IN PROFILE: Kevin Davis, Theory meets reality

Prof. Kevin Davis, a member of the Financial System Inquiry panel, discusses the fundamental issues driving the focus of the Inquiry and the rationale for its key recommendations on banking capital, superannuation and innovation.

The only academic appointed to the Financial System Inquiry, Kevin Davis is well-known and highly regarded at the most senior levels among financial practitioners, policy makers and academics.

Currently a Professor of Finance at both Melbourne and Monash universities, Davis is one of a relatively rare breed of finance academics in Australia, who is equally conversant with the latest theoretical research and the operational complexities of banking and financial markets.

He says, “It always has been part of my philosophy that there is no point in studying finance or economics if you can’t understand and articulate what is happening in the real world”.

This approach stems from his early days as an undergraduate at Flinders University in Adelaide, where there was a strong emphasis on understanding the reality of economic and financial markets as much as the theory.

He says, “I like nothing better than sitting in my study and playing around with various theories. But it is usually driven by something I have seen out in the industry rather than just picking something out of the literature”.

Throughout much of his career Davis has maintained strong interactions with financial institutions, business and government, in various consulting and advisory roles. He was appointed Inaugural Director of the Melbourne (now Australian) Centre for Financial Studies in July 2005, and has been Research Director of the ACFS since January 2009. He is also a member of the Australian Competition Tribunal.

Davis has co-authored and edited numerous books and journal articles in finance, banking, monetary economics and macroeconomics, and he is Managing Editor of Finsia’s Applied Finance Journal, *JASSA*.

He indicates that the two central themes underpinning the deliberations of the Murray Inquiry were the need to ensure: adequate competition within financial markets; and adequate and appropriate funding for end-users within the financial system.

“An important starting point for the panel was that the focus should be on the needs of individuals, households, businesses and governments because that is what financial markets are all about – bringing together providers and end-users of finance.”

He also notes that the discussions between panel members and regulators and financial market participants in Europe, the UK and the US clearly highlighted where the global regulatory agenda was coming from. “Ultimately, we have to take on board these trends and need to be adhering to these standards because we are reliant on international capital markets.”

What has changed since the Wallis Inquiry?

Davis identifies a number of fundamental changes within financial markets since the 1997 Wallis Report which influenced the focus of the Murray Inquiry and its recommendations.

He says, “Some of those changes have involved a collision of theory and reality. Clearly one of these was the global financial crisis which indicated that financial systems aren’t always stable and that there are potential risks associated with inadequate supervision of the finance sector. So the resilience of the financial system was a critical issue”.

Another major change was that the Wallis Inquiry assumed adequate disclosure would lead to good outcomes for consumers. Reality has shown this isn’t the case and that consumers are not always rational. Davis says, “That influences the way one approaches the whole issue of the financial protection of consumers”.

The third major development since Wallis is the rapid growth of the now $1.9 trillion superannuation industry. Davis says, “This means that a large proportion of financial flows is going into superannuation funds from household savings and therefore it is very important that their investment decisions are good ones and they achieve good returns on those savings for their long-term retirement needs”.

He also notes that technological change is now far more pronounced and potentially more problematic from a regulatory standpoint than 16 years ago, when the internet was only about four years old.

The regulatory environment has also changed dramatically, with much of the regulatory agenda post GFC being driven at the international level. But Davis says the panel took the view that ‘if it ain’t broke don’t fix it’.

“Yes we thought some things needed to be modified but, in general, the regulatory structure put in place by Wallis seemed to be working pretty well. A large part of our focus was on assisting the regulators to do their job better, by ensuring they have adequate funding and resources. We also recommended the establishment of a Financial Regulator Assessment Board aimed at: increasing the accountability of regulators by having an organisation that would assess each year how well they have performed against their mandate and whether they have taken into account the competitive impacts of their decisions.”

Resilience

Bank capital ratios

The Inquiry argued that in order to reduce the risk of future financial crises, Australian banks should be in the top quartile in terms of their capital standards vis a vis comparable international institutions, which implies an increase in capital compared with their current capital ratios.

Davis says, “We have enunciated the principle that Australian banks should be well capitalised. But, even with a large, very good Secretariat – which should get a lot more recognition than it does – it is not sensible for us to come up with precise numbers. It is much better for APRA, which specialises in this area, to do that”.

He indicates the Inquiry undertook a cost-benefit analysis on the potential costs of an increase in capital ratios and the potential benefits in terms of reducing the probability of a crisis, and bad outcomes from that. It concluded that an increase in capital ratios was beneficial.

"Higher capital ratios simply mean that a larger proportion of bank funding takes the form of equity (shares) rather than deposits or debt, and it provides an increased buffer of loss-absorbency to protect depositors."

Davis says, "One of the real worries I have, however, is that most journalists seem to interpret an increase in capital as meaning that banks have to put more money under the mattress and not lend it out. There is real confusion out there about what is meant by 'capital'. Because everybody uses the term 'hold capital' people think higher capital means banks can't use this money for lending, and they have to put it in a jar. That really distorts the discussion about these issues and people's understanding about what the implications are".

Narrowing the mortgage risk weights differences

Another major recommendation to APRA is that it should increase the minimum risk weight for the major banks for housing lending. Because the major banks use the internal ratings-based (IRB) approach, they operate with much lower risk weights and therefore with lower capital funding of housing mortgages than do the smaller and regional banks. The latter have risk weights of around 39% compared with the majors which have around 18%. The Inquiry recommended that APRA increase the average IRB risk rate to 25–30%.

Davis indicates that "while this is primarily a competition issue, there were also concerns that the housing sector could be a potential source of systemic risk and instability".

"APRA did some stress testing recently which found that with a major reduction in house prices and increased unemployment, some of the banks would get towards the lower end of their capital requirements and some of their contingent capital instruments in the form of hybrid securities, which have bail-in requirements, could actually be exercised in that very extreme scenario."

Approach to total loss and recapitalisation capacity

To minimise the requirement for taxpayer support, the Inquiry recommended that a framework be implemented to provide minimum loss absorbing and recapitalisation capacity in line with emerging international practice. At the recent G20 meeting, the Financial Stability Board provided a term sheet outlining their proposals on the next steps in developing standards for Total Loss Absorbing Capital, and some Australian banks have already issued bail-in type securities that can be counted as Tier 2 capital.

Davis notes, however, that the panel's approach in this area was somewhat cautious as there has been no past experience with the use of these securities, and many of them are held by individuals and self-managed super funds.

Direct borrowing by super funds

Another key recommendation in relation to the resilience of the financial system was that borrowing by superannuation funds be prohibited.

Davis says, "The twin perils for financial stability are leverage and liquidity. I believe one of the things that helped Australia during the GFC was that a large part of the shocks that were experienced, such as drops in asset prices, flowed through directly to holders of those securities and, because they weren't highly leveraged, we didn't see further amplification of the problems caused by leverage. The other point relevant to this recommendation is the view that superannuation should be about saving for retirement incomes. So the tax benefits should be there to facilitate savings for retirement rather than for accumulating wealth".

An observation was made by the Inquiry that these issues could be examined by a forthcoming taxation White Paper.

Super and retirement incomes

As part of its recommendations to strengthen the superannuation system, the Inquiry recommended that the Government and the Opposition parties develop a clear goal for the system which puts retirement income at the forefront.

With more people approaching the retirement phase, another major recommendation was that super funds should design a comprehensive incomes product as a preselected retirement product. This could include a mix of products e.g. an allocated pension type product plus a deferred annuity that would provide longevity insurance and better smoothing of retirement income.

Davis says, "Drawing on behavioural finance theory – we would expect a lot of people to take that up if they were advised that this was a good way of managing the risks associated with retirement. This still leaves the decision in the hands of the consumer, but they are given this advice".

He adds that by getting people into products that offer a pooling of risks, you can increase the income they will get in retirement from a given balance of savings.

"To encourage people to think of superannuation as saving for a retirement income stream, we have also recommended that super funds be assisted in providing members with projections on their retirement incomes. So the focus is not on how much I have in my account today but whether I am on track to achieve the retirement income I need."

Improving efficiency

Davis notes that the panel examined the issue of why economies of scale due to the merging of super funds have not resulted in significant reductions in fees to date.

"The super industry has been through huge change, including regulatory change aimed at improving efficiencies through MySuper and SuperStream. While we have to allow sufficient time for these regulatory changes to work, we have recommended that a formal competitive process be introduced to allocate new default fund members to MySuper products unless a review by 2020 concludes that the Stronger Super reforms have significantly improved the competition and efficiency in the super system."

Governance

Davis says, "One recommendation that is often picked up is that there be a majority of independent directors on the board of corporate trustees of all public offer super funds. The panel's discussion around this was simply focused on the need to ensure good decision making and efficiency".

He adds that "While some will argue that the industry funds have had better returns than the retail funds, it is not clear how much of this is due to their not-for-profit status rather than their governance structure".

Consumer outcomes

To ensure fair treatment for consumers, the Inquiry recommended the introduction of a targeted and principles-based product design and distribution obligation, so that product development processes are well-documented and product manufacturers clearly identify who are the appropriate consumers of the product.

Davis says, “It was recommended that ASIC have temporary powers to ban products that are clearly not in the consumer’s interest. We also agreed with the banning of commissions for financial advice – conflicted remuneration should not be allowed, and we suggested ASIC should examine remuneration structures in areas such as stockbroking and life insurance”.

Innovation

Davis believes that with technology dramatically changing the way financial markets operate, innovation will be the sleeper in all of this.

“As technology makes it feasible for transactions to occur in many different ways through digital technologies, we need to ensure regulation doesn’t get in the way of innovation by providers of desirable goods and services. So we recommended that regulation be graduated to allow things like crowdfunding, both debt and equity, to emerge.”

He notes that crowdfunding is growing rapidly, both here and internationally and some of the firms investing in digital technology are potentially major disrupters that will provide competition to established intermediaries, so it is important to ensure that the regulatory structure will allow this to occur.

Consultation on the Murray Report will occur over the next three months and the Government’s response, likely to be in the second half of next year, will also need to consider global regulatory developments particularly in relation to the Basel process. All of this points to a watershed year for financial services in 2015.

Ends