26 Larakia Street
Waramanga
ACT 2611

6 September 1996

The Secretary
Financial System Inquiry
Treasury Building
Parkes Place
Parkes ACT 2600

Dear Sir,

I enclose a copy of my submission to the Financial System Inquiry, and I include a floppy disk containing the same in Macintosh Microsoft Word format.

I am making the submission as a private individual, and the views I express are solely my own.

Yours faithfully,

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Submission to the 1996 Financial System Inquiry

Rationale for this Inquiry

Inquiries, despite their stated reasons and objectives, are invariably initiated at the request of some pressure group to resolve a difficulty they face. I happen to know that the previous Campbell Inquiry (to which I was a contributor), despite its wide ranging investigations, was initiated at the behest of a group of stockbrokers who desired the removal of fixed commissions. The Campbell Inquiry's very successful recommendation was of course the introduction of negotiable commissions. The measure of success of this policy has been the total lack of controversy on this decision and the subsequent prosperity of Australian stockbroking.

The present Inquiry was not initiated just because the new Government thought it a good idea at the time. If that was the case, a number of inquiries into pressing problems in other areas would have also been initiated immediately; into Health, Industry and Tariff Policy, Transport and Communications, among others. This did not happen.

A clue to the source of the pressures which initiated this Inquiry lie in the relatively minor key of this Inquiry, and its restricted terms of references. A perusal of the terms of references show that the main concerns of the initiators are the new forms of competition in the area of provision of finance to consumers, brought in partly by technical changes and partly by structural changes copied from abroad.

To be specific, what this inquiry is all about, even though there is "no evidence", and never likely to be, is the competition to Banks provided by the sudden and rapid growth of mortgage intermediaries and brokers. All the rest is a smokescreen.

If this Inquiry takes its terms of reference with a pinch of salt, as the Campbell Inquiry did, something useful may come out of it. Certainly, despite its origins, the timing of this Inquiry is fortuitous, as major changes in Australia's financial system are pending which will eclipse the competitive effects of a few mortgage brokers. As a consequence of these pending changes, it is likely that the present system based on four large banks (and a few small ones) will not cope.

Regulation of Mortgage Brokers

But first back to the mortgage brokers. Can their activities be regulated to the benefit of the banks?

The simple answer is NO. Not because of any moral or equity grounds, or even economic efficiency grounds, or on the grounds of good policy, but because it is just not possible. Money is "fungible". What that basically means is that it does not matter to the borrower where they money comes from, as long as he gets the cheapest loan on the terms and conditions he desires.

So you pass a law restricting the activities of mortgage brokers. What happens? A "rent" or excess profit is created. Somebody gets a bright idea (or copies one from abroad) to get round this law. Very rapidly a new market structure is created to bring buyers and sellers together.

People know it can be done now, and they know that there are vast potential profits to be made, so the reaction time compared to previous years would be much reduced. The regulator will be reduced to a role of trying to plug a very leaky dyke with his fingers. He will very rapidly be reduced to a figure of ludicricousness and impotence - not a very good image for a government instrumentality.

If members of the Commission have in the back of their minds that a Bank and Building Society lending structure is divinely arranged or natural, I need only remind them that in the United States, the source of many of these innovations, mortgage brokers now arrange some 60 per cent of housing loans, having taken over from the largely moribund S & L industry.

So much for the basic purpose of this inquiry. You cannot reduce the competition from mortgage brokers, and it would be foolish to try.

Questions whether the economy would be simpler to control without mortgage brokers are academic. They exist, and will rapidly become more important. Monetary policy must encompass the growth and variety of non bank financial intermediaries, and not hark back to the "good old days" when it was easy to control monetary quantities through the bank SRD fulcrum. Those days have gone for ever.

A scheme of prudential supervision

The best you can hope for is some form of prudential supervision. A system supervising the honesty, viability and sound business practices of the new intermediaries as they appear. As such, the regulatory body would need a general investigative rubric for all things financial, staffed by high quality and highly honest staff with powers to investigate and prohibit any un-ethical or foolish activity, and the mandate and incentive to act fast.

In this respect the record of the Reserve Bank excludes it as a suitable regulatory body for the new financial system, as the new financial system requires experience beyond the current banking structure. Also the Reserve Bank's recent record of supervision has been very inadequate. I need only mention the State Bank of South Australia and the Pyramid Building Society as major failings in its record of proactive prudential supervision.

The regulatory body needs to be staffed by persons drawn from the financial markets, which should make them more suitable, by reason of their contacts and experience, for the supervision of a highly volatile financial environment. This is more appropriate experience than that drawn from the Reserve Bank's present relationship with the major banks and the old "money market" - cash and bills. Even now, if you include the forward, futures and the new non bank intermediation markets, banks and the money market are a very small part of the total.

I suggest therefore that a new financial regulatory body be set up in a major financial centre (not Canberra). It would need to be staffed by highly paid persons from the financial markets. It is crucial to understand the mind-set of the financial community, and where all the bodies are buried. The persons in the regulatory body would be given a contract of a maximum of five years, containing a prohibition to work in Australia for the following five years. Maybe a large pay-out and job search assistance in London or New York would be included. The limited contract is to prevent a growth of "ownership" of the job, leading to corruption over time. (Remember these guys would be daily making decisions on the morality of multi-million dollar deals). The removal from Australia at the end of the contract would hopefully remove most of the influences of a possible "golden parachute" into a cushy job among the regulated.

There will no doubt be criticisms from public servants and the potential regulatees that these proposals are extreme and expensive. A couple of 'Barings style' disasters will change everyone's minds.

The potential for disaster in financial markets is vast and the probabilities are not negligible. For instance, I have heard rumours that one Australian trading bank was rescued by the Reserve Bank at least twice over the last twenty years. The Australian based forward market has over a billion dollars a day turnover, and the futures market has liabilities in the region of hundreds of millions. A lot can go wrong, very suddenly.

Is self regulation viable?

There is a natural and understandable call from operators in the various financial markets,and the producers of various financial products, for self regulation. They argue that it is in there own interests to regulate the industry effectively, and the costly and ignorant interventions by some bureaucrat are not necessary.

An examination of how such a self regulatory system would operate would however show that a *well informed, able and interventionist* government regulatory body is likely to be superior to an industry regulatory body.

It all boils down to a simple concept, the probability of regulatory intervention occurring when that intervention is required.

There are two components to this. First, knowledge that intervention is required. Second, the likelihood of the regulatory body to intervene under those circumstances.

It can be argued that an industry self-regulatory body, being closer to the industry, would be better informed of occasions when intervention is required than a government regulatory body.

The question then arises whether that self regulatory body would be more likely than a government body to intervene when necessary .

The self regulators may argue that it is in their own interests to regulate the industry effectively, and say that history is replete with examples of government regulators taking no action even when the misconduct is blatant. A good example being the recent problems with the conduct of the Australian air regulatory bodies.

However the problem with self regulation is that the persons who have to enforce regulatory decisions would be very likely be drawn from the industry and are likely to have a *too close* continuing relationship with the industry. Occasions would arise that the regulator's private interests would conflict with the public interest of the industry and of the community at large. These persons would be open to many different influences, and at the margin, decisions which should have gone one way will go the other. Activities which a (a fully informed and active) government regulator would have curbed would be "let through" by the self regulator.

So there is a trade-off between the potentially less information accruing to the government regulator against the potential of a reduced incentive to intervene by the self-regulator. (Of course there is a third possibility, an ignorant and inactive government regulator, but I shall deal with this shortly.)

The best outcome for all of this would be a "hybrid". A government regulator staffed solely with persons drawn from the regelated industries, and retaining contacts with those industry. Yet these person would be government employees with no incentive to modify their actions due to any influence from the regulated industries. Their personal interests would be divorced from those industries.

What I have suggested previously is that these persons be given a five year contract, and then sent abroad after their period at the regulatory organisation has been completed.

Is an expensive regulatory system worth it?

Is it worth it? It depends what price you want to pay to prevent a "melt down" in Australia's financial system. In an un-regulated system, something will go wrong in the future in a big way. That is absolutely certain. That is the nature of any financial system.

Why? The essential feature of the financial system is that regardless of the industry, you are dealing with a single commodity. No, not money. Credit. As explained later in this submission, money and credit are the same, and all economic actors create it, even individuals. Despite what the text books say, the amount of credit in a modern financial system is not related to the amount of currency (government credit) circulating in the system.

However credit is a fragile thing. It depends on to a very large extent in the faith in our financial system. Our economic system is totally dependent on the creation and use of credit throughout the economy (not just by banks).

If there is a major financial "shock" to the system, which reduces faith in the financial system, the use of credit will decline. Economic activity will decline.

This is not airy fairy theorising. I shall give an example. In the early 1930's in the US the measurable money supply contracted by one third, largely as a consequence of public fears caused by bank failures and the stockmarket crash.

Where did the money go? Wiped out by the failed banks? No. While several hundred ultimately failed, there was not enough of them and they were too small to have that total effect. The quantity of currency fell by one third? No, it didn't. It stayed about the same. Contractionary government action? No, the Hoover government actually attempted to increase the money supply.

The only explanation left is that intangible - Confidence. Money contracted as credit contracted due to the American public's collapse in their faith in the financial system.

Now, as has been mentioned elsewhere in this submission, the structure of the financial system in Australia has markedly changed over the past ten years, and these changes are likely to continue in the future. It could be argued that banks are no longer central to the financial system, and will certainly become less so in the future.

A financial regulatory regime based on a core of the Reserve Bank, surrounded by the major trading banks is unlikely to be adequate in the future. A believable and effective regulatory system needs to be set up to maintain faith in the entire financial system, including all the new products and institutions coming onto the market.

Given the size of these alternative financial structures, maintaining faith in just the banking system is not good enough.

Monetary Regulation

In a discussion of financial regulation, it is necessary to dispose of some of the baggage which has crept into the regulation of the financial system - that is its relationship with monetary policy.

Not so very long ago, the fixed and stable environment of the financial system, with the trading banks lying towards the core of the financial system, and the Reserve Bank lying at its centre, made it very easy for the authorities to control the quantity of money. The Reserve Bank through its regulatory powers over the banks controlled the quantity of money in the banks' reserves, and the total quantity of money expanded or contracted as a consequence. It used to be said that while you could not guarantee an expansion in business activity this way, you could certainly guarantee a contraction. The last of these ill-starred '"short sharp shocks" occurred in 1982, and it is to everyone's benefit that the Reserve Bank is no longer in a position to engineer one of these events, as nowadays with the new financial structure if banks contract lending the demand for money will be met by increased supply from other sources.

Nowadays, it is a rare firm or business which would not be able to tap alternative sources of lending through a finance broker if its line of bank credit is forcibly reduced by government action.

As a result, the central role of the Reserve Bank has declined over recent years. (No, this is not a polemic against the Reserve Bank - I am just telling it as it is!). The structure of the current Australian Financial System is such that not not only has the Reserve Bank lost control over monetary quantities, but, as a consequence of its actions smoothing exchange rate movements, even over the level of interest rates.

Why is this occurring? The best explanation I feel is to start by describing how money is created.

Everybody creates money. The process is not just confined to banks, or even bank-like institutions. If for example I go to a person and say, I will buy those goods and I shall pay you later, and the seller agrees, a credit transaction has occurred, and effectively money has been created. If we go one step further and I say I'll give you a bit of paper as a record, and the seller uses that piece of paper to purchase more goods, as your credit is "good" with the third party, then that piece of money begins to circulate.

The essential point is that you do not need banks with their reserve ratios, Reserve Banks, or governments to create money. Money can be created by a whole host of persons and institutions ranging from individuals through mortgage brokers, credit unions, building societies to the Reserve Bank.

In fact it would be an interesting exercise for an economist interested in monetary economics to find what proportion of the current money being created is being created by banks. The reason for this inquiry is that this proportion would provide a guide to the effectiveness of conventional monetary policy ie restrictions on bank lending, or the creation of 'inside money' by the Reserve Bank. Under conventional monetary theory the quantity of money is supply driven. Money is created by the major banking institutions, there is excess demand for money, and this "inside money" is then re-multiplied by the 'monetary multiplier' at a decreasing rate to give the final quantity of money.

What if, as it is increasingly becoming apparent in Australia, these institutional strictures do not hold, and money is created to meet demand by the amorphous group of financial institutions which are already beginning to dwarf the conventional banks?

First, monetary policy as we used to know it would not exist. Since money supply would always equal money demand, regardless of the actions of the authorities, attempts to vary the quantity of money to affect economic activity would be a waste of time.

Attempts by the government to "borrow from the Reserve Bank" to fund its activities would be immediately inflationary as money created would be in excess of demand.

Under these circumstances, could the Reserve Bank raise (or lower) interest rates?

The normal procedure (lets assume that domestic rates are completely insulated from international rates) for the government to change the domestic interest rates is for the government to either borrow or lend to the domestic money market.

However if the government borrows to raise interest rates under the current and future financial structure, new money would be created to meet demand by the many different financial intermediaries, and interest rates would
NOT rise, or only temporarily.

On the other hand, if the government created money and pumped it into the system, interest rates would fall temporally as supply exceeds demand, and then almost immediately a paradoxical effect would occur. Interest rates would RISE. Why? Because there would be an almost immediate inflationary effect from the increased money supply.

These circumstances are modified by the present situation that domestic interest rates follow closely those of our powerful trade partner, the United States. If there was total insulation of our domestic monetary economy from the world monetary economy, this tracking of the US interest rates would not occur. We would have total insulation if we had completely floating exchange rate. Unfortunately we do not. The Reserve Bank interventions in the exchange rate, the "smoothing and damping" of the exchange rate movements, means that there are monetary leakages between the domestic money stock and the world money stock. This lack of insulation leads directly to the world ie US, interest rates influencing the domestic interest rates. What we are having is a de-facto fixed exchange rate for limited periods of time, with the concomitant monetary inflows and outflows.

Australians are kidding themselves if they believe that we can insulate ourselves by more than about half a per cent from movements in the Fed rate. In other words, Australian short term interest rates equal the Fed rate plus transaction costs plus some variable risk premium, the forward rate plus some country risk.

In other words you cannot have an independent interest rate policy AND Reserve Bank intervention in the exchange rate.

Arguing that the intervention is "small" has not been borne out by experience,. Whatever the quantities of money involved are, they certainly have had the effect of reducing the ability of the Reserve Bank to follow an independent monetary ie interest rate, policy. It is clear that Australia's domestic interest rates follow the Fed rate, and they should not need to do this under a pure non-interventionist float of the exchange rate.

Returns to scale

Another theme, or sub-theme, detectible in these terms of references is that the major banks are pressing for mergers as they will cause "greater efficiencies" and allow the banks to become more "internationally competitive".

The theme "greater efficiencies through mergers" depends on an economic concept, "increasing returns to scale". This means that (forgetting technical references to marginal returns) that when a bank gets bigger its unit costs fall, due to efficiencies gained through increased size. Similarly "constant returns to scale" means that when the bank gets bigger there are no reductions in unit costs. "Decreasing returns to scale" means that when the bank gets larger unit costs increase. The general situation for most firms is that as they grow they first go through a period of increasing returns to scale, then constant returns to scale, and then decreasing returns to scale.

Whether a firm is operating under increasing, constant or decreasing returns to scale is an empirical matter.

In the case of banks, because this question is related to a number of other interesting monetary issues, such as the "free banking" question, a very large amount of research on returns to scale in banks have been done over the last twenty years. Much more so in fact than any other industry except possibly agriculture.

Of the scores of papers of published research on returns to scale on banking, on banks in a wide variety of countries and a wide variety of sizes, including very small local US banks, I cannot recall a single result which showed increasing returns to scale.

Empirical research on the question is unequivocal, that regardless of the country, constant returns to scale for banks starts at a very small size. If banks grow in branches and deposits, it is mainly due to the use of monopoly rents and the growth imperative is a consequence of monopolistic competition. In areas where bank competition is intense, banks remain small, often single branches.

So what, you may ask? The reason for this discussion is that it relates to the question of mergers being called Australian banks for the reason of "greater efficiencies".

All the empirical work done so far throughout the world for the past twenty years indicates that this stated reason of "greater efficiencies" is complete nonsense. Australian banks must be all operating at least at constant returns to scale, or quite possibly decreasing returns to scale. Any merger would produce absolutely no efficiency gains, that is reduction in unit costs. If a bank claims otherwise, it would have to put a strong case in the face of widespread and entrenched economic opinion that these claims are nonsense.

I can put an alternative reason for these calls for mergers. That is, due to increased competition these banks have detected a fall in their monopoly profits. They feel, foolishly and erroneously, that they will bolster their monopoly profits by increasing the level of monopoly. They therefore call for further mergers.

In fact, the banks' behaviour in closing branches and reducing staff levels makes it clear that they are well aware of their unit costs, and that they are operating under constant or decreasing returns to scale. Their own behaviour reveals that the banks' senior management themselves do not believe that increased size will lead increased efficiencies -reductions in unit costs. These merger proposals are a forlorn and ultimately hopeless grab for monopoly profits, given the current and future changes in the financial structure.

Will increased size improve banks' international competitiveness?

Australian banks claim that they have to be larger than they are at present so that they can make larger loans required by the larger international borrowers.

This is a somewhat dubious reason for a number of practical reasons:

1 Australian banks are already among the largest banks in the world. Only a few of the largest banks in the largest industrial countries are larger than the Australian banks. Certainly Australian banks are on top of the second tier group of world banks.

2. Even the largest banks make few large loans commensurate with their size. Large loans are syndicated to reduce risk, and spread among a number of banks.

3. "Servicing" a large borrower does not require a large bank. Many very large American firms, for instance, are happy to use a small local regional bank for their day to day transactions.

4. Large international loans are relatively unprofitable, with small "spreads". The Australian banks are well aware of this, which is probably the major reason why they are not greatly involved in this area. The domestic largely protected market has been much more profitable.

Again, the likely gains from international competition by increasing size is an empirical matter, but on the face of it this appears to be a dubious claim, especially if it is unsupported by any evidence or research results.

Conclusion

A prudential regulatory framework for the financial market is vitally necessary. The probability of disaster from error or malfeasance is large, and the consequences of a failure in the financial system can be very expensive. Not only can there be direct losses, but there can be flow through effects as other economic actors are affected by the losses to the parties directly affected.

In the past ten years Australia's financial framework has changed massively. So much so that the previous certainties of monetary policy no longer hold. The Reserve Bank has a much reduced control over monetary policy, either through the control of monetary quantities or of interest rates, as new financial intermediaries have a much expanded role in the economy. These new financial intermediaries have a much increased ability to create money in response to demand, and respond to contractions by banks in the supply of money by increasing supply themselves .

The banks' response to the new regime by calling for reduced competition from these new non bank financial intermediaries is useless, as any attempt to reduce competition by regulation is bound to fail. Alternative financial organisations will quickly spring up to offer the same services as banks.

The banks' response to the new regime by calling for mergers is equally pointless. They are unlikely to reduce unit costs by this action, and any monopolistic gains will be quickly lost to the new forms of competition. Gains from increased international lending are likely to be small.

However there is a very urgent necessity for new forms of prudential supervision of the financial sector. This sector is very large, and has been explained above, the commodity it creates and uses, credit, has a very close relationship to public confidence. This public confidence has to be maintained, even if the regulatory regime is expensive.

As the financial markets and products are rapidly changing, the regulatory body needs to have a detailed knowledge of the industry, without a too close involvement. Under these circumstances, a new regulatory body is proposed, as the Reserve Bank has shown that it is unsuited to regulate the new environment.

Further, self regulation is unlikely to be successful, as there is a too close connection between the regulated and the regulators.

I have proposed a hybrid regulatory body, government financed and appointed, but drawing its personnel solely from the various financial industries. I have proposed further safeguards to improve their performance. Namely a maximum five year contract, and an enforced period abroad after the contract is finished.

Finally I have pointed out that if this proposal is regarded as exceptionally expensive, the consequence of not having a very sound scheme of prudential supervision can be catastrophic.