unstable. Paradoxically, if financiers are wary and do not believe stability is guaranteed, they will gear up less, and the outcome is more likely to be that the financial system is comparatively stable and self-correcting.

However, the basic premises of 'efficient markets' philosophy, that no one knows the future and that markets are the least bad way of accommodating changes in expectations, still remain unchallenged. Despite new insights from economics, finance and psychology, including behavioural economics and insights from Minsky, it is clear there is no prospect that consumers, investors and business can learn how to save, invest and borrow without bias with any conceivable allocation of resources to education/literacy improvement. As such, the quest remains to build a strongly performing and sustainable financial system providing the services sought by the non-financial sector, even while coming to terms with the reality that systemic instability concerns mean taxpayers will have to be ready to stand behind the promises made by prudentially regulated entities, where these are systemic. Thus the taxpayers need to be protected themselves, to minimise the risk that the financial safety net will be required.

### **3.3 The Wallis successes – many worth preserving or building on**

The Wallis committee certainly got many things right. The stand outs have been the assignment of regulators to objectives according to the Tinbergen principle, the 'twin peaks' comprising APRA and ASIC, the Council of Financial Regulators and the prudential regulation boundary. These have been 'core' gains, and should be re-used or built on in the Murray Inquiry considerations.

#### **The Tinbergen Principle – a timeless guiding light**

Jan Tinbergen, later the first Nobel Laureate in economics, established a principle that the number of achievable policy goals cannot exceed the number of available policy instruments (Tinbergen 1952). This wisdom has never been in dispute. In line with the Tinbergen Principle, Wallis/Costello decided on a regulatory structure comprising four separate agencies, each assigned the objective of addressing one of the four main sources of market failure.

This Tinbergen-inspired "objectives-based" regulatory architecture involved:<sup>13</sup>

- the Reserve Bank of Australia (RBA), responsible for monetary policy, the payments system and financial stability;
- the Australian Prudential Regulation Authority (APRA), which has responsibility for the prudential soundness of all deposit taking institutions, general and life insurance companies and private superannuation funds;

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<sup>13</sup> See Carmichael 2009.



- the Australia Securities and Investments Commission (ASIC), which is responsible for conduct regulation across the financial system, including all financial institutions, markets, and market participants; and
- the Australian Competition and Consumer Commission (ACCC), which is responsible for competition regulation and consumer protection throughout the whole economy.

**The 'twin peaks' – pathbreaking and a launching pad**

The creation of APRA and ASIC created the 'twin peaks' that identified the Australian regulatory architecture as quite different to anything in the rest of the world. Bringing all prudentially regulated entities across the financial sector (essentially deposit takers, insurers and superannuation funds) under the regulation of a single prudential authority and grouping all market conduct matters under a single securities and investments regulator was pathbreaking at the time. The regulatory architecture served Australia well in the period until and during the GFC.

Because the philosophy behind the regulatory architecture, the Tinbergen Principle, is timeless, it can again be applied by the Murray inquiry as we re-think the regulatory architecture and match it to our changed circumstances. A proposal to move from 'twin peaks' to 'three peaks' is in Chapter 4.

**The Council of Financial Regulators – an innovation that made a difference**

In terms of perspective when discussing the successes of Australia's regulatory architecture, perhaps too much might have been made of the creation of the 'twin peaks' and not enough of another innovation from Wallis/Costello: the creation of the Council of Financial Regulators (CFR). Coordination of the separate regulators through the CFR, chaired by the governor of the Reserve Bank of Australia, proved a vital element in Australia's response to the GFC, and a significant differentiator from the way events unfolded in some countries (the UK and US spring to mind).

Approaching the GFC, the presence of the CFR was low key and its processes informal, relying on clubby cooperation amongst the regulators represented. This proved sufficient at the time and much better than achieved in most other countries (even facilitating – as we have seen – the efficient markets regulatory philosophy to be swiftly discarded by government as the crisis developed).

APRA's FSI 2014 submission aptly describes the CFR as a "non-statutory body that has no regulatory functions separate from those of its members". It did not have significant official status, lacking even a website until 11 February 2013<sup>14</sup>, years after perhaps its finest hours. The CFR website emphasises facilitating regulatory cooperation and collaboration, contributing to the efficiency and effectiveness of regulation and promoting stability of the Australian financial system.

Whether such an 'all care but no responsibility' approach is sufficient for the future is moot. Chapter 4 outlines some of the elements of a more formal and accountable CFR, with responsibilities that might include regulatory effectiveness and macroprudential policy.

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<sup>14</sup> See <http://www.cfr.gov.au/media-releases/2013/mr-13-01.html>



**The prudential regulation boundary – almost spot on**

The prudential regulation boundary that prevails now is very much as it was recommended and implemented by Wallis/Costello. The three criteria the Wallis Committee used to allocate activities to prudential regulation or to non-prudential regulation were:

- the importance of the promise;
- the difficulty in meeting the promise; and
- if the promise is not performed, the adversity of the consequences.

The more important the promise, the greater the difficulty in meeting it, and the greater the adversity from failure leads to prudential regulation. Lesser importance or difficulty leads to non-prudential regulation. The criteria remain entirely appropriate. On this basis, banking, insurance and superannuation services provided by institutional agents clearly should remain prudentially regulated. Similar criteria led to deposits being singled out as the critical banking liability to protect.

The prudential boundary has proved durable thus far in the face of the doubts and questions raised by Davis, Maddock and Munckton in 2013. Their main concerns focused on the already wide coverage of the prudential regulation boundary, the extra cost of 'safe' finance given heightened prudential regulation, the fairness of not extending the boundary to protect more consumers, the riskiness of activities outside the boundary especially to less informed consumers, the potential for regulatory arbitrage by shadow banks, and the issue of potentially far-reaching reforms to the prudential boundary emanating from abroad.

Given that the financial system as a whole appears to work, and changing the prudential regulation boundary would be potentially very disruptive, there would need to be a strong rationale to justify moving the boundary rather than addressing the issues. The main issue is management of the risk to taxpayers that *in extremis* they may have to support the promises of prudentially regulated entities with cash (throwing the government's budget, and the economy, into disarray), as they nearly did in the GFC. The issue is the frequency and extent of the potential call on the taxpayers. A proposal to have this explicitly addressed by the prudential regulator, APRA, is outlined in Chapter 4.

Other matters are questions of balance, as the Australian financial system seems to perform at least acceptably on a range of criteria of competition, efficiency and stability (see Chapter 2), with a bias towards stability but by no means the worst on average in terms of competition and efficiency. Though it may be latent rather than regularly demonstrated, there is substantial public support for the present boundary. The boundary has proved effective: at no stage have non-prudentially-regulated failures threatened the system.

Maintaining essentially the present boundary would seem the most effective path into the future. Very minor adjustments, to include health insurers<sup>15</sup> and any absolutely genuine 'shadow banks' should be contemplated. However, as issues arise, such as the proposals abroad for ring-fencing, it

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<sup>15</sup> The entities with the best claim to be included in APRA's prudential net are health insurers, which are currently regulated by the Private Health Insurance Administration Council (PHIAC) and 'ought to be' prudentially regulated, see Insurance Council of Australia 2014. PHIAC is small and probably captured by industry. Bring health insurance into the prudential net life insurance could see more innovation in financial products.

will be important to have a full strength set of regulatory agencies including a competition regulator to address the way ahead.

We focus on some of these issues below, the first two being shadow banking and consumer protection.

### **3.4 Shadow banking, securitisation and small business lending – market drivers**

*If it walks like a duck and talks like a duck ... regulate it as a duck.*

- Adapted with apologies from McCarthy-era USA.

Regarding shadow banking there are three conflicting regulatory concerns:

- One is regulatory arbitrage if higher regulatory standards for regulated banks raise the cost of prudentially regulated services, increasing risk in the financial system as business is disintermediated from prudentially regulated entities;
- Another is that if shadow banks are be regulated as banks, this will increase taxpayers' risk of having to bail out the shadow banks if they fail; and
- A third is that regulating so that every financial flow is banking business is unduly restrictive and would rule out some socially and economically useful activities.

The regulation of non-banks conducting the business of banking (*aka* shadow banks) is a moving feast. Basel III, like Basel II and Basel I, doubtless opens up new regulatory arbitrage opportunities. From a global perspective, investment banks seem to be the riskiest element still outside the prudential regulation perimeter. Interestingly, almost all major US investment banks chose to become banks at the apex of the crisis in order to get access to Federal Reserve System funds.

The regulatory arbitrage view presumes that regulatory capital ratios for banks are higher than the actual capital that would be sufficient to survive without government support over a run of economic cycles (so-called 'economic capital'). This would seem unlikely: capital ratios in eras when central banks were not present as lenders of last resort were a quantum higher than Basel III's ratios. So far in Australia, there has been no noticeable trend to shift capital from banking into shadow banking, suggesting investors do not think the regulatory arbitrage is appealing. Indeed, in Australia the shadow banking sector is "small and declining"<sup>16</sup> and seems not a systemic risk. Only in the pre-deregulation era did Australia have a significant shadow banking problem, largely the result of banks booking business in less regulated associates.

Other sectors that at times appear to have a claim to be brought into the prudential net are payments system operators and the providers of systemically important financial infrastructure (central counterparty clearers, the ASX and any non-bank entities that are designated Systemically Important Financial Institutions (SIFIs), though none – especially funds managers – are obvious candidates). However, there is virtual prudential oversight of some of these sectors, especially those involved in the payments system.

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<sup>16</sup> See Eyers 2014

Where disintermediation may make progress is with a revival of securitisation. The essential defect of the pre-GFC securitisation model was the lack of retained 'skin in the game' of the initial lender, which exacerbated inherent principal-agent problems. In addition, some securitisations were too complex to understand. With 'skin in the game' now required, and complexities frowned on by the market, the revival of simple securitisations as an effective means of capital management seems only a matter of time, when the economics of the transaction make sense. Quite what will be the catalyst is unclear: it may be rising demand from superannuation funds for investible quality securities, banks seeking to retain high returns on equity or non-bank competitors again finding a cost-effective funding source to compete with the banks. This may produce a welcome boost to competition in lending for housing, but it is likely to leave SMEs, whose borrowings are less homogenous, ever more dependent on bank lending.

The frustrations pervading the relationship between the potential lenders (essentially the banks) and would-be SME borrowers is never likely to be resolved. Numerous inquiries have failed to find a breakthrough. Small companies will always be more dependent on bank finance than either big companies (which can go direct to markets, even overseas) or households (whose assets and potential liabilities are largely homogenous, and can be securitised, inviting non-bank financiers to compete with the banks in the supply of finance).

There is no market failure in the credit scrutiny undertaken by banks: that is their role. SMEs seeking loan funding can reduce the prospect of rejection of loan applications by better business planning processes and other risk-minimisation techniques: they have every incentive to do so.

### **3.5 Consumer protection versus buyer beware – clarify what is safe**

The Wallis philosophy could rely on *caveat emptor*, with increased protection for smaller, less sophisticated financial consumers most likely to suffer from information asymmetries, by requiring appropriate disclosure. As Davis 2013 has reported, disclosure has not been a satisfactory answer in every circumstance. With consumers never the 'rational, well informed beings' assumed in the 'efficient markets' regulatory philosophy, governments and regulators have been focusing more on consumer protection and less on *caveat emptor*.

This could be in response to the risks arising in the increasingly financialised lives that individuals and families are expected by government to lead. The decisions by government to transfer responsibility for management of retirement incomes and longevity risk to individuals (albeit with the age pension safety net in place) presuppose that individuals either have the requisite skills, can learn them or can be protected from apathy, ignorance, mistakes and frauds. They also presuppose that the financial sector seeks, and has the products, to meet households' needs.

Finding a regulatory balance that – in the face of apparent increased consumer protection – encourages the supply of services to meet consumers' needs is likely to be difficult. For instance in the UK and the USA the balance seems to have been shifting all the way to *caveat vendor*. The UK's newly-commissioned Financial Conduct Authority (FCA) has been successful in several charges of miss-selling of complex financial products. In the USA, the new Consumer Financial Protection Bureau (CFPB) is criticised for creating ambiguity in the exercise of its powers that is likely to reduce the supply of financial services to protected consumers, a counterproductive outcome, and for

extending its scope to SMEs, a broadening of the class of protected users of financial services (see The Economist 2014). The fines and/or settlements have been substantial.

Education programs to improve financial understanding and decision-making (often under the rubric of promoting financial literacy) have also been a popular response of government, industry, workplaces and community groups in Australia and in other countries, even though the program objectives are often ambiguous and their effectiveness uncertain and unproven (Worthington 2013).

Several problems arise. Programs aimed at the young through the school curriculum seem appropriate but will take decades to have an impact and the appropriateness of their design will be unknown for a similar period. Programs providing potentially valuable assistance that would be useful at critical decision points in financial life (eg just before or at retirement, when substantial sums become available and need to be invested) often do not reach those who would most benefit. Nevertheless, industry can be very effective in reaching susceptible consumers/investors: see for instance the 'skill' with which Storm and Westpoint investors were identified and targeted. Utilising industry's skills to first identify the consumers most in need and then provide suitable and effective products could be more effective than general programs. Regulators seem bound to pursue the *caveat vendor* line, or government may set regulations limiting who can be sold what, if industry does not grasp this thistle.

But, for this to be effective, other changes in the burgeoning 'consumer protection' arena will be needed. Most fundamentally, the regulation of AFSLs needs to have teeth, with issuance and renewal dependent on the license holder being responsible for the good behaviour of its representatives, all involved in financial advice should have an AFSL (NB including accountants advising on SMSF establishment and asset allocation), and product issuers need to be made responsible for product performance in line with advertised claims and other marketing, similar to that required of goods and services subject to regulation by ACCC.

Furthermore, there is considerable scope to improve consumer-focused messaging about regulation and safety. At present consumers are misled that their investment choices beyond the limits of the Financial Claims Scheme and prudentially regulated/institutionally managed superannuation funds will be both 'improved and safe' with more financial literacy and protection implicitly promised from ASIC.

There has been official obfuscation over both the Financial Claims Scheme and the protection provided by prudential regulation more generally. It is time for government, academics and industry to get over their embarrassment that the FCS and its generous deposit coverage makes inconceivable the existence of a risk-fearing 'efficient market' and its *faux* virtue in containing moral hazard. Even if the amount of deposits covered is reduced in legislation, the public will not believe governments will not protect them in a crisis.

Two useful consequences could flow from advertising the FCS:

- Financial literacy messaging could be much improved if it was made clear that 'the government has made ADI deposits and prudentially regulated financial institutions safe, and everything else is not safe and is your risk'. It is a simple, 'insight the flags, outside the flags' message.

- With what is safe in bright lights, it will make more understandable the distinction between prudentially regulated superannuation and non-prudentially regulated SMSFs when it comes to public compensation for frauds.

Another feature of the Wallis/Costello era was that only prudential regulation would be preventative, whereas conduct regulation would be merely corrective after the event. Having conduct regulation also take on some preventative aspects was resisted because it might open taxpayers to an obligation to provide a safety net in the quite likely event that a non-prudentially-regulated entity fails. However, the benefits of prevention is increasingly seen in other fields, for instance in health policy, where – similar to financial service – information asymmetries, principal-agent problems and consumer myopia and other behavioural biases are common. Provided a way can be found to limit taxpayers bearing a risk, there seems no reason to confine conduct regulation to correction after the event.

The distinction between prudential regulation and non-prudential regulation seems valuable, so long as the risk to taxpayers of the provision of prudential regulation is properly recognised and managed and so long as consumers are always educated to understand what is safe, and the boundaries for that safety. Wallis/Costello was wrong on this: there now is an opportunity (indeed a need), after the GFC and the imposition of the FCS and some higher prudential regulatory standards, to protect taxpayers with more certainty next time.

### **3.6 Harmonising with the developed world or with Asia – safety is valued**

The extraordinary cost of the GFC has led to an across-the-globe impetus to improve the safety of the financial system and its components, in a way only seen once before – after the Great Depression and WW2 – when the Bretton Woods institutions (the IMF, the World Bank and the General Agreement on Tariffs and Trade (the GATT)) were created. The GATT has developed into the World Trade Organisation (WTO), an intrusive set of globally-applicable rules for trade. Every country in the WTO 'club' has had to conform to the rules, with a few contested and transparent exceptions. In hindsight, the process of 'winning over' countries to sign on to the GATT or WTO had a greater degree of difficulty than the crisis-driven G20 financial reforms, as it required suspending innate 'mercantilist' beliefs and trusting the eventual benefits of something quite counter-intuitive, the economic law of comparative advantage. The G20-led financial reforms otherwise are little different in scale, importance or complexity.

Thus far, despite difficulties, the G20-led reforms have been remarkably successful (Hampson and Heinbecker 2013), in terms of "averting grievous harm to the global economy", engaging "in re-engineering the financial system to prevent a recurrence of the crisis and to maintain the global flow of capital." Most significantly, "it has put issues on the table that were once regarded as the exclusive province of sovereign governments, notably monetary policy, exchange rates and debt levels, thereby taking preliminary steps toward longer-term global macroeconomic governance."

None of the steps taken by the G20 are yet completed, not because of sloth but because of the enormity of the tasks. It is a case of 'so far, so good', and 'let's get to the end'.

It is hardly surprising Australia, a capital exporter as well as bigger capital importer and a net borrower from the rest of the world, can argue only for modest exceptions to the overall parameters for global regulation, though we do so from a position of strength, generally having a better starting point than others. By all accounts, Australian participants in meetings of international regulators consistently do make the case for Australian exceptionalism.

Australian entities seeking to engage in business in overseas financial markets and businesses have no choice but conform to local rules pertaining overseas. This is being made easier where negotiations allow 'substituted compliance', enabling Australian regulated entities to substitute compliance with foreign rules by complying with the Australian regulatory regime. Almost by definition, effective and widespread substituted compliance involves virtual harmonisation across countries.

Only if the world economy and financial system was fragmenting would it be a real option to stand aside from international harmonisation and cooperation. The 'G20 and WTO club' would be failing. Were the world economy to fragment and divide into regional or other isolationist groupings, and for instance Asia to go its own regulatory way, Australia could opt to follow that divergent approach – doubtless at considerable short term cost, as much of its activity and financing is with the developed world. But so far, despite grumblings, Asia has stayed within the 'club'.

Australia and Asian countries, even as a regional grouping, may benefit from persuading the developed countries to adopt regulatory standards that provide greater benefits, especially where the standards being developed are on a current 'lowest common denominator' basis. This is generally what our regulators have argued in the international committees such as the G-20, the Basle Committee, IOSCO and other global, regional and bilateral forums.

However, the more important narrative is that Australia's high regulatory standards, and the growth and stability that has flowed from those standards, are held in high regard in Asia. This recognition is an advantage not to be sacrificed for some short-term gain and long-term regret. Australia would be well advised to seek to lead Asia to improve standards that we know will be needed as Asia's development proceeds. Asian investment is likely to be greater in the long-term if there is consistency in Australia's positioning and pursuit of firm regulatory settings, much as Warren Buffett's investment targets, selected for their slow but reliable growth profile, pay off in the long-term (Frazzini *et al* 2013).

### **3.7 If the world 'ring fences' core banking – Australia has to go with the flow**

For banking the most sensitive future issues are ring fencing and additional equity. The major 'thought pieces' abroad include "Volcker rule" in the United States, the Liikanen Report to the European Commission and the proposals of the Vickers Commission for the United Kingdom.

**Figure 11 A stylised comparison of selected structural reform proposals**

	<b>Volcker</b>	<b>Liikanen</b>	<b>Vickers</b>
Broad approach	<b>Institutional separation</b> of commercial banking and certain investment activities	<b>Subsidiarisation:</b> proprietary and higher-risk trading activity have to be placed in a separate legal entity	<b>Ring-fencing:</b> structural separation of activities via a ring fence for retail banks
Deposit-taking institution may:			
- deal as principal in securities and derivatives	No	No	No
- engage in market-making	Yes	No	No
- perform underwriting business	Yes <sup>1</sup>	Yes	Restricted
- hold non-trading exposures to other financial intermediaries	Unrestricted	Unrestricted	Restricted (inside the group)
Holding company with banking and trading subsidiaries	Not permitted	Permitted	Permitted
Geographical restrictions	No	No	Limitations for ring-fenced banks in the UK to provide services outside the European Economic Area

<sup>1</sup> Underwriting in response to client/counterparty demand.

Source: Gambacorta 2013

To the extent that foreign regulators do move to ring fence their Global SIFIs (G-SIFIs) or Domestic SIFIs (D-SIFIs), to make their household and simple commercial financing banking businesses safer and insulated from the vagaries of their trading and other riskier activities, the questions have to be asked:

- why would Australia not do the same (as our banks and other entities need to interact with others abroad), and, if so,
- what would be the process of consideration in Australia?

Australia has a strong regulatory and analytical focus on prudential, market integrity and some consumer issues, but it does not achieve as much as is needed in terms of competition regulation and analysis. The ring-fencing issue is very much about competition, and the regulation and analytical capacity of the regulators needs to be strengthened. A proposal is advanced in Chapter 4.

### **3.8 Funds management and superannuation – short-termism can be overcome**

For funds management/superannuation, the most sensitive regulatory-relevant issue is reducing the obsession with liquidity where it is unnecessary and/or counterproductive (some of which comes from regulation) and promoting longer-term investment horizons where they are appropriate. Short-termism is too prevalent (see Kay 2012 and the collective writings of the members of the Financial Services Research Group of The Paul Woolley Centre for the Study of Capital Market Dysfunctionality).

The prudential net appropriately covers institutionally-managed superannuation funds, not because of the hopefully modest leverage they use, but because of difficulty in meeting the promises made



by superannuation funds as a result of liquidity risks and the potentially important adverse consequence for individuals of a failure.

The feared systemic risk in superannuation is a panic amongst superannuation savers, leading *in extremis* to demands for withdrawals or transfers and a rush for liquidity, which could cascade in a manner similar to a bank run and inflict significant damage on all markets, financial institutions and the economy. More normal (ie non-systemic) business model risks in superannuation are 'slow runs' as contributors retire, cease to contribute new funds and start to withdraw or as contributors exercise choice of funds in a non-crisis atmosphere. Both require liquidity of the funds to be the focus of prudential regulation. But the essence of superannuation savings is that their tenor is long-term: they are going to provide retirement incomes for increasingly long-living Australians.

Rather than having all institutionally-managed superannuation funds hold a high proportion of their assets in very liquid form, there may well be significant benefit of setting up a liquidity facility accessible by such superannuation funds so they can increase their asset allocation to longer-term investment assets more in line with the duration and real underlying liquidity needs of superannuation savers. One unavoidable consequence of such a facility, however, would be a requirement for much more information on the investment performance of individual assets held by the superannuation funds that might be collateral for the liquidity facility.

If only because of its rapid growth and size, the SMSF sector has produced rising concerns amongst some regulators and across the financial sector. Nevertheless, it is welcome evidence of competition in the financial system and engagement of the trustees of SMSFs in the management of their retirement incomes and associated risks. Though the predominant reason given in surveys for establishing an SMSF is usually 'control', it is hard to dispel suspicion that another underlying reason is the comparatively high cost of institutionally-managed superannuation services.

The growth of SMSFs also raises fears of regulatory arbitrage. Here the fears seem unwarranted: SMSFs individually are small in the context of the financial system and pose no systemic risk as yet, and furthermore it is clear, and can be made yet clearer, that SMSFs lie outside the prudential regulatory net. There is no access to a bail-out by taxpayers were an SMSF to fail, beyond the age pension safety net that is available to all. The publicity on who was to be bailed out for the Trio/Astarra losses from fraud and why the compensation flowed only to prudentially-regulated superannuation funds was useful in this respect, and needs to be re-iterated more clearly.

There are other improvements that can be made to the regulatory arrangements affecting SMSFs and superannuation contributions and transfers. For instance:

- To speed transfers between funds (both institutional and SMSFs) when contributors are exercising choice, a central exchange and registry seems appropriate, perhaps established in the ATO. This can be expected to be especially useful when SMSF trustees are older and seeking to transfer their by-then onerous trusteeship and management responsibilities to a more institutionalised retirement incomes provider.
- To add to choices available to superannuation savers, institutionally managed superannuation funds (and funds managers) could be encouraged to attract 'locked in' long-term funds from younger contributors, attracting them with discounted fees as compensation for the 'cost' of



sacrificing liquidity. This would help overcome the apparent shortage of investors with a long-term investment horizon.

## 4. Options regarding the regulatory architecture

This chapter reviews the future appropriateness of the regulatory architecture and puts forward options that will advance the incorporation of macroprudential policies into the range of policy tools available to regulators and clarify the assignment of achievable goals for Australia's current regulators.

The approach taken here is as close to a single goal and an effective instrument as is possible in this complex world (perhaps 'pure Tinbergen'), to improve accountability. An alternative some favour is assignment of all regulatory objectives – stability, efficiency, competition, fairness and ultimately economic growth – to all the agencies, though this would mean no regulatory agency could be held responsible for what occurs.

### 4.1 Role of the regulators – needs focus and pre-emptive industry solutions

There have been many suggestions of additional activities the regulators might become responsible for. The Tinbergen principle would commend the idea of making the regulators responsible for only those roles for which there are effective tools, and restricting the number of objectives to as few as possible, ideally only one per regulator. More extreme overseas proposals come from Claessens and Kodres 2014, who favour setting incentives for regulators so they perform their regulatory roles better, and from Barth et al 2013, who take such a dim view of the performance of financial sector regulators and the ease with which they are captured by industry that they propose establishment of a Sentinel, with no responsibilities other than to independently look over the regulators to ensure they are doing what they are being paid to do. By contrast, the proposals advanced here are a modest realignment of roles so that a regulatory system that works well can adapt to meet the challenges of the next several years of supply of financial services.

#### Industry Promotion – never a good idea

Some propose the financial sector regulators take on an industry promotion or investment promotion function. The role at times has been accepted by Austrade, which is where it should reside. Wherever industry promotion by regulators has been seen abroad, for instance in the UK, the conduct of regulation has suffered.

Promotion by government should come through the budget as either increased outlays on the expenditure side of the budget or reduced revenues on the tax and other revenue side of the budget. Australia has been well served by not distracting its regulators with a need for industry or investment promotion. As a result APRA and ASIC have not been at the forefront of the push for 'Australia as an international financial services hub'. It is much preferable if financial sector regulators continue not to have targets for industry development or for attracting flows of finance.

#### Policy development – not a role in an ideal world

Others are concerned that regulators have been engaged in policy development. This was not envisaged in the original twin-peaks model. Treasury has the major policy advising responsibility, but has facilitated government receiving advice from other agencies. One typical question arises from the termination of Corporations and Markets Advisory Committee (CAMAC): will Treasury pick up its

responsibilities for research and advice, or will it fall to ASIC? As a general principle, the same agency should not be both policy developer and the enforcer of the rules.

APRA and ASIC are perceived to have 'campaigned' for regulatory and policy changes (for instance higher prudential standards and improvements to the regulatory framework for financial advisers), as has the RBA. To some significant extent, this is the product of the complexity and dynamics of finance and of scarce resources in central government and, while it was always thus, the GFC and the need for speed in addressing some problems has probably exacerbated the tendency.

As NCOA 2014 says "Between the categories of policy and service delivery, however, choices need to be made about how things get done. A key challenge, therefore, lies not so much in the separation of policy and delivery (which already exists at the Commonwealth level for the most part) but in working out how best to connect them more effectively".

Treasury, which is responsible for policy advice to government, has lost/is to lose a high proportion of its workforce over the near-term. The need for policy development is not going to reduce. Unless industry can take out some recognised sources of misaligned interests, such as distortive incentive payments that exacerbate information asymmetries rather than provide assurance that trust is warranted, it seems very likely that regulators will continue to participate in policy development, at the request of the policy agencies.

Rationalisation of the roles and responsibilities of the regulatory agencies as considered in this Chapter may create at the margin an opportunity to refocus the regulatory agencies on enforcing the law and restore balance, with the main policy advice role again being filled by Treasury.

### **Costs and benefits – the case for pre-emptive self-regulation**

Given the range of issues canvassed in this paper, the starkest challenge is going to be designing regulations that maximise the benefits and minimise the costs for both the short- and long-term. The experience with recent regulatory reform has not been encouraging.

One approach Australia clearly gets right, in comparison to other countries, is the commissioning every decade or so of a Financial System Inquiry (eg Campbell, Wallis and now Murray). The main merit of these holistic reviews are that they have put the focus on the system, and all elements in the system, in producing benefit for the entire community.

Between these inquiries, the process of regulatory reform too often is adversarial, with government identifying a need for reform and proposing options, and industry opposing both the need and the options proposed. Within this process, to minimise costs and focus on smarter regulation, industry might reflect that government would be better informed if the industry made stronger efforts (albeit at some cost) to quantify and illustrate the costs of alternatives when consultation processes are under way.

Reform of financial regulation has also become party political, moving away from the comparative bipartisanship achieved in the Hawke/Keating and Howard/Costello periods of government. Recent examples, arguably inefficient in achieving stated objectives and costly to implement, have been Stronger Super and Future of Financial Advice (FOFA) reforms.

It would be advantageous to all if bipartisanship could be restored. In part this might be achieved by the development of shared narratives on the changes in regulatory philosophy following the GFC, the emerging pressures on Australia's financial system and stability and the challenges posed in efficiently investing Australians' rising net worth and converting savings to retirement incomes.

Restoration of bipartisanship could be assisted by greater pre-emptive self-regulation: industry leading when problems emerge, and dealing with problems before they become so severe that a political reaction is inevitable. The implementation of the policy and regulatory changes involved in FOFA and the superannuation reforms that followed the Cooper Review would have been less contentious if industry had self-diagnosed the problems that gave lead to the reforms and acted on them pre-emptively.

Of course successful pre-emptive self-regulation as envisaged would require considerable cultural change within regulated entities, itself warranting regulatory oversight to ensure the processes for assuring behaviours are consistent with the improved culture are in place. Almost certainly Boards will have to lead from the top: measuring and reporting and therefore able to manage.

#### **4.2 The regulatory architecture helped in the GFC - but may not in future**

As we saw in Chapter 3, the Wallis/Costello 'Tinbergen Principle' assignment of four regulatory tasks (central banking, prudential regulation, market conduct regulation and competition regulation) to four separate regulators (RBA, APRA, ASIC and ACCC) was enlightened, unique around the world, and stood the Australian financial system in good stead through the first decade of the 2000s.

As a regulatory structure, it is the envy of many in other countries, and more recent regulatory architecture reforms in other countries are often based on what is described as the Australian 'twin peaks' approach (a prudential regulator separate from the central bank and market conduct regulation in a separate single regulator). For instance, the UK claims to be pursuing a 'twin peaks' approach in breaking up its all-in-one Financial Services Authority into two regulatory agencies, a Prudential Regulation Authority (PRA) and a Financial Conduct Authority, even though the PRA is placed within the central bank, the Bank of England.

The wisdom of the objectives-based architecture have been borne out to a considerable extent by the Australian experience. "This model avoids the conflict of objectives faced by regulators under virtually every other architecture. Where an agency faces multiple objectives there is a danger is that one will, for whatever reason, dominate the other in terms of visibility with senior management and/or allocation of resources (as appears to have been the case with Northern Rock in the UK)." (Carmichael 2009).

Despite the comparatively good performance of the Australian regulators and regulatory architecture in the GFC, it is instructive that no country is seeking to transplant the architecture in Australia and apply it elsewhere. The focus on financial sector stability has been heightened, and the new challenges need a strong and effective response. This applies as much to Australia as elsewhere. It is important that the regulatory architecture that served over the last 15 years be refined to be the most suitable for the next periods.

### 4.3 How the regulatory architecture can be reformed – from the top

Under the Wallis/Costello assignment, the regulators generally had clear missions, encapsulated in their names and equipped with effective instruments to achieve their single goals. But the complexities of finance have increased, additional functions have been added and other functions moved from one agency to another and, above all, systemic risk has become more important. The proposals advanced here start with the organisation that should be at the top of the regulatory pyramid that is accountable to government: the Council of Financial Regulators (CFR).

The RBA says that the present non-statutory CFR arrangements and process work well, embodying valuable flexibility, and no change is needed (see also IMF 2012). But with the risk of systemic crisis now always present, a more formal existence for CFR would seem necessary. This would involve a higher statutory profile, and formal responsibilities and accountabilities. The dynamic of CFR's meetings can be invigorated: the agencies meeting at CFR need competitive tension to contest the tendency to complacency that pervades high-level and permanent committees. Dynamic financial stability assessments must be made, written from a perspective of paranoia about what can go wrong. This can be achieved by, for instance, putting CFR in charge of, and accountable for, macroprudential policy decisions, with their implementation delegated to the appropriate agency (typically the RBA or APRA, or even ASIC, ACCC or the Treasury/ATO).

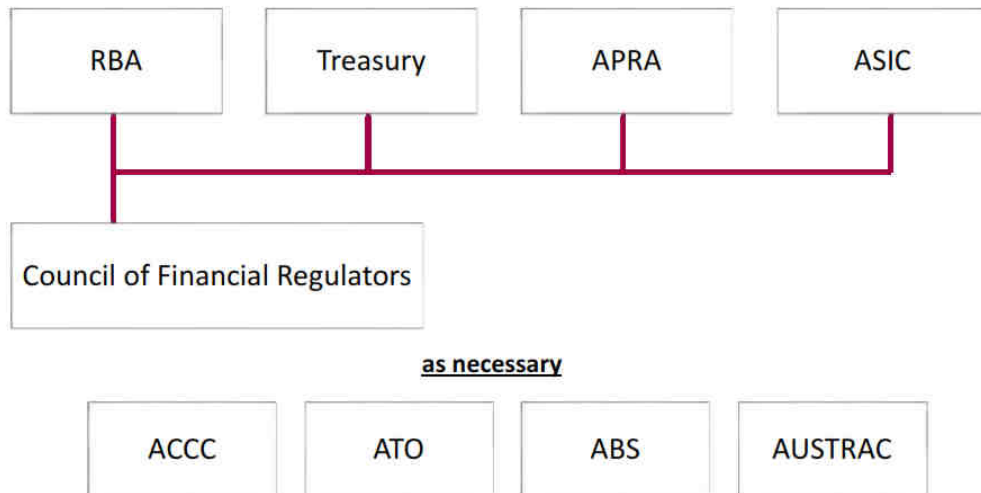
There is an emerging wealth of research showing that pre-emptive use of macroprudential policy will allow better focusing of monetary policy on inflation control (see for instance Borio 2012) and will help stabilise and make economic cycles less disruptive and more sustainable. The tools that might be brought into action have been used or explicitly considered in other countries (though not the place for a full listing, these include limits on bank lending at high loan-to-value ratios when such lending has been driving housing prices upwards, dynamic loan loss provisions, counter-cyclical liquidity ratios and others). Australia has done well so far without exercising macroprudential policy tools<sup>17</sup> but the challenge is how to continue to limit the normal economic swings now that balance sheets are extended with housing assets and liabilities. Freeing up the use of additional policy tools seems one of the few rational responses.

Some suggest CFR should be given an economic growth objective or mandate (eg ABA FSI 2014). This author's sense is that the responsibility for economic growth and macroeconomic policy should rest with the elected government, which has control of fiscal policy. The CFR would seem to be more likely to be effective in improving financial system regulation and maintaining financial stability if it did not have an economic growth responsibility.

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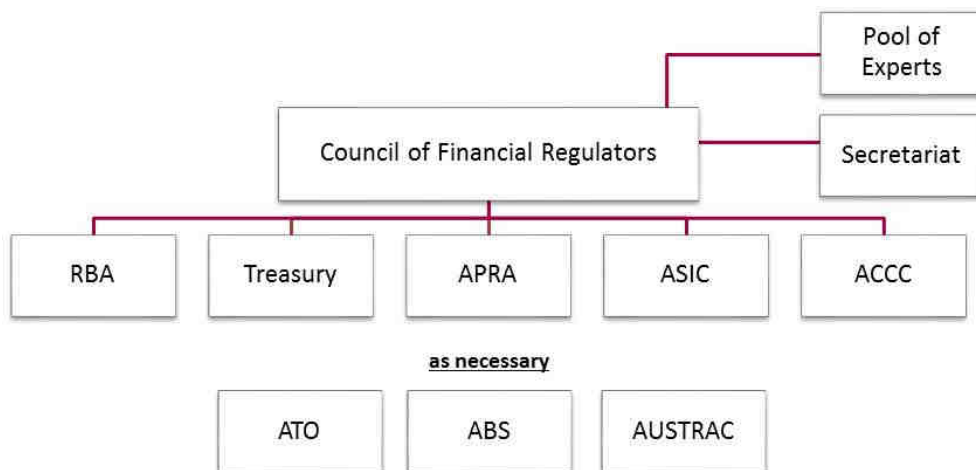
<sup>17</sup> There is an argument from the 'official family' that APRA does consider macroprudential policy and implement macroprudential policy tools in the regular discharge of its prudential policy responsibilities. But no macroprudential actions can be discerned in anything APRA has done: there have been no heightened or lowered regulatory ratio settings because of the state of the economic cycle and no regulatory actions taken to alleviate pressure on the central bank to adjust interest rates.

**Figure 12 Current Australian financial system regulatory architecture**



The reforms proposed touch all agencies involved in in financial system regulation. In summary, the proposals are to elevate the importance of the Council of Financial Regulators by making it a statutory body responsible for macroprudential policy and for overall efficiency of financial regulatory policy and by appointing an independent non-executive Chairman, allowing the RBA to focus on monetary policy and on payments system efficiency and stability, transferring the competition and consumer functions of APRA and ASIC to the ACCC which would be a member of the CFR (effectively making ‘three peaks’), enabling APRA to focus on prudential regulation and ASIC on market integrity.

**Figure 13 Proposed Australian financial system regulatory architecture**



Starting from the top, with more detail:

- The coordinating body, the Council of Financial Regulators (CFR), a creation of Wallis/Costello, needs a higher statutory profile. As noted, this Wallis inspiration is informal, unaccountable and

not necessarily proactive. Recreated as a statutory body, publishing a regular agenda and minutes and accountable to parliament, it should have two roles, to oversee the effectiveness of regulation, and to be perpetually paranoid about systemic financial instability and make forward-looking macroprudential regulation decisions. CFR could contract the RBA and other regulatory agencies to implement its macroprudential policy decisions, bypassing the present problem where a decision to engage in macroprudential policy action implies acknowledging failure in the regulatory agencies' conduct of their day-to-day policy responsibilities. In fulfilling its responsibilities, CFR could be expected to monitor and review overseas proposals for regulatory reform for their appropriateness for adoption in Australia. The re-cast CFR should have an independent non-executive Chairman (appointed by government and not an agency head attending ex-officio), and a membership that includes as executive/ex-officio members the heads of the RBA, Treasury, APRA, ASIC and ACCC. It would probably be unwieldy to require a majority of independent non-executive members as executives, though that should be considered. For some deliberations CFR might draw on a rotating pool of industry experts, much as the Takeover Panel does. In any event, the Chair would need to be very well-informed, with excellent access to research resources.

With the statutory CFR and other regulators accountable to parliament, it would seem appropriate to ensure parliament has the resources to hold the regulators to account. This might have an ancillary benefit of increasing bipartisanship, focusing governments on priority legislative and regulatory reforms and reducing the focus on less priority matters.

Turning to the regulatory agencies, there are some consequential changes if the CFR takes ultimate responsibility for financial stability, macroprudential policy and regulatory coherence, and there are other changes simply because the present structure is failing.

- The Reserve Bank of Australia. The task of central banking has evolved into 3 tasks, monetary policy, the payments system and systemic risk/financial stability. Fortunately, thus far, the monetary policy tool has not been badly compromised by systemic risk considerations, but an additional policy tool for macroprudential policy (essentially for counter-cyclical reasons) seems very desirable. The confusion as to the location of responsibility for macroprudential policy will be resolved by elevating macroprudential policy decision-making to the CFR. The central bank's current three objectives, which includes financial stability, would be reduced to two: low inflation (the best means of creating a climate for sustained economic growth and full employment) and an effective payments system. Its stability and inflation goals already clash: surges in housing lending and house prices have taken monetary policy hostage. With the CFR determining macroprudential policy actions pre-emptively, monetary policy can then focus more acutely on inflation.
- The Australian Prudential Regulation Authority. Despite the more-encompassing words used by regulators in Australia, prudential regulation actions have all been of a 'micro prudential' nature affecting categories of institutions and individual institutions on a structural – not counter-cyclical – basis, with higher and rising prudential requirements and sharper tools to counter the moral hazards arising from the formal acknowledgement that the big ADIs are too-big-to-fail (TBTF). With CFR making macroprudential policy decisions, APRA may well be the prime agency

for implementation. APRA's 'micro prudential' mandate should explicitly require agreement of a risk appetite with government (which would be published) and managing the risk of taxpayers to having to bail out either prudentially regulated financial entities facing failure or their depositors and policy holders. The anticipated frequency and extent of resort to taxpayer funds will clarify the appropriate prudential ratios for ADIs, insurers and APRA-regulated superannuation funds. The regulatory capital ratios set for individual entities might also be published. The prudential boundary should be extended to obviously genuine shadow banks and to health insurers and motor vehicle insurers. APRA's data collection could be reformed and improved (as could the ABS's), arguably at little net cost. Its competition mandate, largely overlooked in practice as stability concerns have dominated decision-making, should be transferred to the ACCC, where the concerns of the regional banks might receive a hearing.<sup>18</sup> Finally, there is still a need for APRA to explicitly replace the previous pretence that depositors would not be bailed out with an – as yet unfunded – Financial Claims Scheme (FCS).

- The Australian Securities and Investments Commission. ASIC's confused legislation gave it six objectives and often inadequate instruments, and since then its responsibilities have only grown, making ASIC a predictable failure of the Tinbergen Principle. The task of market conduct regulation in practice has become several quite distinct and thus separate tasks under the rubric of market integrity, consumer protection and registry. The two main objectives (market integrity and consumer protection) often clash, creating uncertainty. Arguably both are rising in importance, integrity vital for safe globalization (and needs more high-tech data and analysis) and consumer protection vital as superannuation balances build up (and deplete) for funding retirement incomes. The case has been growing for reallocating some functions away from ASIC so it can focus on one priority objective with effective tools. Government has already identified moving out ASIC's registry responsibilities (the NCOA suggests its transfer to the ATO, the Budget proposes its privatisation). To focus ASIC on one objective means choosing between integrity and consumer priorities. Competition issues might be transferred to the ACCC, as the NCOA suggests, and consumer protection also move to ACCC, equipping the ACCC to be an integrated competition and consumer regulator. ASIC as a market integrity regulator should remain funded by taxpayers. Industry funding would make regulatory capture more certain. As for ASIC's tools, the scope to make AFSL holders responsible for the actions of their representatives should be enhanced, with the regulator equipped with a practical power to remove the AFSL if this responsibility is not properly discharged. At the same time, more responsibility should be put on product issuers to attest the product is what it says it is and will perform in the way the product issuer claims (whether this should be regulated by ASIC or ACCC has to be determined). This facilitates an 'inside the flags'/'outside the flags' description of products. That way, both integrity and appropriateness objectives will be covered.
- The Australian Competition and Consumer Commission. The task of competition regulation in the financial sector for the ACCC has focused on regulating to ensure no collusive conduct that would be detrimental or impact on the Australian market (whereas ASIC has focused on

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<sup>18</sup> For their part, the regional banks who complain that regulatory settings support the dominance of the big four banks might reflect on the virtual complete failure of even well-endowed foreign banks in competing with the big four.



regulating to limit misleading and deceptive conduct). However, the carriage of ACCC's role was immediately overwhelmed by the mandating of 6 pillars and then 4 pillars, and then sidelined into irrelevance by the urgency created by the GFC to allow weakened mid-sized ADIs to be incorporated within the big 4 (whereas weak non-ADIs were allowed to fail). Competition policy in the financial sector is likely to be more important and challenging and a stronger competition regulator is required. The impact on competition of the increasing vertical integration of the already dominant banks needs to be assessed, and may run counter to the possible international trend to ring-fence core banking from riskier trading businesses and enable frameworks for the orderly failure of prudentially regulated entities. The ACCC should receive the competition mandates currently held by APRA and ASIC, as well as the consumer functions that have been in ASIC's responsibilities. The exact border between ACCC and the other regulators will need detailed attention<sup>19</sup>. Whatever the outcome, ACCC should join the CFR, becoming in effect a 'third peak'. It would need to be equipped with sufficient powers and penalties, especially as regards product issuers,<sup>20</sup> and sufficient resources.

- The Treasury. The Treasury is the government's pre-eminent adviser on economic and financial sector policy, legislation and regulation. A great truism in finance and regulation is that the devil is in the detail. The staff reductions in train in Treasury, amounting to one-third of all positions or more, do raise the question of whether its responsibilities can be adequately discharged in future: the quality and appropriate timing of advice is likely to suffer.
- Australian Taxation Office. An additional regulator has emerged, the superannuation administrator. The ATO's Portfolio Budget Statement says its role "is to ensure the community has confidence in the administration of Australia's taxation and superannuation systems". The ATO has substantial and rising superannuation responsibilities: it is *de facto* regulator of SMSFs, the fastest growing component of the superannuation sector, and superannuation tax concessions for entity earnings and contributions are collectively the biggest tax expenditure of the government (The Treasury 2014). These are made more difficult to discharge by the complexity (and at times inexplicability) of the rules and legislation for superannuation. Fortunately, the systemic instability risk of SMSFs is very minor and the direct exposure to individual risks make trustees more engaged than many to the risks posed by *caveat emptor*. Castillo 2012, a PhD thesis on the role of the ATO and its regulatory powers, finds that the ATO is a competent regulator for the SMSF sector. One important function that ATO might take up would be provision of an easy-to-use, efficient and timely mechanism for the movement of contributions between superannuation funds, facilitating choice and getting rid of months of frustration and delays.
- The Australian Bureau of Statistics. With the experience of the GFC confirming the value of rich financial sector data in helping look forward to guide policy, it seems even more important to

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<sup>19</sup> Whether ACCC should inherit the financial literacy functions still in ASIC after establishment of the not-for-profit entity Financial Literacy Australia (whose grants are funded by 'voluntary' contributions from companies signing ASIC-negotiated enforceable undertakings) is moot.

<sup>20</sup> Powers and penalties raised against a financial institution providing a service that does not deliver what was promised at a minimum might be the same as for non-financial entities. Variations might be upwards, if necessary.

improve the data the ABS prepares on the financial sector, and especially on superannuation and funds management.

The reforms to the regulatory architecture proposed in this paper are comparatively modest. A powerful critique of the failure of overseas (mainly US) regulators, Barth *et al* 2012, would have a publicly-funded Sentinel set up to act as public-spirited watchdog over the gamut of financial regulators, to ensure sufficient focus on systemic stability. In Australia that might be a duplication if the CFR is given real responsibility, supported by and accountable to the parliament, sufficient to counter the ever-present self-interest of the financial sector. It might also seem unnecessary in Australia in light of the vigour of the press and the commentariat.

However, the reforms cannot be only domestic. More TransTasman and Asia regional cooperation will be needed. In addition, Callaghan 2013 has set out a proposal for an international equivalent of the Australian CFR, tied in with the G20, to cover 'higher order' financial regulation issues:

"... a Finance Ministers and Central Bank Governors Committee on Financial Regulation [should] be established. It would consist of G20 finance ministers, central bank governors and heads of regulatory agencies along with the non-G20 members of the International Monetary and Financial Committee (MFC) plus Hong Kong. It would meet at the time of the spring and annual IMFC meeting and would replace the G20 finance ministers meeting held at that time. The committee would have a specific charter, which would cover not only oversight of the development and implementation of the new regulatory standards, but also their overall impact on financial stability and economic growth. The secretariat to this committee would be the FSB and IMF."

Were such a G20 committee on financial regulation to proceed, in practice there would need to be a limit on the number of heads of regulatory agencies present at meetings. Australia's representative should be the head, or a delegate, of the reformed statutory Council of Financial Regulators.

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