SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

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This brief paper is submitted in my capacity as a non-executive director of the ANZ Bank. It is consistent with the ANZ Bank submission, but expands on some points I find to be particularly relevant in assessing banking and regulatory trends over the past five years.

As well as being a non-executive director of the ANZ Bank, my other involvements with financial institutions are in an advisory capacity; I am on the international advisory boards of Goldman Sachs, the China Bank Regulatory Commission and CHAMP Private Equity.

Some Observations on Financial Regulation during and after the Global Financial Crisis

The Global Financial Crisis.

Unlike its peers in the US, UK and Europe, the Australian banking system came through its most severe stress test – the Global Financial Crisis – unscathed. No bank failed, no depositor or creditor lost money and the government did not have to spend a cent on bailouts. There are a number of deep-seated reasons that explain this extremely favourable outcome.

First, there is great public confidence in the soundness of the Australian banking system. In the 114 years that the Commonwealth has existed no bank depositor has lost money, nor has the government had to spend tax payer's money to bailout a bank, big or small.[1] There was a widespread feeling among the public that banks cannot fail or be allowed to fail and so there was a smaller tendency for a 'bank run' to occur in Australia than elsewhere. This was despite the Banking Act only providing depositor preference, but no guarantees. It was largely because of this public confidence that Australia (along with NZ) was the only OECD country not to have implemented a formal deposit insurance scheme until recently (see later).

Second, Australian banks balance sheets' hardly contained any of the 'toxic assets' that were in the balance sheets of UK, US and European banks, and which contributed so much to their downfall. This is because there were a number of incentives in Australia's case that ensured banks did not have to engage in excessive risk taking of this type. The main ones were:

- There were plentiful lending opportunities in Australia and our region, and so there was no need to acquire US-originated assets.
- Australian banks can only partially fund their lending by raising domestic deposits, and so require funds from offshore wholesale markets. Our banks' prudential position was therefore under international scrutiny, and the major banks, in particular, had to be careful not to jeopardise their AA rating by excessive risk taking.
- The intense competition for corporate control that led to multiple takeovers in the US and Europe was absent here, at least between the major four banks. The threat of being taken over often leads to banks increasing risk in order to raise their earnings and share price as a defence, or as a means of being the predator rather than the prey. It is informative that the two OECD countries whose banking systems did not need to be bailed out were Australia and Canada. These

[1] Some may point to the failures of the State Banks of Victoria and South Australia in the early 1990's, which cost their respective State governments dearly. But they are not relevant to the current discussion because these banks were not the responsibility of the Commonwealth government or the RBA. More importantly, the expenditure incurred by the State governments was not due to them being the government or the regulator, but due to them being the *owner* with an unconditional guarantee to all creditors.

For those with a pedantic disposition, it has to be conceded that there is one tiny exception to the statement that no depositor has lost. A small bank called the Primary Industry Bank failed in 1931 and depositors received 19 shillings and 9 pence in the pound (98.75%).

were the two countries where major banks were not permitted to takeover each other[2].

Third, prompt monetary and fiscal policy action avoided a recession, and this, of course, helped banks. The financial crisis in Australia was a liquidity crisis, not a solvency crisis. The Reserve Bank therefore provided ample liquidity, including by widening the range of short-term paper that it was prepared to deal in. The Federal government quickly instituted a fiscal expansion which supported economic activity in the crucial period in late 2008 and early 2009. In Australia, we avoided the self-reinforcing process whereby a banking crisis leads to a recession which leads to an increase in bad debts and further bank failure.

Fourth, Australia has a sound financial regulatory framework with clearly defined roles for the Reserve Bank, APRA and ASIC. The Reserve Bank is responsible for monetary policy, the payments system and for the provision of liquidity in the event of a crisis. APRA is responsible for the prudential regulation of ADI's, superannuation and insurance. Under APRA's guidance, Australia had been an early adopter of the Basel 1 and Basel 2 frameworks for bank supervision. Although APRA closely monitored the risk position of Australian banks, as a good supervisor should, it would be wrong to say that APRA prevented banks from a large exposure to 'toxic assets' ; the banks themselves did not seek to acquire such assets for the reasons outlined above.

Regulatory Changes affecting Banks during the Financial Crisis.

Although the start of the crisis can be dated as far back as August 2007, it really only became a full-blown crisis with the failure of Lehman Brothers in September 2008. A massive increase in risk aversion occurred with interest spreads widening and some markets effectively closing. Ireland, under pressure from the European Union on 30 September, was the first country to step in and apply a sovereign guarantee to its banks' borrowings, followed by a number of other countries. Australia responded on 23 October by announcing its intention to do the same. Legislation came into effect on 28 November and the first guaranteed borrowing occurred on 22 December (by the ANZ Bank).

This action by the Australian government was entirely appropriate; it would have been a travesty if overseas banks of dubious prudential standing had been able to borrow internationally more cheaply than sound Australian ones. Once the foreign countries had acted, the Australian government had no alternative but to match them. On the other hand, it is not correct to say that this action 'saved' the Australian banks. Certainly, the major banks would have been able to survive these difficult times if no government had issued the guarantees, but since some did, Australia had to respond and the banks had an incentive to pay for the guarantee rather than borrow without it. As it was, the Australian banks were able to operate without availing themselves of the guarantee from the fall of Lehman Brothers in September to the end of the year; this period was the epicentre of the crisis. For the major banks, at least, this was because they were being flooded with domestic deposits, and they could also borrow offshore, but on shorter term than normal. In

[2] See I. Macfarlane. "The Crisis; Causes, Consequences and Lessons for the Future. The Australian Perspective" *ASIC Summer School, 2009 report.*

the event, the guarantee did not have to be exercised, and the scheme is estimated to generate around $5.5 billion of revenue for the government by the time the last loan matures in 2015.

The second major initiative by the Australian government during this crisis was to implement a formal deposit insurance scheme - the Financial Claims Scheme (FCS). This had been in the pipeline for several years and the onset of the crisis hastened its implementation. It is hard to argue against such a scheme, although the banks had done so in the past. It brought Australia into line with international practice, and undoubtedly assisted the smaller ADI's, which had been losing deposits to the major banks. The only question is why did it take so long to implement this scheme, which had been recommended by the Council of Financial Regulators, the Financial Stability Forum and the IMF.

Regulatory Changes affecting Banks since the Financial Crisis.

The main regulatory change affecting banks since the Financial Crisis has been the progressive implementation of Basel 3. Its centerpiece is a significant increase in banks' capital ratios. As a result the ANZ's Core Equity Tier 1 ratio has risen from 5.3 per cent in September 2007 to 8.5 per cent in September 2013, and its total Tier 1 ratio has risen from 7.0 per cent to 10.4 per cent over the same period. Thus Tier 1 capital has more than doubled from $16.5 billion to $35.2 billion over this period.

In addition, Basel 3 requires banks to hold more high quality liquid assets. In Australia's case, with our relative scarcity of government and semi-government paper available to banks, a new facility at the Reserve Bank had to be created. This facility – the Committed Liquidity Facility (CLF) – allows some categories of high quality private paper to be used to access Reserve Bank liquidity. A fee applies to both drawn and undrawn facilities. This is a good example of co-operation between APRA and the Reserve Bank.

Basel 3 has continued to evolve and additional requirements are being regularly suggested and sometimes adopted. One that is of relevance to the major Australian banks is the concept of Domestic Systemically Important Financial Institutions (DSIFI's). Each of the four major banks in Australia has been declared a DSIFI, and therefore has been required to hold an additional one per cent on to its capital ratio. The concept of a DSIFI is an unhelpful one in several ways. First it applies the capital penalty to the largest and most secure banks – the ones that depositors moved to in the Financial Crisis. Second, it unfortunately entrenches the concept of "too-big-to fail", something that all countries have been trying to downplay. By designating four banks as being systemically important, it implies that the other banks and ADI's are not important. It is therefore not surprising that the public (and the ratings agencies) assume that the important ones will receive more official support in a crisis than the unimportant ones. Of course APRA has had to deny this, but it runs into the classic problem of whether it is able to make a "credible pre-commitment". It is just not credible for a government or regulator to promise not to step in and prevent large scale bank failure in a financial crisis. The public know they will, and no amount of words will dispel this expectation.

Another recent change, but one not connected with Basel 3, is the proposal to pre-fund the FCS by a tax on deposits. An argument behind this is that if a future financial failure occurs and the government has to provide funds so that depositors do not lose money, this will be a drain on the budget. So it is better to provide for it in advance. A major problem with this is that providing funds to resolve a banking failure has never been a drain on the budget, but floods, droughts, wars and other mishaps have been. So why are we pre-funding the former, but not the latter?

A related issue is where will the money raised by the tax be held. If it is to be a genuine pre-funding, the money should be held in a special fund and invested as is the case with the US Federal Deposit Insurance Corporation. If instead, it goes into consolidated revenue, it is merely a tax on deposits, something that could never be argued to be a prudential improvement for the banking system

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An Assessment of Financial Regulation

It is acknowledged worldwide that the Australian economy and the Australian banking system came through the Global financial system in remarkably good shape. It would be wrong, therefore to criticize any of the financial regulators for their performance during the financial crisis. On the other hand, we should not forget that their task was made easier by some long-standing and deep-seated characteristics of our banking system that predisposed it to stability.

One part of the structure of financial regulation in Australia that is hardly noticed, but is very important is the Council of Financial Regulators. This body, set up in the late 1990's and chaired by the Governor of the Reserve Bank, brings together the Reserve Bank, APRA, ASIC and the Australian Treasury in order to discuss and co-ordinate financial regulation in Australia. It helps explain the relatively smooth cooperation between regulators in Australia, which is a contrast to the strained relations observed in some other countries.

The major piece of regulation affecting banks at present and over the next few years is the further implementation by APRA of Basel 3. Banks in Australia accept that there is no choice but to implement this, even if much of its impetus came from the failure of banking systems much less robust than ours. Adherence to Basel 3 is a necessary requirement for being accepted internationally as a bank. However, given the extraordinarily good performance of Australian banks compared with their international peers, we question why APRA seems so keen to exceed he international norm. This overachievement is most apparent in the extremely stringent definition of capital applied in Australia. For example, Australian banks are required to deduct from capital the entire equity position they hold in publicly traded foreign financial entities. While there is room to argue about what value to assign them, it is hard to believe they are worthless. Such interpretations, and others, mean an Australian bank reporting its capital ratio has to show a number lower than it would if it reported on an internationally harmonized basis. This means that Australian banks are actually more highly capitalized than they appear to be. Another example of APRA's desire to overachieve is its decision to meet certain commitments earlier than required by the Basel 3 timetable.

We recognize that APRA has an important role to play, and that it has generally performed it well. Like prudential regulators everywhere, it has a difficult task. When it is doing its job well and the financial system is performing smoothly, it is barely

noticed; when an institution fails, it is blamed and is subject to public and political vilification. The incentive in these circumstances is to always err on the tough side. While there are some advantages to this (particularly in crisis-prone countries), there is a cost at the margin in terms of the competitiveness of Australian banks vis-a-vis their international competitors, and in terms of opportunities foregone for domestic credit expansion and economic growth.

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