Chapter 10

Need for a root and branch inquiry

10.1 In May 2011, after concluding a comprehensive inquiry into competition in the Australian banking sector, this committee recommended that an independent inquiry into Australia's banking and broader financial system be established.[1] Since this recommendation was made, there does not appear to have been any developments in the sector that would refute the need for a broad ranging independent inquiry. On the contrary, since this committee completed the Competition Inquiry, other sector-wide risks and long-term funding issues have been further highlighted.

10.2 This chapter briefly outlines some of the reasons as to why an inquiry into the financial system is warranted. It also identifies key issues that would be particularly worthy of examination.

A banking sector in transition

10.3 The responses to the global financial crisis will fundamentally change the global banking system. Internationally-agreed regulatory changes intended to address key vulnerabilities exposed by the crisis have been finalised and work to implement them is now underway. At the same time, the Australian banking sector has been dealing with a number of other changes, including foreign legislation with extraterritorial effects as well as various domestic reforms. Professor Kevin Davis from the Australian Centre for Financial Studies described the cumulative effect as a 'virtual tsunami of regulatory change', much of which 'is a piecemeal response to problems identified in the GFC'. The professor indicated that this result strengthens the case for an independent inquiry:

> … a critical question is whether those changes are just papering over the cracks in a structure that is ultimately unstable.[2]

10.4 The head of Treasury's Markets Group considers that the Australian banking system is in a period of transition and will not return to how it functioned pre-crisis:

> I think that sometimes a lot of people seem to ignore the fact that we are in this transitional period and they are looking back pre GFC. In my view, we are not going to return to a pre GFC model for a financial system—primarily in other countries. When I say that, I do not mean our regulatory structure, which has proved quite resilient but I mean in terms of potential risks that banks may take in terms of their lending practices, the seeking of

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1 Senate Economics References Committee, *Competition within the Australian banking sector*, May 2011, paragraph 3.91 [recommendation 1].

2 Professor Kevin Davis, Australian Centre for Financial Studies, *Committee Hansard*, 8 August 2012, p. 35.

> credit by consumers. I think we are seeing that in the number of consumers who are much more reluctant to leverage off their own credit.[3]

10.5 Although they recognised that the banking sector is in a period of transition, some witnesses questioned where the sector will end up:

> I would like to know where we are going. If I am going to go somewhere I would like to have an idea of what that destination might be. I would not want to leave it to whatever gods of the banking sector there might be to see where we end up before we decide what to do about it … I think there is a real opportunity for us. Because we are not in crisis, because we are in a good place, because the banking sector across all institutions is really sound, that is in fact a really good reason for us to hold an inquiry and to make some determinations about where that destination is. I certainly would reject one of those arguments and say that we have got a great opportunity to influence the course of where our banking sector goes and influence the outcomes for consumers in this.[4]

10.6 An ING Direct executive remarked 'transition is never going to stop … [w]hether it is regulatory or simply the dynamics of the global landscape or whether it is the domestic and the consumer landscape':

> There is a time at some point to determine that there is a need to review the landscape and see in general how the Australian public is being treated and whether they are getting a fair go or not.[5]

10.7 Other witnesses added that the government should consider its role in shaping the result of the transition, noting that it has performed this role in the past:

> The extent to which we should simply let evolutionary forces take their sway is that you cannot stop evolution, but governments certainly can influence it. One only has to look at the Australian financial sector to say that governments have influenced the development of the Australian financial sector over the course of the last 20 or 30 years, partly through tax changes, through superannuation, partly through other regulations. I think we need to be aware that financial institutions operate under a range of special privileges which governments concede to them or provide them. It is appropriate for governments to ask the question: are those privileges, those rights and those constraints they operate under the right ones in terms of the way in which the system is going to evolve?[6]

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3 Mr Jim Murphy, Executive Director, Markets Group, Treasury, *Committee Hansard*, 8 August 2012, p. 2.

4 Mr Mark Degotardi, Head of Public Affairs, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 12.

5 Mr Bart Hellemans, Chief Risk Officer, ING Bank (Australia), *Committee Hansard*, 10 August 2012, pp. 33–34.

6 Professor Kevin Davis, *Committee Hansard*, 8 August 2012, p. 37.

Over fifteen years since the previous inquiry

10.8 The last major comprehensive inquiry into the Australian financial system was the Financial System Inquiry chaired by Mr Stan Wallis (the Wallis Inquiry) which reported in 1997. The inquiry was asked to provide:

> … a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.[7]

10.9 The inquiry fundamentally changed the regulation of the financial system in a number of important ways, particularly as it led to the creation of APRA. However, the nature of the banking system has changed significantly since the Wallis Inquiry. Obviously an important development was the global financial crisis and its flow-on effects, such as its impact on debt markets, funding costs and competition. Substantial internationally-driven and domestic regulatory changes have also taken place since the Wallis Inquiry, as well as other developments that are easier to overlook such as changes to technology and consumer behaviour. ING Direct observed:

> The challenge also is that, in addition to the regulation changing, not only has the world changed but also the way that consumers operate and think has changed. Consumers have more access to information. The challenge is that finance for most people is very important, but often it is a low-interest category, so financial education also becomes very important, and I think we need to invest more in making sure that people are financially literate. The challenge on our side is that, in many cases, our products sometimes become complex. One response to that is to say, 'Okay, you've got to give customers more documentation.' So you end up with a very big document that, frankly, most customers do not read. So the challenge for us is to make simpler products that the customers can understand.[8]

10.10 Following the global financial crisis, there have been a number of parliamentary inquiries into banking issues and a number of policy announcements and proposals by the government. The most recent is the consultation initiated by Treasury in September 2012 regarding APRA's crisis management powers. While these inquiries and policies may result in important improvements to the sector, they necessarily focus on specific groups of issues rather than the financial system as a whole. In other countries, debates have taken place regarding the desired structure and regulation of their banking systems in response to the global financial crisis. In the US, debate about its financial sector was widespread; an example of the formal consideration being the *Dodd-Frank Wall Street Reform and Consumer Protection*

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7 Financial System Inquiry, *Final Report*, March 1997, p. 5.

8 Mr Bart Hellemans, ING Bank (Australia), *Committee Hansard*, 10 August 2012, p. 33.

Act. In the UK, the Independent Commission on Banking was established in 2010 and reported in 2011. The Commission, chaired by Sir John Vickers, was asked to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition. It made a number of recommendations that led to the release of a white paper in June 2012. A key recommendation from the Vickers Report being pursued by the UK government is the ring-fencing of banks so that retail activities such as deposit-taking are separate from international wholesale and investment banking operations.

10.11 While the effects of the global financial crisis were clearly more acute in the US and the UK, complacency in Australia would be unwise. Professor Davis argued that 'we should be thinking about designing the desirable financial sector of the future':

> In my view, 'if it ain't broke don't fix it' mentality needs to be replaced by asking the questions of while it may not be broke, could it be better and how do we ensure that it will not break in the future.[9]

Competition

10.12 Given the focus of this committee's previous inquiry into banking issues, it should not be surprising that one of the key issues identified by the committee for consideration by an independent inquiry is the state of competition. Competition in the banking sector is a means to encourage increased efficiency, support the performance of the broader economy and enhance the welfare of Australians. Consumers benefit from greater choice in products, more innovation and lower prices. Increased competition in the sector has previously benefited consumers—the growth of non-ADI lenders in the 1990s and early 2000s challenged the major banks' lending rates and the expansion of foreign banks introduced new products such as online savings accounts with higher interest rates.

10.13 As discussed in chapter 2, market concentration in the financial sector has increased in a number of product markets. The major banks have increased their share of many banking activities due to the diminished role of foreign banks and the funding challenges facing non-ADI lenders due to the state of the securitisation market. The smaller banks also do not appear able to gain market share in the post-crisis sector:

> One would have thought that if competition was working, and working better than it was a few years ago, then the smaller banks, the nonbanks, the credit unions and the building societies would have started to take market share from those major four. It is clear from our submission, which has been based on research, that the interest rates that are being offered by the smaller lenders, the credit unions and the non-bank lenders are noticeably lower than those of the major four, but they just do not have access to sufficient funding to be able to have a critical mass in the market—as they did, certainly in the non-bank sector, pre-GFC. They needed to have only

9 Professor Kevin Davis, *Committee Hansard*, 8 August 2012, p. 35.

> about a 13 to 15 per cent share of the market to have the big four looking over their shoulders to see what they were doing. Now the big four do not need to worry about what the smaller lenders are doing, because they have 80 per cent of the market.[10]

10.14 Some witnesses questioned perceptions of competition in the sector. A representative of Abacus stated:

> We think there are real questions around competition and whether there is enough effective competition in a market. It strikes me as odd that the Bank of Melbourne would put out a press release saying how it is going to be taking it up to the big four. That seems kind of ironic to me. There are questions about whether consumers are well enough informed and what the industry, our regulators and the government can do to ensure that we get better informed consumers so that they can make a choice. But we also have to provide them with that choice in banking as well.[11]

10.15 More intense competition is presently observable in some markets, such as for retail deposits. However, this may have a long-term impact on smaller banks that have traditionally been more reliant on deposits.

Regulatory structures and distortions currently in place

10.16 Related to competition are questions about the major banks being too big to fail and the benefits that they gain from this (the possible benefits for their funding costs were noted in chapter 4). As also identified earlier in this report, certain tax distortions impact foreign banks and may affect their ability to compete with the major established Australian banks.

10.17 Some witnesses questioned the desired role, size and operation of the financial sector, and whether the current regulation of the sector is meeting its desired objectives. Professor Davis argued:

> There are two important considerations here. First, what is the underlying vision of how financial markets operate and the appropriate form for regulation? Second, can we design the structure of the financial sector to operate more efficiently and robustly or do we simply take as given the existing structure which historical evolution reflecting the interplay of market and regulatory forces has endowed us with? … My view is that there is an inherent dynamic within the financial sector towards increasing complexity, which, if accepted as a natural state of affairs, leads to increasingly complex, costly and intrusive regulations and which prompt

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10 Mr Phil Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 8 August 2012, p. 30.

11 Mr Mark Degotardi, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 11. The Bank of Melbourne was acquired by Westpac in 1997. In 2004 the separate brand name was discontinued, however, in 2011 Westpac rebranded its Victorian St George branches (acquired by Westpac in 2008), naming them Bank of Melbourne.

> innovative responses by financial institutions aimed at escaping the regulatory straightjacket. But I think there is a possible alternative. Legislation could design a simpler structure where some financial institutions face well-defined limitations on their allowable activities and consequently require simpler regulation. In such an alternative scenario, the other financial institutions could be less fettered provided that if or when they fail their exit is graceful with minimal disruption to the financial sector and at no cost to taxpayers.[12]

10.18 Another issue is the special privileges granted to the sector by the government and whether they strike the appropriate balance. Professor Davis argued:

> Any inquiry would have to look at the balance of the benefits of having a licence to operate in particular parts of the financial sector against the constraints that are imposed, and what is the appropriate balance of those. It would also have to look at what that balance of privileges and constraints does to the overall efficiency of the financial sector.[13]

Funding mix and stability

10.19 The funding mix utilised and the cost of funds banks face has changed significantly following the global financial crisis. As a number of sections of this report have discussed, the sector is facing greater challenges in securing sufficient amounts of reasonably priced funds, either because of market developments or regulatory changes. Given that funding issues are interrelated with both competition and financial stability, the implications of these changes for the sector and the consideration of any risks associated with these funding models is clearly important.

10.20 As part of this, the interaction of the superannuation system with the banking sector could warrant examination. A large portion of Australia's savings are in superannuation where they are largely invested in equities. This pool of savings will grow further as the superannuation guarantee is gradually lifted to 12 per cent. However, Australia's banks are unable to secure sufficient funds domestically to support their lending activities, and need to turn to volatile international wholesale debt markets. An independent inquiry could examine this disconnect as well as proposals that could address this outcome in a way that is mutually beneficial for both the superannuation and banking sectors.

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12 Professor Kevin Davis, *Committee Hansard*, 8 August 2012, p. 35.

13 Professor Kevin Davis, *Committee Hansard*, 8 August 2012, p. 37.

Broad support

10.21 The establishment of a root and branch inquiry into the financial system has broad support. One of the major banks, NAB, indicated its support at a public hearing:

> … we would be conceptually supportive of a full inquiry. We would like to see the terms of reference being quite broad and covering all the issues that we think need to be covered.[14]

10.22 Abacus, the industry body for credit unions, building societies and mutual ADIs had the creation of a well-resourced independent inquiry as its main recommendation to the committee:

> It has been 15 years, as you know, since the last one and the world is a pretty different place to 1997, particularly in the banking sector. We have had 15 years of tumultuous change that includes the global financial crisis, the subject of this inquiry, and the subsequent massive economic and regulatory fallout.[15]

10.23 The MFAA was also supportive, although it emphasised the need to act quickly.[16] Professor Ian Harper, a member of the Wallis Inquiry panel has also recently publicly called for a new inquiry.[17] It would also appear that Treasury is supportive (or at least has been recently). In its incoming government brief following the 2010 election, it advised the government that:

> While there is considerable work being done in a number of areas, both domestically and internationally, to improve existing arrangements, there is a clear need for a comprehensive review of the financial sector regulatory framework … Such a review could draw together outcomes of the work currently being undertaken both here and internationally, and consider broader, more systemic issues, including the lessons from the financial crisis and the balance between the dual objectives of stability and safety, on the one hand, and competition and efficiency on the other.[18]

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14 Mr Bruce Munro, Group Chief Risk Officer, National Australia Bank, *Committee Hansard*, 10 August 2012, p. 72.

15 Mr Mark Degotardi, Abacus-Australian Mutuals, *Committee Hansard*, 9 August 2012, p. 11.

16 Mr Phil Naylor, Mortgage and Finance Association of Australia, *Committee Hansard*, 8 August 2012, p. 34.

17 Peter Martin, 'Call for rethink of RBA's role', *Sydney Morning Herald*, 6 August 2012, www.smh.com.au/business/call-for-rethink-of-rbas-role-20120805-23nuo.html (accessed 21 September 2012).

18 Treasury, *2010 Treasury Incoming Government Brief: Labor*, 'Overview', archive.treasury.gov.au/documents/1875/PDF/01_Overview.pdf (accessed 21 September 2012), p. 5 (emphasis omitted).

Committee view

10.24 The committee considers that an independent root and branch inquiry into the financial system is required. While the onset and ramifications of the global financial crisis provided an argument for such an inquiry to be delayed, this argument is now less compelling. The nature of the future regulatory environment is becoming clearer. International regulatory changes have been agreed to and steps to implement them domestically have commenced. It is recognised that Australia's financial system is in transition, but to some extent it will always be in transition. There is now an opportunity to examine the state of the banking sector following the global financial crisis and to consider whether it is delivering what Australians want from it. Similar questions have been asked in other countries and have led to significant policy changes. While Australia avoided the worst of the crisis, this should not be allowed to result in complacency about the structure and performance of our financial system.

10.25 There are many issues that a comprehensive inquiry could review. The emphasis on financial sector stability has served Australia well, but has the crisis stifled competition and innovation? A highly competitive but unstable banking system is obviously undesirable—the benefits of competition would quickly vanish if the system could not withstand a crisis. A system that is only concerned with stability and does not adequately facilitate competition, however, would ultimately be detrimental to consumers in the long-term, as they may have to tolerate fewer choices of products, a lack of innovation and higher prices. While Australia's post-global financial crisis banking system scores well for stability, and there are competitive forces within the sector, there remains concern about the overall state of competition. Whether these concerns are being adequately considered—and what can be done to improve competition—remain important questions despite recent parliamentary inquiries and government policies regarding banking competition. A comprehensive inquiry could examine whether there are means to encourage greater competition without affecting stability.

10.26 Further, such an inquiry could also examine the regulatory arrangements imposed on the sector and consider whether the current system is appropriate. The global financial crisis has demonstrated that the major banks have a special role in the economy as they are not only too important to fail, but are also too important to stop or contract their lending activities. Whether the current regulatory structure acknowledges this appropriately should be debated. Additionally, a stocktake of the current collection of regulations could be undertaken to review whether they are achieving their objectives, and to assess their overall costs and benefits for the sector and for taxpayers.

10.27 Related to both stability and competition there are legitimate questions about the funding models being used by banks. Australian banks are significantly exposed to volatile offshore funding markets. While steps were taken by the government during the crisis to allow them to access funds, and changes to funding mixes have been made since the crisis, the ability of banks to secure sufficient quantities of stable funds in the future is an important issue. At present, demand for credit is subdued and

households are saving more. The increased competition among banks for stable funds, such as deposits, is currently manageable for market participants and affected borrowers, but this may not be true in the future. It is not clear whether sufficient consideration of this new funding model has been undertaken. The role that Australia's growing superannuation savings could play in the financial system should also be considered.

10.28 Finally, the committee believes that the transition to the next stage in the development of the Australian financial sector needs to be guided by a clearly articulated vision of what the sector should look like and how it should function rather than being the accidental product of piecemeal regulatory responses. A full inquiry into the future shape of the financial sector will help articulate that vision. This future inquiry should give due regard and scrutiny to the evidence received by this Senate inquiry.

Recommendation 10.1

10.29 That an independent and well-resourced root and branch inquiry into the Australian financial system be established.

Senator David Bushby
Chair