AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

Financial Regulatory Reform: What is the Australian Vision?[1]

Professor Kevin Davis
Research Director, Australian Centre for Financial Studies

Introduction

1. The GFC identified many deficiencies in financial regulation globally – existing approaches were not up to the challenge of controlling market based financial systems to get socially desirable outcomes. There were failures of the market, of regulation and of supervision, with relative shares of blame open to debate. Governments adopted a "belts and braces" approach to dealing with the problem, with the scale and nature of interventions having lasting effects for how the financial sector can and should be regulated.
2. That experience has prompted a major international financial reform agenda and an ongoing reassessment by scholars of how well financial markets work. The links between the reform agenda and theory are not always as close as might be liked.
3. In Australia, where the GFC impact was muted, there has also been a local financial reform agenda arising from those developments, in addition to the global developments such as Basel III. FoFA, CSBS, Stronger Super are parts of that agenda
4. There are many positive regulatory changes which have been implemented, some others less well founded, and still a lot of potential regulatory developments to come.
5. But is there a "grand vision" for redesign of the financial system, or is it primarily just "tinkering with the plumbing"? Do we need significant institutional changes to create a better, more efficient, and more robust financial system? There is a tendency for reforms to be directed to rectifying specific issues identified in the GFC. Excessive leverage, solution – increase capital requirements; liquidity and counterparty spillovers, solution – use of Central Clearing Counterparties, higher risk weights for financial sector counterparties, minimum liquidity requirements;

[1] Address to NSW Economic Society Forum, Sydney, 19 July 2012

inappropriate incentive structures – ad hoc interference in remuneration structures, codes of practice for credit rating agencies, etc.

6. There is much concern about the aggregate effect of such a plethora of piecemeal changes. A couple of simple example may illustrate. First, increased demands for high quality collateral for derivative and other transactions accompanied by the impact of the Basel Liquidity Coverage Ratio requirements in increasing the demand for government securities can be expected to create a "liquidity premium" in government security rates. Government bond rates may no longer be a good indicator of the risk free rate of time preference, but pushed below that because of that liquidity demand. Second, the high ($250,000) cap for coverage of deposits at any ADI under the financial claims scheme, must – particularly when banks are competing strongly for deposits in response to Basel 3 requirements – reduce retail investor demand for corporate bonds, which other regulatory changes are trying to promote.

7. My thesis is that it is largely the latter ("tinkering") approach that hold sway. This appears particularly so in Australia where the "if it ain't broke, don't fix it" maxim (prompted by our successful navigation of the GFC) has currency. I think that the appropriate approach should be to ask the questions: "it may not be broke, but can it work better?" and "how can we best ensure that it doesn't break in the future".

8. One consequence of the past largely "hands-off" approach by government to financial sector institutional and structural development (ignoring the impact of compulsory superannuation – which had other objectives) has been increasing complexity of financial institutions, markets and their interdependencies. A consequence of that increasing complexity, and the problems arising, has been the need for increasingly complex and intrusive regulations. It is worth asking whether it is possible to redesign the financial sector in a simpler form which, while limiting some freedom of action by financiers, can operate efficiently and robustly with simpler regulation. Perhaps the analogy is with road rules where individuals are required to drive on the designated side of the road. Without that particular restriction on freedom, there would need to be a plethora of complicated, hard to enforce, rules specifying who has to swerve (and how) to avoid collisions.

9. I hope to provide some hints towards answers to those questions of what types of regulatory changes might have merit, but realize that there is an element of "reform fatigue" already prevailing from the patchwork of regulatory changes already in train. Suggestions that a radical reform of the financial system, based on some "grand vision" is worth considering are likely to meet with opposition and skepticism.

10. But some "root and branch" restructuring reform may prove less painful than on-going micro-regulatory reforms to deal with the evolutionary development of the financial sector. It may not be feasible, not on closer examination worth pursuing, but it is a question worth addressing.

11. In some countries, radical reforms are being contemplated, or introduced. The most obvious example of this is the British banking reforms proposed in the June White Paper drawing on the earlier Vickers Report. The USA is also implementing some potentially far reaching changes as a result of the Dodd-Frank Act, but that case probably serves more to emphasize how regulatory change is ultimately driven by political considerations and vested interests rather than by economic logic.

12. The British proposals have an economic logic to them, although not necessarily one which all would agree with. Whether they survive the lobbying process to emerge largely unscathed as legislation remains to be seen, but recent financial sector scandals can only serve to weaken the opposition forces. The JP Morgan "London whale derivatives" losses, originally described dismissively by the CEO as a "tempest in a teapot" but recently estimated as being around the $6 billion figure, provide some support to the view that large complex financial institutions are "too big to manage" and understand. The Barclays LIBOR fixing scandal, and the current US based accusations against HSBC and Standard Chartered Bank of facilitating money laundering, further raise doubts about the quality of internal governance arrangements in large complex financial institutions, and the adverse incentives which can exist. The political power of the financial oligarchy, and its ability to impede reform, is probably at its lowest for many decades.

13. I want to return later to the British proposals, but first it is appropriate to consider whether the "if it ain't broke.." maxim really is appropriate for Australia.

Australia and the GFC

14. It is certainly true that the Australian financial sector weathered the GFC relatively well and has emerged relatively unscathed, with generally sound, profitable financial institutions and well functioning financial markets. And while the global financial sector remains turbulent due to the ongoing European problems, Australia's financial markets and institutions do not appear to have significant direct exposures to those problems.

15. But our relatively smooth path through the GFC owed a lot to massive government and regulatory interventions, although addressing the counterfactual - of how bad the experience would have been without those interventions – is likely to elicit a range of answers.

16. What were those interventions? Most obvious was the introduction of bank wholesale debt funding and deposit guarantees. While some, bankers and Federal Treasurers in particular, point to the healthy government fee revenue from the debt guarantee scheme it is worth noting two things. First, guarantee fees were set significantly below those applied by other nations and well below what would be regarded as an actuarially fair price given the market conditions at the time. Second, without the scheme, Australian banks would have had a funding crisis leading to a credit crunch, liquidity problems, and markedly reduced profitability. There was a substantial taxpayer subsidy to our banks, in the form of foregone guarantee fee revenue, to help them deal with their exposures to the financial market instability at the time.

17. Deposit guarantees at zero price also provided Australian banks and ADIs with massive support which is ongoing. In current circumstances, the zero price probably is an actuarially fair price (since the structure of the Financial Claims Scheme means that ultimately uninsured creditors of a bank are effectively providing the insurance cover – a feature not well understood). But the lingering effect of the GFC intervention is to assure depositors and other creditors that there is implicit government insurance which extends beyond the FCS cap of $250,000. Higher capital requirements being introduced under Basel III are aimed at reducing the value of that

implicit guarantee, but arguably still leave other non-bank financial institutions at a competitive disadvantage.

18. There were less publicized government interventions to support banks and other financial institutions, which were also significant. Liberalization of repo-eligibility conditions enabled banks to use an increased range of private securities to access liquidity facilities at the RBA. FX swap arrangements between the RBA and the US Fed enabled provision of US Dollar liquidity to Australian financial institutions.

A Broader Reform Vision?

19. So, while we survived and our financial institutions generally continue to prosper, I don't think that it is appropriate to rest on our laurels. And while the Basel and other changes can be expected to reduce systemic and individual institution risk, by and large they take the existing structure of, and interrelationships between, financial institutions and markets as a given starting point. It is true that they will alter its shape. Higher risk weights for exposures to other financial institutions and incentives for use of Central Clearing Counter Parties for derivatives trading are just two examples which will alter the shape of counterparty exposures and interdependencies. Liquidity requirements, the LCR (which I think is not well founded) and the NSFR will also have marked effects.

20. But should we take the existing financial structure as a starting point for "fiddling around the edges", or think more deeply about an optimal design. Some will no doubt say that a benevolent "invisible hand" of market forces has, despite government interference, led us to an appropriate financial structure. In response to that, I would make the point that business organizational structures and market arrangements emerge in the context of legal systems whose laws and regulations provide license and impose limitations on what is allowable. As a society we have the right, and duty, to review whether those arrangements remain optimal.

21. In that regard, I would take aim at the consequences of excessive exploitation of "limited liability" in the financial sector. Limited liability is surely one of the greatest innovations of the capitalist system, which enabled individuals to undertake risky ventures in search of profit without putting all of their personal wealth at risk. But

through combination with excessively high leverage, it has been used by the financial sector to pursue profit by primarily putting the wealth of other individuals at risk, while limiting risk to the owners of the enterprise.

22. It wasn't always so. One only needs to go back to the late 19th Century to discover that bank shareholders in many countries, including in Australia, were subject to laws which imposed double or unlimited liability in the event of failure. And, of course, the large investment banks were until the late twentieth century structured as partnerships, which arguably meant that incentives towards leverage and risk taking were much less than under the subsequent limited liability corporate structures.

23. I would not suggest that limited liability should be abolished in the case of financial institutions. And in modern financial systems attempting to impose double or unlimited liability on bank owners (who change by the second as shares in banks are traded) is impossible. But granting the privilege of limited liability, and other concessions such as gathering of deposits without need to issue a prospectus, and access to Central Bank liquidity support, surely endows society with the right to impose other restrictions on activities. Indeed, this is effectively what the current British bank reform proposals, which I will turn to shortly, do.

24. But before going there, I would make the point that the Basel III changes, and others in prospect, are indirectly changing liability arrangements. Contingent capital requirements expose holders of such hybrid securities to the risk of conversion of their claims into an equity position if certain triggers are touched by a distressed financial institution. "Bail-in" powers for regulators, supported by the IMF and the G20, mean that bond holders at a troubled bank could have their claims written down (given a haircut) at the discretion of the regulators in order to (hopefully) prevent its failure.

The British Banking Reform Proposals

25. The most publicized feature of the British proposals is the requirement for "ring fencing" of retail banking. Only ring-fenced banks will be allowed to take retail deposits and provide payments services to retail and SME customers. Those banks will only be allowed to have limited financial exposures (such as making loans, receiving funding, trading transactions) to other financial institutions with the main exceptions related to managing liquidity risk and hedging exposures created by customer transactions. Particularly significantly, while they may be part of a larger financial conglomerate, they must be separate legal entities with boards with a majority of independent directors.

26. This proposal aims to constrain implicit government guarantees to those ring-fenced institutions and activities where, arguably, such guarantees cannot be avoided. By limiting exposures to other financial institutions, it is hoped that spillovers from other troubled institutions, or parts of the conglomerate, due to counterparty exposures will be avoided.

27. It is worth noting that reducing counterparty exposures is also an important feature of plans of international regulators to require or induce use of Central Clearing Counterparties for OTC derivatives. This reflects the somewhat belated recognition (by us all) of the importance of the network structure of the finance sector in the transmission and/or absorption of shocks. There is thus some form of vision involved that society can consciously design a better financial system than has evolved via market forces (in response to regulatory impediments and incentives) but there is much devil in the detail of how such a grand design might work.

28. There is also much devil in the detail of ring fencing, but it is also worth noting several other potential benefits of such structural separation beyond limiting risk spillovers. First, remuneration incentives in "utility" banking (such as undertaken by the ring-fenced bank) should be much less "high-powered" than for "casino" banking which might be undertaken in other parts of a financial conglomerate. Separation reduces the risk of wrong incentive structures being spread across an entire financial conglomerate. Second, personal risk preferences of management are likely to be an

important determinant of risk taking by the institution, and structural separation may induce self-selection of individuals into careers where the desired institutional risk appetite better matches individual risk preferences.

29. Ultimately, the question here is whether there are substantial costs associated with ring-fencing and their size relative to the anticipated social benefits of such a reform. Ultimately, this comes down to questions of whether there are some economies of scope which such structural separation destroys. Ring-fencing does not necessarily destroy any economies of scale, because the financial conglomerate remains able to undertake the same scale and set of activities, but with some located only in the ring-fenced subsidiaries.

30. The empirical literature on scope economies in banking is not particularly persuasive of their being substantive in nature. But perhaps one of the key issues is the extent to which risk diversification is impeded by ring fencing. Of course that is one of the key objectives – but couched in the context of preventing risk spillovers. Even without the reduction in the value to shareholders of implicit guarantees sought by imposing ring fencing, that change may well increase the required rate of return of shareholders (the cost of equity capital).

31. The British proposals also envisage substantially higher capital requirements (loss absorption capacity) than Basel 3 (and some other nations have already gone down this route). They also propose "insured depositor preference" something which we already have in Australia – indeed in a broader form of preference for all depositors.

32. The other radical feature of the British proposals is "bail-in" powers for the regulator, enabling it to apply "hair-cuts" to amounts owed to various creditors of a failing institution prior to the point of insolvency. Thus, hopefully, "bail-outs" by taxpayers can be avoided if the ongoing survival of the entity is deemed necessary (or if some recapitalization is necessary to effect a takeover by another entity). Of course, such "bail-ins" must logically be accompanied by management restructuring and changes in control (ownership) rights – with existing shareholder claims written down to zero.

33. It is worth noting that our New Zealand neighbours have had an as-yet untested scheme for "bail-ins" in place for a couple of years. But their quite radical scheme

involves bailing in all creditors including depositors by way of haircuts. Naturally, government guarantees over the residual deposit liabilities would be needed to prevent "runs" and this highlights the dilemma associated with the more general bail-in proposals. How can investor/depositor confidence in the bank where a bail-in has occurred be ensured such that it remains a viable institution? Living wills (recovery and resolution plans), now being required of bank boards by prudential regulators, may help speed the transition to new ownership, management, recapitalization, but maintenance of confidence is another matter. It seems likely that either government ownership or takeover by another viable institution are the only feasible options. And that raises another important issue pertinent to Australia!

D-SIBs and Too Big to Swallow

34. The Basel Committee has produced recommendations for higher capital requirements for 29 large banks which it decided warranted designation as Globally Systemically Important Banks (G-SIBs). The big four Australasian banks weren't included, although they are clearly domestic or regional SIBs. On the criteria used for the Basel Committee for G-SIB status of cross-jurisdictional activity, size, interconnectedness, possible substitutability of their role in providing financial system infrastructure, and complexity, they score quite highly (although not high enough to be G-SIBs).

35. Recently, the Australia-New Zealand Shadow Financial Regulatory Committee, an independent group of senior academics, has argued that there is a case for different regulatory treatment of the big four D-SIBs compared to smaller banks and deposit takers. Why? The reason is that the big four are "too big to swallow".

36. The ANZSFRC note that "it is the negative social externalities of failure of SIBs which give rise to proposals for special regulatory treatment". And "resolution arrangements (including 'bail-outs' due to too big to fail considerations) which exist to shield stakeholders from loss have the moral hazard downside of reducing market discipline and allowing (if not inducing) socially excessive risk-taking by SIBs".

37. Generally, APRA is able to limit externalities of failure of smaller troubled institutions by facilitating a smooth exit through takeover by another competitor. But this is not really a feasible option should one of the big four get into trouble (either in

Australia or in the New Zealand subsidiaries). And while there is a budget appropriation of $20 billion for the Financial System Stability Special Account to assist in dealing with a troubled bank, that is unlikely to be adequate in the case of the big four (each with $400 billion or more assets in Australia). Given the opaqueness of large banks, the scale of possible hidden risks would make any potential acquirer hesitant. Hence, there is an arguable case for additional regulatory imposts upon D-SIBs, which could take the form of higher capital requirements, additional contingent capital requirements, or perhaps even special taxes on big banks!

What other regulatory changes might yet come?

38. What are some of the radical possibilities which might get onto the agenda?

39. One, which has been supported by a number of politicians and others is a "Tobin tax" – a tax on financial transactions which would throw "sand in the wheels" to prevent excessive trading and volatility. But gaining the required international consensus to make such a change feasible in integrated world financial markets seems unlikely, particularly given the vested interests of those financial institutions whose business models are built on turnover and churn.

40. A second relates to financial sector remuneration and incentives. Andy Haldane of the Bank of England makes the obvious point that it is not clear why banker remuneration should be linked to return on equity rather than return on assets (ie the return to all stakeholders). Using the latter would avoid giving incentives to higher leverage. I note that recent FoFA reforms have argued that financial adviser fees should not be linked to the levered amount of assets involved, but to the equity of the client, in order to avoid adviser incentives to recommend increased leverage. There is a certain congruence here with a case for banker remuneration being related to performance of the total assets managed for all the providers of finance.

41. A third possibility, also noted by Haldane (among others) would be to change governance arrangements for banks. In particular, why shouldn't depositors have some degree of voting rights. And certainly, holders of contingent capital or "bail-innable" debt would anticipate some control rights. With these stakeholders having little to gain from higher bank risk taking, the preferences of equity holders, given

limited liability, for higher leverage would be somewhat moderated. But whether shareholders really have any influence on entrenched bank boards and management is an issue about which I am skeptical. Also relevant in this regard is the legislated duties of Boards of Directors. In the case of life assurance companies, Directors are obliged to put the interests of policy-holders first, above the interests of shareholders. Whether some such priority of duty to bank depositors should apply for Bank boards is a question worth asking?

The Future of the Financial Sector

42. In concluding, it is worth noting that the regulatory reform agendas are likely to lead to an increased cost of financial intermediation, some shift in activity to less regulated institutions, and a smaller financial sector. Is that a bad thing? Not if much of the expansion of the financial sector has been a result of perceptions of implicit government support for some parts of it. The dramatic increase in size of the financial sector over the past decades since financial deregulation does raise the question of whether the finance sector has grown too big. This is a question which has been posed by directors of the ECB and is starting to be addressed by academic researchers both at theoretical and empirical levels. Several recent working papers (from the BIS and IMF) have found empirical evidence suggesting that beyond a certain size, the beneficial effect of financial sector development on economic growth and development ceases to exist and turns negative. While those results are sure to be debated and challenged, the Australian financial sector is well in excess of that estimated "tipping point"

43. The financing process involves massive information asymmetries, opaqueness, end-users who are not generally well informed, and complex products. It is my personal view that much of the activity, be it in "intermediation" or "trading", is essentially redistributive rent-seeking rather than socially value adding activities. Of course, market forces should limit that, but given the scale of market imperfections, and with a "new sucker born every minute" the invisible hand doesn't quite work as well as it might.

44. And to conclude it is perhaps worth giving a quote which I stumbled across the other day from a 1984 article by the Nobel Laureate James Tobin. *...we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity.* I wonder what he would have thought about how the financial sector has changed since his death in 2002?