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Australian Financial Services Licence 362215

## Financial Services Inquiry – Second Round Submission

22 August 2014

We welcome the consultative approach that the Financial Services Inquiry panel is taking through its *Interim Report* and the public sessions.

It is our view that the *Interim Report* of the Financial Services Inquiry has not sufficiently addressed the philosophy, principles and objectives underpinning the development of a well-functioning financial system.

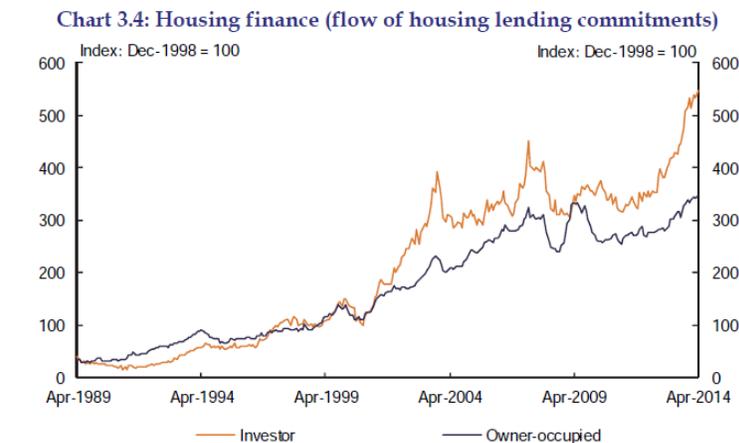
While the words ‘money’ and ‘credit’ are very familiar to most people, there is a general poor level of public understanding of what ‘money’ is, and of how ‘credit’ is created.

For us to live within a well-functioning society, we rely upon smooth social co-ordination. Fraud and deceit are sure ways to harm our social co-ordination. We rely heavily on the rule of law, government regulation, open information disclosure and private property rights to protect ourselves against such acts of harm. We also rely on a well-functioning financial system to enable smooth social co-ordination. This in turn allows for accumulation of productive capital and for the development of a workforce with specialised skills – two hallmarks of a successful economy.

There are signs, however, that this smooth social co-ordination is at serious risk. One clear sign is that the RBA cash rate is at an historical low. Another clear sign is that Australian government 10-year bonds yields are at or near historical lows. European cash rates are at historical lows (and are now negative). UK cash rates are at historical lows. US cash rates are at historical lows. Japanese cash rates are at historical lows. The Japanese, UK and USA central banks have all undertaken extensive government bond purchase programs. German bond yields are at historical lows. The European central bank is contemplating an unsterilised government bond purchase program (i.e. what is known as ‘Quantitative Easing’).

Falling interest rates destroy capital as those who have borrowed at higher fixed rates become less competitive. Alternatively, rising interest rates hinder the formation of capital, as new capital providers become less competitive against existing capital providers. It is stable interest rates that work best to promote smooth social co-ordination.

A telling chart that something is seriously amiss with the financial system is Chart 3.4: Housing finance, included on page 2-54 of the *Interim Report*. It shows in the 25-year period from 1989 to 2014 there has been a remarkable increase in the level of housing finance for both owner-occupied and investor segments.



Source: RBA.<sup>22</sup>

The composition of the leading stocks in the Australian share market also reflects a heavily distorted financial economy. The big 4 banks (Commonwealth Bank, Westpac, ANZ and National Bank) now comprise about 30.0% of the S&P ASX 200 index by market capitalisation, and about 34.0% of the S&P ASX 200 Index by net profits. Financials (including the big 4 banks) now comprise over 45% of the market capitalisation of the index.

<b>S&amp;P ASX 200 Index</b>			
<b>as at 15 August 2014</b>			
<b>Weights by Industry Sector</b>		<b>Top 10 stocks</b>	
Big 4 Banks (CBA, WBC, ANZ, NAB)	29.75%	Commonwealth Bank	9.58%
Financials (ex Big 4 Banks)	15.45%	BHP Billiton	9.11%
Materials	17.38%	Westpac	7.71%
Consumer Staples	8.00%	ANZ	6.49%
Industrials	6.76%	National Aust Bank	5.97%
Energy	6.21%	Telstra	5.05%
Telecommunications	5.42%	Wesfarmers	3.62%
Health Care	4.73%	Woolworths	3.30%
Consumer Discretionary	3.85%	CSL	2.45%
Utilities	1.70%	Woodside	2.19%
Information Technology	0.75%	<b>Top 10</b>	<b>55.47%</b>
<b>Total</b>	<b>100.00%</b>		
	<b>PE T+1</b>	<b>Share of T+1 earnings</b>	
Est Big 4 Banks PE T+1	13.3	34.0%	
Est Ex Big 4 Banks PE T+1	16.2	66.0%	
Index PE T+1	15.2	100.0%	

Source: own calculations, Yahoo Finance, Morningstar, State Street STW

Over the past 25-years Australian households have accumulated a mountain of debt. Household debt (owner-occupier housing credit; investor housing credit; and personal credit) has risen from around A\$117b to A\$1,521b (source: RBA Statistics, June 2014). In the last twelve months alone, household debt has risen by A\$85.7b.

As mentioned in the *Interim Report*, the number of households entering into retirement with a mortgage is on the rise. From 2002 to 2010, for a reference person between 65-74 years of age, the percentage of households with an owner-occupier mortgage rose from 4% to 9% (source: RBA Statistics, published 2012)

The unprecedented rise in household debt in Australia has its foundation in the ability of the banking sector to create 'money' through the process of borrowing short and lending long, commonly referred to as 'fractional reserve banking'. The *Interim Report* says this intermediation process "is an important mechanism by which funds are channeled from savers to borrowers to facilitate business investment and household purchases of major assets, and to help businesses and households manage their liquidity requirements". The *Interim Report* adds that as the banks "transform short-term liabilities into long-term assets" they must manage "the liquidity, credit and other risks associated with this activity". The *Interim Report* doesn't, however, contemplate the implications that transforming short-term liabilities (eg. bank deposits, term deposits etc.) into long-term assets (eg. home loans) leads to the creation of additional 'money' in the economy. This 'money' is backed by government fiat – that is the government commands the use of it for monetary purposes.

This increase in government fiat 'money' in the economy leads to actions by economic agents that otherwise wouldn't occur in a well-functioning society. One example of this is the excessive exposure that the Australian economy has developed to the banking sector.

While many Australian savers may not have a solid understanding of what 'money' is, and of how 'credit' is created, in the past 25-years they have been living with the consequences of rapid money supply growth. They have learned from experience, that savings held in nominal assets for too long will end up losing future purchasing power. As such, it is not that surprising that Australians have developed a strong preference for holding real assets such as property and equities. This type of phenomenon can also be seen in China, where empty apartments are often owned as a form of store of wealth.

A well-functioning financial system should allow people, over space and time, to convert income into wealth; and wealth into income. There is much discussion in the financial services industry about what may be seen as 'large' accumulated savings in retirement that won't be sufficient able to pay 'high' levels of retirement income. This is an implicit recognition that there is something wrong with the current financial system, as in a proper functioning financial system, savers should be able to convert wealth into income over space and time.

Our current financial system, where bank credit creation produces large supplies of new 'money' has done a great disservice to Australian savers, especially those that have maintained a 'conservative' approach to investment, using bank deposits, government bonds and other nominal assets such as annuities.

Under the current financial system, savers in nominal assets are the 'patsy at the poker table'. The smart players are using the new 'money' to buy real assets. This process is a significant contributor to inequities between similarly productive people in our society. Those closest to the new 'money' – including the bankers, financial services executives, and borrowers – have benefited greatly at the expense of those furthest away from the new 'money' – including the farmers, teachers, and savers.

It should be of great concern to our society that the government fiat 'money' that we currently use will lose its marketability (i.e. it will lose its acceptability for exchange). Our current government fiat 'money' has a poor record of maintaining its purchasing power over time. The purchasing power of the Australian dollar has fallen by 50.0% over the past 25-years in terms of consumer prices (source: ABS). In terms of median house prices, the purchasing power of the Australian dollar has fallen even more dramatically over the past 25-years. For example, in 1989 the median property price in Sydney was A\$170,850 (source: Abelson & Chung). It is now above A\$740,000 (source: ABS, Dec 2013). Back in 1971, when the President Nixon removed the convertibility for foreign central banks and governments of the US dollar into gold, the median house price in Sydney was A\$21,200 (source: Abelson & Chung).

The ability of money to maintain its form across space and time is a critical component of a well-functioning society. Our current government fiat 'money' fails this test. Instead, it has led to a heavily distorted economy. An example of this is Australian society's significant reliance on foreign funding to maintain our lifestyle, despite Australian having an abundance of natural resources to sell to the global market place. To date, foreign creditors have been willing to accept Australian government fiat 'money'. That said, increasingly it seems some foreign creditors prefer to convert their debt ownership into equity ownership of real assets such as property.

It must be questioned why Australian society needs to rely upon foreign capital to support our lifestyle. While foreign creditors remain willing to accept Australian dollars as payment, then Australian society will probably continue to consume more than it produces. Part of the reason foreign creditors are willing to take Australian dollars is a result of their own government fiat 'money' systems. With the world now using government fiat 'money', the foreign exchange markets have become a race to the bottom. Even the historically strong Swiss franc has been weakened with the Constitution change to abolish the gold standard in 2000, and the Swiss National Bank's decision in 2011 to manage the currency to a ceiling of 1.20 francs to the euro.

For a debt to be repaid, it needs to be self-liquidating. Instead, under our current government fiat 'money' system, debts tend to be rolled-over at the end of their terms. If you are invested in government bonds to meet your future retirement needs, you need to question how the government will be able to fund the face value maturity proceeds of the bond. It is unlikely they would fund it through increased taxes on the workers of the day – especially if the government's finances are under fiscal pressure from an ageing of the population. Funding the borrowings from natural resources royalties has proven to be politically impossible. Instead, it is most likely that the government will look to refinance the debt through the issue of further government bonds. The continuous refinancing of debt is essentially a 'Ponzi' scheme. If a creditor cannot repay their debts from operations, they become insolvent as soon as lenders stop refinancing.

The Reserve Bank of Australia holds its paper money 'Australian notes on issue' on its balance sheet as a liability. However, it is a liability to pay nothing. The note says it is 'legal tender throughout Australia and its territories',

but it not redeemable for any asset on the balance sheet of the Reserve Bank of Australia. With paper money classified as a liability on central bank balance sheets - one which the liability is to pay nothing - it is not surprising that many of the large central banks around the world have been tempted into the 'unorthodox' monetary practice of Quantitative Easing (otherwise known as 'money printing').

There is no doubt that government fiat 'money' will eventually lose all marketability. The owners of government fiat 'money' will be left holding only an irredeemable promise. That is, they will be left with nothing. This is the outcome of all previous 'paper money' systems in the history of mankind (e.g. the American 'Continental' 1775-1781; American 'greenbacks' 1861-1879; France with John Law's 'Ecus de banque' banknotes 1716-1720; French 'Assignats' 1790-1792; French 'Mandats Territoriaux' 1796-1797; Weimar Republic 'Marks' 1918-1923). Historical experience suggests that most 'paper money' systems collapse within a relatively short period of time.

When government fiat 'money' loses its marketability it will be important that an alternative form of money is available to take its place. The *Interim Report* mentions a range of crypto-currencies, including Bitcoin, that are currently being facilitated by market participants. The development of crypto-currencies seems to reflect a growing public recognition that government fiat 'money' is not suitable for meeting the space / time conundrum. In particular, the proponents of crypto-currencies argue that they are 'decentralised' (ie. they are free from government or central bank manipulation) and 'limited in quantity'. However, the fatal flaw with crypto-currencies is that are not a marketable good. Over history, the collective human subjective assessment of the most marketable good has nearly always been gold, and its most marketable form is a coin of defined fineness and weight, such as the gold sovereign. The next most marketable good is silver, also in the form of a coin with defined fineness and weight. It is not important to understand why the gold coin is the most marketable good, but it is very important to understand what happens when the gold coin is replaced by government fiat 'money'. Simply, it always ends with the holders of the government fiat 'money' losing their claim against future goods and services.

We recognise that in a world where government fiat 'money' is universal and Keynesian economic theory is the prevalent basis for policy formulation, the Financial Services Inquiry may be limited in its ability to make recommendations with regard to facilitating the development of an alternative monetary system. However, at a minimum, we believe it would be prudent if the Financial Service Inquiry's recommendations ensure that alternative monetary systems can develop where they are in the best interests of the people. With regard to this, we ask the Financial Services Inquiry to include within its recommendations that the Royal Australian Mint not be privatised; as is currently under consideration by the federal government.

We make the following comments with regard to specific proposals arising from the *Interim Report*.

#### **Restore the general prohibition on direct leverage in superannuation on a prospective basis.**

Disagree. We don't believe that direct leverage should be prohibited for the superannuation sector. Already many investments by superannuation funds are made in companies that are financially leveraged. For example, it may well be less risky for a superannuation fund to invest in a lowly geared direct property investment, than in a highly geared listed Real Estate Investment Trust (REIT). We would encourage the Financial Services Inquiry to recommend the industry develop improved risk metrics which can help superannuation investors understand the 'see through' risks, including leverage, of all of their investments.

#### **Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.**

Disagree. Prior to retirement, government has been happy to allow individuals to make decisions (and take risks) on whether to make optional contributions to superannuation (in addition to the compulsory amounts) and if they so wish, to make their own investment decisions. It seems incongruous now to provide policy incentives to manage risks in their retirement phase. When, and how, after retirement individuals convert their wealth to income over space and time should be at the individual's discretion.

The government should remove existing tax regulations that disadvantage certain products including deferred annuities and GSAs, as these products can help provide retirees with longevity risk protection and provide them with a way of converting their wealth into income during their retirement.

**Introduce a default option for how individuals take their retirement benefits.**

Qualified agreement. We are comfortable with default options as long as the default option is solely determined by the trustees of the superannuation fund, and the 'opt-out' process is easy for individuals. Under this method, the trustees are responsible for ensuring the default option is suitable for those members who do not 'opt-out'. We don't believe the 'default option' should be mandated by government or any party other than the Trustee.

**Mandate the use of particular retirement income products (in full or in part, or for later stages of retirement).**

Disagree. The income needs of retirees vary significantly, as do the resources available to individuals to fund their retirement. Wealth at the time of retirement may or may not comprise: a home (removing the requirement income for rent); superannuation assets; and other assets such as shares, property, bank deposits, and other items of value. The retiree may also have financial liabilities, such as a mortgage or personal debt. Although we believe the FSI should formulate policy to facilitate a stable financial environment which allows the conversion of wealth into income over space and time, the mandating of a particular retirement income product will by definition take the timing of that decision out of the hands of the retiree. This may well be to the detriment of that individual. For example, a retiree with a substantial mortgage may be best advised to use a lump-sum payment from his superannuation fund to extinguish that debt.

While the government may wish to make it difficult for retirees to 'blow' lump sums on what it sees as inappropriate retirement expenditures, and then for the person to 'fall back' on the Age Pension, there is the important point that the wealth at retirement is the private property of the individual – not that of the government.

While there may be some restrictions imposed, such as no withdrawals prior to preservation age, to reflect the tax advantages over non-super savings, we believe it would be inappropriate if a particular retirement product was mandated. The risk of political capture from those likely to benefit from the funds which are to be directed into the mandated retirement income products is also a significant problem.

**Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-tests.**

Qualified agreement. We can see advantages in moving to a more flexible, principles-based approach to determine if an investment strategy in retirement should be tax free. This should facilitate product development and improved competition in the retirement product offer to consumers. In any policy option that is being considered with regard to the tax-free status of retirement income products, all efforts should be made to minimise administrative and regulatory costs.

If you would like to discuss our submission in more detail, please contact Mr. Martin Hickling, Co-Chief Investment Officer, Polymath Investors by email, [martin.hickling@polymathinvestors.com](mailto:martin.hickling@polymathinvestors.com).