Submission to the Financial System Inquiry

Alan Cullen, Managing Director, Cullen Capital Pty Ltd

Since the Campbell and Wallis Inquiries the trend towards a focus on markets in the intermediation of financial assets and liabilities rather than institutional financial intermediaries has become more developed. This has enabled risk shifting and greater liquidity in formerly illiquid assets, and the participation of new market entrants including non-banks. The contraction of the securitisation market following the GFC is a temporary halt to the inevitable greater globalisation of the market system. The context of the inquiry is that of a global system in adjustment thus presenting challenges for longer term policy making.

In the period since Wallis the Australian financial system has become more concentrated. In a small Economy like Australia this is a fact of life for most industries and for which the normal operations of the ACCC and the availability of competition from offshore (as was the case with mortgage originators) should provide adequate protection against excessive pricing. However, it may also mean substantial shifts in asset allocation as the small number of institutions take common action, often advised by a similarly small core of professional firms.

The greater concentration of banks and the advent of very large superannuation funds pose structural issues in determining whether our domestic savings are contributing in an optimal way to Australia's future growth and control over its own assets. This is especially important because Australia is too small and too remote for many foreign banks and investment institutions to invest the management resources to enter the market. For example, many foreign investment funds have mandates that exclude Australia from their geographical footprint.

The domestic institutions are able to gather large proportions of domestic savings in financial assets because of advantages associated with their treatment by Government and the structure of employee relations. The superannuation funds in particular have the bounty associated with a system of compulsory superannuation channelled in a way that reflects a structured rather than freely competitive system. This is not necessarily negative. However, if these institutions obtain advantages in the market through Government then it is appropriate that they reciprocally care about how the investment of their funds contributes to the advancement of the community from which their savers and taxpayers contribute.

At a time of economic transformation in Australia, three among the policy issues that are relevant to this inquiry are:

1. Promoting innovation
2. Strengthening the agribusiness sector
3. Supporting the resilience and growth of SMEs

In each of these cases, the standard asset allocation of superannuation funds to listed equities, fixed interest and property leaves most investment opportunities outside mandate. Similarly minimum investment sizes exceed the requirements of the Australian market. Where funds appoint alternative asset managers they often appoint overseas fund managers many of which have mandates that exclude Australia geographically or exclude the above asset classes. Recently, the industry funds as a group ceased to support the local venture capital industry.

Australia has a serious gap in innovation between the enormous investment in basic research that cannot bridge the commercialisation chasm between prototype and revenue. The worthy initiatives of the IIF Scheme and Commercialisation Australia are insufficient to give oxygen to the large number of leading edge discoveries and inventions.

Much of Australia's agriculture remains to be aggregated and corporatized and to obtain the transformational investments that will drive higher yields in a globally competitive market. The general profile of volatile income is generally unsuitable for the style of investment on the ASX. Once again foreign investment is active while domestic investment is subdued.

The SME sector comprising mostly private companies has restricted access to equity compounded by the drawback of superannuation funds from private equity and venture capital. The increased regulatory burden on banks has not been positive for SME lending especially where risks have been elevated in a transforming economy. Interest margins have been increased and debt covenants have been compressed. The ASX is not an option for many of these companies and capital formation remains hampered by the lack of transparency of the sector. Initiatives associated with smaller stock exchanges and attempts at bond issues have largely been unsuccessful.

Obviously, if Australian institutions could invest in these assets with the risk/reward characteristics desired they would do so and benefit from the virtuous circle of stimulating the wealth of their investors. The main obstacle appears to be cultural conservatism. The background of the investment managers and their advisers is predominantly in the common investment classes. Similarly Boards are comforted by the safety of being in the common mode.

There is, however, an inadequacy in the pure pursuit of a yield on invested capital without regard to the collateral effects on investor wealth through the consequences of an investment strategy. It is obviously in the interests of all members of superannuation funds that the Australian Economy and indeed the industries of membership sustain employment and growth in income.

It would not be in the national interest for Australia's savings to be exported before we have made the best use we can of them in Australia. It would be perverse to rely on foreign capital where we have excelled at funds capture but not succeeded in distribution.

These observations suggest that the key action required is leadership from the financial sector. Without abandoning the objective of maximising returns to investors Boards can look at the strategic issues around asset classes and seek the professional advice that enables successful investment in non-traditional areas that are drivers of economic growth and the wealth of their members. This can be augmented by similar leadership from Government.

From a regulatory standpoint it would appear that deregulation could be more positive for stability. The regulatory burden on banks is excessive in relation to taking risk in the SME sector thus transmitting stress away from the banks to their customers.

From the innovation perspective the financial markets, private investors and corporations have shown limited appetite for pre-revenue innovation. There seems to be little choice but for Government to fill this gap for innovations that have been achieved largely through government funded research.

Markets thrive on information and transparency. Many of the issues discussed above would benefit enormously from improvements in information that enable reduced discovery costs, better analysis and better management. This particularly applies to SMEs.

The comments in this submission have been informed by practical engagement in the markets and I would be pleased to provide the Committee with more detailed information should this be of assistance.