Competition and the public guarantee of banking systems

Submission to Senate Economics References Committee inquiry into competition in the Australian banking sector

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Competition and the public guarantee of banking systems

The terms of reference of this inquiry refer, among other things to 'competition' and 'innovation'. However, as noted in term (f), there is a general perception that large banks are 'too big to fail', and this distorts the process. In practice, given the interconnectedness of the sector, many other institutions are likely to be protected from failure, and therefore from the sharpest incentives provided by competition. Hence, the objective of a competitive and innovative banking sector is problematic unless prudential policy is radically redesigned.

The purpose of this submission is to argue that

(i) in the presence of an implicit or explicit public guarantee against failure, competitive incentives will be distorted and the outcome of competition may be to undermine financial stability

(ii) an implicit and undefined guarantee, such as that which prevailed in Australia prior to the global financial crisis, is likely to cause more problems of this kind than an explicit, and explicitly limited guarantee, provided that the limitation of the guarantee is politically credible

(iii) in the presence of guarantees, the primary motive for financial innovation is the desire to take on additional risk while adhering in formal terms to the requirements of the guarantee. Hence, financial innovation should be presumed undesirable until proven beneficial

(iv) Serious potential problems remain in the Australian financial system. A comprehensive inquiry into the system, revisiting the conclusions of the Wallis committee is highly desirable.

The public guarantee

Until October 2008, retail depositors in and wholesale lenders to Australian banks were protected by a quasi-guarantee. Governments sought to assure both the general public and wholesale lenders that our major banks are completely safe, while simultaneously denying that their liabilities were guaranteed. This system failed when confronted with the global financial crisis, and was replaced by an explicit guarantee. The guarantee was in two parts:

* A retail guarantee provided free of charge to depositors with accounts under $1 million

* A wholesale guarantee for borrowings over $1 million, for which banks paid a fee to the government

The guarantee represented an abandonment of the long-standing position of Australian banks and regulators that no explicit guarantee of deposits was desirable or necessary. This position was expressed in strong terms when the Wallis Committee sought to examine the possibility of deposit insurance and remained strongly held until the possibility of a catastrophic failure of the banking system was clearly imminent.

The guarantee was presented as temporary. It was not accompanied by plans for the development of a new regulatory system appropriate to institutions fully guaranteed by government, and therefore ultimately, by the Australian public.

In reality, however, it seems unlikely that the guarantee of retail deposits can be withdrawn or substantially reduced. The problem, obviously, is that even in relatively stable times, a substantial reduction in the guarantee level would lead depositors to withdraw money in excess of the guarantee and seek to place it elsewhere.

Moreover, although the government has withdrawn its wholesale guarantee for liabilities over $1 million, the precedent of 2008 remains. Although large lenders might be exposed to some risk in the event of an isolated failure by a single financial institution, they can reasonably be expect to be protected against a failure occurring at a time when other institutions are at risk – by far the most likely case.

The system of implicit quasi-guarantees was proved worthless by the financial crisis and cannot be restored. The only replacements for an explicit, unlimited guarantee are guarantees that are explicitly limited (or completely removed).

As argued above, there is little value in limiting the amount guaranteed, at least as far as retail deposits are concerned. So, the only effective way to limit guarantees is to fully guarantee some investments and institutions while excluding others.

Effects of a guarantee

As long as deposits are guaranteed, depositors have no interest in determining the safety or otherwise of the financial institutions to which they entrust their funds. Wholesale lenders are in a similar position, at least as it relates to bank exposure to systemic risk, since they can anticipate a government rescue similar to that in 2008. Although shareholders and bank senior management face some risk associated with a bank failure, they can only be wiped out if the bank is allowed to fail, and this seems unlikely. The evidence from the United States is that, while the economy as a whole remains deeply depressed, profitability and management incomes in the financial sector have rebounded to levels close to those of the pre-crisis boom.

The result is a distortion of competitive incentives. Banks face an incentive to take on additional risk, and in particular to increase their exposure to systemic risk, that is, the risk of losses in the event of a general financial breakdown.

These incentives may manifest themselves in ways that appear beneficial to customers, including higher rates of interest on deposits and more generous access to credit. In particular, under these incentives, banks may be expected to increase lending to cyclically sensitive activities such as housing.

Measures to increase the competitiveness of the sector, while maintaining these incentives, may simply make matters worse. The more intense the competition the more difficult it is for any individual institution to take a 'responsible' low-risk stance at the expense of short-term profitability.

This is particularly true if large-scale takeovers and mergers are permitted. In this context, it is worth recalling the observations of former Reserve Bank Governor Ian MacFarlane are particularly. MacFarlane told an ASIC Summer School in March 2009 that the four pillars policy against bank mergers, long derided by supporters of financial deregulation, prevented the banks from adopting risky strategies in the pursuit of competitive advantage.

Financial regulation and guarantees

A sound system of financial regulation must begin with a clearly defined set of institutions (such as banks and insurance companies) offering a set of well-tested financial instruments with explicit public guarantees for clients, and a public guarantee of solvency, with nationalisation as a last-resort option. Financial innovations must be treated with caution, and allowed only on the basis of a clear understanding of their effects on systemic risk.

In this context, it is crucial to maintain sharp boundaries between publicly guaranteed institutions and unprotected financial institutions such as hedge funds, finance companies, stockbroking firms and mutual funds. Institutions in the latter category must not be allowed to present a threat of systemic failure that might precipitate a public sector rescue, whether direct (as in the recent crisis) or indirect (as in the 1998 bailout of Long Term Capital Management). A number of measures are required to ensure this.

First, ownership links between protected and unprotected financial institutions must be absolutely prohibited, to avoid the risk that failure of an unregulated subsidiary will necessitate a rescue of the parent, or that an unregulated parent could seek to expose a bank subsidiary to excessive risk. Second, banks should not market unregulated financial products such as share investments and hedge funds.

Third, the provision of bank credit to unregulated financial enterprises should be limited to levels that ensure that even large-scale failure in this sector cannot threaten the solvency of the regulated system.

In the resulting system of ‘narrow banking’, the financial sector would become, in effect, an infrastructure service, like electricity or telecommunications. While the provision of financial services might be undertaken by either public or private enterprises, governments would accept a clear responsibility for the stability of the financial infrastructure.

The role of public and co-operative financial institutions

One possible risk of a move to ‘narrow banking’ is that the range of options available to depositors seeking a publicly-guaranteed investment option would be limited. This would be the case if, for example, the major banks decided they could operate successfully without access to a deposit guarantee.

In this context, it makes sense to consider policy action to promote access to safe and convenient basic banking. To ensure that guaranteed low-risk banking services are universally available, government should consider the establishment of a publicly-owned savings bank similar to the New Zealand Kiwibank.

The role of co-operative financial institutions such as credit unions would also be expanded under the proposed model. Movement in this direction by the Commonwealth government should be commended. However, it is unlikely to be of much value in the absence of comprehensive prudential reform.

The case for a new inquiry

The last major inquiry into the financial system was that of the Wallis Committee in 1996. As Committee member Ian Harper has noted, the global financial crisis exposed the inadequacy of the efficient financial markets hypothesis, which formed the theoretical basis for the Committee's approach. At a policy level, while the Committee rejected deposit guarantees and deposit insurance, these instruments proved to be an essential part of the response to the global financial crisis.

In these circumstances, six of Australia's leading economists (of whom I was one) issued a call in 2009 for a new inquiry into the financial system (appended). The present period of relative calm in Australia's financial markets would be a good time to hold such an inquiry.