

# **Submission to The Senate Economic References Committee Enquiry into Competition within the Australian Banking Sector**

by

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## **The GFC's Effect on Australia's Financial Sector**

The Global Financial Crisis (GFC) of 2008 changed the financial services sector for most countries, in ways they mostly understand, and for Australia, in ways we mostly seem to have not yet understood.

The GFC left the balance sheets of most developed nations in tatters.<sup>1</sup>

Asian nations emerged largely unscathed in part because they had learned and acted upon the lessons of the Asian crisis of the late 1990s.

Australia emerged largely unscathed in part due to luck, in part due to Asia's continued growth, and in part because our banking sector had not developed the appetite for risk of its US and European counterparts.

The US and Europe are now engaged in major financial regulatory reforms. Australia has undertaken only the most minor of reforms, on the basis that our performance through this crisis means the next one will hold no fears for us. However, blind faith is rarely the best basis for financial regulation.

The GFC led to three major changes in the Australian financial system.

The first major change was a dramatic concentration within our financial sector as Big Four banks acquired St George, BankWest, Aussie Home Loans, Wizard Home Loans, Challenger Financial and RAMS as well as numerous smaller wealth management and other financial services firms. This concentration was increased, in a time of financial uncertainty, by the movement of many customers away from credit unions and regional banks to one of the Big Four banks. The result is that the Big Four banks now account for over 92% of the market with the biggest, the Commonwealth Bank, accounting alone for

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<sup>1</sup> The G-7 nations now owe US\$30 trillion in debt: IMF, *World Economic Outlook* (Oct, 2010).

almost 30% of the market.<sup>2</sup> Compare this to the US where the biggest four banks account for only 34% of the market, and the top ten together represent only 44.8%.<sup>3</sup>

The second major change was that the implicit government guarantee of depositor funds in banks became explicit in late 2008 with the implementation of the Financial Claims Scheme to insure deposits in banks and the Guarantee Scheme to guarantee bank wholesale liabilities. Parts of these schemes were phased out in 2010 and the balance are due to be phased out in 2011.

The third major change is that the implicit government guarantee of depositor funds, when it revives with the phasing out of the explicit guarantees, will be far more certain and relied upon, than ever before in Australia's history. This is because in the aftermath of the devastation caused by the collapse of Lehman Brothers (which wasn't even a commercial bank), virtually no one believes any government is going to allow systemically significant financial institutions to fail. This effect is strengthened in Australia by the dramatic concentration in our financial sector caused by the GFC.

Moral hazard in financial regulation is when financial actors don't have to bear the full consequences of their actions (or suspect they won't have to). It is one of the major preoccupations of all financial regulators, as it makes systems less stable and crises more likely. The net effect of the GFC on our financial sector has been to increase the level of moral hazard in it substantially.

The US sub-prime crisis that led to the GFC was a direct product of the moral hazard engendered when the institutions that made housing loans never intended to hold those loans on their books for more than a few weeks. Thus credit quality became irrelevant to loan originators.

Australian governments have traditionally managed the moral hazard that results from the government standing ready to bail out any failing financial institution by never committing to do so. The Reserve Bank of Australia, as lender of last resort, has always stood ready to inject large amounts of liquidity into a struggling bank, so as to stave off runs on the bank, but only to the extent the bank could give good collateral for the loans. Once a bank could no longer offer good collateral (in other words once its total borrowings approached the value of its assets) further injections of liquidity into it was a political decision that was always deliberately left ambiguous.

For the reasons given above, the GFC has largely removed that ambiguity. Moral hazard is therefore now much more strongly present in our system.

Research indicates financial institutions tend to take on far more risk when they believe governments will step in should they fail.<sup>4</sup> In addition, the Australian government is

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<sup>2</sup> S Ellis, IBISWorld Industry Report K7325, 'National and Regional Commercial Banks in Australia', October 2010.

<sup>3</sup> 'Biggest banks lose market share, slightly', *Los Angeles Times*, October 17, 2010, available at [http://latimesblogs.latimes.com/money\\_co/2010/10/banks-market-share-deposits-foreclosures-tbtf.html](http://latimesblogs.latimes.com/money_co/2010/10/banks-market-share-deposits-foreclosures-tbtf.html)

<sup>4</sup> Milneux, A, 'The Governance of "Too Big to Fail" Banks' (September 21, 2010), available at SSRN: <http://ssrn.com/abstract=1680252>; and Poole W, 'Moral Hazard: The Long-Lasting Legacy of Bailouts', *Financial Analysts Journal*, November/December 2009, Vol. 65, No. 6, 17.

currently actively seeking to implement reforms to promote competition among banks as a response to the sharply increased concentration in the sector. Research indicates appetite for risk is strongly correlated with increased competition between banks.<sup>5</sup> Accordingly, our government's response to the changes the GFC wrought in our financial sector may well increase the sector's future appetite for risk.

So it may well be that one of the features of our system that served to insulate us against many of the contagion effects of the GFC (our banks relative lack of appetite for risk) will be much diminished by the next time there is a global crisis. And the bad news is that a further global crisis is likely in the medium term.

The EU and IMF response to the debt problems of Greece and Ireland in 2010 were typical of how the IMF has traditionally responded to developing country debt crises: bailout loans coupled to severe fiscal austerity. This remedy rarely works in the medium to long term. Severe austerity typically so restricts the debtors capacity to grow their economies and service their debts that default becomes inevitable. I am the author of the seminal work on developing country debt and there are strong parallels between the position in Southern Europe today and the position in which developing countries frequently find themselves. Furthermore, while this coming crisis may well not be as severe as the GFC, most OECD nations now lack the fiscal capacity to introduce such substantial stimulus measures again, and so it is unlikely to be as well handled globally.

Such looming crises are one of the reasons the US and Europe are so vigorously debating how to deal with their 'too-big-to-fail' problems. Yet in Australia this phrase is rarely heard. We have a bigger too-big-to-fail problem any other OECD nation, and we deal with the problem by pretending it doesn't exist.

To make matters worse for the stability of our financial system, at the G20 meeting in November 2010 the Australian government argued for, and won, an exemption for our banks from the new requirement to hold a higher proportion of bank capital as highly liquid assets such as government bonds.

For political reasons, the debate in Australia has largely focussed upon home loan interest rates, and yet the real areas in which competition is low and super-profits earned by the banks are in payment systems, including credit card transaction processing. These areas, in which fees are by international standards very high, are the principal reason that the underlying profits of the Big Four banks represent almost 3% of Australia's GDP: in other words, of every \$100 of economic activity in Australia almost \$3 ends up as underlying profit of a major bank.<sup>6</sup>

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<sup>5</sup> M Agoraki, M Delis & C Staikouras, 'Reform, competition and risk-taking in banking', presented at the 2008 European Financial Management Association Annual Meeting, 25 June 2008, available at <http://www.aislab.aueb.gr/acccfin/Downloads/seminars/ATT00037.pdf>; and W Bolt & A Tieman, 'Banking Competition, Risk and Regulation', (2004) 106(4) *Scand J of Economics*, 783.

<sup>6</sup> J Fear, R Denniss, D Richardson, *Money and Power: The Case for Better Regulation in Banking*, August 2010, at 6, available at [http://www.catalyst.org.au/catalyst/images/pdf/catalyst\\_event\\_flyers/tai\\_banking\\_regulation.pdf](http://www.catalyst.org.au/catalyst/images/pdf/catalyst_event_flyers/tai_banking_regulation.pdf)

The G20 considered in 2010 the imposition of a levy on financial institutions. While in international banking regulation, a level playing field is always the policy goal, this issue was too difficult to resolve given the strong commitment of the French, German, US and UK governments to a levy, and the strong opposition to it of the Australian, Canadian and Russian governments. So the G20 resolved that this was a matter for individual governments.

Australia's opposition to imposing a levy on our financial institutions, and to requiring them to lift their liquid capital requirements, is allegedly because they navigated the recent GFC so well. But one rarely wins the next war by preparing to fight the last one. The only valid reasons not to impose a levy on our banks, and require higher liquid capital ratios, would be that, going forward, these measures would not make our financial institutions safer or otherwise not serve Australia: two propositions that are highly improbable.

That the Australian government is arguing against the bank levy in international fora is testament to the political influence of the big four banks, rather than good policy.

The only rational response to these fundamental changes in our financial system is a strengthened regulatory regime.

### **Enhanced Regulatory Measures**

There are a range of regulatory measures that could serve to promote the stability and resilience of Australia's financial sector: (i) a financial institutions levy, (ii) a financial activities tax, (iii) a financial transactions tax; (iv) a rule preventing commercial banks from engaging in proprietary trading; and (v) other responses to Australia's too-big-to-fail problem. Each will be explored.

#### ***A Financial Institutions Levy***

The IMF recommends that governments impose a levy on the assets of their financial institutions. In its words, "Expecting taxpayers to support the [financial] sector during bad times while allowing owners, managers and/or creditors of financial institutions to enjoy the gains of good times misallocates resources and undermines long-term growth."<sup>7</sup>

Most developed nations (including France, Germany, the UK and US) are doing so, for four reasons: (i) to recoup some of the costs of bailing out their financial sectors in the wake of the GFC, (ii) to accumulate funds so that future bailouts are funded by the financial services industry rather than taxpayers, (iii) to shrink the size of financial sectors that are seen to have grown too large in part due to being under-taxed, and (iv) to discourage risky behaviour within those sectors.

Yet Australia has decided not to do so, notwithstanding that reasons (ii) to (iv) apply here and that the only reason Australia did not have to bail out its banks may have been the government's deposit and liability guarantee schemes of October, 2008.

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<sup>7</sup> IMF Staff, *A Fair and Substantial Contribution by the Financial Sector, Final Report for the G20*, June 2010, at 9, available at <http://www.imf.org/external/np/g20/pdf/062710b.pdf>.

After the GFC, for reasons explored later, it is almost inconceivable the Australian government will allow a failing major bank to collapse. Yet if Australian taxpayers are, in effect, standing behind our banks, and the banks' credibility in the marketplace is thereby strengthened and their cost of funds correspondingly reduced (for which there is considerable evidence), there is a very strong equity argument for a levy on bank assets. The issue is not that a levy is an unfair penalty given how well the banks navigated the shoals of the GFC. The issue is that failing to impose a levy is unfair on the Australian revenue, which is not being compensated for absorbing a massive risk, and unfair on all other industry sectors that don't enjoy the benefits of an implicit government guarantee of their liabilities.

### *A Financial Activities Tax*

The IMF has also called for a Financial Activities Tax on financial institutions' profits and staff remuneration, with the delightful acronym, FAT. The G20 has resolved that individual nations should feel free to impose a levy, but said nothing substantial about a FAT. The IMF suggests a FAT be set so as to raise from 0.2% to 0.4% of a nation's GDP annually.<sup>8</sup> The IMF sees a levy and a FAT working together; the former repaying the 2008 bail-outs and building up funds for future bail-outs and the latter acting as a tax on profits, primarily designed to shrink the financial sector and blunt its appetite for risk.

Financial markets have grown disproportionately to the real economy. For example, Australia's financial market turnover is 81 times greater than real economic turnover (GDP) today, and before the GFC the ratio was 98 times.<sup>9</sup>

Hedge funds pay very little tax and investment banks pay less than their fair share. This matters on equity grounds. It matters more on efficiency grounds and is one of the reasons the IMF believes the size of the financial sector needs to be reduced in many countries. If there is a sector of the economy that pays too little tax, resources should logically flow into it, which is what we have seen over the past 30 years. For example, the assets under the management of hedge funds in Australia increased by an extraordinary 30 times from 2000 to 2008.<sup>10</sup> These savings, that could be being put to productive uses, are in large measure going into purely speculative, socially useless trading.<sup>11</sup>

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<sup>8</sup> Id at 14.

<sup>9</sup> Compiled from data from the Australian Financial Markets Association, *The Australian Financial Markets Report* (2010) <<http://www.afma.com.au/data/afmr.html> and ABS, "Key National Accounts Aggregates: Annual 2011", at <[http://www.ausstats.abs.gov.au/ausstats/meisubs.nsf/0/8F24C4E60A3CE152CA2576DA0012BEA2/\\$File/52060\\_dec%202009.pdf](http://www.ausstats.abs.gov.au/ausstats/meisubs.nsf/0/8F24C4E60A3CE152CA2576DA0012BEA2/$File/52060_dec%202009.pdf)>.

<sup>10</sup> Australian Trade Commission, *Alternative Investments in Australia* (September 2010), <<http://www.austrade.gov.au>>.

<sup>11</sup> In the words of Lord Turner, Chair of the UK's Financial Services Authority, the City of London has grown "beyond a reasonable size" [and] some of it is socially useless activity" Angela Monaghan, "Tax 'Socially Useless' Banks, Says FSA Chief Lord Turner" *Telegraph* (UK), 27 August 2009.

### *A Financial Transactions Tax*

A financial transaction tax would be a tiny impost, of between 0.005 per cent and 0.05 per cent, levied on all wholesale capital market transactions globally.

A FTT is designed to reweight our markets in favour of longer-term investment and away from rewarding short-term speculation. This is not a radical idea. In 2009, the Aspen Institute issued a paper entitled "Overcoming Short-termism" signed by a spectrum of leaders of corporate America, including Warren Buffett, Pete Peterson, former Chairmen of IBM and Goldman Sachs, and others.<sup>12</sup> We need to slow our markets down to human time and encourage them to trade on the value of the asset being traded, not merely its market performance in the hours or minutes preceding the trade. Our hypothesis is that the best way to do this may well be a FTT.

Revenue estimates for a FTT vary because of the dissuasive effect of the tax on transactions, but reliable revenue estimates for a 0.05 per cent tax are usually in the US\$500 billion p.a. range, ie many orders of magnitude greater than a bank levy or FAT.<sup>13</sup>

These funds could do so much good: restore damaged national balance sheets, build reserves against future financial crises; finance the adaptations required to combat climate change; halve global hunger and poverty; provide universal primary education, and still have money left over to improve drinking water and health care in poor countries. And all this from a tax that would be essentially pain-free. For this tax would improve the operation of capital and foreign exchange markets by dissuading excessively speculative and short-term transactions. Warren Buffett and George Soros have made their fortunes in the financial markets, and each believe this tax would improve the operations of markets.<sup>14</sup>

Unlike a levy and a FAT, however, a FTT cannot be unilaterally applied by Australia, as unless it is imposed in the major global financial centres, it will result in trading activity moving offshore. So the question here is not whether Australia should impose a FTT, but whether Australia should argue for its global imposition in the G20 deliberations. At the moment Australia argues against it.

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<sup>12</sup> The Aspen Institute, "A Call to Action" (Media Release, September 9 2009) <<http://www.aspeninstitute.org/policy-work/business-society/corporate-programs/cvsg/public-policy>>.

<sup>13</sup> Lawson estimates revenues of US\$700 billion p.a. from a 0.05% tax. Max Lawson, "Financial Transaction Tax – the time is now!" on Max Lawson, *Rethinking Finance* (16 December 2009) <<http://rethinkingfinance.org/documents/financial-transaction-tax-time-now>>. See also Stephen Schulmeister, "Boom-Bust Cycles and Trading Practices in Asset Markets, the Real Economy and the Effects of a Financial Transaction Tax" (Working Paper No 364, Austrian Institute of Economic Research, March 2010) 21622. Assuming global GDP figures for 2007, a tax rate of 0.05%, and medium range dampening effects on transaction levels, Schulmeister estimates tax receipts of US\$661.1 billion.

<sup>14</sup> Center for Economic and Policy Research, *Support for A Financial Transactions Tax* (January 2010) <<http://www.cepr.net/documents/ftt-support.pdf>>.

### ***A rule prohibiting banks from engaging in proprietary trading***

The Dodd-Frank Act in the US emphasises the traditional role of banks as intermediaries between depositors and borrowers. Section 619 prohibits depository institutions and their affiliates from engaging in proprietary trading, or acquiring or retaining an interest in a hedge fund or a private equity fund or sponsoring a hedge fund or a private equity fund.

Proprietary trading is broadly defined so as to generally prohibit the buying and selling of securities as principal for the bank's trading account, while explicitly permitting trading in government securities, in connection with underwriting or market making, in risk-mitigating hedging, and on behalf of customers.<sup>15</sup>

In the post-GFC environment, for the reasons given, the Australian government in effect underwrites the solvency of each of the major banks. Accordingly, the question of whether Australia should follow the US lead and prevent commercial banks from gambling with their own funds (for that is all proprietary trading is) is now an important one for the nation.

Australia has long had the European model of universal banking, in which no distinction is drawn between the activities of commercial and investment banks. So as major a change as this is unlikely. However, the very idea could prove important if it were part of the public debate, because it could serve to highlight that Australian banks want the right to engage in proprietary trading with the higher risks this brings to the federal revenue, and have the benefits of the implicit government guarantee, all while resisting the imposition of a levy or FAT. This stance may strike many fair-minded observers as untenable.

### ***Other Responses to 'too-big-to-fail'***

Institutions that are too big to be allowed to fail (due to the adverse systemic effects of their failure) represent a serious adulteration of free market principles. Institutions that are too-big-to-fail are also too big to bail out without doing very serious, long-lasting damage to the national balance sheet. Furthermore the implicit government guarantee that these institutions' size necessarily calls forth is highly likely to encourage excessive risk taking due to the moral hazard it engenders.

A number of possible policy responses have been advanced to this problem. Some are the levies and taxes considered above, as the levies and taxes seek to reduce the probability of institutional failure by making banks less prone to the excesses of high leverage and low equity capital.<sup>16</sup> Another option is 'living wills' in which banks stipulate how they might most effectively be broken up and sold in the event of failure without having to call on the public purse.<sup>17</sup> A third, admittedly radical and politically

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<sup>15</sup> The Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, H.R. 4173, s 619.

<sup>16</sup> Avgouleas, E, 'The Reform of the too big too fail bank', in 'Regulatory Responses to the Financial Crisis', 10th biennial conference, Deutsche Bundesbank, 28-31 July 2010; and Avgouleas, E, 'A new regulatory model for the institutional separation of casino from utility banking', in the 7th Euroframe Conference on Economic Policy Issues in the European Union, University of Amsterdam, 11 June 2010.

<sup>17</sup> Ibid.

unlikely option, involves mandating the breaking up of banks into smaller institutions as the US did in the 1930s.

Again, as with a rule against proprietary trading, these issues need to be part of the national debate, as they will serve, at the least, to put into context other more moderate responses to this major problem such as levies and a FAT.

## **Conclusion**

The GFC has increased the concentration of the financial services sector in Australia considerably, and increased the level of moral hazard in the sector dramatically.

These developments make the sector far less stable and less resilient to external shocks than before the GFC.

The only rational response to these substantial changes is enhanced regulation of the sector.

This submission has considered the range of regulatory measures that are likely to be effective in combatting our current too-big-to-fail and moral hazard problems. All of these measures should be part of the national debate on this issue, as the more radical measures serve to place the less intrusive ones into their proper context.

Some measures, such as a financial transactions tax, require the co-operation of the world's major financial centres. Other measures, such as mandatory breaking up of banks into smaller entities, or a rule against proprietary trading, would be major and unprecedented in the Australian context.

The very minimum Australia should do at this time is to impose a levy on the assets of financial institutions. This would have three salutary effects: (i) to raise funds so that any bailouts required of financial services institutions in the future could be funded by the sector, (ii) to even up the playing field so that financial services pays something towards the implicit government guarantee it enjoys to the exclusion of all other industries, and (iii) moderate the size of the sector and diminish its appetite for risk.

In imposing such a levy we would only be following the lead of nations such as France, Germany, the UK and the US.

In an ideal world, Australia would do more and impose a tax on financial activities, ie. a tax on profits above a defined level and upon the remuneration of directors and executive officers. The IMF is right when it recommends both a levy and a FAT. Australia's financial sector needs a FAT to prevent the sector growing too large relative to the real economy (as the IMF admits has happened in the UK and US) and to dampen the sector's appetite for risk.

In a full and informed national debate on the stability of our banking system, in which options such as breaking up the larger banks or a prohibition on proprietary trading were on the table, a levy and a FAT would be seen as moderate, minimum measures to ensure the stability of a sector that every Australian now underwrites whether they wish to or not.