Financial System Inquiry

Speech – 1 May 2014 – Australian Business Economists

Mr David Murray AO

(Check against delivery)

Progress of the Inquiry

Thank you to the Australian Business Economists for the invitation to speak today.

We are now four months into the Inquiry and have just finished an extensive consultation process. We received over 270 submissions from all over Australia including peak consumer, small business and financial services bodies; government and regulators, academia and business.

As well as receiving submissions, I attended most of the almost 100 stakeholder engagement meetings we have held. In early April we met with our International Advisory Panel to hear international perspectives. We've also met with international experts and regulators who have visited Australia mostly associated with the G20.

Let me give you a quick overview of what we have heard. It doesn't do justice to the thousands of pages of argument and empirics we have received, but it will give you a broader context for the issues that I'll canvas today:

- Major financial providers are telling us the financial system is competitive but over-regulated, and may be uncompetitive in some sectors internationally.
- Smaller players are saying they are disadvantaged, asking us to 'level the playing field' (on regulation, competition and cost) especially in banking.
- Big business is saying the financial system is working well – though domestic bond markets could be a more active part of the capital structure in Australia.
- Small business is saying there are problems with access to and cost of finance.
- Consumers are saying that the regulatory framework is generally sound and lending has improved – but there are concerns about disclosure and financial advice and investment, as well as financial exclusion and low-income access to some financial products.
- Regulators are saying the system works well, or are asking for more powers.
- Generally, submissions on international issues either want us to support managing more international funds in Australia, and/or facilitate integration with Asia.
- Technology is a key theme. Submissions note the changes to the financial services industry that test the structure of the industry, the business models employed in the industry and perimeter of our current regulatory regime.
- Demographics and longevity are an issue. We have a large superannuation pool, but it might need to be better aligned to the needs of members in retirement.

Overall, the most frequent issues raised were regulation, competition, consumer outcomes, ageing and super, banking and technology. We have spent the last few weeks reviewing, analysing and testing the submissions. We have more to do but have a very broad and deep database of empirics and ideas.

In our assessment the submissions point to three fundamental issues that suggest we should not have too high a level of comfort about some current financial system settings:

1. Moral hazard: that is, the expectation that government will stand behind the financial system to prevent or minimise loss.

2. Potential consequences of current system settings for the flow of funds in the financial sector and the economy.

3. Drivers of change – regional and demographic change, but especially technology and innovation.

Responding to these issues will require us to balance objectives of the system, and find trade-offs between efficiency, stability, reliability, fairness and accessibility. It will require policy decisions about appropriate allocation of risk throughout the system.

Moral hazard and role of the government

A moral hazard problem arises when there's an expectation that a government will have no choice but to bail out a failing institution – using taxpayer funds. This expectation reduces market discipline, encourages riskier behaviour and can represent a large implicit public subsidy of private enterprise.

This is what the Chair of the Wallis Inquiry Mr Stan Wallis, had to say 17 years ago about the role of government in the financial system:

'*Regulation cannot and should not ensure that all financial promises are kept. Indeed, the [Wallis] Inquiry considers that the government should not provide an absolute guarantee in any area of the financial system (just as it does not do so in other areas). Primary responsibility should remain with those who make financial promises. It would be inequitable for the government to underwrite some financial promises but not other promises made by participants in the broader economy.*'[1]

Nevertheless there is a long global history of governments using taxpayer funds to support distressed businesses in the financial system. In Australia, the GFC led to government support in ways that the Wallis Committee did not expect– the Wholesale Debt Guarantee, the Financial Claims Scheme, direct intervention and support for the securitisation market, coupled with direct fiscal stimulus.

The perception of the government as a backstop may provide competitive advantages to some, and can distort prices and the efficient allocation of capital.

Significantly, the overall outcome was that the GFC shifted public expectations of when and where governments will intervene. The question for us now is whether we are content to accept that shift.

[1] Source: Financial System Inquiry Final Report 1997, page 128

We also need to think about the role and performance of our regulators. Submissions provided evidence that our strong legal system and respect for our regulators supports investment in this country. Most submissions want our regulators to remain strong, well-funded and independent, to make decisions in the best interests of the long-term growth of the system, and to be accountable for their performance.

In a post-GFC environment it is perhaps not surprising that some submissions noted that concerns about the safety and stability of the system may have overridden the longer-term interests of competition and innovation. This Inquiry presents an opportunity for us to ask whether we should recalibrate.

Current system settings and flow of funds

A second fundamental issue is current system settings that may not result in the most desirable outcomes for the economy.

Some examples of these settings raised in submissions included:

1. Australia's foreign funding dependency leading to reliance on foreign capital markets;
2. The role of superannuation, its growth and how it is managed;
3. An increasing level of financial integration with Asia and particularly China;
4. Housing credit growth and household indebtedness.

Our economy continues to rely on international markets, predominantly in Europe and the US, for funding and capital. Large imbalances and overhang still exist from the GFC and most of the economies we look to for capital and funding have quantitative easing programs in place that we expect will affect the price and availability of funding when they are ended.

This uncertainty is one example of why a strong Australian Government balance sheet is central to maintaining a well-functioning financial system. With substantial risks remaining in the global economic environment, maintaining fiscal strength is critical. By doing this, we retain fiscal capacity to respond to future adverse shocks where needed.

Over time, we can expect Australia will reduce its dependency on traditional sources of international capital flows and tilt toward Asia. China has set a timetable for allowing its currency to be freely traded and its capital account to be liberalised. This will have wide-ranging implications for the Australian financial system, including potentially significant amounts of Asian direct investment moving into our market, and into others around the world.

In the domestic system there are significant incentives for people to make voluntary contributions to their superannuation. Some predict that superannuation assets will exceed those of the banking system by around 2030. With $1.8 trillion in superannuation assets[2],

[2] Source: APRA, *Quarterly Superannuation Performance (interim edition)* December 2013 (issued 20 February 2014)

Australia has the fourth largest pool of superannuation (or pension) assets in the world and is one of only a few countries with pension assets worth more than annual GDP.[3]

Major superannuation industry groups and the Reserve Bank of Australia have drawn attention to the short-term focus of superannuation funds. A well-functioning and efficient superannuation system would be expected to better match the maturity of assets and liabilities. Efficiently matching the investment horizon of assets and liabilities could be expected to improve capital formation. You would also expect it to be cost effective. I note the recent Grattan Institute Report suggesting ours may not be.

Many submissions have also pointed to a weakness of the superannuation system in the retirement phase. Our superannuation settings focus on maximising wealth creation during the accumulation phase, rather than the delivery of income at the time of retirement. There is a paucity of attractive financial products that help retirees manage their income and risks, particularly longevity risk.

These issues need to be carefully assessed to ensure that our settings support broader economic activity, productivity and growth, including whether or not significant expansion of credit for housing is at the expense of fixed capital investment.

Technology change

Australia quickly adopts and adapts new products, technology and services to the Australian market. For example:

- In 2013, 56 per cent of the four major banks' customers used the bank's website or app while only 31 per cent used a branch; satisfaction levels were higher for internet than branch banking.[4]
- Nielsen Research[5] shows 98 per cent of online Australians have compared a product or service online; 97 per cent have purchased a product or service online.

Submissions note that our financial system and its regulatory structure need to adapt to the opportunities and risks presented by technology:

- Payment platforms are currently regulated across a number of regimes; and a number of submissions question whether the regulated environment might need to be adjusted.
- Traditional product disclosures are falling behind technological innovation. Consumers now regularly compare products online.
- Regulators' tools and expertise might need to be updated to deal with cyber security, online fraud and privacy.

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[3] Source: Towers Watson, Global Pensions Asset Study 2014, http://www.towerswatson.com/en-AU/Insights/IC-Types/Survey-Research-Results/2014/02/Global-Pensions-Asset-Study-2014

[4] Source: Roy Morgan 2013, *The rise of internet banking*, http://www.roymorgan.com/findings/5203-internet-banking-on-rise-201309200624

[5] Source: iselect prospectus Nielsen Australia March 2013 Research, page 28, http://corporate.iselect.com.au/wp-content/uploads/2013/09/4-June-2013-Prospectus.pdf

- Better adoption of technology should promote service standards to remote/rural communities; support for those currently unable to access technology is important too.

But technology is not an end in itself: it is about the capacity of the system to change and innovate, and it has impacts for business models and the wider economy.

A good example is the growth of the market financing or shadow banking sector. The internet and platform developments have enabled new business funding sources like 'crowd-funding' and 'peer-to-peer lending'. While different, they are both forms of non-intermediated lending. Small business owners and entrepreneurs are directly matched with individuals willing to provide funds.

At the moment, business surveys suggest that these innovations provide a very small share of funding for new or small businesses[6], but it is an area we need to assess closely – especially when we consider the rapid growth of some of these innovations globally.

There are also more and more examples globally of businesses that begin outside the financial system but leverage media or technology capabilities to then provide financial services ancillary to their original business. With an increased capability to collect and analyse data, the financial system will see more instances of technology, data or media providers seeking to provide financial services based on the information they already hold.

Technology is also creating new techniques for risk management – again because of an enhanced ability to amass data. The insurance industry globally is considering where this will end in terms of use of biometric information and accessibility for some consumers to health and life insurance services.

For technology issues a key trade-off will be between stability (particularly of our payments system) and fostering an environment where innovation and technology can better meet user needs. We will be posing questions in our Interim Report on a number of areas where technology is challenging existing business models, delivery channels and current regulatory settings.

The Interim Report

So, with the GFC behind us, the Inquiry must reassess whether risks in the system are appropriately positioned for the benefit of the wider economy.

Accordingly we are working toward a July release of an Interim Report. Among other things in that Report we'll be asking you some key questions:

- When would you expect government to step in to prevent losses to consumers? How far should the government go to try to prevent loss?
- Do current system settings prevent our economy from operating and allocating funds efficiently? If so, should we act or wait to see whether other innovations address the risks or unwelcome distortions?
- Is our regulation appropriately calibrated to provide confidence in our financial system while allowing technological change, innovation and entrepreneurship?

[6] Source: Reserve Bank of Australia 2014, *Submission to the Financial System Inquiry*, page 131

Your perspectives in the submissions following our Interim report will be important, because trade-offs are not easy. As I said at the outset, we must balance the objectives of the system, which will not be a simple exercise.

Risk, in particular, presents complex tensions. In its discussion of the financial system and risk transfer, the RBA submission describes this tension well:

> *Importantly, the role of the financial sector is not to remove risk entirely. Rather, it should facilitate the transfer of risks to those best placed to manage them... Moreover, it is not the goal of the financial sector necessarily to minimise risk. The socially optimal amount of risk is almost certainly not the minimum feasible level, given the importance of risk-taking to innovation and entrepreneurship*[7]*.*

Finding the socially and economically optimal level of risk will be a central challenge for our Inquiry, and for our financial system in the years ahead.

I will now take some questions.

[7] Source: Reserve Bank of Australia 2014, *Submission to the Financial System Inquiry*, page 11