

## **Australia Needs a Comprehensive Financial System Inquiry**

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Ever since the severe market failures in Australia's securitisation industry were identified in 2008, we have been concerned that these problems were partly attributable to more fundamental flaws in Australia's ageing regulatory architecture and the inadequately defined role of government in dealing with such crises.

The shortcomings within our governance system have been exacerbated by the relentless changes that have occurred in financial markets since the essential elements of our regulatory infrastructure were put in place decades ago. One example of this is the 1996 Wallis Inquiry's rejection of the use of deposit guarantees, which have been critical tools for maintaining stability during the current crisis. Following the lessons that have been learned during the global financial crisis, and the 12 years that have elapsed since the last such exercise, we believe that a broad-based inquiry into the integrity of Australia's financial system is now warranted.

While the \$40-50 billion per annum residential mortgage-backed securities (RMBS) market supplied the funding for up to a quarter of all Australian home loans it did so with little-to-no government oversight or support. The growing depth and liquidity of this market enabled the emergence of significant alternatives to the major banks in the form of empowered regional banks and building societies, and smaller non-bank lenders. When this market disappeared due to an entirely external shock—the US sub-prime crisis—many of these institutions were brought to the brink of collapse and forced to withdraw from lending altogether or merge with competitors. At least one smaller Australian bank would likely have failed had it not done so.

The biggest beneficiaries of this chaos have been the four major banks that receive the most favourable regulatory treatment under the existing system, which was not conceived with many of their smaller rivals, and the new markets that they rely on, in mind. Yet the forced 'reintermediation' of the major banks into the residential lending arena has had other unintended effects, with the pressure placed on their balance-sheets in turn compelling them to ration credit to the higher risk small business, corporate, and commercial property sectors.

We are still in the midst of understanding the consequences of the global financial crisis and the actions of governments (including Australia's) in response to it. Importantly, it remains uncertain to what degree Australia's comparatively successful performance in navigating through this catastrophe has been due to our own regulatory foresight or just good luck. We would do well not to discount the possibility that a 'good roll of the dice' left us without more significant system failures such as those seen in the UK. In future crises, we may not be so lucky.

This cataclysm was imposed upon us by the increasingly interconnected and globalised nature of capital markets. These interdependencies also extend to government policy. The

catalytic event that was US sub-prime borrowers defaulting on home loans that barely exist in Australia pushed the world into a deep recession and has subjected Australia to a marked slowdown accompanied by significant job losses. As a nation with a large foreign debt that has continually increased its liabilities via enormous current account deficits, Australia's vulnerability to foreign shocks is in many respects greater than most of our peers.

It is, therefore, critical that policymakers take this opportunity to thoroughly review the existing system and evaluate whether changes need to be made to it. Although the dependence of financial institutions on national governments has been reinforced by the crisis, global capital market integration is not going away. We have little comprehension of the consequences of the raft of new policies that are being implemented by other nation states. What effect will the whole or partial nationalisation of banking systems around the world have on Australian institutions and, more specifically, our ability to source foreign credit? Will the UK Government's recent decision to guarantee securitised home loans along the lines of the Canadian model place Australian lenders at a competitive disadvantage in a global capital raising context? What are the long-term ramifications for Australia of the new regulatory regime being instituted by the Obama Administration?

These linkages cannot be ignored and should be examined under the auspices of a first-principles system review process similar to that undertaken by Campbell in 1981 and Wallis in 1996 with the benefit of new insights.

If there is any doubt as to why Australia needs to urgently revisit the foundations of its financial architecture, and evaluate what renovations might be required in light of the current crisis, consider that the following questions remain unanswered:

- Will the Australian government seek to establish a regulated clearinghouse for the hundreds of billions of dollars worth of over-the-counter derivatives contracts that are otherwise beyond the remit of policymakers;
- Should banks be subject to a 'systemic capital charge' to account for the risks associated with the correlation between bank balance sheets given that current capital charges reflect the idiosyncratic risks to the institution itself, and may not be collectively large enough to compensate for system-wide catastrophes;
- Will the deposit and/or wholesale funding guarantees be phased out and, if so, what new policy guidelines will explain how they might be redeployed when capital markets seize up again in a manner that minimises disruptions to other sectors (such as the knock-on effects seen in non-guaranteed sectors like the commercial paper debt markets, the mortgage trust industry, and the CMBS and RMBS markets). If they are not phased out, how will the terms and price of these subsidies be determined and what regulatory constraints will be applied to prevent the emergence of moral hazard risks. More

broadly, what parts of the credit markets will or will not be guaranteed in the future;

- Should APRA impose ‘automatic stabilisers’ that require banks to accumulate capital in good times to serve as insurance against the bad;
- Has this crisis reminded us that Australia’s major banks fulfill a unique community role akin to public-private utilities that warrant special controls to guard against system stability risks? Here it is odd that we’ve been repeatedly told that our banks were lucky not to have had substantial overseas exposures and yet they now appear to be rushing offshore to obtain exactly these;
- What new regulations will govern executive compensation at banks and securities firms to mitigate the ‘call-option’ like payoffs that have tainted these arrangements in the past and how might these be tied to prudential supervision (eg, higher risk-weightings for firms that have short-termist structures and/or claw-backs on remuneration for executive negligence and adventurism);
- Can real competition emerge while consumers face significant costs in switching between financial institutions? Does a government-regulated securitisation market provide an opportunity to consolidate mortgage account standards and more effectively enable switching;
- Where government guarantees are deemed necessary is it preferable for them to be offered against complex institutions like banks, or against tangible portfolios of assets the characteristics of which can be relatively easily assessed by independent experts;
- Should citizens who feel unsure and unqualified to shop wisely in our financial markets be able to access basic savings, payments and wealth management products that have been vouchsafed by governments as being safe and professionally managed (eg, why can’t Australians invest with the Future Fund)? In this regard, is there a role for a publicly-owned entity, akin to KiwiBank in New Zealand, to offer essential services in Australia’s finance sector that leverage off unique government infrastructure (eg, Australia Post, the tax system, and the government bond market);
- How will policymakers remedy the regulatory asymmetry between institutions like the larger banks that rely on short-term retail deposits as their primary source of funding (in combination with wholesale debt) and many of their competitors that depend on the longer-term and (ironically) ‘matched’ funding furnished by the RMBS market? Whereas banks benefit from a range of government subsidies (implicit and explicit deposit guarantees, term funding guarantees, RBA liquidity support, etc), which glue

together the enormous asset-liability mismatch created by funding 30 year loans with at-call deposits, Australia's regulatory architecture does nothing to maintain the liquidity and integrity of its securitisation market. This contrasts with the Canadian system, which has remained open and functional throughout the crisis (and displayed lower default rates than Australia);

- Should the RBA 'lean against' incipient asset-price booms fuelled by increases in system-wide leverage;
- Should Australia's global foreign debt position be the subject of any general policy oversight and, if so, what measures should be pursued to ensure that these exposures are prudent;
- What position should Australia take in relation to the restructuring of the global financial architecture? This will begin in earnest once it is clear that the worst of the crisis has passed. We need to be prepared for the negotiations that lead to new organisations, treaties and the global regulation of finance. For example, European states appear to favour a global super-regulatory body. The US has not embraced this approach. What should Australia's position be? And what will Australia's views be on other key issues, such as the uniform global reform and regulation of rating agencies and hedge funds; and finally
- What does Australia want to achieve from trade negotiations in terms of the opening of foreign financial systems to overseas firms? Australia should be able to expand its supply of global financial services because of its location, political stability, resilient financial infrastructure, skilled workforce and competitive institutions. What steps will be taken to optimise Australia's ability to both import and export financial services?

These are but a small subset of the many profound policy questions facing Australia and its financial system. Our relatively strong economic position offers an opportunity to review, investigate, consolidate and reform (if necessary). We need to take active steps to avoid the temptation of complacency and accept the lure of challenge. Only a full-scale independent commission on the financial system—roots and branch—can put us on a path to continued stability and insulation against the unpredictable. Following in the footsteps of Campbell in 1981 and Wallis in 1996, such a review's time has now come.