From:

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To:

The Financial Services Inquiry

Online Submission

Second Round of Submissions

Dear Committee members,

We are a group of concerned banking system users, taxpayers, citizens and Australian residents with no particular commercial or political interests.

Introduction

There are 5 themes in late 19th and early 20th century science that have changed forever how we think about science, mathematics, philosophy, politics, economics, and much more. They didn't just represent revisions of our classical understandings of reality, they totally revolutionised our cosmos by providing us with very new paradigms of thought.

The first new paradigm was provided by Einstein's theory of 'General Relativity'. The physicist John Wheeler once summarised Einstein's explanation of the interrelationship between matter and space as follows: "Matter tells space how to curve. Space tells matter how to move". That is, matter tells space how to 'be' but space tells matter how to 'do'.

The second new paradigm was provided by 'Quantum Theory' and Heisenberg's Uncertainty Principle. The principle says you cannot know beforehand the exact position and momentum of anything simultaneously. This means the idea of classically separable causes and effects is not correct. That is, due to the asymmetrical interpenetration of the position and velocity of all things, resulting in their wave-particle nature, our cosmos is always in motion, indeterminate, and its uncertainties or imperfections can never be eliminated.

The third new paradigm was provided by Kurt Gödel and his Incompleteness Theorems. Gödel showed us that even the most formal mathematical systems (including in those systems their axioms and their theorems) are incomplete, or incapable of proving all truths about all the relations and statements they contain. They are also incapable of demonstrating their own consistency because they rely on axioms. Thus, even our most careful logic is fettered by uncertainty.

The fourth new paradigm was provided by genetic support for Darwin's understanding of Evolution and Natural Selection. Early in the 20th century, with the "Evolutionary (or Modern) Synthesis", Darwin's theory became reconciled with genetics. The gene was now understood as subject to mutation, but through that slight instability in the population, was also the agent of phenotypic changes that could bring about better adaptation to the local environment.

The fifth paradigm that came to maturity in the 20th century was the Scientific Method. In the 1930s, Karl Popper argued that there is no such thing as inductive reasoning. He claimed that the empirical character of science had to do with the deductive property of falsifiable scientific hypotheses. He held that there is only one universal method, a method not particular to science: The negative method of criticism, or colloquially termed trial and error. It covers all products of the human mind as well as the evolution of life.

We hope you can see some recurring themes in these 5 radical ideas. The first is perhaps incompleteness. The reason why a 'something' – including a mathematical system, a replicating organism, a scientific claim, an entire economy, or the path in space and time of a single photon - cannot demonstrate its own consistency is that to do so would depend not only on itself, but also on absolutely everything else. All we can do is deal with our challenges ever more proficiently as we apply ourselves to learn more through trial and error. Now if something (material or immaterial) is incomplete, then it is also subject to the instability, uncertainty or probability that the classical world misunderstood. That is, while a natural or artificial system may always achieve a certain level of order, there will always be a certain level of disorder or uncertainty caused by the necessary limitations or boundaries or partial dependencies of that system.

In one sense, there is a *relativistic separation of powers* between the direct and indirect, the ordered and disordered, or the organiser and the thing being organised. An example of this rule is the separation of powers between the executive and the legislature found in the system of government of the USA. In this analogy, the executive is the dynamic *doer*, like matter, whereas the legislature is the stable *relator*, like space. Likewise, we could speak of the separation of powers in a democracy between the decentralised voters that elect the legislators and their proposed legislative platform, and the centralised government bureaucrats that carry out the wishes of the voting public.

Similarly, we could picture the relationship between economic production ('real' credit) and money (financial credit) in the same terms. In this case, production is *moved* by money, but money finds its place, role, or relationships, through production.

Finally, we could also speak of the direct – indirect relationship between the mind and the brain/body, in which case the mind, as an arrangement of space's interactions, would tell the brain/body how to move, but the brain/body, as an arrangement of matter's particles, would tell the mind how to be.

So most generally, we would claim that whenever we see this 'separation of powers' at play, we see an opportunity for adaptive evolution, or more generally, emergence. For example, despotic governments have very little opportunity for innovation in the areas of governance and risk-mitigation. Nevertheless, the reality of emergence is that systems of all types will always be inherently unstable, uncertain and incomplete – or at least lack the ability to demonstrate their own consistency and completeness.

What does all this intimate? Firstly, we need to discuss the mechanism of natural or artificial selection a little more carefully. What makes it work? Well, if we want systems to adapt favourably to their environments, then:

- the separation of powers between the direct and indirect (or the 'traffic' and 'traffic-policy') must be protected
- the parts (genes, concepts or policies) must be allowed to compete and cooperate, or 'struggle', in their environment
- there must be opportunity provided by the environment for occasional mutation or dissention from the norm or the current paradigm
- the parts (genes, concepts or policies) must reside in a population pool that gives opportunity for new gene- or idea- arrangements to spread through imperfect replication

If money and production are locked into such an arrangement, in which case money would represent the genes, logic or policy, and production the environment of such money-policies, then:

- Money-policy makers should be separate to their beneficiaries, just as courtroom judges are independent of their judgments
- The development of policies of money supply (including funding for house mortgages as opposed to funding of housing construction) should not develop behind closed doors in the board rooms of profit-seeking organisations. Money-policy should be transparent, yet subject to appropriate regulation (including self-regulation)
- Money-policy providers occupy a privileged position in modern society, something akin to pharmaceutical wholesalers and retailers. In exchange for the privilege we grant them, it seems appropriate that a regime parallel to the Community Service Obligations imposed on pharmaceutical services is also placed on intermediation services
- There should be more than one money-policy provider, so that various systems may compete for their adoption by traders
- The barriers to entry into intermediation service provision and money policy choice must be low enough to allow for their occasional mutation or innovation
- Money-policy should be debated in public arenas. Such policies should be open for inspection just as parliamentary bills are open to the public

It is only as we consider these concepts with respect to monetary policy that we can hope to adapt favourably in a fast-changing economic environment.

History

In 2013, approximately $120b CBA debt was issued in foreign currency, and over $12b in Australian dollars. In comparison, Australian CBA deposits and the like was about $410b and overseas deposits about $50b. That is, for every $4.10 of Australian bank deposits, the CBA Group adds $1.20 of overseas borrowings to fund its home loan program of about $3.73 and other term loan program of about $1.30. Similarly, for every $4.24 of deposits and like borrowings, Westpac adds $1.44 of overseas borrowings to fund its loans program of $3.62 for housing and $1.74 for other.

In 1994, the RBA decided to follow a core policy of inflation containment (today the target is between 2-3%). This meant house buyers could get mortgages at much lower interest rates than in the past (remember 17% rate in the 1980's?) This raised the demand for cheap mortgages. Consumers used mortgages for house extensions, new cars, trips overseas, or to temporarily pay off credit cards. Credit card debt shot up as well.

In this new era, the banks no longer pursued the big margin policy (the RBA policy meant interest rates were too low to do so). The banks pursued the big volume strategy instead. The Big 4 steadily increased overseas borrowings to fund the Australian hunger for consumer debt. House prices went up, but the stock of houses didn't increase much, partly because housing construction financing did not increase at a rate compatible with the increase in home loan debt. There were also supply-side constraints. Planning approvals and construction delays hampered attempts to bring online new housing stock. Nevertheless, during this period the banks roughly maintained the 15% ROE, even with their stark change in revenue policy.

In the 2000's, the securitisation industry took off. Banks and other companies were able to take assets and their associated ownership risks (mostly mortgage and lease receivables) off the balance sheet and replace them with fee-based income on the P&L. That is, the ROE ratio improved, which enabled the banks to borrow more from institutional investors in New York, Tokyo, London, or Paris.

The result in Australia was again to push up house prices without greatly increasing the stock of houses. Those who had property or bank shares did well, at the cost of many young people who did not have the opportunity to enter home ownership in the new environment.

In the USA, bank lending practices got loose, perhaps to help the poor get into the housing market. This was happening in an environment of low interest rates, which in turn was due to very loose monetary policy over an extended period.

Then the GFC hit. For the USA particularly, the housing bubble burst. However, the bubble didn't burst here in Australia. Rather, government debt skyrocketed, and for little return in terms of infrastructure gains. Further, in many OECD countries the 'underemployed' also skyrocketed. Full time jobs were replaced with part time jobs and a high number of former employees couldn't find full time work at the old rates of employment. A major GFC legacy has been that the 'underemployed' has remained high in Australia ever since. This would reflect similar long-term effects of the 1987 crash.

The steep rise in sovereign debt levels meant that the investment bankers (debt underwriters) got even richer. At the same time, the largest commercial businesses got government bail outs because they were 'too big to fail'. Earlier in 2008, other businesses like Lehman Brothers were allowed to fail, but with alarming flow on effects. Political leaders quickly learnt the lessons.

In Australia, a major outcome of the GFC was that the Big 4 acquired 'implicit' guarantees from the Federal Government. That is, should ratios like the debt to equity ratio get too large and ROE too low, the Australian government guaranteed that the Australian taxpayer would bail out the Big 4. There was also a secret US Federal Reserve bailout of Westpac in excess of $1b in 2008-2009.

These changes had a large impact on the Big 4 and the nature or profile of Australian debt. It meant the overseas institutional investors could invest in the MTN programs of the Big 4 without an ultimate risk of loss of investment. That is, Big 4 MTNs became as safe as government-backed Treasury bonds. This meant the demand for Big 4 debt issues would go up and the demand for Aussie bonds would go down (a problem for government). Further, the institutional investors didn't need to worry about whether the money was being used wisely, because that became a political /

taxpayer problem. That is, the implicit guarantee weakened the market discipline imposed on the Big 4 by the institutional investors.

The result was that the Big 4 could use their funds for more risky or lower NPV projects, such as for mergers and acquisitions (Aussie Home Loans, the St George group including BankSA, Bank of Melbourne and RAMS, BankWest, overseas banks, insurance companies, etc.) Naturally, the Big 4 got bigger and competition in the Australian banking sector diminished. The Big 4 became more profitable and at the same time, housing continued to get more expensive. The gap between the property haves and the have-nots got wider in Australia. Today the financial sector in Australia is 10% of GDP – a ratio greater than in any other market in the world. The Big 4 are now all members of the Top 20 Retail Banks in the world!

Too Big to Fail

Our group would say it is time to remove the government implicit guarantees to the Big 4. However, if the government was to do this, then mortgage interest rates would need to go up to reflect the greater cost and difficulty of raising funds overseas. The banks would also need to be more choosey with their handing out of new or rolled-over mortgages. The Big-4 share prices would go down and they might lay off workers due to the credit squeeze. Australian house prices would likely deflate, even if the bubble didn't burst. What shareholder wants to see their shares go down in value? What retail borrower wants to pay higher mortgage interest? What property owner wants to see property prices go down? What politician would want to bear responsibility for this? Bottom line – the pollies are reluctant to do anything. Likewise, bodies like APRA, ASIC and the ACCC are powerless to do anything to curb the Big 4's market power and market dominance. That is, the Big 4 are no longer subject to the market disciplines or close scrutiny that would normally operate in a capitalist system. They are also free to follow their goals of considerable overseas expansion.

In summary, there is no identifiable independent market force outside of the inquiry's committee that can discipline the Big-4 to ensure they remain prudential and beneficent writers of debt. The RBA fails to meet the market test or the relevance test because its main role is to manage inflation. It is not to manage the banks, even though RBA monetary policy greatly affects Big-4 operations. (Higher interest rates increase the banks' opportunities to improve product margins over deposits at zero interest). The RBA can increase the overnight cash rate and thus dampen demand for mortgage credit, but when it does this, it also dampens the rest of the economy. The broad economy, with unemployment at decade-long highs, is more sluggish than the housing markets of Sydney and Melbourne and so still needs RBA support via low interest rates.

Further, Basel III requirements ensure the Big 4 hold a certain level of capital adequacy reserves, but this does nothing to reverse the bad effects of the government's implicit guarantee. Nor does it address the way the Big 4 use their funds to write mortgages at a higher pace than housing construction finance, thus pushing up the price of housing, contributing to the housing bubble and the growing gap between the property 'haves' and 'have nots'.

For example, in 2013 Westpac loans in Australia totalled $340b to retail borrowers, but only $6b to construction (not just housing construction). Overseas, $25b was loaned to retail borrowers, with $1b to construction. In terms of maturing loans in Australia, $1b was in construction but $19b in retail, perhaps reflecting the considerably longer term of retail loans compared to construction finance. The question would be how much these figures are driven by the bank's short term and strategic profit-seeking behaviours that might be at odds with Australia's best interests in terms of long term social fabric. Has the government of the day ever discussed this issue? In the case of Westpac, we can determine that the $19b represents 5.6% of all retail loans, but has a calculation ever been made across the banking system, over time and compared with other jurisdictions overseas? Additionally, what portion represented Australians owning property outright for the first time? It seems this could be one indicator of the diversification or concentration of wealth over time. Are there natural relationships or ratios between housing borrowings, the loan retirements of single-property owners, and construction that reflects a prosperous society cross-generationally? Could such a study help explain why the financial sector in Australia currently represents 10% of GDP?

The Big 4 are effectively in the same position as their Big Brother, the RBA. That is, central banks can write as much debt as they want, more or less, as can the Big 4. The Big 4 are not really commercial entities any longer. Like the central banks, their only discipline is a socio-political one, rather than one of capitalist markets. That is, central banks can create money and debt to the level the socio-political environment is willing to bear, unconstrained by market forces. We have seen this with the Federal Reserve's willingness to increase the US money supply. If the central banks 'print' too much money, currencies get hammered, institutions collapse, and revolution or rebellion on the streets ensue. We saw a little of this in Greece. We are not conspiracy theorists (we prefer the view expressed in the TED Talk at www.ted.com/talks/james_b_glattfelder_who_controls_the_world#t-155047) and not suggesting this will happen in Australia. Nevertheless, we do need to reinstitute market disciplines over our Big 4 before further banking scandals (such as the recent CBA financial planners scandal) arise. This has become a democratic issue and an issue of post-GFC applied capitalism, just as the huge injections of funds by sovereign governments into markets on behalf of taxpayers during the GFC were departures from democracy and capitalism. Bank behaviour has caused some, like Mike Carlton in the SMH (3/7/14), to call for a Royal Commission of the Big 4.

However, it is not just an issue of financial planner indiscretions or an issue of implicit 'a nod is as good as a wink to a blind horse' guarantees. In one sense, it is an issue of whether or not, in 5-10 years' time, we will look back and still agree that the deregulation of Australia's financial sector in the 1980's was a good thing. We still think the concept was a good one, but just how are the combined institutional settings looking today? Is competition between the banks back to the sorry state it was in when Paul Keating tried to shake it up with the introduction of foreign banks into Australia?

Back in the 1980's Keating complained Treasury was too powerful and the governor of the Reserve Bank too weak. Today the tables have turned. The RBA is so independent that the Treasurer never seems to consider the socio-political impacts of its policy in terms of actual Big 4 banking practices. Bottom line is that house prices keep going up because funds flow for mortgages but not to housing construction in a commensurate fashion.

However, this post-GFC problem is not just an Australian one. At an international level, while Australia struggles with removing the Big 4 implicit guarantee, other sovereign states are also grappling with implications of the 'Too Big to Fail' (TBTF) syndrome. Whether a government has backed a bank, insurance company or other commercial entity, the problem is how to remove that backing in an orderly manner and reassert normal market disciplines. In one sense, cash injections and equity participations are easier to reverse than financial market guarantees.

Governments need to address at least two aspects of the global financial problem – restoration of market discipline and a restoration of social justice. That is, the solution should try to reverse the gap between the haves and the have-nots that was the result of banking practices under government guarantees. Further, from lessons learned, the solution should try to strengthen our democratic institutions in the areas of monetary policy.

One possibility being discussed by the G20 is to impose a political solution on TBTF entities and their institutional backers. This solution will firstly identify a list of TBTF entities according to jointly agreed criteria. As we understand it, if a TBTF entity drops below a certain threshold, e.g. determined by a mix of financial ratios, then its financial backers will find that a relevant portion of their held debt securities will convert to equity. This is intended to act in the same way as when governments became owners of equity in TBTF entities during the GFC by using taxpayer funds. In this case the 'toxic assets' will transfer to debt holders rather than taxpayers. However, there is a big difference. Before the GFC nobody knew who the TBTF entities were, or how to reduce exposure to the risks they represented. Identification of TBTF entities will invoke all kinds of risk-mitigating activities this time around. We are not sure what the result of this activity might be. It might be to disguise the real TBTF entities before another crisis. In a future crisis, the issue might more clearly be 'too connected to fail'.

There are other considerations here. While the G20 solution still under discussion may reimpose a certain market discipline on the identified TBTF entities (that is, institutional investors will reassert their market muscles in proportion to the risks they take on when investing in TBTF entities), we are not sure how it would assert this same discipline on the small group of global institutional investors themselves. In fact, if not well implemented, the solution may exacerbate the problem it is trying to solve. That is, because the club of global institutional investors at this level is so small, it may globalise, centralise and escalate the problem rather than diversify the risk to global financial stability.

While it is true that the big institutional investors would typically rather hold interest-bearing debt than equity in a TBTF entity, this would not necessarily always be the case. It could be that down the track such investors would prefer to grow the balance sheet rather than the P&L. National rules in normal trading conditions might block takeovers of TBTF entities. However, what if a significant holder of debt securities in a TBTF entity withdrew its future services, such that the TBTF entity could no longer get the required funding and G20's TBTF rules were invoked? This would bring about an automated takeover without national prudential scrutiny. This could happen either in isolation outside a future GFC, or inside a future GFC. Would we taxpayers really want to shift the temporary governmental role of implicit guarantor to the very small club of global investors? This is a place where we need to discuss the issues of democracy and robust social fabrics rather than just capitalist market discipline. The solution to market discipline must be cognizant of the issue of social justice. Perhaps the biggest problem we face post-GFC is not the one of economic discipline, but the one of political democracy. This is the over-arching problem of eroded social capital compared to misaligned financial capital – but the two are clearly interpenetrating.

Enter Mark Carney, governor of the Bank of England. He marries together the ideas of economics and politics in his May 2014 speech, "Inclusive capitalism: Creating a sense of the systemic". The speech begins, "Inclusive capitalism is fundamentally about delivering a basic social contract comprised of relative equality of outcomes; equality of opportunity; and fairness across generations." The next paragraph says, "…few would disagree that a society that provides opportunity to all of its citizens is more likely to thrive than one which favours an elite, however defined … research suggests that inequality is one of the most important determinants of relative happiness and that a sense of community – itself a form of inclusion – is a critical determinant of well-being." He goes on, "It is necessary to rebuild social capital to make markets work. This is not an abstract issue or a naïve aspiration." In the section entitled "Financial reform and rebuilding social capital", he says, "Central banks' greatest contribution to inclusive capitalism may be driving financial reforms that are helping to re-build the necessary social capital. In doing so, we need to recognise the tension between pure free market capitalism, which reinforces the primacy of the individual at the expense of the system, and social capital which requires from individuals a broader sense of responsibility for the system. A sense of self must be accompanied by a sense of the systemic." This is the theoretical and philosophical core of his speech.

Carney then refers to the G20 efforts discussed earlier. He notes, "the FSB [the UK Financial Stability Board] is developing proposals, for the G20 summit in Brisbane, on total loss absorbing capacity for institutions, so that private creditors stand in front of taxpayers when banks fail. In addition, we are working with industry to change derivative contracts so that all counterparties stay in while resolution of a failing firm is underway." He continues with comments on addressing the various financial scandals of recent years, such as the manipulation of Libor, and addressing compensation schemes in the financial sector. He then finishes with the idea, "building a sense of vocation and responsibility … recognising that financial capitalism is not an end in itself, but a means to promote investment, innovation, growth and prosperity."

Perhaps ignoring the emphasis on growth, the words sound promising, but keep the prudential governance of financial specialists within the 'club'. While there is talk of social responsibility towards citizens, there is no thought of sharing governance with them. We would suggest that to truly address the post-GFC issue, and truly diversify the risks identified, we need to start working with models that enable citizens outside of the banking elite to participate in the democratic determination of financial governance and monetary policy at the street level. We need a new separation of powers between financial capital (money) and real capital (production). Just as in the case of Einstein's Law of General Relativity where, famously, space moves matter but matter bends space, so there is relativity between money and production. That is, money moves production, but production bends money. Alternatively, money enables production to move, but production enables money to be. We all share this economic 'bottom line'. Monetary policy directs or codifies the traffic of modern economic production, but without productive wellbeing, policy becomes irrelevant.

We as citizens are not all medical experts, but we can decide at the ballot box whether we want to retain or modify our Medicare system according to proposals put forward and publicly debated. The same should be true of central bank policy and banking regulation. We know what happens when dictatorships (benevolent or otherwise) rule – options for the betterment of society become diminished. Conversely, where there is a separation of powers, better solutions emerge from their dynamic interactions.

Solutions

- It is time for a separation of financial powers. If the global financiers are not self-deluded, they know this too, just like the European monarchs knew their time was up, or the British knew Gandhi was right, or LBJ knew Martin Luther King was right (see http://www.npr.org/blogs/codeswitch/2014/01/18/263512728/when-king-and-johnson-joined-forces-to-fight-the-war-on-poverty).
- The core solution must recognise that the centralisation of players in the global financial markets represent the most important source of financial instability, as those players vie for more profits or more equity. Conversely, the only true solution to the global financial instability that threatens non-violent trade/capitalism and non-violent government/democracy is a diversification of power and control. We believe that this is the core concept to which the inquiry must apply itself in order to explore solutions in the Australian context. Diversification of Big 4 market dominance must be sought in ways that will not be quickly reversed in the next GFC.
- This must mean opening up how banking is traditionally done in Australia – before massive disruption attacks the banking system in a disorderly fashion. If the banking system is not reformed, it may be that pirate crypto-currencies become as commonplace as pirate videos (with which most of the Australian public seems already accommodative). We challenge the committee to come up with a set of bold, world-leading and cutting-edge reform programs.
- The government's implicit guarantees to the Big 4 must be seen to be removed.
- A diversified banking system must be seen to serve the best interests of the Australian people – in current and future generations. This is why we ask for a Community Service Obligations regime to be set up for entities that provide intermediation services. It could be seed-funded by part of the banks' Capital Adequacy Reserves. Its aim should be to ensure there are arrangements in place for all Australians to have access to housing at a reasonable price (ownership or rental). This would mean construction funding is made commensurate with mortgage funding, thus alleviating the tendency towards a speculative housing bubble in Australia.
- The aim of the CSO Pool should also be to make it commercially viable for intermediation service providers to supply R&D and venture capital funding services, so that entrepreneurs can get access to funds currently denied them because their bank risk profiles are unattractive, or alternative uses of bank funds are more attractive from the profit-motive perspective. In this context, the committee should also consider micro-financing options, perhaps guided by experiences in Bavaria and elsewhere (see http://www.mikrokredit.net/microcredit/).

Kind Regards,

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[End of submission]