

30 November 2010

Dear Members of the Senate Economics Committee

This submission is to the Senate Economics Committee Enquiry into competition within the Australian banking sector. The Terms of Reference for this Enquiry appear to refer to mortgage loans and the interest rates charged by banks and non-bank lenders on these, so this response is largely focused on these aspects of bank operation. The Terms of Reference sub topics also refers to banks being "too big to fail", to regulations and to legislative change, so it is also assumed that suggestions on modifying the Australian banking system can also be made.

### **Introduction**

The way in which the terms of reference have been worded indicates an assumption that more "competition" between lending institutions is desirable, and beneficial to Australia. It is my strong view that this is incorrect, and that the current practice of the banks loaning vast sums of credit into existence against Australian residential housing is highly undesirable. I will argue that the focus on increased competition in the provision of credit as a means of furthering Australia's interests is a red herring.

### **Setting the scene**

This response will begin by considering that three of Australia's "big four" commercial banks derive approximately 60% of their loan books from residential mortgages. In aggregate, this represents a vast sum of credit that has been loaned into existence in order to allow people to buy houses. It appears to be accepted without question in Australia that housing should be extremely valuable, particularly in urban areas. Many reasons (population growth for instance) have been given as to why house prices should be so high. However, the primary cause of high Australian house prices is the willing provision of vast amounts of credit by the commercial banks. It would be prudent to begin any investigation of housing bank loans by asking whether this situation is a desirable state of affairs.

Given that all of Australia's property would still be owned by someone even in the absence of bank credit for housing, a strong argument can be made that Australia's housing has gradually been hijacked by the banks into instruments for their own massive profits over the past few decades. This is an extraordinary situation for a generic asset that is so prevalent and so essential for the welfare and productivity of every Australian citizen. Although we all need accommodation, the only parties who benefit from high housing prices are the banks, since this enables them to increase the interest charged over and above the repayment of the original loan principal, particularly through the long duration of multi-decade housing and investment loans, and through the compounding effect as heavily indebted house buyers see interest working against their principal repayments.

### **Is competition a red herring?**

The attention given to increasing "competition" between the banks often appears to be associated with a poor understanding of the actual lending process. Many observers seem to believe that the supply of bank credit is limited by the amount of bank deposits, and thus finite - but this is not the case. Bank credit is created out of nothing as a double accounting entry - and is thus only limited by the preparedness of borrowers to borrow credit, and by the ability of the banks to borrow capital in order to meet the prudential liquidity requirements of their loans. Australia's significant and increasing trade deficit over the past three decades has ensured the potential availability of large sums of Australian capital held by overseas banking institutions for securing Australian mortgage loans, which has provided an easy mechanism for the continual expansion of Australian mortgage credit.

Rather than focusing on increasing competition between the banks to increase housing "affordability", it is more relevant to ask whether it is desirable to allow the banks to turn something as essential as housing into a vehicle for their own profits and also into a vehicle for speculation by heavily leveraged individuals. This situation has resulted in extremely high Australian house prices and poses major systematic risk should there ever be a significant property downturn in Australia, or should the availability of capital loans dry up. In fact,

this happened back during the global financial crisis in 2008, when Australia's overseas creditors refused to roll over their loans and the Federal Government had to step into the breach with the capital guarantee.

### **The problem of excessive risk**

In addition, the provision of large quantities of credit to speculators also enables them to take on very high levels of personal financial risk. Should the speculator ever default on their loan, perhaps through personal or economic circumstances, this risk is then passed on to the loaning institution. This risk is accentuated by the very low capital requirements on loans - approximately \$8 or less for each \$100 of mortgage loan. For individual defaults, this level of risk would be manageable and easily contained by the Australian banks. However, if property speculators as a whole were to run into problems, then the systematic economic and financial risk to Australia becomes significant, since the capital backing mortgage loans will be insufficient to cover widespread defaults, particularly given that the capital backing those assets is often borrowed short term by the banks. If the Australian housing market were to run into serious problems, it is unlikely that overseas investors will continue to be so willing to continue to loan the capital required to back Australian mortgages.

This "relayed" risk does not take into account the risk to individuals, who, through the existence of large loans against their properties (with matching low equity), face the prospect of being wiped out financially, should they ever be forced through personal or economic circumstance to sell in a weak market.

### **The problem of credit**

The dominance of credit in the Australian community's money supply ensures that for the Australian community to have access to sufficient credit for the economy to continue to function, ever expanding sums of credit need to be loaned into existence to avoid the situation where loan principal repayments, combined with interest repayments, act to wipe out more credit than was created by the original loan. Were borrowers to significantly cut back on borrowing, the principal and interest repayments of existing loans would act to steadily drain credit out of the Australian economy. This aspect of credit alone creates a significant risk to Australia.

### **Poor returns on housing investment**

The wide availability of large loans against housing have combined with Government housing related policies to create a situation where the effective rental return on many houses is well below 5%, even assuming no maintenance, improvement costs or real estate agent fees in running a lease. Given that risk-free Commonwealth Government securities at rates near 5% are already readily available from the Reserve Bank, this is an extraordinary state of affairs. A secondary effect of high house prices is that few home owners have the capacity to invest in improvements to the house that they have bought due to the repayment requirements of their large loans, so high house prices also serve to keep the quality of the Australian housing stock low. If house prices were lower, then this would enable new home owners to have more credit available to spend on housing stock improvements - surely desirable during an era of increasing climate change threat and energy consumption concerns.

### **Diversion of productive investment**

Large housing loans also serve to prevent individuals from building up significant amounts of bank credit, which could otherwise be invested in more productive assets or infrastructure. The provision of high levels of bank credit, and the requirement to pay back mortgage interest with credit not created at the time of mortgage creation also sucks investment money away from other more productive areas of the economy, which is likely to lead to dramatically decreased levels of entrepreneurial activity in other areas more likely to be beneficial to the Australian national interest.

The provision of mortgage loans by the banks have not been delivered into a vacuum - they have been delivered into a society that has responded to these financial products by indulging in a massive house buying binge. A share of the blame also belongs to Australian Government through their taxation rule changes and through their creation of financial incentives to invest in housing. This has drawn credit away from potential investments in other potentially more productive activities, to the detriment of Australia as a whole.

## **Contract risk**

The focus on unfair terms in contracts appears to be based on the supposition that mortgaged house buyers and banks are equal partners in entering into a loan agreement, and that problems only arise when the bank inserts unfair conditions into the contract. I believe this is incorrect. Few mortgagees understand the credit mechanism, or have the time or ability to properly investigate the state of the Australian economy or housing market. By and large house buying decisions by individuals are driven by external advice, often from vested interests, and by the observed behaviour of the people around them. The banks, on the other hand, have significant amounts of organisational experience and in house data on which to draw, and have a full grasp of the mechanisms of credit creation and banking. It would be far more sensible for Government to take a much stronger role in protecting the interests of mortgagees by reforming the rules and regulations on Australian property and banking, so that individuals are not required to take on such high levels of financial risk in order to purchase property.

These observations lead to the obvious question, what changes should be made to minimise the severity of these problems?

## **Proposed solutions**

Consideration should be given to requiring Aust's banks to have 100% capital funding secured for the life of the loan, rather than assuming that they can continue to roll over capital borrowings. This would completely eliminate foreign funding risk, and also eliminate the systematic risk that widespread mortgage defaults would pose to the Australian banking system.

Banks facing solvency problems through asset value write downs or funding problems should be presented with a choice - either to continue to operate without any Government guarantee or support, or, in the event that they cannot remain solvent, they should be nationalised and shareholder equity wiped out, but with deposits guaranteed by the monetary sovereignty of the Australian Government, and mortgage assets transferred to the Australian Government.

In addition, a significant proportion of the salaries of senior banking executives earning over \$1 million per year should be placed in escrow by the Australian Government, with funds in escrow released one year after initial deposit. Should the bank become insolvent, any funds held in escrow at that time should be automatically forfeited. All components of a salary package, such as options, should be made subject to this escrow arrangement. This ensures that bank executives and shareholders have a significant interest in the ongoing solvency of their financial institutions, to the extent that they will accept significant personal losses in order to maintain the bank as a solvent concern.

In the case of nationalised banks, the management of depositor money should be treated as a service, without the managing institution having the ability to create credit. Bank employees should become public servants, and the money creation power reserved solely for the Reserve Bank.

Consideration should also be given to changes to discourage property speculation - such as the elimination of tax rules that encourage property speculation. Many of these have already been covered by the Henry Review, so I have chosen not to cover these here.

An obvious problem with these proposed remedies is that the banks do not presently have the capital to back 100% of their mortgage books. Another major issue is that the already existing high levels of housing debt implies that any attempts to change the present arrangements are likely to produce big winners and big losers in the general community. This is highly undesirable. However, it is still worthwhile to have an open discussion as to how our banking system should operate to best benefit the Australian community, and then to have a secondary discussion as to how to move towards that desired arrangement from our present situation. The sovereign power that we have over our own currency - that Government has the ability to spend money into existence - raises the possibility of proposing arrangements such as the following:

Mortgage amnesties could be proposed in which heavily leveraged individuals can choose to give up their properties in return for the elimination of 75% of their mortgage debt. In return, the Government would absorb the 75% balance of the debt, perhaps through bank nationalisation, and permit the former mortgagee to live in the property indefinitely at a rental rate fixed at some moderate percentage of average income, depending on the location of the property. The former mortgagee would be required to pay off the 25% balance of their original loan. This would not preclude affected individuals from making improvements to the property, since they could expect to receive long term benefit from the improvements, if new rental rules providing increased security of tenancy were also introduced. However, it would also observe the principle

that penalties for high risk behaviour should be allocated between all responsible parties.

### **General summary**

Money and credit are community assets, and are required for the healthy functioning of the Australian economy. It is highly undesirable that the supply of credit in particular has come under the control of private banks, which have used their credit creation power to create massive private profits through provision of excessive levels credit against a single asset class, at the expense of high levels of systematic risk to the Australian financial system, and to the detriment of the Australian community.

Competition, bank profitability, change and innovation should not be considered desirable goals for management of the Australian banking system. The fact that they are appears to derive from not understanding the true nature of the credit creation process. If we were to ask what banking system was in the best interests of the Australian community, it is highly unlikely that we would continue to argue for our current banking system.

The objective should instead be to ask how the Australian banking system can be best modified to become a stable and low risk servant of the Australian community. It should be managed in order to provide maximum community benefit. Instead, Australian banking has expanded to dominate political debate, economic life and magnify risk, both to individuals and to the Australian economy.

I am happy to clarify further, should any aspect of my submission not be clear.

Yours faithfully

Andrew Selby Smith