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FSI Submission (Second Round)

Introduction

I have addressed my comments to the Observations and Policy Options contained in Interim Report of 15 July 2014. The numbers used below refer to the sequence of observations in the Report.

Observation 1 The banking sector is competitive ...

Option 1.3 Provide direct Govt Support to the RMBS market...

The use of Residential Mortgage Backed Securities played a major role in developing the Sub-Prime Mortgage Crisis in the US and spread ripples into the global financial system.

The key problem with Residential Mortgage Backed Securities is that they are structured such that the RMBS investor has no recourse to the originator in the event of a default.

The changes the role of the originator from a principal to an agent which further acts detrimentally to:

- relieve the Authorised Deposit Taking Institutions of their primary responsibility for sound lending.
- undermine the prudential regulation of ADIs by moving assets off the balance sheet with the use of Structured Investment Vehicles.
- obscure proper risk assessment.
  The originator has the opportunity to individually assess the credit rating of every borrower but a mortgage backed security can only be rated in general terms. In the event of a financial crisis, confidence in mortgage backed securities will evaporate which will act to spread the crisis.

  Mr G Debelle in a speech to the Finance Professionals Forum on 31 March 2009 said that *"In Australia, the institution originating the loans that comprised the securitisation maintained a number of linkages to the loans, typically including a direct financial stake, as well as a substantial reputational link."* It is not clear how much comfort can be drawn these links in a crunch.
- form the basis for further layers of ever more innovative financial engineering with more potential for instability.

To reduce the risk of future financial crises, Residential Mortgage Backed Securities should be prohibited and other means employed, such as corporate bonds for financing for bank and non-bank institutions.

This may result in higher funding rates for institutions perceived to involve more risk and they will have to seek to compete through other means, such as reduced overheads and simpler products.

Observation 4 There are structural impediments for SMEs to access finance .

Option 4.2 Facilitate development of SME finance database

It is difficult to see how such a database would reduce the need for a lender to make a thorough assessment of a potential borrower's viability and creditworthiness.

Observation 5 Australia has an established domestic bond market.

Option 5.2 Listed issuers to issue vanilla bonds directly to retail investors

The reputation and performance of a listed company should allow retail investors to make an informed choice without a prospectus.

Observation 6 There is little evidence of strong fee-based competition in the superannuation sector.

Option 6.1 MySuper

MySuper is an excellent idea and any further improvements should be considered.

The practice of charging a fee based on the value of the funds under management may be both excessive and unrelated to performance. A management fee of 1% of the capital may appear to be modest but it is a big slice of the fund income of say 5% . A fee based on the annual fund performance would also expose the manager to the same income volatility as the clients, which would be fairer in good times and bad.

Observation 7 Direct leverage in Superannuation Funds.

Option 7.1 restore the general prohibition on leverage on a prospective basis

There is ample opportunity to use leverage for investments outside of superannuation. Superannuation investments should be more reliable consistent with the single purpose test of delivering a retirement income. It is bad enough for a super fund to underperform but the use of leverage creates the possibility of plunging underwater.

Jeremy Cooper wrote a sound commentary in the W/E Financial Review 16 Aug 2014 pg 2.

Observation 8 Too big to Fail

Option 8.1 impose losses on creditors

Savings Accounts should be insured against loss as the ADIs are paying their depositors less than the risk free rate in return for providing security and convenience. Deposit Insurance should give no comfort to the ADIs as any payout should be directly to the depositors after failure rather than to the ADIs to prevent them failing.

Other creditors are being paid above the risk free rate precisely to compensate for the risk of default. The prospect of having to take a haircut ought to encourage the creditors to sharp and proper interest in the prudent management of the Bank. Removing the moral hazard of being considered too big to fail by the government would be a powerful prudential measure for the ADIs.

Option 8.5 ring-fencing

Ring fencing would be beneficial to;

1. focus the regulatory oversight on the licensed activity within the business
2. prevent the licensed business from using its prudential reputation to underwrite its other activities

   For a counter example, prior to the Financial Crisis in 2008, the American International Group appeared to be a triple A rated insurance company but had morphed into a giant hedge fund, with a massive exposure to Credit Default Swaps.
   The company relied on its credit rating derived from the status of its regulated insurance business to sell the CDS. However the CDS were not considered to be insurance policies and so the activity escaped regulatory oversight in the US.
3. prevent privileged information gained from the licensed activities being used to gain a competitive advantage to sell other products
   For example, having just sold residential mortgage a bank is ideally placed to sell the customer an in-house insurance policy, ahead of other insurance companies.

Derivative Trading which is not being undertaken strictly for hedging the principal business activity should either be ring-fenced or conducted as a separate business.

Long Term Capital Management is usually cited as negative example but it did have many redeeming features including;

- An honest purpose : the sole objective of the company was to profit from mis-pricing in the financial markets using the leverage available from derivatives.
  The investors who were able to pony up the minimum investment would have been in aware that they were investing in a highly-geared, speculative enterprise.
- Expert Management: the seven principals of the company were leading experts in the theory and practice of derivative trading. Unfortunately they were still subject to a few unknown unknowns in the risk management area.
- Skin in the game : the principals were risking substantial amounts of their own money
- No government guarantee : When the company collapsed, a controlled landing was arranged through the other major trading houses on Wall Street.

Observation 13 Affordable quality financial advice

Option 13.2 Raise education and competency standards

In principle, a reasonably competent person ought to be capable of managing their own finances and financial rules and regulations should be designed to permit this.

Expert advice is always valuable but ideally it should be a two-way street with the client able to make a critical appraisal of the advice offered and ultimately take ownership of their own plan.

This often doesn’t happen because the financial laws and regulations are excessively complex and the clients may not be well versed in financial matters

Clients would benefit from having had a lifetime of investing but many don’t think about investing until they are approaching retirement.

There is nothing like the experience of having occasionally lost some of one’s own money over the years on some sure-fire investments to engender a measure of healthy caution and prudence in a person.

The most vulnerable clients are those who are forced to rely entirely on an adviser to both prepare and implement their financial plan.

Simplifying the rules and regulations would encourage more people to take an active role in managing their investments and allow them to use financial advice more discerningly and more effectively.

Observation 20   Retirement Phase of Superannuation

Option 20.2   retirement income products

The reason that annuities and other are not very popular is because they are not very attractive.
An annuity may be suitable for a risk averse or infirm person but moderately astute retired investor would expect to earn more than 4% indexed to inflation while retaining or increasing the real value of their capital indefinitely with manageable risk.

Observation 21   Impediments for retirement income products

Option 21.3   Eligibility for Tax Concessions

In principle, retirees ought to benefit from any additional income, whether they are receiving the pension or not.

One approach would be ;

1. to apply income tax to everyone’s income from any source, starting from a minimum threshold of zero dollars.
2. to provide a rebate equivalent to the current pension for people over pensionable age, which would also be permitted to generate a refund if the nett tax payable is negative.

The advantages would be ;

1. The removal of any incentive for retirees to take a lump sum in order to qualify for the pension.
2. Self funded retirees would not feel that they have disqualified themselves from receiving the benefit of a pension.
3. More tax would be paid by retirees on high incomes.
4. Simpler superannuation rules
   For example, there would be no need for an upper limit on savings or restrictions on contributions.

The disadvantages would be ;

1. May be a difficult idea to sell.

Observation 23 Access to growing amounts of information

Option 23.2 Review record keeping and privacy requirements.....

The data collected in one business activity can be used to give a company a competitive advantage in its other activities.

Customer loyalty programs combined with extensive data mining are created new opportunities for cross marketing and further potential for commercial concentration.

For example, some supermarket chains in the UK have been granted banking and insurance licenses which vastly expand the breadth and depth of their customer database.
This would provide a substantial advantage in information over competitors, especially independent operators or those in a single line of business.

“Now that you have Medical Insurance Policy with us, our dietician thinks that you haven’t been buying enough green vegetables at our supermarket.”
“If you opt to get them home delivered, we can give you a discount on your motor insurance.”

Option 23.4 Principles-based Regulation

Principles based regulation should be approached with caution because it can easily turn into procedures-based regulation.
That is, where being seen to go through the motions of compliance becomes an end in itself, as distinct from achieving the intended result.

Observation 25 International Integration

Some company structures have been set up with complex network of local and overseas holding companies. These structures seem to have no purpose other than to extract management fees while making their business activity more opaque to analysts and regulators. eg some infrastructure funds set up prior to 2007 by merchant banks.

ASIC or the ATO should have the power to require companies to show that their structure will not avoid Australian regulation or Australian taxes.

Ideally they should be required to adopt a simple company structure registered in Australia.