Response to:

Financial System Inquiry Final Report 2014

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The final report disappoints in a number of material ways.

My first view of the Interim Report was that it is a report prepared by and on behalf of bankers for banks. That criticism continues for the Final Report. It is a limited document designed to address a number of operational problems that have emerged in the banking sector over recent years.

The Inquiry was meant to be a 'root and branch review' of the banking system; a review that had a lifespan of anything from 15 to 20 years as achieved by the Campbell and Wallis Committee Reports.

The Report continues to refer to the status quo as a benchmark for analysis and recommendation. It has missed the opportunity to cut through the current system and simply reviews a few basic but nevertheless important issues.

> *Senator David Leyonhjelm put it very well in an article in the AFR on 27 February 2015:*
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> *"Murray's belief that bank bailouts should remain an option, and his faith in the effectiveness of regulation, should come as no surprise. He is a former banker, and his report was prepared by bureaucrats from agencies that regulate the banks.*

The lesson we should draw is that the financial industry shouldn't be reviewed by insiders wedded to the idea that the industry is special and needs special regulation.

It should be reviewed by outsiders who are intelligent enough to understand the industry but are not captured by it. The Productivity Commission might be a better choice."

There has been no attempt to understand and describe the state of the current architecture. The basis of the Report should have included a comprehensive study of the structure of the banking sector for instance:

- The size of a sector and the importance of banking in our economy, the trends and forecasts;
- The degree of concentration or otherwise of the sector and comparison with other countries; (Our 4 main trading banks are now in the top 5 listed ASX Companies representing over 30% of the ASX Index);
- Trends in profitability and pricing and return relative to other sectors and internationally;
- A breakdown of the main products and services within the sector and the changes and trends that are taking place with forecasts for the future;
- The extent to which the banking sector is satisfying demand not only in respect to existing products and services but product and services that might be missing, in other words what are the gaps in product and services;
- The problem facing new entrants entering the various sectors and the role played by regulation;
- What is the state of consumer satisfaction by segment;

- Australia as a net importer of capital and as a developing country likely to be so for many years, what are the forecasts for future financial needs;
- Why is the banks reputation so low? And the role of remuneration systems in influencing culture and values.

The description of the work required for the briefing finality could go on, but I believe the point has been taking clearly a scoping of a study would be an important exercise.

My view is that such an analysis would have revealed some deep issues that would have given the Inquiry a better architecture for report and enabled the identification of consistent themes and better report logic.

Some of the comments you could make about the results of such an economic study:

- The 4 banks are highly profitable as a sector and achieve high returns. David Murray has made the valid point that there are at least 50 other companies that achieve several returns. This is not the point, the fact is that the sector is far more profitable than any other sector. Within some sectors there are high performing companies for instance in retailing Woolworths achieves world class returns well in excess of the banks, while Wesfarmers does not. In media the returns are all over the place. The important issue is that in the banking sector as a whole returns are very strong. This has important implications for the capacity of the banks to cope with certain recommendations.
- My concern is the huge focus that has been placed on the need for bank capital. My view is that our competitive advantage rests on our democratic

traditions (although at the moment some might doubt that), the rule of law, our growth prospects, low foreign debt and a strong banking system, good governance (Reserve Bank, APRA, ASIC, ACCC etc). It is a competitive advantage for Australia to have one of the best banking sectors in the world and this would far outweigh any minor profit reduction and in return on equity that might result from the Murray requirement for further capital.

- My view is that this is a Claytons argument by the banks designed to avoid facing up to other and more deeper issues. The Murray Report has only made an 'in principle' recommendation in relation to bank capital so there is room for the banks to continue to wriggle enabling them to continue to focus on this issue and to in effect say the Australian banking system's ability to fund growth is questionable despite that according to the IMF we are 25th highest foreign borrowers of 27 countries.
- Our foreign funding needs to be analysed although I accept that there would be some bold assumptions made so the research may not be very valuable. The banks are being clever in arguing in that it is because of the concentration that we may not be able to meet the demand for foreign capital.
- Clearly if we had another major bank in the country, say a foreign bank, that had a different source for deposits and foreign borrowings then the capacity of the banking system to handle the future would be enhanced quite apart from the competitive advantages of having another bank hopefully against our oligopoly. My view is that the argument dominating the newspapers is fundamentally flawed, it should not be about bank capital about how do we get further banks into the market place to help fund Australia's growth and put pressure on the oligopoly.

- Another important issue is that of the current reputation of the banks. Cameron Clyne, before he retired as CEO, said that it was important for the banking system to deal with reputation issues. The former CEO of Citibank recently made the same comment in being highly critical of bank reputation and culture against the background of the Australia banks being some of the most profitable in the world. In my view bank reputation issue is only getting worse as a result of recent events, the financial planning at the Commonwealth Bank, ANZ Bank, Macquarie Bank Financial Advisors and NAB debacle, and the benchmarking debacle at ANZ. I am sure others will emerge that raise serious question marks about the conduct, ethics and values of the banks and with what amounts to unconscionable conduct.
- It is not surprising we have these issues, at the heart of banking is money. Money is a very finite commodity and it is easy to calculate profit and return in banking and the remuneration systems are geared to improve performance, ROE and as a result it is inevitable that greed enters the equation. Greed is at the heart of a lot of problems that the banks are currently facing. What can be done about it? Clearly greed cannot be dealt with by the Competition Inquiry. Harper has made it clear that he is only prepared to make recommendations that cover all sectors, not individual sectors. The reality is that there are different issues in all sectors. We have seen that in supermarkets and we are now seeing it in banking. The reality is, that as with retailing, there is unconscionable conduct that takes place in banking which is causing the reputation problems.
- Unfortunately there is a perception that when we talk about consumers, we are talking about the man in the street with a bank account, a mortgage and a

credit card. This is not the reality. We are all consumers going up to our major corporations and there is no doubt that in the small business sector, and small to medium size business, there is a lot of conduct that is taking place that is unconscionable. Unfortunately given the nature of banking and one on one relationship, it is very hard to get evidence so that everyone can talk about it. With the unlikely prospect that competition regulation will deal with this unconscionable conduct on a Sector basis we get to the bottom of this we need comprehensive research and surveys to ascertain if this assertion is correct. Until we can get the facts, it will be very difficult to do anything about the reputation issues that banks face.

- Whilst the banks complain about being over regulated, the reality is that they have to be because of the role of greed and self interest. But there is no doubt that regulation has had a twofold purpose and effort, not only to deal with poor practices but to protect the banks. The one size fits all approach by APRA doesn't suit the small banks. More importantly the regulatory barriers to entry are very high; it is a massive investment to move through the regulatory system.
- Whether APRA is prepared to make concessions to enable ease of entry I do not know. The Competition Inquiry has insisted that a new mandate for APRA that include competition. This in my view needs a lot more fleshing out if it realistically is to have any effect.
- There is no doubt that the race by the banks to improve their return of equity and to be better than their competitors is having a big impact on behavior within the banks. Senior bank executives have received extraordinary bonuses as a result of being able to increase the ROE and in turn shareholder

value. The critical factor which helps ROE is the amount of capital the banks are required to have. The less capital the easier it is to return and to improve ROE. So it is not surprising that the banks are fighting the requirement for further capital. The banks are not thinking about Australia or what is good for Australia's competitive advantage or what is good for its customers in the long term.

- ROE is the driver and it permeates down the ranks in the banks in the different segments in different ways. Whilst the banks might have codes of conduct and other similar things that work against the drive for ROE improvement unfortunately greed and self interest is more powerful.
- The comparison with the Wallis and Campbell Reports is interesting. Both Reports had solid foundations, and particularly the Wallis Committee that did a good analysis of the current situation. This enabled a report to be written that flowed from the state of the Sector rather than the Murray approach of dealing with a laundry list of issues. Having said that, there are some good Murray recommendations and the criticism is about the architecture of the report and the issues not dealt with.

  One could describe the report as an operational report driven be someone who had a deep knowledge of the sector and knew where the problems were and wanted those problems resolved so that the sector could move forward. This is a very different proposition to a <u>root and branch review</u> which goes to the very basics of banking and tries to sort out some of the deep issues that exist. The Report would not have the long term life that the other reports had. As Geoffrey Carmichael has written in the Australian Financial Review 15th December page 39, "The Report does not deal with unfair consumer outcomes and falls short on these issues head on. In many cases it falls short of providing new insights or even in-depth analysis."

- I agree with Geoffrey Carmichael that commercial incentives have been driving bad behavior and produce poor consumer outcomes but that is rarely it is not given the importance that it deserves in the Report. Nor is the deep conflict that exists between advisors selling bank products.

What will change: Very Little

Competition Inquiry

Banking Inquiry

1. The Murray Report will not have the long term impact of the Campbell or Wallis Reports or achieve as much widespread acceptance;
2. The banks will continue to improve their ROE through driving efficiency, fractionalizing costs and handing on the margin increases required as a result of issuing more capital;
3. The banks will continue to grow as a percentage of our economy and be successful with their financial services generally;
4. Consumers generally will gain little in the overall architecture of power between the banks, regulatory agencies and the consumers;

Bank Capital

1. The in principle decision by David Murray is for the regulatory agencies to finally determine what quartile of capital should ultimately be adopted in the one sense is sound because it is changing and dynamic situation. On the other hand it gives the banks room to mount a campaign the other way which they are doing;
2. Some banks will continue to fight the need for increased capital on the basis that Australia as a developing country and our net import of capital it is vital that the country can fund this growth;
3. The regulators, politicians, commentators and the analysts will succeed and force the banks into providing high capital at the 75th percentile on the basis of

what is in the national interest and the ability of the banks to cope with the small increase in cost;

4. If the public has to pay by small increase in margin the banks are highly likely to pass most of that on and in any event it is the long term interests of the Australian public to accept the small increase in margin;
5. The proposition that the capital should not be increased because it will inhibit the bank's ability to lend is an outrage given that the answer to the problem is that there is insufficient competition and we need another major bank entrant, possibly a foreign bank, that can source deposits and wholesale funds from other sources thus expanding the capacity of the Australian banking system to cope with our growth.

   This will facilitate the flow of funds into Australia because the bank's credit ranking can only be enhanced making them better funding options with better / lower interest rates. Although there may be other factors that influence this.

   The bank's argument about funding growth is self serving and selfish given the enormous support they have received from the regulatory agencies (including APRA cartel type policies) and from the Government with implicit guarantees. The banks are not acting in the national interest but being driven by remuneration systems where small changes in leverage can influence remuneration and results is appalling.

The Consumer / Bank Reputation

1. The reputation of the banks is unlikely to change and the banks will continue to be dogged by a wide range of reputation and conflict issues in the community given there has been no effective initiative to deal with this deep cultural and values problem within the banks;
2. Consumers generally will gain little in the overall architecture of power between the banks, regulatory agencies and the consumers;
3. Whilst information imbalance will improve in some sectors it will not be anywhere near significant enough to get to a reasonable level;
4. The remuneration systems written around shareholder value and ROE will continue to cause problems of greed against the interests of consumers. The conflict in the remuneration arrangements which drives greed will continue to cause culture and reputation problems for the banks and it is acknowledged that it is very difficult to eradicate;
5. There is a danger of assuming that the consumer means the man in the street with a mortgage and credit card and there has been and likely so a huge focus on assisting them with information imbalance and other interventions. However it should not be overlooked that at all levels, we are all consumers of the banks and in the area of small business, farmers and mid size business there is a lot of behavior going on unknown to the public. The nature of the behavior is "<u>unconscionable conduct</u>" which is a consumer protection concept that is emerging as one way to deal with problems in some sectors eg. Retail.
6. The Competition Inquiry, which includes consumer protection issues, is focusing on the whole of the economy and it is difficult to delve into one particular sector otherwise all sectors will want action.

One way through this is tailoring solutions to the specific problems that emerge in some parts of some sectors is the concept of a code dealing with unconscionable conduct. In Retail, a Code is likely to be agreed to by the retailers and the ACCC which will be legally binding. There is clearly a need for this in the banking sector.

Unfortunately given the one on one relationship that exists in consumer banking situations, it is extremely difficult to get the evidence or to get a hold of a pattern of behavior which indicates widespread unconscionable conduct but clearly in banking concepts of unconscionable conduct should be developed so that customers are aware of where they are being unfairly treated and the evidence in the street is that there are a remarkable number of them and they cannot all be discontented clients who have not got their way;

7. Penalties and fees beyond what is reasonable will continue to occur because the effect of driving ROE is very significant, they do not require capital and banks and other organizations will find other ways of introducing them directly or indirectly;
8. There will be little change in a monitory percentage of loans to small business and medium sized businesses and to total loans.

Competition

1. The regulatory agencies, particularly APRA, ASIC and ACCC although they may be mandated (as a result of the Murray Inquiry) to consider competition issues and ease of entry for new entrants particularly from the technology companies this will achieve very little and the banks competitive position will remain strong and the four bank oligopoly will stay in place;
2. It is unlikely that any new players will emerge because of the strength of our existing banks and the past advantages received from the regulatory agencies, particularly APRA, in terms of competition which new entrants cannot share;

   Regulation is still likely to protect the banks from new entrants and not make any concessions for the effect of past regulatory advantages that have been bestowed on the banks;
3. Recent statements by the head of APRA to micro-regulate the bank investor type loans is worrying. APRA want to put percentage caps on in effect market shares. This is anticompetitive and means with someone with say a 5% market share is restricted more than one with 10%. How do you get innovation if the smaller players cannot fight to get market share? This type of regulation encourages cartel type behavior.
4. The recent statement by the head of ASIC that it wants to challenge Fortescue attempt to limit production is interesting. He is complaining that this is cartel type behavior even though as an export activity, it is exempt.

   The argument is that by curbing production this will increase prices thus increasing export revenue, taxes, employment etc. for Australia.

   What is the difference between this and the moves made by APRA?

In the case of APRA you can argue that there is a higher cause; the stability of our financial system. The financial system is more integral to the economy than export income but you can understand why Fortescue is frustrated and why some would criticize the bank / APRA cartel type arrangement which inhibits competition.

We desperately need more competition in banking to innovate, change, introduce new products and differentiation particularly in respect to risk.

There is a very important side issue with this micro-regulation. APRA will not reveal the detail or how it is applied to the individual banks. The policy will have a huge impact on banking and the community and we are entitled to know.

There is a culture of secrecy with APRA, The Reserve Bank and Treasury that is worrying and the interchange between the agencies. This makes it very difficult to debate public policy for instance competitive effects.

Treasury continues as a extremely powerful force in the community; its tentacles are everywhere, including a huge reach by its officeries with the formulation of the Murray Report.

How do we get our balance from in terms of competition, the consumer and protection from the oligopoly and the safety of the finance systems?

General

1. The banks will continue to have huge influence, as in some respects they should, on the debate about our financial system but we should continue to be wary that they do talk their own book and often the reality is different to the articulation;
2. Australia given the strength of the financial system which is a credit to the banks and the regulatory agencies are unlikely to have a crisis of the kind that happened with the global financial crisis as the lessons have been learnt and the steps put in place to avoid that. The Murray Report has a huge focus on this systemic risk issue and this is one of the more credible parts of the report where it is delivering value but where it needs to be counterbalanced by other issues as above;
3. Recommendation 30 of the Murray Report which reads:

    > *"Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate."*

    The recommendation is weak and lacks a lot of back up. Clearly there are a lot of issues in dealing with competition that have not been identified in the Murray Report. A three year review is simply delaying dealing with the competition and regulation issues in the sector.

    It is not only the problem of dealing with the smaller players and new entrants but the "one size fits all" approach that permeates APRA that causes lots of problems. The Productivity Commission Report on regulation is excellent and highlights the issues faced by regulators. Clearly more work should have been done on what the APRA Objectives or Mandate be in this context.

Without this being established, what is it you are reviewing? The three year review simply means the issues are stalled for another three years. The same can be said about the proposed Financial Regulator Assessment Board.

Murray /Harper Report

Finance / Competition Report Comparison

The Harper Report is a better Report. It has a good overarching structure. It is a good mix of the principles and philosophy underlying competition policy, raises key issues and delivers very practical recommendations including suggested legislative drafts on competition changes. More importantly the Harper Report gives you a feeling of independence, transparency and articulation of all the issues before outlining its recommendations.

On the other hand, the Murray Report is of concern. How independent and transparent is the report? In my view the bankers, regulators and treasury have had too much influence. The Banking sector role in the community has not been addressed any near as well as systemic risk.

Also we have an oligopoly. It is a huge challenge for new entrants. The role of APRA is facilitated what has only be described as a cartel.

Unlike the Harper review, where the consumer is paramount the consumer gains little from the Murray Report. Systemic risk is without the counterbalance of competition is worrying. It is questionable whether APRA has even considered competition issues and the effect on consumer choices.

The Murray inquiry makes no progress in dealing with the poor culture and values that exist within the banking sector. Consumers gain little in the overall architecture of governance and the role of the consumer in any material way. The Harper Inquiry frequently refers to the economic gain to the community in many of its recommendations. The Murray Report does not.