

**86 HOLDSWORTH STREET
WOOLLAHRA NSW 2025
25 November 2010**

**The Department of the Senate
Parliament House
Canberra ACT 2600**

Dear Sir

GOVERNMENT GUARANTEE OF THE BANKING SYSTEM

I set out below some thoughts regarding government support for the banking system and opportunity for policy action.

The safety of retail deposits in the banking system is fundamental to the economy and it is an appropriate role of government to underwrite this key intermediation role performed by the banking system between savers and borrowers.

This government support, explicit since the GFC, has given the major banks in particular, a key competitive advantage. It has allowed them to dominate the financial services sector, increasing their domination beyond this core role.

Is it sound public policy for the taxpayer to provide such support and permit them to expand beyond this core role into ever wider areas of activity and increasingly outside Australia? Should the government support this continued expansion when access to offshore wholesale funding markets, critical to the banks current funding, has been exposed as a major system vulnerability?

The review date for the explicit retail deposit guarantee is November 2011. This provides an opportunity to restore some balance to the system.

It seems to me that government support should be limited to the core intermediation role that banks perform in the economy. It should not be utilized to permit the major banks to extend their domination at the expense of other participants and the consumer?

The GFC exacerbated the trend of increased concentration of the Australian banking system and financial services more broadly. The takeovers of BankWest and St George were permitted in the extraordinary atmosphere of the GFC. The Government guarantee explicitly given for the first time, leaves no doubt in the mind of bank management and depositors that government support will remain permanently available.

Following the deregulation of the banking system, the banks have increasingly broadened their activities in the financial system away from this core intermediation role. The banks have used this government support to aggressively expand and compete in many of the following areas:

- Speculative (“Principal”) trading/investment – subject of the Volker

- proposal in the USA
- Funds/Wealth Management
- Financial Advice/Planning
- Stock Broking
- Investment product development
- Private Equity
- Underwriting
- Offshore banking operations
- Offshore Investments
- Life Insurance
- General Insurance

They have used the benefits of the government guarantee to acquire businesses and compete against others without it. These ancillary financial services were previously provided by specialised institutions that did not take retail deposits and could be allowed to fail.

What is the opportunity as we approach the review date for the retail deposit guarantee in November 2011? Considerations will include some form of self funded deposit insurance/guarantee scheme. Post the GFC we are in a different world. This review presents an opportunity to address the current imbalance between the actual need for government support and that currently provided.

Limiting the guarantee to the core intermediation function is at a different level to the issues of Capital and Liquidity currently being addressed by the Basel Committee on Bank Supervision. The current strength of our banking system provides the opportunity to narrow the level of government support and significantly limit the current moral hazard.

Not addressed, further distortion of the financial landscape is likely. Those with the guarantee will increase their domination of broader financial services sector – well outside the area where the guarantee is necessary. This domination has started to see calls for other forms of inefficient and less desirable non market controls/regulation on interest rates and the like.

It would be preferable to limit government support to institutions which provided core intermediation services only. The alternative is to insist on the separation of the pure intermediation function into a separate and segregated banking subsidiary which had the benefit of the guarantee (whether explicit, implicit OR by a deposit insurance scheme). This banking subsidiary should not be permitted to undertake any speculative or non core intermediation functions and should be fully quarantined from any other activities permitted by the banking group. This is a narrower concept than that I believe comprises the Banking Group under the Macquarie non-operating holding company.

This seems an opportunity to take sensible action to halt this undesirable trend and head off more undesirable outcomes. The banks are in excellent shape and the review date for the retail deposit guarantee provides an appropriate trigger for a strong policy response.

For your consideration as appropriate.

Kind Regards
Yours Sincerely

Geoffrey Hodgkinson
BEc(Syd) FCPA FAICD