The Australian Banking Sector Post-GFC

Introductory Remarks to Senate Economics Committee

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In our submission to the Committee, the Australian Centre for Financial Studies (ACFS) argued that a wide ranging review of Australia's financial sector was now warranted. There are several reasons, which are related to the subject of this Inquiry.

An important one is that there is a virtual tsunami of regulatory change washing over the financial sector, with both domestic and international origins. Much of that is a piecemeal approach to problems identified in the GFC, but a critical question is whether those changes are just papering over the cracks in a structure that is ultimately unstable. While the Australian financial sector weathered the GFC well, it was not without quite massive government and regulatory assistance. More importantly we should be thinking about designing the desirable financial sector of the future. An "if it ain't broke, don't fix it" mentality needs to be replaced by asking whether "it may not be broke, but could it be better" and "how do we ensure that it won't break in the future".

In that regard there is already a deal of international discussion, and some resulting action, about whether a more "root and branch" restructuring of financial sectors is required. The recent British proposals for "retail banking ring fencing" are a good example of this. There are two important considerations here. First, what is the underlying vision of how financial markets operate and the appropriate form for regulation? Second, can we design the structure of the financial sector to operate more efficiently and robustly, or do we simply take as given the existing structure which historical evolution, reflecting the interplay of market and regulatory forces, has endowed us with? Some might see the Schumpeterian competitive "forces of creative destruction", involving ongoing evolution and adaptation to external shocks and innovation, as a process which society cannot improve upon. However, the applicability of this notion to the financial sector where exits of failed firms can create massive disruption and dislocation and thus lead to government involvement is, I believe, questionable.

My view is that the inherent dynamic within the financial sector is towards increasing complexity, which if accepted as the natural state of affairs, leads to increasingly complex, costly, and intrusive regulations – and which prompt innovative responses by financial institutions to escape the regulatory straightjacket. But there is a possible alternative. Legislation could design a simpler structure where some financial institutions face well defined limitations on their allowable activities and consequently require simpler regulation. In such an alternative scenario, the other financial institutions could be less fettered – provided that if or when they fail, their exit is graceful with minimal disruption to the financial sector and no cost to taxpayers.

The British ring-fencing and the US Dodd-Frank Act (and associated Volker rule) will change the structure of those financial systems. Proposals for requiring use of Central Clearing Counterparties for OTC derivatives are also relevant in that regard. But whether such changes are good, and whether they have any lessons for an optimal redesign of Australia's financial system are questions which require substantial study.

In thinking about why legislative interference in the design of the financial sector might be appropriate, I would note that banks have several "rights" and "benefits" conferred upon them by legislation or political processes. They can operate with limited liability, as can other businesses, although that was not always so for banks. They can attract funds in the form of deposits without need for a prospectus. They can be, and are, highly levered. They benefit from, although some would deny it, an implicit guarantee from government.

Many of the recent regulatory changes are aimed at reducing those latter two benefits (of high leverage and implied guarantees) and the adverse consequences for competition, financial sector stability, and risks to taxpayers.

But it is questionable whether implied guarantees can ever be eschewed in the case of core savings of unsophisticated households who have no chance of understanding the risks associated with the opaque institutions with which they are dealing. Perhaps it is better, as the British are hoping to do by ring fencing, to limit such risks and guarantees by limiting the activities of certain designated, privileged, institutions.

That does not, necessarily, mean limiting the range of activities which a financial conglomerate (which includes a ring-fenced bank) can undertake through its other arms. So any claims which might be made about interference with "freedom" are somewhat specious, particularly since the "freedoms" to operate under the protection of limited liability and to accept deposits etc., are granted by legislation and law. It is already the case, for example, that some financial institutions, superannuation funds, are required to be "sole purpose" entities.

I should emphasize that I am not recommending a return to the intrusive heavy handed regulation which existed when we had separate trading and savings banks (a distinction which was only removed in January 1990). My view is that legislating to require alternative structures may enable simpler and less costly regulation of some core parts of the financial sector. But whether that is so, what set of structures is appropriate and achievable, is something which can only be assessed as part of a large scale study, such as from a "daughter of Wallis" Inquiry.

In the ACFS submission we canvassed a number of other issues from the Inquiry's terms of reference. These included: the difficult issue of assessing the degree of competition in banking; the arguments relating to different regulatory requirements for large, systemically important banks; the pricing and structure of the financial claims scheme; the impact of Basel III changes to bank capital and liquidity requirements; and bank loan pricing. I would be happy to answer question on any of these, or other relevant matters, and thank you for the opportunity to appear here.