

**Submission to the Senate Inquiry into  
Competition within the Australian Banking Sector**

**by**

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I apologise to the Committee for my casual writing style. No disrespect is intended: neither to the Committee nor to anyone. As a former academic I find it difficult to write simple, plain English.

In economics textbooks and in common usage “competition” is taken to be beneficial for consumers because, it is argued, it produces efficiency and hence lower prices or better services or both. In the real world this does not always happen. Competition may result in poorer services and inferior products for consumers and other negative outcomes for the community at large. For example, competition to lend for housing has resulted, in recent years, in marked deterioration in lending standards and in the standards of associated sectors, such as the real estate valuation profession. Banks and others were lending for housing with little regard to the borrowers' abilities to repay or even service the debts and valuers were writing valuations with consideration only of the lenders' criteria (rather than of market value). The result was the GFC which, for some reason, is often spoken of as having passed but which, it seems to me, is still very much with us.

In Australia we have been congratulating ourselves on having avoided the GFC but I fear we may be being premature in reaching that conclusion. Hence an inquiry by the Senate Economics Committee into our banking sector is timely and welcome, if perhaps of shorter duration and not as wide ranging as I feel is required.

My primary concern is with the overall performance of the banking sector so it falls within the Inquiry's Terms of Reference item (m) although I will say a little about some of the others.

### **(b) Fees**

If my memory serves me correctly, there was a substantial increase in the number and quantum of fees levied by the banks in about 1992. At the time at least two of the 4 major banks announced very large losses. The government allowed the fees because, I suspected, the banks were in fact broke or close to it and the government wanted to allow them to re-capitalise.

(In the week, in 1992, that the ANZ announced one of the biggest losses in Australian corporate history, it increased its CEO's salary by 25%.)

Since then fees have grown and are sometimes used to get a competitive advantage by masking the true cost of a product. They are now an important source of bank profits and, if abolished, the banks will have to make up the losses from higher interest rates. In my opinion fees that do not properly reflect the costs incurred should be abolished. It is preferable to charge the correct level of interest to borrowers rather than have others subsidise it. It is to the benefit of borrowers and the economy at large that borrowers know and pay the true cost of their funds.

### **(i) Cost of Capital**

I assume that this refers to the interest rates charged by the banks and to their level of profits. I don't consider the level of profits of the banks, including of the 4 majors, to be excessive. The returns on equity and returns on assets over the last 10 years of the “big 4” are substantially lower than, for example, those of Woolworths or Telstra. Yet, their businesses are much more risky and hence demand a higher level of return. One should therefore question the competence of bank management rather than the level of profits they have achieved.

The costs of doing business (or cost to income ratios) of “the big 4” are substantially lower than

those of the smaller banks. In the case of the “big 4” these have been falling considerably over the last decade. If this is a result of competition, as the textbooks imply, then it must be because of the competition between the majors.

Use of taxpayers' funds to help or subsidise the smaller lenders of housing finance should therefore be questioned, at least on the basis of economic efficiency, if not of fairness to taxpayers.

### **(f) Too Large to Fail**

There is considerable concern in the community that the explicit or implicit guarantees of the banks by the government will create “moral hazard” and encourage the banks to take excessive risks. In my opinion the government was right in guaranteeing bank deposits in response to the GFC. Whatever one may think about the government's stimulus measures, I believe that the necessity of the bank guarantees cannot be questioned.

For how long they should continue and to what level is another matter. As the Committee knows, the major banks are no longer relying on the guarantee for their wholesale funding. My feeling is that there is still considerable insecurity amongst retail depositors so an extension of the guarantee may well be required, at least until the GFC or, if one prefers, its ramifications play themselves out.

I doubt that the explicit or implicit government guarantee is likely to contribute significantly to the chances of a bank failing. Many non-bank companies fail and bank practices have been less than cautious, even well before the issue of “moral hazard” arose publicly.

The government's task is to structure the banking sector to prevent, as far as humanly possible, the failure of a bank. In my opinion this is a more important and pressing matter than deciding what is the best method of shaving a few basis points off the interest rates paid by mortgagors and other borrowers, important as that is to a lot of people.

### **(m) Other Matters**

If one lends money to a person for investment (to buy a productive asset) then one is relying on the income from the asset to service and repay the loan. If one lends money for consumption, say the purchase of a cricket bat or an ice-cream or a house, then one is relying on the borrower having an income from another source to repay the loan. Clearly the former is intrinsically a less risky loan.

If one borrows foreign currency then one has to repay the loan in foreign currency. If one's only income is from domestic sources then one has to rely on others to export to obtain the foreign currency. So borrowing from foreigners for consumption is most risky.

The major banks are the main source of funds for business, especially for small business. Yet the majority of their lending is for consumption, mainly housing, and two thirds of their housing loans are financed from overseas. This state of affairs is condoned, in fact encouraged, by prudential regulations and will continue to be, I understand, under Basel III.

This shows that the falseness of the textbook “axiom” that a large number of individual players acting purely in their own self interest will produce the best out come for the market at large. On the individual bank level the actions of its management is correct and it is what is expected of it: to maximise shareholders' returns. The implicit assumption is that the individual bank does not materially influence the overall performance of the economy. But when all the banks act in the same

way it does. The banks are undoubtedly aware of this, but no individual bank can afford to act on its own. If the banks were to reach an agreement on lending standards then that would be collusion and contrary to law. So there is a need for government to act to protect business and the economy. Business is the ultimate source of all employment, including government employment through its taxes and those of its employees.

Housing is a vital human need so it is not surprising that government and all political parties take a keen interest in providing housing for Australia's inhabitants. In recent decades the federal and state governments have spent a lot of money (taxpayers' money) in subsidising housing (via various means including First Home Owners Grants (FHOG) and abolition of stamp duties for first home owners). It is therefore surprising and worrying that there has not been an increase in home ownership, but rather a decrease and many young people find it impossible to own a home. All that we have seen is a huge increase in the cost of housing.

Many people have tried to explain the reasons for the increases in house prices and many reasons have been given. Most explanations revolve around notions of demand and supply, in outline: demand has out-grown supply; demand growth comes from growth in population, from government subsidies and low interest rates; supply has not grown because of lack of growth in vacant land due to government inaction; and, in addition, the cost of production of vacant land has increased due to increases in government levies. There is validity to all of these points but I don't think they fully explain what happens. So I have tried to understand what happens at the individual buyer and seller level.

In the 1990's, after the crash of 1992, there was little inflation in house prices although interest rates were very low, by historic standards, and there was growth in population. By the late 1990's prices were beginning to increase slowly. In 2000 the government introduced the FHOG of \$14000. At the time that would have paid the deposit (10%) on a new house on the outskirts of Sydney. Within a few years it was insufficient to be the deposit on the land (vacant) of such a house.

I observed that even in small towns, too far removed from large cities to suffer spill over effects, where there was ample vacant land and little demand from first home owners, there was a marked increase in house prices. So it appears that the usual explanations did not apply.

At any particular point in time, there are far more home owners looking to buy houses (whether to occupy, often to upgrade, or to rent) than there are people looking to buy their first homes. Consequently, the demand and level of prices is primarily set by home owners, those buying and those selling. Home owners are less price resistant than first home buyers because they have more capital. Moreover, it is human nature to believe that one's home is more valuable than a similar one owned by someone else. So if an owner feels that prices are rising or have risen, then he is more prepared to pay a higher price for a new house because he feels that he will get a higher price for his (or has already received it). In addition, his equity in his current house is more than sufficient to finance the new house. Sellers, being human, always ask more than their properties are worth. So if there is a feeling of inflation in the market then the sellers will increase their prices and the buyer/seller will pay more and so inflation will occur. Inflation is accelerated by the high gearing of house purchases. (For example, a \$10,000 increase in deposit will finance a \$100,000 more expensive house.) As house prices increase the banks get a false sense of security, relax their lending criteria (to compete for business) and increase the gearing that they provide. Thus further fuelling inflation.

Once there is a general perception that house prices are rising and will continue to rise, people rush

to buy thus further increasing demand and prices. Some rush in to make a profit and others do it to “catch the train before it leaves them behind”.

It seems to me that the FHOG of 2000 came at a time when house prices were already rising and it convinced more people that they would continue to do so. So the inflation genie was out of the bottle. The banks did their bit by lending to anyone who was willing to accept a loan. The valuation industry did its bit by assigning whatever values the banks required to fulfil their ever decreasing lending standards and to keep the prudential regulators happy. The banks made huge “profits”, or so they said, and their executives were showered with money. Everyone felt rich and spent accordingly and the economy boomed. The government was not going to rock the boat and the regulating authorities took moderating actions that were too timid to be effective. Many people bought houses primarily for profit rather than for shelter. Despite the recent economic turmoil many continue to do so, by buying houses that are too big for their needs and too expensive for their means.

It is clear that the banks have played a crucial role in making housing unaffordable for many. But no individual bank can be blamed. Each was simply competing for the benefit of its owners. Rather it is the sector as a whole that is responsible.

The ultimate goal of all economic activity is consumption. But one must make plans for future consumption and not just for immediate consumption. A balanced economy must have productive capacity to provide for future consumption. Hence there must be a balance between capital allocated for investment (in productive assets) and that used for consumption. In my opinion the current allocation (by the banks) of more than two thirds of capital to consumption (mainly housing) is dangerously excessive. It is even more concerning when it is realised that two thirds of that comes from overseas. So 2/3rds of our consumption is now funded by foreigners while we have had a chronic balance of payments deficit for decades. What will happen when Australia stops winning the “beauty” contest?

### **Prudential Regulation**

It is indisputable that the viability of the banking sector is of paramount importance to the well being of the nation and all its people. In view of the GFC I think it is prudent for the government to conduct a thorough examination and reassessment of the banking sector to determine our future requirements from it and to decide how to ensure it does not fail. We have seen that in many nations, including older, larger and more experienced ones, their prudential authorities have failed to prevent their banking sectors from financial collapse. I think it is unwise for us to assume that our prudential regulators are so much better or that our financial system is so different as to avoid what has happened overseas and therefore to do nothing.

I do not see any benefit for ADIs to also be insurance companies, “wealth management” companies or other businesses. I do not see any benefits to their shareholders or their customers, whether banking, insurance or fund management. The only beneficiaries are the egos of the senior management and their salaries.

Even if I am wrong, the importance of ADIs is so great that they should not be exposed to the additional risks of other businesses. ADIs should be simple, transparent operations. That makes it easier for the prudential authorities to oversee them and, importantly, for the market to assess them. The nation's financial welfare should not be hostage to the success of only the prudential regulators and three (foreign) ratings agencies. The more transparent the operations of the ADIs, the more people that will assess them and the better for the economy.

For similar reasons I feel it would be better to have one prudential regulator solely for the ADIs and another independent one for insurance companies, etc.

Unpalatable as it is, I would suggest that the prudential regulator be involved in setting and overseeing lending standards of ADIs, particularly for housing. The primary standard should be the ability to service and repay the loan, with valuations being only a secondary “backup”. Most real estate agents can attest that valuations often do not reflect the market and are susceptible to influence by the commissioner.

## **Derivatives**

There has been a lot of demand from banks to allow them to issue covered bonds. The faith in, and praise of, these instruments by those advocating them makes me think of them as “magic wands”. Having seen the effect of the many “magic wands” that the US banks introduced, I am somewhat sceptical. The impression their backers give is that they minimise risk. In reality they simply redistribute risk, so that the bond holders are exposed to less risk and the depositors, including the “mums and dads”, are exposed to more risk than they would otherwise be.

In view of the current insecurity amongst retail investors I doubt now is the time to experiment with “new” products (even if they have been used in other countries for a long time).

## **Salaries**

The salaries of bank CEOs may not be in the ambit of this Inquiry but there is so much outrage in the community that I trust that I'll be forgiven for adding my tuppence worth. For some years now, boards of large public companies have tried to allay the public's disquiet about the high level of salaries of their CEOs and senior executives. Remuneration packages have been broken up into (base) salaries and bonuses whose levels depend on meeting pre-set targets. The result: CEO pay has grown rapidly and so has the community's outrage.

The bonus targets are always financial, usually consist of Short Term Incentives (STI) and Long Term Incentives (LTI). Apparently the purpose of the STI is to provide short term motivation and of the LTI to provide long term motivation. Bonuses are paid over time (typically 3 years) to ensure that the CEOs have acted in the long term interests of their companies and that there are no short lived blips. The targets are comparisons with the performance of pre-determined peers. In each such plan that I've seen, there has been an element of deception because substantial bonuses are paid if the executive performs no worse than average. Most people expect such performance (or better) for the (base) salary.

Motivational studies have shown that money is not a positive motivator. That is, once a certain level of income is reached then more money does not motivate to perform better. Most of the major advances of mankind have been made by people who were highly intelligent and were challenged by their work (and money played no role).

It seems to me that if boards need to motivate their CEOs to perform then they have chosen badly and should remove them. If unfair dismissal laws (and others) prohibit it then the laws should be amended to exclude highly paid employees.

As for the major banks, both here and abroad, it would appear that most of their boards did not

choose their CEOs wisely since none, to my knowledge, foresaw the GFC. Here, the performance of our big 4 in attempting to justify their recent interest raises was less than stellar.

I have not studied the government's proposals on executive remuneration so I cannot comment in detail. My gut feeling is that more disclosure cannot be bad but that the 25% vote will be difficult to obtain.

I would suggest an additional clause to the effect that the remuneration of a CEO be limited to, say, 20 times that of the lowest paid full time employee. During the 1980s when Japanese companies were taking the world by storm, their average multiple was 17. In USA it was many times that and their companies were going backwards.

If implemented, my suggestion would undoubtedly produce a lot of wailing, gnashing of teeth, predictions that the sky would fall and worse. Nevertheless, if it succeeded, after a few years of operation, in dampening expectations of stellar salaries by senior executives, then I expect that the inevitable unintended negative effects will be swamped by the benefits. A cap on salaries in ADIs might well be a good start.