31 March 2014

Mr David Murray AO

via website : http://fsi.gov.au/consultation/submissions

Dear Mr Murray

Re: Financial System Inquiry

INTRODUCTION

Regnan represents institutional investors with widely diversified portfolios held for very long terms; including both superannuation funds and fund managers; spanning commercial, public sector and not-for-profit organisations.

These investors have a common interest in the strength and stability of the economies in which their investments are made. The breadth and the duration of their portfolios means there is a high degree of alignment between their interests and the stated objectives of The Financial System Inquiry (*The Inquiry*); an efficient, effective financial system that supports Australia's growth over the longer term.

More particularly, long term investors are aligned with the national interest in desiring a financial system supportive of ***sustained*** growth, economic ***resilience***, and ***lasting*** prosperity. Regnan urges the Inquiry to explicitly prioritise these features. Short-term returns are distinct from lasting enterprise value creation; similarly the efficiency / competitiveness of individual sectors can come at the expense of broader economic performance and resilience. These are uncontroversial observations, yet, too often, the former is used as proxy for the latter.

To support lasting prosperity, the financial system needs to restrain (rather than amplify) natural behavioural biases, ubiquitous agency risks, and patent market failures, as these lead to suboptimal allocation of capital (and other factors of production) across the economy.

SIZE & INFLUENCE

Financial sector influence over other parts of the economy warrant particular vigilance in the context of domestic policy (namely, compulsory and tax-advantaged superannuation) which has the effect of inflating funds flowing into the financial sector. We note an emerging body of research concluding that beyond a threshold level, financial sector size and growth have a negative association with stability[1], economic growth and productivity[2]. A range of plausible mechanisms for this association have been proposed, including that large and / or fast-growing financial sectors divert needed resources such as financial, political and human capital from other sectors, and that the financial sector "crowds out" real investment [3].

Regnan identifies intermediation and short-termism as a further means by which the size and composition of the financial sector may hamper economic and productivity growth. These observations derive from our experience with listed markets, based on our research into S&P/ASX200 listed companies. They have also been confirmed over many years by innumerable *in camera* discussions with the directors of S&P/ASX200 companies, many of whom decry the reduced role of patient capital in the markets.

INTERMEDIATION AND SHORT-TERMISM

Businesses and their customers (at one end of the investment chain) and long term investors / beneficiaries (at the opposite end) are subject to significant intermediation by financial sector participants whose priorities and preferences can differ substantially from those of either group.

This fragmentation hinders the efficiency with which the market is able to connect seekers and providers of patient capital. Via trading practices oriented towards returns over short timescales,[4] intermediaries can express and thereby encourage neglect of initiatives which build resilience and underpin future performance, such as R&D, energy efficiency investment,

[1] Rajan, R. (2005) *Has Financial Development made the World Riskier?* NBER Working Paper 11728
[2] For instance, Cecchetti, S. & Kharroubi, E. (2012) *Reassessing the impact of finance on growth* Bank of International Settlements Working Paper No. 381
[3] Eg summarised in Bird, R. & Gray, J. (2014) *The Size of the Financial Sector and its Contribution to Economic Growth / Productivity* Submission to the Financial System Inquiry (FSI)
[4] As little as microseconds

or training programs. Numerous studies confirm that capital allocation within companies does in fact exhibit myopia of this sort.[5]

Similarly, a disproportionate role for finance (and especially trading / speculating behaviours) can result in overemphasis on narrow units of analysis such as securities *price* rather than broader measures of value. By confounding the price signals sent by long-term investors with sentiment and momentum-based signals, such intermediation can weaken the investment case for others who might otherwise invest for the long term. This feedback loop further limits the incentive for financial and industrial actors to invest in future growth and productivity[6].

Example:

Long-term investors benefit from detailed information about long-term business strategies and risks when selecting listed companies in which to invest. Yet owing to intermediaries' preference for short-term performance, companies have been slow to develop such disclosures, and in engagement with Regnan have frequently referenced (by way of explanation) the lack of demand from those financial intermediaries with whom they communicate directly. Lack of *apparent* investor interest in the long term curtails the communication of long-term value to well-matched investors; a market failure.

The lack of connectivity between ultimate providers and users of capital limits the ability of business to optimise long-term performance, and the ability of capital to efficiently allocate to long-term returns.

Further examples are available on request.

We note that intermediation and short-termism are the subject of substantial inquiry in other jurisdictions, and we advocate close attention to their recommendations[7], particularly those that redress the present skew to short-term behaviour through mechanisms which privilege long term investment behaviour over other market activity.

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[5] For instance those described in Haldane, A. (2011) *The Short Long* Speech given by the Executive Director, Financial Stability, Bank of England.

[6] Haldene, A. (2010) *Patience and Finance* Speech given by the Executive Director, Financial Stability.

[7] For instance the Kay review into UK Equity Markets and Long-term Decision Making

It is understandable that groups who profit from short-term oriented intermediation would wish to preserve the franchise. However we urge the Inquiry to recognise and address the opportunity costs associated with this activity; in the efficiency with which investors can allocate their capital to productive enterprises, and the growth and resilience of the businesses whose decisions are shaped by access to patient capital.

Notwithstanding that a level of liquidity is needed for efficient capital allocation, the influence of short-term interests within a system can hamper efficient capital allocation, hinder investment in the engines of future growth and consequently impede the development of an optimally productive economy.

We thank you for the opportunity to provide our perspectives.

Yours sincerely,

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