

Centre for International Finance and Regulation (CIFR)

Workshop Address

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❖ Introduction – topics to be covered:

➤ **Central banking and the role of insurance for bank liquidity and solvency.**

The best way to remove the moral hazard problem of 'too big to fail' is to have an insurance scheme for banks (and other ADI's) that has premiums based on their risk.

➤ **The 'Four Pillars Policy'.**

This policy is an unnecessary constraint on a banking system that is competitive and open to international competition.

➤ **Superannuation**

Claims that the Australian Super Industry is not cost efficient implies that it is uncompetitive. The 'evidence' brought to support such contentions is weak and the analysis weaker.

➤ **Housing and the mortgage market.**

A lot of emotion is wasted on housing and claims that it is 'overpriced' and an inefficient use of resources, in particular, when it is claimed that it is investors who are the cause of the problem because of 'negative gearing'. To disallow 'negative gearing' is to double tax debt, having got rid of double taxing equity why would we want go back and double tax debt.

The Central Bank (RBA)

Establishment of Central Banks:

- Bank of England 1694, privately owned until nationalised in 1946
- US Federal Reserve, Dec.23rd 1913
- Australia – CBA in 1911, Treasury controlled note printing until 1924 then CBA, RBA took over from CBA in 1960

The Role of the Central Bank

Central banks have their critics but no one could credibly argue that they (and associated regulators) do not have a role in limiting or preventing ‘bank runs’ and managing major bank insolvency to ensure financial stability. They do not have to be in the ‘frontline of action’ to be successful, they can direct from the sidelines. For example, not long before I joined the Board of the Bank of Melbourne, at the time of the collapse of the Pyramid Building Society, there was a run on the Bank of Melbourne which was an amalgamation of a former credit union and building society. Of course ‘the run’ was not publicised but other major banks were instructed by the RBA to supply the bank with credit until the ‘run’ stopped. It was successful and the ‘run’ was short lived.

The Global Financial Crisis (GFC) reinforced the importance of central banks. They were critical in the provision of ‘liquidity’ to financial systems, particularly the banks. A central bank such as the RBA provides liquidity during a crisis by buying some of the banks’ assets to provide the bank or banks with cash to meet the demands of depositors or other holders of the bank’s liabilities. A critical issue is what price should the central bank pay for such assets? It is not such a big call when the central bank purchases government issued securities because of the bank’s ability to control or at least have a significant effect on nominal interest rates. It is a much bigger call, as occurred during the GFC, when central banks extended their purchases beyond government issued securities to privately issued securities such as mortgage backed securities or the like which have a significant credit risk attached to them.

It is a judgement call but the central bank should price the securities at a price that it believes it can get out them at a later date – in this context it is a ‘commercial’ decision. If the bank e.g. the RBA were forced to discount the assets they are purchasing to a ‘significant’ degree the bank could be forced into insolvency. The discount could lead the value of the assets to fall to an extent that it extinguished the equity of the bank and its ability to meet creditors’ demands when they are due. In these circumstances, the provision of liquidity will extend to

handling the insolvency of a bank. If the RBA buys at a price that it cannot offload those securities at a later date, the RBA will not only lose on the transaction(s) they can encourage banks to adopt risky lending policies leading to a ‘moral hazard’ problem. In effect, encouraging banks to incorrectly pricing risk knowing an RBA will ‘bail them out’ – they are ‘too big to fail’.

Clearly, the quality of the assets of the bank is critical to whether the RBA has to handle a relatively simple liquidity problem or whether it is facing a bank insolvency problem.¹ It should be apparent that the provision of liquidity can extend from a relative simple problem to a major issue of bank solvency – they are different points on the continuum from short term liquidity problem through to insolvency. Moreover, it may not be clear when the central bank has to intervene whether it is facing a simple liquidity issue or a bank solvency problem.

Banks are not the only enterprises that face liquidity issues that may result from a short term mismatch between assets and liabilities and NOT poor quality assets, many companies can and do face these problems. Centro Properties now called Federation Centres is a case in point. But why should banks get special and apparently favoured treatment in these circumstances? It is because banks are critical to intermediation (allowing transactions) in the economy such that a problem with the banking system will embroil the economy even though it may be perfectly sound apart from the banking issue. However, the economy cannot be held to ransom by the banking system, its apparently favoured treatment needs to come at a cost to the banks and not just the rest of the economy, otherwise we have the ‘moral hazard problem’ previously referred to.

Conceptually, the cost to the banks for RBA’s provision of a ‘lender of last resort’ facility should resemble an insurance premium. The attempt to address this issue to date has been to give, under the Financial Claims Scheme(FCS), a guarantee to depositors (below \$250k) and charge the bank a set fee – it is depositor insurance. Such insurance, while it might prevent a bank run by one group of the bank’s liabilities, it does not protect the bank from poor quality assets and ultimately insolvency. So without a more general charge for the insurance against insolvency there is still the potential for ‘moral hazard’. In order to overcome this problem, under government direction, APRA and other members of the Council of Financial Regulators (CFR), including the RBA, have adopted a more interventionist approach. They specify certain financial constraints such as maximum leverage ratios and the likewith APRA

¹ In fact one of the reasons the RBA had to do little intervention during the GFC relative to other central banks reflected the quality of the assets of Australian banks which in turn reflected the relative strength of the Australian economy through the GFC.

assuming the main role of prudential supervision of banks and other approved deposit taking institutions (ADI's).

The approach is somewhat prescriptive and one could argue a constraint on the banking system from a more free market approach. The question is what is the least interventionist way of protecting the economy against bank illiquidity and default but allowing as much freedom to banks to determine their own destiny and the consequent benefits that are likely to arise from unfettered entrepreneurship and innovation?

My own preference is to re-introduce a version of the Australian Government Guarantee Scheme adopted during the GFC where banks' large depositors and wholesale funders were covered against default for a fee. It is far better to introduce such a policy when there is no pressure on the banking system than to do so in reaction to a crisis. Moreover, unlike the current FCS of a fixed rate, I would like to see a variable premium reflecting the risk assessed by the RBA working with APRA, along with Treasury and ASIC (in effect the CFR). I believe if the basis for the determination of the premium were known and the factors affecting the premium publically reported this would make the banking system more transparent and competitive. The risk of contagion if a bank had its premium increased is minimal under these circumstances since, like the share market price of banks, the banks' premiums and related financial statistics would be closely monitored by financial analysts and the financial media so that shocks are likely to be small, although more frequent than would occur under a more covert system of regulation.

Four Pillars Policy

In 1990 the Keating government introduced, a 'six pillars policy' comprising of the four major banks plus insurers AMP and National Mutual. I believe its intention was to prevent a merger of ANZ and National Mutual but there was also speculation that ANZ and NAB could merge around that time. The policy has since morphed into a 'Four Pillars Policy'.

The objective of the policy was to preserve the strength of the major Australian banks against takeover by foreign interests and to prevent market power that could emerge with further amalgamations amongst the four majors.

A lot of changes in financial markets have occurred since the introduction of the policy and the Wallis Report (1997) recommended its termination. This is a view I subscribe to but from recent press reports it is at odds with the head of the current inquiry. I believe the onus should be on the government and therefore the Murray Inquiry to justify the policy since it clearly is

a constraint on the banks and therefore a constraint on potential developments in financial markets.

Although the banks may not have universal popularity amongst their clients there would be few who could mount argument that there is not competition amongst the banks. It is often contended that evidence of increasing competition is the reduction in the gross margins over the past 20 years. The emergence of mortgage originators in the early 90's is credited with pushing the banks into significant reductions in gross margins – from my observation they have reduced from around 4.5% to around 2-2.5%. Other-things- being equal we would expect this to have a significant adverse effect on bank profitability. However, this is not the case.

The major banks return to book equity has remained at around 15% over the same period of gross margin reduction. A number of reasons can explain this:

- Technological advances in banking arising from the IT and consequent communications revolution has enabled banks to significantly reduce the cost of delivering their services – when did you last visit your bank to conduct normal banking activities?
- Accompanying the IT advances has been a significant change in the type and level of services that banks offer. Many customers complain of the lack of personal service that they historically enjoyed from their bank and in their place there is often a fee for service.
- The above has also given greater economies of scale which has also favoured the majors. They are 8 to 10 times larger than the 'second string banks'.

Accompanying the changes in banking has been an increasing 'globalisation' of financial services. The internet has enabled foreign banks to establish here without a major branch network. 'Shadow banking' activities has increased to the extent we are seeing major retailers expanding their credit facilities to compete with banks.

It is argued that the 'four pillars policy' necessary to maintain competition in the domestic banking market? I would argue that it is not. An amalgamation between any two of the majors would be unlikely to lead to 'monopoly rent', market share is not necessarily a major indicia of market power, I believe the existing² and potential competitors to any attempt at 'rent seeking' would cause such an attempt to be short lived. At best, the amalgamation would enable economies of scale to give greater profit to the group but it would not enable the group

² These include smaller Australian banks, credit unions, building societies, non-financial company credit providers, subsidiaries and branches of foreign owned banks and other authorised deposit taking institutions.

to impose conditions on the market that would lead either to a decrease in service or, equivalently, an increase in cost or both than currently exists.

Australian banks, although a large proportion of the Australian equity market and large by Australian company comparisons, are not large by international standards. In terms of total assets (Bankers Almanac February 2014) the biggest of the Australian banks, the NAB ranks only 41st amongst international banks with the smallest (Westpac) ranking 48th. An amalgamation is unlikely to lead to a simple addition of the participants' assets but even then an amalgamation between the two biggest NAB and CBA would rank at 17th. Preventing an Australian bank from expanding through merging with another Australian major limits the export potential of banking services, an unnecessary constraint on our current account even if there are no further economies of scale domestically. Imagine the state of Swiss banking and the Swiss economy if they were similarly constrained.

Another major argument for the 'four pillars policy' has been to prevent the takeover of a major domestic bank by a foreign bank or group. The fear is that such a takeover would expose the bank and therefore the Australian banking system to foreign events leading to an increase in the risk to the Australian banking sector. One could argue that the increased globalisation of banking activities cannot insulate a domestic banking system from international influences nor should it if that industry is to be efficient and competitive. Moreover, there is no reason why a domestic subsidiary of an overseas bank cannot be exposed to exactly the same regulation as a domestic bank with the same outcome. Reliance on overseas funding is already significant amongst the major Australian banks without a significant exposure to exchange risk because of hedging such exposure, a foreign owned bank would be wise to adopt similar hedging policies if it wanted to protect the Australian assets it controls.

Superannuation

A recent article in The Age newspaper (The Age, 23rd April, 2014) asked:

“... Why Australians pay higher fees on their superannuation than almost any other country in the Organisation for Economic Co-operation and Development. It has been estimated that paying just 1 percentage point more in fees results in a retirement benefit worth 20 per cent less over 30 years. Fees differ between superannuation sectors.”

A number of similar comments have been made in the light of the RBA Submission to the Financial Systems Inquiry. My reading of the RBA Submission, although raising the issue of fees' it did not suggest the fees were abnormally high but it did ask the rhetorical question of

whether the ‘disengagement of members’ lead to a lack of competitive pressures in the industry. It echoed the Cooper Report (2010) concerns, that report recommended the introduction of ‘My Super’ a low cost default fund for those that do not actively choose a fund. The recommendation has been introduced by the previous government but, in my opinion, it is too early to reach a conclusion from a benefit/cost analysis of the system.

The most recent of these criticisms of the level of fees being paid by investors in Superfunds is a recent Grattan Report . I will return to some specific comments on that report shortly.

There are many components to the decision to transact when a person is considering a superfund; they cannot all be captured in some simple cost analysis. To undertake an analysis on just this basis is a bit like choosing a suit simply on price, you just maybe interested in the quality of the cloth, tailoring etc. There are good reasons that could explain the apparent higher fees for the administration of superannuation funds in Australia relative to other OECD countries. The majority of Australian Superannuation Funds manage Defined Contribution (DC) for members in contrast to most OECD countries which have Defined Benefit (DB) pension schemes. DC schemes allow members considerable discretion in the asset types they can invest, the result is that chasing returns, members tend to take on a greater proportion of risk assets than DB schemes in the expectation they will be rewarded for the additional risk. DB scheme members do not have discretion and the trustees of such schemes are encouraged to adopt a ‘safety first’ to ensure their funds are fully funded. They invest in defensive assets typically with a high proportion of government securities.

The fees for the management of funds is highly correlated with the risk of the assets invested and even the range of fees in any general asset class varies enormously. However as an example, in Australia managers of listed microcap companies’ fees are around 100 basis points, large cap around 40 basis points and fixed interest around 20 basis points. Private equity is usually well above 100 basis points. Therefore, it is not surprising that the fees for the management of Australian super appear to be a lot higher than overseas pension funds when the asset classes are often quite different.

In fact, the variability of the types of investments that super funds can invest and the vastly different regularity and cultural systems means that it would be almost impossible to assess the competitive intensity of the industry on the basis of fees or performance across countries or jurisdictions. A far better indicia of any lack of competition would be what could be preventing competition, for example the presence of ‘barriers to entry’. If these cannot be identified, what may appear to be evidence of a lack of competition in performance indicators is more likely to reflect the stochastic nature of returns and differences in fees reflecting the different approaches that can be taken to fund management.

Returning to the Grattan Report: They blame the ‘disengagement’ of account holders, evidenced by the significant proportion of those who finish up in a ‘default fund’ for the ability of funds to get away with high costs. The solution they suggest is to have a government tender for ‘the default fund’ that would be managed by government, they suggest economies of scale and ‘better management’ would reduce fees. They may be right, there could be benefits in such a central default fund for ‘disengaged’ members of a fund since such a group self-select but to condemn the whole industry for ‘excessive’ fees is a ‘bridge too far’. The evidence Grattan bring to support their conclusion that there is a ‘Super Sting’ is far from impressive.

Even if two thirds of accountholders were ‘disengaged’ would not be sufficient to enable a lack of competition or ‘economic rents’ to survive in the industry. It is the marginal investor that determines price in an open and competitive market; therefore to support their contentions of a ‘Super Sting’ they need to show what is preventing such an investor or accountholder from causing competitive tension amongst the funds. Surveys of account holder attitudes or even average behaviour are not sufficient evidence.

To support their recommendation of a ‘central default fund’, they would need to show that the indifference or ‘disengagement’ allowed funds to charge such members fees which allowed ‘rent’ to accumulate and not be competed away with other services to such members. Moreover, insofar as members of Balanced Funds are a mixture of the ‘disengaged’ and the ‘engaged’, and to the extent there is competition amongst superfunds for members of Balanced Funds, would suggest that these fees are not excessive, at least for the ‘engaged’.

Further, to draw conclusions about the behaviour of fund management with as little as ten years of data (and frequently less) is dangerous with such a stochastic process as investment returns and the consequent performance of funds. The period they covered was a period of falling interest rates with the consequent great returns from investing in long bonds, on the basis of this period some have suggested that a portfolio of long bonds is what investors should be investing. The conclusions would be totally different if we examined investor experience over since the Second World War. We can usually find support for any hypothesis in fund management no matter how ridiculous if we are prepared to accept short time periods as evidence of how the market behaves.

Housing

Housing loans account for over half of all total loans made by the banking system (RBA Submission p.78). This translates to about 40% of domestic bank assets. It is a large proportion by international standards (RBA, P. 85). Therefore, although the default rate on

home loans is very low in Australia, the proportion of home loans in banks' assets means they gets considerable attention by the RBA amongst other regulators.

Housing and house prices also get considerable attention from the Australian press and public which is not surprising since it is a considerable component of the assets and liabilities of all its citizens. There is often a lot of emotion attached to housing. There is a notion that housing is non-productive and therefore housing investment is somehow inferior to other forms of investment. This is nonsense! Housing is very much like another staple, food. A certain amount is necessary for production and therefore it is partly a production good, beyond that it becomes a consumption good but we should not need reminding that the whole point of production is consumption – production is not an end in itself nor despite the apparent policies of some politicians nor is consumption possible without production.

No one doubts that it is difficult for the RBA to manage monetary policy in a 'two speed economy' – low interest rates may encourage 'excessive' investment in housing but they can be necessary to stop industry from 'tanking'. Amongst the 'culprits' accused of 'distorting' the housing market are investors, particularly foreign investors. Whether the purchaser is a home owner or an investor should be irrelevant unless an externality can be shown for one group relative to the other. I am unaware of any such evidence but there is plenty of assertion. Arguments about 'crowding out' homeowners by investors could be reversed and we could argue that home owners 'crowd out' renters. While both assertions are probably correct, we would have to argue that there is some positive community externality in home ownership v's renting. There maybe but it has not been an argument advanced in support of 'limiting' houses as an investment. Further, to try and 'block' house prices from rising implies prices are 'too high', an intervention implying superior insight than the market that inevitably causes other forms of regulation and greater problems than the problem of rising house prices.

One of the mechanism advocated by those who believe there is too much investment in housing is the removal of 'negative gearing'³ for investors. It would be a big mistake, theoretically and practically, to target investment in housing with such an action.

One of the basic principles of optimal resource allocation in an economy is to treat all asset classes the same way when applying a tax. As I have indicated above the only time that rule should be modified is if an asset class delivers a cost or benefit to the community that is not

³In the context of property, 'negative gearing' is when a property owner and investor borrows such that the interest cost offsets (or more than offsets) the income (rent) from the property so that there is no income tax liability. Effectively this converts the return from the property from rent plus capital gain to all capital gain. Moreover, capital gains are typically taxed at a lower rate than rental income.

borne/received by the owner of the asset, i.e. when there is a 'social cost/benefit' associated with the asset. A special tax or subsidy may be (but only may be) the best means of addressing this issue of 'social cost'.

All asset classes, again as a generality, can be 'negatively geared' and in my opinion there is no good reason to single out housing for special treatment, to do so will result in a misallocation of resources. Removal of 'negative gearing' effectively double taxes debt capital since the interest is taxed in both the hands of the borrower and the lender. In a similar vein, we have been there with a 'classical tax system' which double taxes dividends but fortunately Australia has removed that flawed tax system.

The Campbell Committee (1981) recommended an 'integrated tax' system, the ideal system for company taxation. The introduction in 1987 of a full 'imputation tax' goes close to the ideal where company profits are only taxed in the hands of the owners and not taxed twice at both the company and owner levels. To remove 'negative gearing' on property which would result in a double tax on interest on debt is going backwards.

It is sometimes asserted that 'negative gearing' does nothing to increase the supply of housing because most investment property is for established dwellings. What causes 'negative gearing' to suspend the laws of supply and demand? To the extent that 'negative gearing' increases the demand by investors for housing, causing house prices to rise, resources will be attracted into housing, thus increasing the supply of housing. There are studies suggesting that our relatively high house prices is a supply issue, i.e. the lack of the release of land and the associated tax and regulatory cost of development cause the supply to be restricted because of the greater cost to adequately compensate for these imposts but this has nothing to do with 'negative gearing'. It is a separate set of issues which should not involve a financial systems inquiry.

