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Submission to the Financial System Inquiry Interim Report

This submission is written with the intent of making a constructive contribution toward the Financial System Inquiry terms of reference points 4.1, 4.2, 4.3 and 4.4 as well as the two interim report observations, **'Stability - Addressing too big to fail'** and **'Consumer outcomes - Effective disclosure'**.

When a taxpayer walks into an Australian bank to open a new bank account so that they can either receive or pay wages, take out a mortgage to buy a house or an overdraft facility for their business, there exists information asymmetry.

Information asymmetry can be defined as (2):

> *"A situation in which one party in a transaction has more or superior information compared to another. This often happens in transactions where the seller knows more than the buyer, although the reverse can happen as well. Potentially, this could be a harmful situation because one party can take advantage of the other party's lack of knowledge.*
>
> *Information Asymmetry can lead to two main problems: 1. Adverse selection- immoral behavior that takes advantage of asymmetric information before a transaction. For example, a person who is not be in optimal health may be more inclined to purchase life insurance than someone who feels fine."*

Point One - Effective disclosure

This submission seeks to make two main points.

The first point is that Australian consumers should be informed, before they take out new mortgages, business overdrafts or credit cards, where the money will actually come from.

Your immediate response to the above may be, “Why does it matter? What difference does it make if they know where the money will come from?”

It matters because if Australian consumers where informed about where the money comes from, they may choose to seek alternative sources of funding for their houses, businesses and general spending.

The point about information asymmetry is that if a restaurant owner knows he is usually using dog and cat meat for the "chicken schnitzels" he sells to his customers and his customers are under the impression they are always made of chicken, his customers are being mislead. If the customers were fully aware of what they were purchasing, they would likely seek an alternative.

If customers only have a choice of four main restaurants in their local area and similar information asymmetry exists between all four restaurant owners and the local customers, reducing the level of information asymmetry is likely to increase the demand for alternative sources of take away food.

We do not need to be concerned about where the alternative sources of food will come from because enterprising and creative individuals will identify the problems and develop solutions to satisfy the demand, which is the beauty of the market.

Therefore, a proposed recommendation would be something like:

> **1. Ensure Australian consumers are informed about the source of the money they are seeking to borrow from approved financial institutions in laymen's terms as well as the timeframe involved for those sources of money.**

An important point above is the time frame involved with each source of money use to fund the lending. If a customer is looking at borrowing $600,000 from a bank to buy a house, the bank may say that $40,000 is going to come from deposits from Australian customers who do not have term deposits, $200,000 is going to come from bonds sold to investors in the EU that will expire in one month, another $200,000 is going to be from selling 20 year bonds to Australian super funds and $160,000 is going to be created on the spot by the bank (3).

While the time component in the above rule does not completely remove the ability of the bank to mask how it is funding the new loan, it will help to improve transparency.

Point Two - Stability

The second point to be made in this submission is about the risk profile associated with the different types of bank accounts customers have with Australian banks.

When a worker or a business owner applies for a bank account in Australia, currently, they do not need to be concerned about the risk profile of the bank account they will be keeping their money in because of the guarantee scheme (1) in place by the Australian Government. The Australian Government guarantees the first $250,000 the worker or business owner holds in their account.

If I purchase a brand new Toyota Camry for $26,990, should the Australian Government cover my comprehensive car insurance costs for the next 5 years in the event that something goes wrong?

Should the Australian Government cover my hire car costs if there is a recall on my particular model of Toyota Camry?

Why should the Australian Government be providing similar protection to Australian deposit holders?

How can Australian consumers have the same level of security for their bank deposits without having to subsidise that risk reduction by their government guaranteeing deposits?

An answer can be found with the following proposed recommendation:

> **Ensure Australian banking institutions make available to their customers a bank account where the money is guaranteed by the bank and can be paid out in full to the customer even if the bank becomes insolvent.**

If a customer is standing in a bank branch opening a new account and they are informed that they can have an account with zero risk (and therefore a zero interest rate) then both the customer and the bank have a greater level of choice and motivation about what happens next.

From the banks perspective they can create innovative accounts with varying levels of risk and return and they would likely find it easier to encourage the customer to speak with one of their financial planners about having some of their money in interest bearing accounts.

There would likely be value on the banks side to place time restrictions on how quickly money can be moved from risk exposed account classes to the zero risk account for a customer so that in the event of a crisis customers can't just move all their money from interest bearing accounts to their zero risk account.

One of the benefits with the above rule is that if customers are aware that they can have their money in a zero risk zero return account and they choose not to, then there is no need for the government to guarantee deposits and there is no need to be concerned if a bank fails, because everyone was fully aware of the risk associated with the choices they made.

A further benefit is that the rule doesn't require the creation of some bureaucracy at taxpayers expense or a new regulatory department to stifle the banks.

If something similar to the two rules above were in place I believe they would create the conditions for further innovation.

Why can't I buy Australian bonds that are used to fund legitimate Australian mortgages?

Why do four main banks have a near monopoly on funding new residential mortgages?

Why can't I log in to my super account and change the ratio of my money that is held in Australian bonds that were used to fund mortgages, or Government infrastructure projects for that matter?

The above two recommendations are adapted from the banking policy page located at https://www.taxpayersparty.com.au/policy/banking/ . If you aware of information that would help refine the two recommendations above or you are aware of information showing that implementation would be difficult or costly, please make contact so that they can be improved upon.

Yours Sincerely,

David Collett
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(1) http://www.guaranteescheme.gov.au/
(2) http://www.investopedia.com/terms/a/asymmetricinformation.asp
(3)
http://www.bankofengland.co.uk/publications/documents/quarterlybulletin/2014/qb14q1prereleasemoneycreation.pdf,
https://www.taxpayersparty.com.au/open-letter/rba-full-reserve-banking/