The Australian Economists Advisory Group
PO Box 386, Kensington, NSW, 2033
21/8/14

The Chairman,
The Financial System Inquiry

Dear Mr Murray,

Supplement to Oral Submission at Sydney Public Hearing 20/8/14

1. The terms of reference were obviously written by a lawyer and not by an economist although **the substance of the Inquiry is economic in nature**. There appear to be wide ranging implications in the approach adopted by the Inquiry.
2. **To illustrate this point I focus on the role and function of Non-Bank Financial Intermediaries (NBFI) in the economy**. NBFI raise many issues including, competition, stability of the system, and particularly innovation that historical evidence supports.
3. To illustrate I raise three questions:

    (i) Is there a shift in opinion towards the case for a "super regulator" of the Financial System, as distinct from the dichotomy that we have (ie RBA and APRA)?

    I draw attention to the recent decision in the UK to bring the Financial Services Authority under the wing of the Bank of England. Further in the US Dr Greenspan in his *The Age of Turbulence*, and in numerous other places, has confessed that **he did not see** the US sub-prime crisis coming which is **surprising** as there are many elements in the GFC similar to the Savings and Loan Crisis in the early 1990s. And it is **unsurprising** given the restrictions on the powers of the Fed.

    It is doubtful that the US, for political reasons, has learnt the obvious lesson: **a central bank that does not accept responsibility for macro-economic prudential supervision, allegedly to concentrate on monetary policy, is operating on the body economic with its hands tied behind its back**. Recent speeches by Dr Janet Yellen draw attention to this deficiency in the ways that the US central bank can operate. **Monetary policy needs to be broadly interpreted as it has been historically in Australia with a comprehensive set of objectives and tools that should not be restricted**.

    Monetary policy narrowly conceived, as it has been by Milton Friedman, as controlling the money supply alone, cannot control sector bubbles (eg the stock market or housing) as Dr Yellen has recently emphasised. **But there is a range of devices that have been used by our central bank to achieve just that outcome (eg moral suasion, advance policy directives, etc).**

    It is important to note in this context that NBFI, that are deposit taking institutions, have the ability to create credit (cf Gurley and Shaw, *Money in the Theory of Finance*, etc) just as the banks have credit creation abilities. The latter's ability is partly from their means of payment function and by virtue of their very high gearing that is only possible with the support of the central bank provision of **lender of last resort**. The latter has been a feature of central banking since 1694 (when the Bank of England was established as lender to the government and as a note printing authority).

(ii) Secondly, should banks be required to divest themselves of trading activities?

There are many important issues here. Proper discussion is hampered by the absence of a **detailed industry classification of the financial system**. But the issue of **conflicts of interest** in investment banking and trading bank responsibilities is the usual focus of discussion.

However, one contemporary example is: **should the trading banks be required to divest themselves of their financial planning (FP) activities as distinct from their product provision to this sector, in the light of recent well publicised events (CBA, Macquarie, etc)?** Over-regulation in the FP area can have important implications for the provision of the quality of advice, innovation, costs etc. The linkage between deposit taking and lending, investment banking and FP has important **conflicts of interest** that I presume the Inquiry will probe.

It is a poor defence of the status quo to argue that the Australian financial system is highly concentrated and not to ask why? I agree that there are costs and benefits of that concentration but those costs and benefits need to be spelt out for proper decision making about this issue as well as a critical examination of the propensity of the trading banks to gobble up successful innovations in the finance sector.

(iii) Thirdly, was the GFC Deposit Guarantee Scheme (DGS) unfair to NBFI?

For example, the DGS was extended to credit unions presumably as small co-operative banks but not to mortgage banks? Why was this restriction imposed? See my *Credit Unions in the South Pacific, The Economics of Instalment Credit* and *The Management of Instalment Credit* that all deal in part with the stability of credit unions that all borrow short and lend long like banks.

Consider the fate of Howard Mortgage Trust, then Australia's largest mortgage bank that has been wound up post GFC over the last six years. Depositors have only been getting their money back in stages over that period. This is an unsatisfactory result. In contrast the Howard Mortgage Trust in the 1990s crisis met all demands from a line of bank credit. It could be argued that DGS introduced more instability into the Australian financial system and aided concentration. Similar comments could be extended to the Money Market Funds (eg AMP Enhanced Yield fund that also was closed and wound up over a long period).

The consumer voice here would argue that the GFC treatment was unfair in a number of important respects to the institutions concerned and their customers.

It is not inconceivable to establish centrals, as for the credit unions, for mortgage trusts where the centrals deal with the central bank with its lender of last resort powers, that increases the central bank influence.

Similar arrangements are possible for other NBFI (eg development banks, other trusts). It is not just a question of *too big to fail* or *too small to worry about failing* but of proper prudential supervision and appropriate regulatory responses that may have to be innovatory responses.

Conclusion: It is not clear at this stage that the lessons of the US experience in the GFC, with its world wide ramifications, have been properly digested. The fact that the US taxpayers have been refunded from the US emergency loans is not the main point. **Taxpayers (who are also workers, consumers and investors) worldwide paid an enormous price for the resulting US and worldwide GFC and recession: this is the main point in a discussion of the *too big to fail* discussion. It is now widely conceded by US regulators that the decision to let Lehmann Bros fail in September 2008 was wrong: this was a *failure of regulatory response* that had enormous ramifications.**

Insulating against these wide ranging potential losses in a financial crisis, among both banks and NBFI, requires a **more creative approach** based on adaption of the **lender of last resort** power rather than a legalistic solution that abdicates the central bank fundamental responsibility to ensure the stability of the financial system. Legalistic debates about *too big to fail* and the corollary *not too big to fail, opt in* and *opt out*, *ring in* and *ring out* and *bail in* and *bail out* miss the main point of the prudential responsibility of central banks to achieved *stability in the financial system* that is the vehicle for our payments system, savings and investment and the facilitator of innovation and development.

Macro-prudential supervision and monetary policy are intimately linked; and a Council of Economic Regulators (RBA, APRA,ASIC, etc) is probably only a stepping stone but possibly an important one to a more logical conclusion.

Thank you for your comments at the meeting.
Yours sincerely,

Dr Neil Runcie
Director