Submission To

THE FINANCIAL SYSTEM INQUIRY

Second Round

By George Ivanov

26 August 2014

This submission was inspired by attending the FSI forum in Sydney on 20 August 2014. I thank the committee for allowing me to attend and to make a submission. I had not intended to make a submission so this submission is somewhat “off the cuff”. Moreover, it has suffered as I was hindered by having my internet disconnected for some days because Optus could not handle a change of bank account details from which to debit its fees. I apologise for not being able to provide statistics.

As requested, I say a little about my background. I am “retired” and formerly worked as an academic, engaged primarily in research, in several universities and one major research institute, in Australia and overseas. I spent (or perhaps misspent) much of my life in business, as principle, in property development, the arts, consulting and even fast food.

I will try to be brief, as undoubtedly what I have to say has already been said by others. But I hope that I have a different perspective which may be of some value to the committee. Rather than address separately the 3 areas that Mr Murray invited submissions on, I will refer to them as the narrative proceeds: in the interests of brevity and clarity.

But first I would like to raise a practice that has concerned me for a long time and from which I have suffered in the last fortnight. I am referring to service providers demanding to be allowed to direct debit their fees from a client's credit card or bank account. This exposes the client to considerable losses but with little protection. Moreover, it is apparently common that such service providers continue to withdraw funds long after their services are terminated (especially, I am told, gyms). I was informed by my bank that it is particularly difficult to withdraw the debit right from credit card accounts as it requires both parties to consent in writing.

My experience during the past fortnight with Optus were most frustrating. The problem appears to be that their computer system is unable to recognise non-credit card accounts although it allows the option. I was connected and disconnected repeatedly because staff cannot over-ride the computer system which does not allow payment by any other means.

My savings account has still not been debited so I may be disconnected again without warning. We are now so dependent on the internet that financial activity (and a lot of other activity) is almost impossible without it. One cannot even find a telephone number. It is a form of imprisonment.

I ask that the committee to consider recommending the banning of service providers demanding payment of their fees only by direct debit from client bank accounts. The practice is now common.

The financial system (FS) is all pervasive and impacts all our lives, both personal and business. It is like the -

water supply, although we don't always realise it. Like the water that we drink, we expect it to be safe but, unlike water which one can boil to remove or destroy dangerous contaminants, there is little, if anything, that the individual can do to protect himself or herself from harm from failings of the FS, as recent events have shown.

Australia is a wealthy country and it has served its people exceptionally well but in one field it has not. One of the most basic human needs is shelter. Yet in recent decades our nation has failed miserably to provide it. Housing in Australia is now the most expensive in the world, by any reasonable measure, and many people cannot afford to own adequate housing or even to it rent.

There are many causes for this, including state and and federal governments, but since the late 1990's the banks and other mortgage providers bear a large part of the blame. The discriminant and irresponsible lending up until the GFC (and now beginning to reappear) caused massive inflation. (I know of an ordinary worker, a storeman, with no private wealth who bought 7 “investment” properties.)

The CPI underestimates inflation in housing and hence total inflation because it does not measure changes in land prices. In the late 1960s unit sites on the then outskirts of Sydney were selling for $1500 per 2 br unit. Now they cost more than $150,000. The cost of bricks rose from about $45 per 1000 to about $1000 per thousand and bricklaying costs have risen about the same (with similar numbers), as have overall labour costs – of self employed contractors working on houses and low rise unit blocks. More recently, in 2000 when the GST was introduced and the Federal government started making “co-payments” (by another name), new houses could be bought for about $140,000 on the outskirts of Sydney, such as near Penrith. Within a few years the land on which they were built was selling for that much. Of course, the escalation in the price of land closer to the Sydney centre and in wealthier suburbs has been much greater, both in absolute terms and relative to building costs. These large increases in the cost of living is felt by households but is not reflected in official statistics on which governments make decisions.

Against their wishes and better judgements, many buyers felt obliged to jump on the train of escalating house prices for fear that they would be left behind and never be able to buy a dwelling. The result was a horrendous increase in household debt: almost four fold, in “constant value”, in less than 10 years. House ownership fell dramatically and outright ownership (no mortgage) fell from 55% to 40% (if my memory is correct). People are now retiring with mortgages on their homes: something that was once unheard.

Household debt is currently $1.84 trillion or more than $79,000 for every person in the country. This is not only having a serious detrimental effect on the lives of the people but it is also having, in my opinion, a serious detrimental effect on the nation's economy. To paraphrase Mr Glen Stevens (of the RBA) households have used up their “animal spirits”.

The major part of the banks' lending is now for consumption (60% for housing, credit cards, cars and other personal loans). So there is very little left for business and even less for small business. It is business that creates jobs which the country needs badly. But business is even paid less on bank deposits than people. Paradoxically (perhaps) the global effect of individual banks over reliance on “safe” housing assets is actually lowering their safety as it is making it harder for business to acquire and employ productive assets which produce the income that house borrowers need to service and repay their debts.

The major banks are now so dependent on housing that they have become glorified building societies. So one might say that, ironically, they have been consumed by the many building societies and other minnows that they consumed over the last 3 decades or so.

I know the last chairman of the Betta Electrical group. The group was destroyed by its bank during the worst of the GFC because it panicked and couldn't do its analyses properly. I was informed that the courts also came to that conclusion but it was too late and most franchisees were ruined. Many people lost their jobs. So it is not only individuals who have suffered from incompetence and malpractice by the banks.

A couple of years ago I opened an account with one of the Big 4 banks. Shortly afterwards, I was ushered, against my protestations, into the office of the bank's investment advisor (a man young enough to be my son, if not grandson). It made me wonder how I might have reacted if I had been looking for a loan or some other service from the bank. Would I have felt obliged to give this young man some business, against my better judgement? Would I have been pressured to take an insurance policy with a bank subsidiary?

Recently I bought some shares on the ASX using a broker owned by one of the banks. Upon receiving the invoice I noticed that there was no brokerage fee but an explanation that it was because the bank was the seller. This broker, like others, regularly publishes assessments of listed companies, and like others, I read them. So there is a potential conflict of interest on the part of the bank/broker. I have been buying and selling shares for many years and I think I am not particularly gullible but, it was the first time that this obvious realisation hit to me. I recall that the same broker had recently put out 3 very different opinions of a major public company, from strongly positive to strongly negative and then back to strongly positive. There were no significant public announcements or other public information about the company. I wonder if the bank did any trading in that stock?

The major banks now are not just deposit taking institutions (DTI). They all have insurance arms, fund management arms, investment advice arms and brokerage firms. I can't see any great value to the country for this. There is value to senior management, in very large salaries and kudos, and possibly to share holders but I don't see any great benefit to the banks' depositors or borrowers. On the other hand there are potential disadvantages to depositors, borrowers and others who do business with the banks and their subsidiaries, as mentioned above (and as many have already found out). There are dangers of potential conflicts of interests when a bank lends to businesses that compete with businesses that the bank owns. If for no other reason than that it obtains confidential commercial information about its competitors.

Ownership in insurance companies is a concern. Insurance is a very complicated and risky business (as QBE learned in the last few years) so ownership by a bank increases the bank's riskiness. Shareholders who want exposure to insurance or fund management, etc should be able to do it without also compelling bank shareholders to be exposed.

I ask that the committee to give consideration to recommending that DTIs be prohibited from owning other businesses. That would, of course, require the major banks to be broken up, but I don't think it would be difficult or prohibitively expensive. Although that should not be a factor in the decision. (It would have a negative impact on my finances.)

There is evidence that single purpose businesses are more efficient than conglomerates, so there would be benefits (perhaps not immediately) both to shareholders and the public at large. It would make it very much easier for investors, creditors and customers to assess the quality and soundness of the particular entity (bank, fund manager, insurance co, etc). The simpler a bank's structure and operations the easier it is to understand it and assess its viability. Hence the cheaper its borrowings would be.

Mr Murray asked the question whether the dominant purpose of superannuation should be to provide retirement income or to be a source of savings. Both are, in my opinion, fundamentally important to the nation. In the current situation, I feel that savings should be given a slight preference if a preference has to be given. I say this because in the past couple of decades we have been spending like drunken sailors, often foreigner’s money at that, so we have little left for investment. We need to become more self sufficient in funding our economy.

The saving benefit can be enhanced by controls on what assets super funds can buy. I think it was a mistake to allow “investment” in art or in housing. Housing has multiplier effects but these are now relatively small and getting smaller since the major component, land, is growing and most dwellings purchased are established. Moreover, the country does not need any more sources of house price inflation.

Rental returns on dwellings are too low to sustain a retired person or couple (except for those with large holdings) and one cannot eat (unrealised) capital gain, although it is a hedge against inflation. On the other hand finding productive assets, with reasonable returns, in which to invest is difficult in Australia.

I think it was a mistake to relax the requirement that super assets produce an income stream. I don't know what the current limit on super funds' borrowings is, but feel that it should be very low and preferably reduced to zero. Equity investments are risky enough without multiplying the risks by gearing.

Increasing longevity is a concern as it will place demands on super that not all funds will be able to meet. Self funded retirees will need to have assets that produce sufficient cash flow to cover their living costs. In addition the cash flow will have to grow with inflation and a little more to pay increases in health costs due to aging. The government will have the same demands on its finances to pay for pensioners.

I don't think these can be met if unemployment is not reduced. The “real” unemployment rate is now about 14%. Called the “underutilisation” or “underemployment rate” it is ignored by politicians and, perhaps, by government advisors as well. The 6% figure for “unemployment” comes from a ridiculous measure whose only purpose seems to be to make politicians look not so bad. In the “bad old days” the unemployment rate was about 0.5% and 1% was regarded as disastrous. One was counted as unemployed if one did not work more than 20 hours per week. Now one is counted as employed if one works 1 hour per week. It is a cruel joke. So investment in new productive assets is badly needed.

The growth in SMSFs is caused in part by the high fees charged by super fund managers, which may be a result, in part at least, of the market being dominated by 5 participants, including the Big 4 banks which have a captive market. Splitting off the banks' fund managers should, in the long term, increase competition and thus reduce fees. It would encourage more innovation.

There is concern in the community about “moral hazard” and “too big to fail” associated with banks' operations. A lot of the concern is about the taxpayer being exposed to bailing out the banks if they fail. I am more concerned about the effect on the nation that the failure of a major bank would have. It will impact on the entire economy and thus on all taxpayers. The world is still feeling the effects of the GFC and no-one knows for how long this will be. It may be decades.

Various proposals are being enacted (both domestically and overseas) and considered. In my opinion, increasing the capital requirements of banks will help but will not prevent bank failure. Lowering a bank's gearing substantially from, say, 12:1 to 8:1 (assets to equity) will still make it the most highly geared company in the economy. No other company would survive with such high gearing even with better assets.

So additional protections are needed. I am not in a position to make any suggestions but I'd like to illustrate a general principle by an analogy. What should be done to prevent trucks drive too fast on the highway? The two most obvious approaches are: (A) impose a speed limit on trucks or (B) physically limit the speed that trucks can travel. Neither is foolproof. The former would require constant vigilance by the police and the employment of large numbers of police. Failure could result from police not being able to constantly monitor every section of the road and from policemen occasionally making mistakes. And by truck drivers inadvertently or intentionally speeding. The latter (B) could be circumvented by deliberate tampering with the speed limiters. Both would inevitably happen but I believe the latter less frequently, because it would be a planned act and more permanent, thus making it easier to detect. So I think the latter would be the superior approach, especially if police numbers and resources were to be diminished over time. Of course, employing both approaches would be best.

As a general principle I feel that prevention is better than deterrence.

Continuing the analogy, one would need to consider the effect of a major truck accident on the highway. The bigger the truck the more damage it would cause, to its immediate vicinity and down the road (due to road closures, etc). It would cause damage to the suppliers using it and to the suppliers' customers. The bigger the truck the more widespread the damage would be. On the other hand bigger trucks are more cost effective, at least to the users if not to the community, which is often much harder to assess. As always, there are costs and benefits and these cannot be completely and accurate quantified and will change over time. My own preference would be to use more smaller trucks. Australia is a wealthy country and a I think most people would prefer the added security and be prepared to bear the higher cost, especially as it would increase employment (of truck drivers, etc).

Getting back to the FS there is a lot of debate about the possible alternative measures. They all seem complicated and a little bewildering. There is talk about "ring fencing", "Chinese walls", "holding companies" and Glass – Steagall (GS). From what I understand, the first two would entail a lot of vigilance on the part of the authorities (presumedly APRA). How successful could the authorities be in policing the internal bank operations (i.e. bank staff) when the banks themselves cannot do it? (Pre GFC we used to hear almost annually of rogue bank staff loosing billions on FX trading, of insider trading, etc.) If after a period of no major problems from the banks, would the government continue to fund the authorities at the same level? To what extent would the effectiveness of the authorities depend on the abilities and commitments of its staff?

I have little faith in Chinese walls as it is too easy to inadvertently or intentionally breach them. And they rely on deterrence.

The other two approaches appear, to me, to be similar, but that is probably just my ignorance. As I understand G-S was an enforced separation of "good or safe banks" and "bad or risky banks" in ownership, control, staff and commercial dealings. Is this what the holding company option proposes, with the exception that the ownership remains the same ("safe" and "risky" banks to have the same shareholders) and both banks be controlled by the board of the holding company? I think this is not sufficient separation. (Suncorp is an example.)

I know very little about G-S. I understand that the Act was repealed (or at least the relevant sections), in the late 1990s, because over time it had been watered down or re-interpreted so much that the distinction between the two types of banks had disappeared. I don't know if the repeal was the primary cause of the GFC, as many contend. (Did Alan Greenspan going on about “new paradigms” play a role?) But it appears that G-S had a significant beneficial effect for a number of decades.

The US system is somewhat different from ours and G-S did not apply to all DTIs. I assume that here it would apply to all DTIs. When considering various options it might be helpful to ask “why not impose an Australia version of G-S here”.

As new structures or laws will be imposed, it might be better to make them a little stricter and more demanding than ideal with the view of making relaxing adjustments over time as experience suggests. Our banks have been very successful and overall have served us, the people, very well for a number of decades. But perhaps we should not “push our luck” and it is time to clip their wings a little. (I expect it will re-invigorate them.) Now would be a good time as the government may be more prone to muster the courage to do it.

My impression is that Australians are bear the costs of protection and want the best.

In the raging debate, bank shareholders have received a bad name. They have been blamed for most, if not all, of the harm caused by bank failures. Yet shareholders here, and I expect in the USA and in other western countries, have no say in the management of the banks (as in other public companies). I am, of course, referring to households who are the ultimate owners. Employees are hired by other employees (boards) who appoint themselves and decide on the management, direction and future of the companies. Occasionally employees of other institutions have a say. Households have less real say in the election of company boards than in the election of governments. All that households can do is shuffle ownership amongst themselves. (It is little better than in the former communist countries.)

Australia has a high proportion of share ownership: both direct and indirect. Direct ownership is increasing rapidly with the increase in SMSFs, which are usually managed by people without great expertise and with little time to devote to the task. Hence it is important that shareholders be protected and that large public companies be viable and be seen to be viable. Otherwise more people will flock to “investing” in housing.