Mr D. Murray AO
Chair
Financial System Inquiry
c/o The Commonwealth Department of the Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir

COMMENTS ON INTERIM REPORT OF JULY 2014

The Interim Report (the Report) is an extremely disappointing document. It is needlessly verbose and obtuse. It does not present an adequate record of the current condition of the Australian financial system, and rather than robust economic analysis, it too often provides the reader with spin.

My submission will plug the information gaps in the Report, highlight some key instances of spin, and make recommendations on initiatives that are reasonable in the circumstances.

The Australian Financial System (the System) we have today has taken shape as a result of the Campbell Report and consequent finance industry deregulation. The public record is very clear on why those deregulatory reforms occurred. The Hawke Government and the econocrats of the day expected this would curb the power and profits of the banks, and drive them to lend for investment in the productive economy – eg the manufacturing sector [1]. The Treasurer of the day, Paul Keating, went so far as to present the reforms as a way to hurt the banks. To jeers from the delegates at the NSW ALP State Conference of June 1984 he invoked ALP hatreds from the 1930s and said "I wouldn't have thought any of you would want to do favours for Westpac![2]"

The banking industry did not develop as advocates of its reform in the early 1980s predicted. The banks did not lose their power or profitability [3] and if they lent for investment in the productive economy, that lending was tiny compared to their lending for financing the property industry. In 2010, corporate elder statesman Don Argus stated that Australia's banks had become "giant building societies" [4]. In June 2014, UBS analysis showed that 95% of all new loans by banks were for property (overwhelmingly residential property) [5].

So, although the Report repeatedly remarks on the role that banks can play in financing investment and the development of our economy, very long experience shows that – left to their own devices - banks will not do this. Deregulation of Australia's banking system – assessed against the stated goals of those who initiated that deregulation – is a complete, unmitigated failure.

The Australian financial industry is subject to a regulatory framework that resulted from the Wallis inquiry of 1999. The Report makes clear that those running the Inquiry view the framework favourably – particularly in the light of Australia's relatively benign experience of the Global Financial Crisis.

In doing so the Report makes a commonplace analytical error – it links Australia's GFC experience to the judgement of "experts", and ignores the influence of chance and natural variability. European Union countries such as Poland and the Czech Republic, together with the Eurozone nation of Slovakia, did not have any banking crisis to speak of post 2008 [6]. By the reasoning of the Report, this means these countries can teach the world about successful and sustainable banking. This submission will consider this in more detail later.

Aside from the analytical blunder of ignoring the influence of chance on outcomes; the claim that Australia's financial regulation structure is effective cannot be squared with reality. It ignores regulatory failures in the collapse of HIH [7]. It ignores the farce of the Lewski/Prime Trust case [8]. It ignores the extensive abuse of low-doc loans that has been brought to light by Denise Brailey and the BFCSA. It ignores the evidence that has been submitted to the Senate's 2014 inquiry into ASIC that has, amongst other things, seen the CEO of the Commonwealth Bank issue an apology.

Most tellingly this rosy assessment of financial regulation overlooks evidence presented in the Report itself. On pages xxxvii to xxxix, the report notes that penalties available to ASIC are light in international terms. It further records that elderly Australians are not able to access "income streams with longevity protection" due to inaction by the relevant sections of officialdom. On those two fronts alone, some people would say Australia looks like a place where demonstrably sub-optimal outcomes are acceptable to regulators.

The fact that the Report assesses the banking system and financial regulation in Australia, without mentioning its systematic failures, is unfortunately part of pronounced pattern of spin in the report. Where the report touches on issues that could reflect badly on companies in the finance sector, in Australia or overseas, it discusses these in terms that flatter the private sector and cast doubt on the judgement of its critics. Examples of this lack of impartiality in the report include the following.

The report notes that the non-bank sector went into crisis after the GFC "as the cost of funding rose". It would be more accurate to say that these organisations suffered, even as the cost of funding went <u>down</u>, because (post GFC) they could not get funding at any price. They had an experience similar to people who sought to renew their public liability insurance in 2000 and 2001, only to find insurance companies had stopped offering suitable insurance. Put very bluntly, the GFC revealed that many financial flows were dependent on the world of "shadow banking", and those conduits of finance quickly ceased to operate.

The report argues in the fashion of impeccable neo-liberal economists that "taxation distorts households' saving and borrowing decisions towards housing" and that household leverage has doubled since 1999. This might lead readers to believe that governments have made some major taxation policy blunders since 1999 and the banks have been simply bystanders in the process. That disregards the fact that in 2001 Peter Costello's "A New Tax System" was introduced which neo-liberals applauded and said would reduce economic distortions and increase household saving. More particularly it ignores the fact that banks vigorously promoted property lending over the period [9]. This "Government bad, private enterprise good" framing is unacceptable in any report that purports to serve the people of Australia.

The Report is most ludicrous where it explains the GFC in one sentence. It reads "The catalyst for the crisis was the deterioration of the United States housing and mortgage market….".

Deterioration is a highly misleading term, particularly because it absolves anyone and everyone of even some responsibility for events. A significant factor in the GFC, that the Report does not acknowledge, was large-scale white-collar crime including fraud, and failures of financial reporting. Private enterprise financial market players took a key role in wrecking the USA's financial markets. This is why Harry Markopolos (the man who proved Bernie Madoff was a fraud in 2002) called his book "No-one would listen". If it were true that the USA financial markets had simply "deteriorated" it would have been necessary for Markopolos to call his book "Everyone had serious but undiagnosed hearing problems".

CONCLUSION

When one strips away the Report's inaccuracies and the herculean efforts of the FSI to make the case that the finance industry is strategically crucial, what remains are the foundations of reasonable policy for finance in Australia. The essence of this evidence-based policy is that the wider economy does not need the finance industry we have, and that when governments pretend to the contrary, fraud and property speculation result.

RECOMMENDATIONS

The following measures will shift the Australian finance industry away from its current form, as a complex, overly influential, property-fixated monster, towards a more basic and socially useful form.

1) All banks and financial institutions to be made subject to radically tougher licence conditions that focus on enforcing diversity of lending. This is to ensure that – as outlined in a 2011 article by Andrew Sheng [10] – banks get an unambiguous message that their right to continue operating is a tremendous privilege and not a formality.

2) Capital adequacy requirements for banks and financial institutions to be recalculated such that all bank assets relating to real property, except owner-occupied housing, are rated as three times more risky than is currently assumed in calculating capital adequacy.

3) Bank lending to be made subject to a ceiling that depends on Australian-domiciled bank deposits. That is to say that, during the years to 2020, banks will need to increase the value of Australian-domiciled deposits on their books relative to the value of loans on their books, such that by June 2020, such deposits will fund 90% of loans.

4) ASIC to have a $200 million increase in their budget, increased in parallel to GDP growth over the long term. This money is to be used exclusively for pursuing and prosecuting fraudulent or dishonest financial advisers or investment companies that offer their services in the retirement income and superannuation markets. $40 million of this is to be allocated to a "honey-pot" fund, which will be used specifically for entrapment of offenders.

5) All recruits to any bank or bank subsidiary to pass an examination (with a mark of at least 70%) on the Message from the Commissioners booklet that was distributed by the Government Savings Bank of NSW to its recruits in 1926 (see Appendix 1). All employees of such organisations to pass an examination on this booklet at least once every 3 years.

6) All recruits to ASIC, APRA and Commonwealth Treasury to pass an examination (with a mark of at least 70%) on Harry Markopolos'es book "No-one would listen". All employees of such organisations to pass an examination on this book at least once every 3 years.

Yours sincerely

Alun Breward

ENDNOTES

[1] see

(a) the PhD thesis (“Labor and financial deregulation”) of The Honourable Stephen Martin at ro.uow.edu.au/theses/319/; pages 201 to 219. Stephen Martin was a ALP Member of the House of Representatives, and Cabinet Minister in the 1980s and 1990s.

[1] (b) testimony by Ian MacFarlane, Governor of the RBA, to the House of Representatives Committee on Economics, Finance & Public Administration 17 June 1999; or the speech by Ric Battellino of the RBA in Sydney on 25 February 2000.

[1] (c) see Paul Kelly’s “The End of Certainty”, Allen and Unwin (2008)– Chapter 4.

[2]) the PhD thesis of the Honourable Stephen Martin (“Labor and financial deregulation”), p204

[3] see testimony by Ian MacFarlane, Governor of the RBA, to the House of Representatives Committee on Economics , Finance & Public Administration 17 June 1999; or the speech by Ric Battellino of the RBA in Sydney on 25 February 2000.

[4] see www.smh.com.au 25 March 2010.

[5] see http://www.businessinsider.com.au/bank-earnings-at-risk-as-housing-market-cools-2014-6

[6] see “The Banking Sector in Central Europe (Performance Overview)”, Deloitte Center for Financial Services in Central Europe, 2012

[7] for example, The Australian, 16 Jan 2003, revealed that the HIH Royal Commission had been told that NSW authorities requested in 2000 that APRA investigate HIH. APRA declined to do so. It then, later, failed to inform Minister Hockey about NSW concerns.

[8] see “A Betrayal of Trust” (ABC Television), 4 Mar 2013

[9] For example see the NAB campaign of 2003 “Investing is a new way to save”

[10] see “Central Banking in an era of QE” by Andrew Sheng www.centralbanking.com/central-banking-journal/feature/2102750/central-banking-era-qe

Appendix 1

Message from the Commissioners of the Government Savings Bank of NSW to

(Insert name)

March 1926

You have become part of the organisation of a great institution, the motto of which is "SERVICE" and in welcoming you as a member of the staff, the Commissioners wish to offer you some advice which if given your attention, will, they believe, make you a more efficient officer of the Bank, make your duties easier and more pleasant, and lead to your advancement in the service.

In the first place you should realise from the outset that the customers of the Bank are the Bank, that is - without customers there would be no bank. Remove from your mind at once any thought that the Bank's officers are conferring any favour on a customer by performing for him any of the services which the Bank offers its customers. The business which every client brings to the Bank, be it a modest deposit of 1 shilling or the substantial one of some hundreds of pounds, be it a loan or any other business which the Bank conducts, is to be appreciated without any feeling of patronage towards the customer. At the present time, the Bank has over one million savings accounts open in its books and many thousands of current loans to farmers and persons who have borrowed money to build their homes. These numbers are growing every day and will continue to grow in proportion as the service the Bank offers and the spirit in which it is offered by the staff give satisfaction to the public.

At all times be courteous, remembering that civility costs nothing and is like oil to a machine. Pleasantness to your fellow officers as well as to customers of the Bank will repay you amply in happier working conditions and reciprocated goodwill.

Be interested in your work. Every line of duty in the bank is important and has its place in the widespread organisation of the institution. Regard your work as important in itself and give it your whole attention, but at the same time learn all you can of higher duties to qualify for promotion. Be observant. Ask questions. Try to understand why things are done and not merely how to do them. The more you can learn about the Bank's system and business and the more proficient you become, the more progress you may confidently expect to make.

Reports from the manager or departmental head under whom you work will be under the following headings.

Accuracy
Speed
Dependableness
Zeal
Personality and Address
Punctuality of attendance
Regularity of attendance
Ambition
Self-reliance
Originality
Executive ability

You should therefore appreciate the importance of endeavouring to acquire those qualities in the highest possible degree and avoid all conduct likely to result in unfavourable reports under any heading.

The importance of absolute integrity and candour cannot be too firmly impressed on you. The Bank is an institution where credit and character are of the utmost importance. Any act of yours which causes the slightest doubt in the minds of the Commissioners as to your honesty and straightforwardness will have an adverse influence on your career and may lead to termination of your service. There is only one safe rule of conduct in this regard - scrupulous honesty in every phase of your work and particularly in relation to money, stamps or any medium of value.

The rules of the bank prohibit gambling in any form and you should understand that any breach of this instruction on your part will have serious consequences.

Choose your companions from among those whose tastes and habits are not above your means, so as avoid incurring debts which may lead you into financial difficulties and be a temptation to dishonesty.

The Commissioners hope that you will take to heart this advice which is given to help you in your career in which they wish you every possible success.