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Financial System Inquiry: Funding Australia's Economic Future

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Check against delivery

Good afternoon and thank you to CEDA for inviting me here to speak today.

There are many views that have been aired as part of this current financial system review – and I'm pleased that is the case – our financial system is the life blood of our country and its performance matters to us all.

The global financial system is operating in an environment of significant change; change from technologies, change from regulation and changes to economic paradigms. For much of the developed world, the impacts of the Global Financial Crisis or GFC are still being managed, with the focus of regulators and governments on ensuring that disaster doesn't repeat.

In Australia, the approach of regulators has largely been one of compliance with global standards, notwithstanding that some of those standards were designed to remedy ills that have not been experienced here. We have seen a focus on bank capital and funding, aimed toward the resilience of individual banks and the safety of bank deposits.

Our financial system's existing structural framework means the majority of Australia's savings are invested in markets rather than bank deposits, which creates an interesting challenge for the Inquiry to consider and brings me to the two interrelated questions I will address today.

Number one - is our system currently designed to best support optimum investment and economic growth, and especially, what is the impact of our superannuation system and bank regulations on the ability of banks to support economic growth?

And second - does government involvement in funding of the system create artificial distortions? In particular, has the introduction of the Financial Claims Scheme (FCS) and the implicit government support of banks, especially systemically important banks, reduced the efficient allocation of capital through moral hazard?

IS OUR SYSTEM DESIGNED TO BEST SUPPORT OPTIMUM INVESTMENT AND ECONOMIC GROWTH?

Starting with the first question, there are two factors that most profoundly influence whether the system supports optimum investment and growth: the channels of financial intermediation – banks or markets; and how the system solves situations of growth.

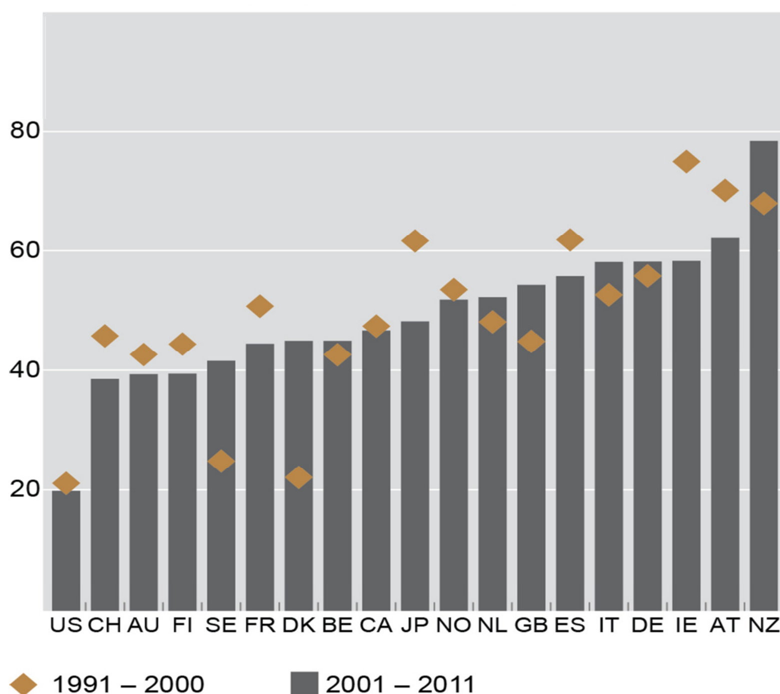
THE ROLE OF BANKS AND MARKETS

We know that intermediation of credit by banks plays an important role in providing capital for investments in Australia.

This role is supplemented by effective market-based intermediation. The chart below shows the results of a recent Bank of International Settlements (BIS) study.[1] For many it will be a surprise that Australia already has relatively well developed markets for private sector funding, with only the USA and Switzerland advanced economies less 'bank oriented' than Australia based on the ratio of bank credit to total private sector funding.

[1] Gambacorta, L, Yang, J and Tsatsaronis K, BIS Quarterly Review March 2014 'Financial structure and growth.' The ratio of bank credit to the private sector is expressed as a percentage of the sum of bank credit plus bond and equity market capitalisation.

Figure 1 – Ratio of bank credit to total private-sector funding (%)[2]



Notwithstanding the capacity of our markets, banks play a unique role in credit intermediation. Banks remain the most efficient and flexible translators of risk – via credit, maturity and liquidity transformation. Banks also provide the broadest reach of credit provision ranging from large corporates to SMEs and households. They achieve this through focusing on knowing their customer, building strong relationships and having a deep understanding of credit risk.

As the BIS study also highlighted, in normal cyclical downturns banks are more inclined to continue providing credit compared with markets-based sources, through drawing upon the knowledge gained through long-term relationships with customers.

[2] Countries are: AT = Austria, AU = Australia, BE = Belgium, CA = Canada, CH = Switzerland, DE = Germany, DK = Denmark, ES = Spain, FI = Finland, FR = France, GB = United Kingdom, IT = Italy, JP = Japan, NL = Netherlands, NO = Norway, NZ = New Zealand, SE = Sweden, US = United States.

Banks also dedicate substantial resources and focus on credit-decisions. For example, Westpac makes around 11,500 individual, non-automated credit decisions each week across its customer segments involving thousands of customer serving and risk employees. Most banks operate with a similar level of diligence, and this is a function that cannot be easily replicated by markets.

Some argue that much of this intermediation could be done by a larger fixed income market. I think this argument grossly simplifies the unique role that banks play.

Certainly, the fixed income market is an important supplement to bank credit provision, and its accessibility and depth will improve with initiatives to reduce the regulatory burden on corporate bond issuance. [3]

However it tends to serve a relatively narrow element in the spectrum of funding requirements, compared with the flexibility of banks which provide different forms of financing including project finance, working capital and cash flow matching, to name a few.

Fixed income markets function best where:

- There is deep information and transparency of the credit worthiness of the issuer. Independent credit ratings assist in this regard, as does publicly available financial information as provided by listed companies; and
- There is sufficient liquidity in the security to allow price transparency and ease of buying and selling. Large issue sizes and common maturity dates assist this outcome.

This explains why the Australian fixed income market is dominated by large listed corporate issuers, the major banks, semi-governments and government securities. Secured securities, such as RMBS and covered bonds, are also important and attractive to professional investors.

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[3] The second reading speech of The *Corporations Amendment (Simple Corporate Bonds and other Measures) 2014 Bill* confirmed the Government's intention to reduce the regulatory burden on issuers of corporate bonds. Measures include requiring companies to offer simple corporate bonds through an offer-specific prospectus; enabling bond issuers to incorporate or refer to information already disclosed by the bond issuer as part of the disclosure material; putting in place architecture to enable parallel trading of simple corporate bonds in the wholesale and retail markets.

The nature of the Australian economy, combined with the features of the fixed income market, is why we have quite a low number of issuers compared with, for example, the US where the fixed income market is a more major pillar of funding. To illustrate - the US corporate bond market has featured a pool of 500-600 investment grade issuers each year for the last three years, while Australia's market has ranged between 30-50 issuers in the same period.[4]

To summarise - banks play a unique role in providing credit in Australia's system. While markets-based intermediation will continue to be an important supplement to bank funding, an efficient financial system must feature a well-managed, well-regulated and sustainably funded banking system.

AUSTRALIA'S SAVINGS PATTERN

The relatively high proportion of market-based private sector funding in Australia highlights that an already large pool of savings is allocated outside the banking system. This is likely due to two structural features of Australia's financial system - the first is dividend imputation, which increases the relative attractiveness of equity markets. The second is Australia's compulsory superannuation system, which directs a high portion of savings into superannuation funds.

It is within that context we should assess the current framework of Australia's financial system – how well positioned is it to support optimum growth?

Australia's strong compulsory superannuation system is where most growth in Australian savings has occurred. When the Wallis Inquiry presented its findings back in 1997, total superannuation assets were $279.5 billion. By December 2013, that number had reached $1.8 trillion. This is a compound growth rate of 12.3% pa. Superannuation assets are predicted to reach $7.6 trillion by 2033.

Our superannuation framework is unquestionably an important and appropriate base for Australia's retirement savings. Indeed, the strength of this system is the envy of many other developed markets as Australia has sought to more effectively deal with the global phenomenon of an ageing population.

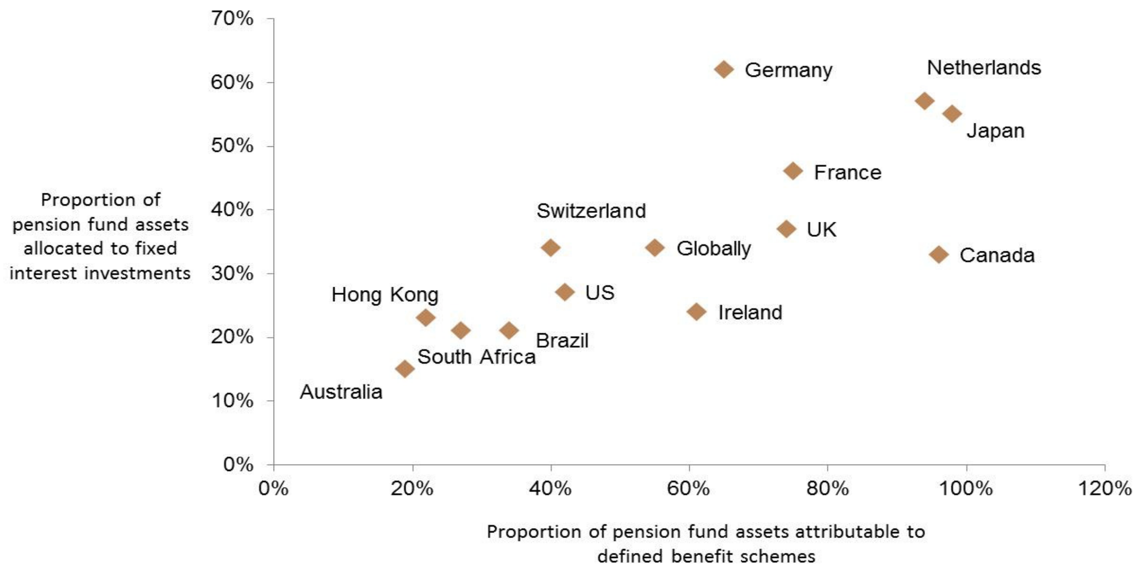
[4] JP Morgan, analysis 2014. US issuers number excludes financial institutions.

In our system, for most people the retirement amount saved is entirely a function of employee and employer contributions and investment earnings. Members bear the risk of not generating sufficient savings to fund their retirement. The resultant growth orientation of our system favours a greater allocation of superannuation savings to equities.

Many other countries operate with a larger focus on defined benefits schemes – where employers promise a specified level of income on retirement. This favours a greater asset allocation to more long-term, fixed income investments with greater certainty of returns.

The funding of our financial system therefore starts from a different base compared to many other nations. As the next chart shows, the proportion of Australia's pension fund assets invested into fixed interest investments is extremely low by global standards, which correlates with a low proportion of Australia's pension fund assets attributable to defined benefit schemes.

Figure 2 – Pension fund fixed interest allocation and the relative size of defined benefit schemes[5]



[5] Westpac analysis. Data from Tower Watson Global Pensions Assets Study, 2013.

The nature of Australia's compulsory superannuation system favours an allocation of national savings where:

- A higher proportion of savings is invested in equities;
- A higher proportion of savings is managed by institutional and sophisticated investors; and
- A higher proportion of savings is invested overseas.

In turn, this allocation of savings affects the framework within which the financial system is funded:

- There is less direct saving by households into bank deposits;
- As a result, there is more wholesale funding on Australian bank balance sheets; and
- More overseas capital is provided for credit and equity funding, which has the effect of neutralising the balance of payments.

This framework is vitally important to how the system adjusts in periods of growth.

REGULATORY CHANGE IMPACTING BANK FUNDING

The next important factor for the framework of how the system is funded is regulatory change since the GFC, focusing on individual bank resilience.

The most significant of these regulatory changes is the Liquidity Coverage Ratio (LCR), which requires banks to hold increased levels of liquid assets to meet a 30 day liquidity stress scenario.

Under the new LCR rules that come into effect in January next year, a clear distinction will be made between different types of deposits, and how much a bank can lend from them. The best type of deposit, typically retail, will allow a bank to use 95% of the value for lending to customers. Whereas the least valuable deposit in an LCR world - typically short term deposits from financial institutions - will not allow any lending.

The Net Stable Funding Ratio due in 2018 will further encourage banks to reduce the composition of funding from shorter term wholesale sources.

HOW THE SYSTEM 'SOLVES' FOR GROWTH

We know that credit demand will always be equal to credit supply and the system will always operate in equilibrium. But what is important is 'how' this equilibrium shifts – who are the winners and losers of this process of adjustment?

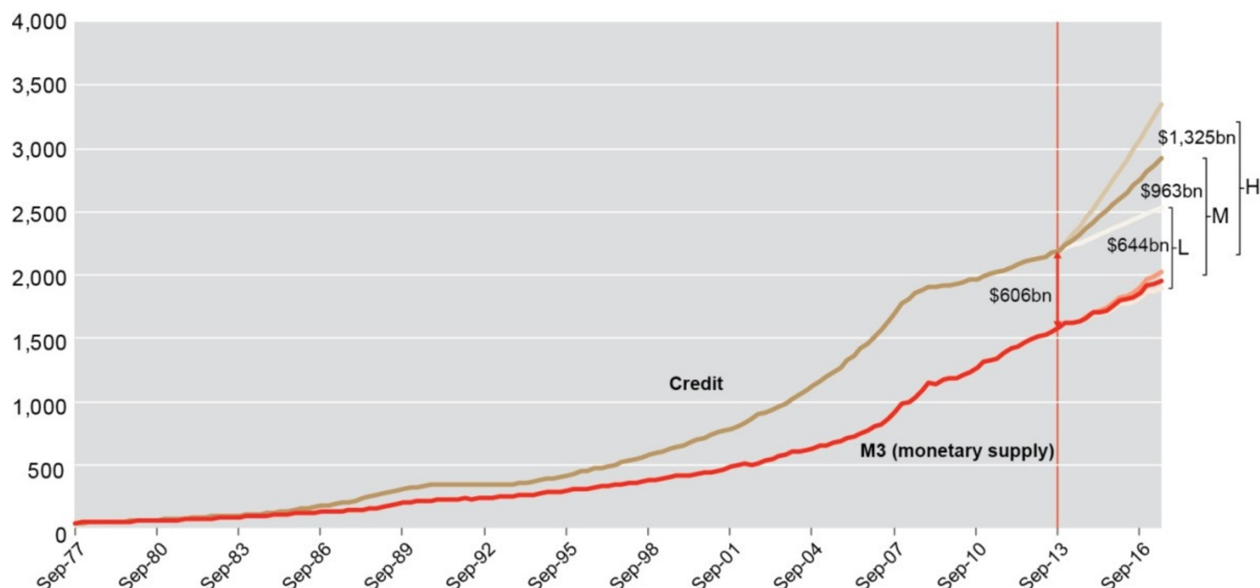
A high growth outlook in Australia would normally require, and be supported by, higher credit growth and bank lending. But in some probable economic scenarios, higher credit growth and bank lending in our system may not be possible, and a gap between credit demand and higher quality forms of bank funding could be created.

PwC research[6], shown on the next chart, highlights that currently the gap between deposits (represented by monetary supply) and credit demand is around $600 billion. This is essentially met through banks accessing wholesale funding markets.

The research considered what would occur if credit growth picks up, and the household savings rate did not similarly increase. Under medium (8% pa) and high (12% pa) credit growth scenarios, the PwC analysis shows the magnitude of the gap between deposits and credit demand increases substantially – to $963 billion for the medium scenario, and $1,325 billion for the high growth scenario. These numbers also understate the real gap, in that they don't take account of the impact of the LCR requirement and the quality of funding required.

[6] PwC, 'Sustainably funding Australia's prosperity,' December 2013. Annexed to ABA Submission to the Financial System Inquiry.

Figure 3 – Magnitude of system imbalance between credit demand and monetary supply (A$bn)



In these cases of medium and high credit growth, Australia's banking system will face a substantial funding task to meet demand for credit. And given changes to banks' funding environment, the ability of Australian banks to meet such a funding task in wholesale markets is uncertain.

Inevitably, the gap between credit demand and higher quality forms of bank funding will be solved. But the issue is – how.

Some predict that the shortfall in deposits would be offset by higher wholesale borrowing by banks – but prudent bank management will be wary of creating undue financial risks through higher wholesale borrowings. Just because investors are prepared to buy Australian bank bonds today, does not guarantee they will do so in the future.

I think it is almost certain that banks would push up deposit rates as they compete for more stable, high quality funding to satisfy lending opportunities. The high loan demand and higher deposit funding costs are likely to see lending rates rise. Higher demand for funding will also likely be satisfied by more corporate direct bond issuance, and potentially greater equity investment from offshore.

So – critically - who will be winners and losers of these adjustments? The winners are likely to include:

- Financially flexible borrowers that can easily switch between various sources of debt and equity funding. They have the recognised credit-standing and sophistication to access capital markets when it best suits them; and
- Parties looking to attract overseas capital. More international investment in Australian companies would seem likely through this adjustment, similar to 2008-2009 when there was increased foreign equity investment in Australia totalling $141 billion.

The losers are likely to be those sectors of the economy that primarily rely on bank credit including individuals, SMEs and corporates that are unable to access market-based funding. They are likely to pay more for their loans than they would have otherwise. And those sectors are very important for Australia's growth in the future.

The question for the Inquiry – and for our system – is whether this outcome leads to a level of credit provision that optimises investment and economic growth.

For me, the answer is likely not.

MORE EFFICIENT WAYS FOR THE SYSTEM TO SOLVE

The most efficient way to ensure the system can best support growth in periods of higher credit demand is to increase the source of high quality funding to banks to support lending. Two suggestions on how this could occur are:

- Equalising the tax treatment of deposits; and
- Incentivising increased investment of superannuation savings into bank deposits and fixed income securities.

The first suggestion of equalising the tax treatment of deposits is relatively straight forward and it was supported by the Henry Tax Review.

Obviously, changing the tax treatment of deposits may have implications for government revenue. But the current treatment is distortive. It actively encourages investment away from a high-quality funding source that maximises productive lending. This seems an unintended consequence that should be remedied.

On the second suggestion - encouraging superannuants to take out products offering an income stream in retirement would be an effective way to increase investment of superannuation savings into bank deposits and fixed income securities.

At the super fund/trustee level, this would likely drive a more conservative allocation of superannuation assets, and impact the manner in which trustees manage member monies in seeking to achieve a targeted level of lifetime income for their members. In effect, trustees would behave more consistently with trustees of defined benefit schemes.

At the individual retiree level, income stream products in retirement would provide a stable, predictable return and help manage longevity risk. Given these characteristics, there are likely to be opportunities to design these products to meet the high-quality funding requirements of banks, such as through their duration.

So what could be done to encourage greater take-up of retirement income stream products? Certainly their importance continues to be widely discussed – so I think the Inquiry should review current regulatory impediments and other barriers to their innovation and wider take up.

The Inquiry should also consider options for streamlining members' transition from the accumulation to the retirement phases of superannuation at an appropriate age – for example by offering members the opportunity to switch to an income stream in simple ways, such as through their regular member statements.

No doubt there will be challenges with the implementation of these and other ideas - but they present an excellent opportunity to assist Australians with better planning their retirement income, and to also increase the source of high quality funding to banks.

To summarise - the efficient bank funding framework of the financial system is a pressing matter for the Inquiry that goes to the heart of whether our system can support optimum investment and economic growth.

DOES THE SYSTEM HAVE ARTIFICIAL DISTORTIONS THAT REDUCE COMPETITION AND EFFICIENT ALLOCATION OF CAPITAL THROUGH GOVERNMENT INVOLVEMENT IN THE MARKET?

I'll now turn to my second question as to whether government involvement in funding of the system has created artificial distortions.

Following the GFC there has been much discussion regarding the extent of moral hazard risk inherent in Australia's financial system.

This risk tends to split into two:

- Moral hazard implications of the FCS. This is relevant to deposit funding; and
- 'Too Big To Fail' (TBTF).This is relevant to the wholesale funding of systemically important banks.

On 12 October 2008, the Australian Government introduced separate guarantee arrangements for deposits and wholesale borrowing. The FCS provided a guarantee of deposits to a limit of $1 million.

The introduction of these schemes was designed to support the stability of the financial system in a time of extreme global volatility and uncertainty, and was necessitated by similar actions being taken around the world.

The question is whether these guarantee arrangements created distortions that reduce competition and reduce the efficient allocation of capital through moral hazard.

THE FCS AND MORAL HAZARD

The FCS was designed to stabilise the flow of deposits which was threatening the liquidity and solvency of a number of smaller financial institutions.

Westpac supported the introduction of the FCS and the subsequent stabilisation of the financial system, albeit that its introduction improved the competitive position of non-major banks. In September 2008, Westpac's household deposits grew at an annualised rate of 36%. Household deposit growth for the non-major banks grew at a rate of less than 5% in that month. And the growth disparity widened even further in early October.

The ongoing FCS provides little absolute benefit to a bank as strong as Westpac - and in fact, is a comparative disadvantage. We would gain a bigger share of system growth without it. The FCS enables less strong financial institutions to gain additional deposits they otherwise would be unable to source.

Therefore in the context of deposit funding, there is certainly no major bank distortion arising from the operation of the FCS.

A more relevant question is: has or could the FCS encourage additional and unwise risk taking by the less strong banks? The theory here is that if deposits are guaranteed, the relevant financial institution has no incentive to actively protect depositor interests. Indeed, the incentive may be to seek the highest possible returns, and hence greater risk, because the downside risk is effectively eliminated by the government guarantee.

The incidence of bank failure in the US, which also operates a deposit guarantee and is a banking system with a high number of regionally-based smaller banks, suggests that this risk is real. Since the start of 2009, 475 US banks have failed.[7]

Several submissions to the Inquiry propose that a fee be charged for the FCS, and indeed the Government has referred the issue to the Inquiry. We do not agree that an ex-ante fee is necessary or appropriate. Due to the high loan to deposit ratio in Australia, and our depositor preference arrangements, our deposits are well covered by high quality assets.

However if a fee was introduced, it may be that a mitigant to moral hazard could be achieved by a fee levied on a relative risk-basis, although appropriate regulatory supervision is likely to be a better approach.

[7] Federal Deposit Insurance Corporation, Failed Bank List as at 5 June 2014. http://www.fdic.gov/bank/individual/failed/banklist.html.

WHOLESALE FUNDING AND 'TBTF'

The second area of moral hazard raised is in connection to wholesale funding and TBTF. The argument made is that some banks' operations are sufficiently large to require government intervention in a time of stress to maintain financial stability.

To date, Australia's experience of moral hazard from TBTF is a theoretical risk. And regulatory and supervisory controls are effective in preventing any potential moral hazard issue.

Let me elaborate on three issues in the context of TBTF:

- The nature of implicit government support, and who benefits from this support;
- The moral hazard risk associated with this support; and
- Claims that major banks should be required to pay a fee for their rating benefit because of implicit government support.

IMPLICIT GOVERNMENT SUPPORT

There are acknowledged benefits to the rating of Australian banks from the assessment that in a crisis those banks would receive some form of extraordinary government support. Moody's and S&P recognise this support, and accordingly apply a rating uplift to individual banks' ratings based on a combination of the fiscal capacity of the government, and the likelihood of support from the government.

There is clearly a symbiotic relationship between government and bank ratings. A strong financial system is specifically identified as an important factor supporting Australia's AAA rating. So a strong banking system supports a strong government rating, which in turn benefits bank ratings.

The populist narrative regarding government support is that major banks are 'guaranteed.' The assessment of extraordinary government support in a crisis is not the same as a guarantee of ongoing solvency or obligations of individual Australian banks. In fact, the ratings of major banks are debt ratings, and seek to indicate the security of a depositor or debt holder's funds.

This distinction is illustrated by the fact that the most highly-rated Australian bank ratings are three notches below the sovereign Australian rating. This implies a probability of default three times higher than the Australian Government. Clearly, the rating agencies do not assume we are guaranteed not to fail.

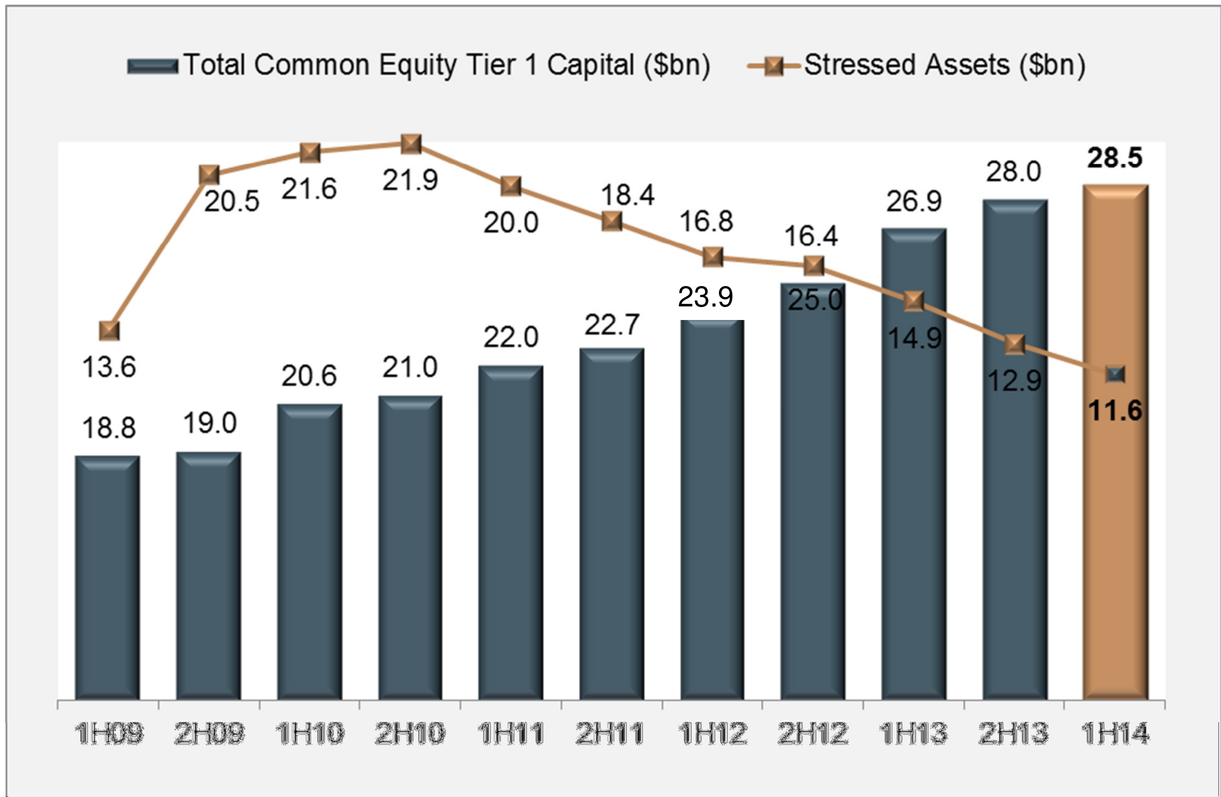
MORAL HAZARD RISK

The recognition of implied government support is not unique to Australia. 77 per cent of top 100 global banks receive a rating uplift for operating with perceived government support.

For moral hazard to be a consequence of this outcome, the Australian major banks would need to be advantaged compared to a "normal outcome," and have taken on more risk, compromising usual commercial considerations and relying on government support. There is no evidence to support this conclusion.

Australian major banks, if anything, have reduced the risk of their asset portfolios following the GFC. This is illustrated by the next chart, which shows a reduction since the GFC in Westpac's stressed assets and a significant increase in Westpac's total common equity tier 1 capital over the same period.

Figure 4 – Westpac Total Common Equity Tier 1 Capital and Stressed Assets 1H09-1H14[8]



A FEE FOR 'TBTF' BANKS

I would like to briefly address arguments that a fee should be levied on large banks for the rating benefit arising from implicit government support.

I find it very difficult to see how imposing this fee would reduce moral hazard or improve allocation efficiency.

[8] Westpac Group Published Financial Results.

Making a perceived government support explicit by charging a fee would seem to increase the risk of moral hazard. The bank being charged would likely emphasise this aspect as an investment feature. This could have the perverse outcome of diverting funding to the major banks at the expense of smaller banks and non-banks. A rational customer and investor, for example, is likely to direct more of their savings to a guaranteed bank than a non-guaranteed financial institution unless there is a material price difference or risk premium.

So if a TBTF fee were imposed, it could see more funding directed to the major banks, exacerbating systemic risk.

It would be difficult for government to argue that this fee represented no additional support. It is for this reason that regulators around the world, including in Australia, are looking to reduce the risk of banking through more higher-quality capital, more liquid assets, more longer term stable funding, better resolution planning and more equity conversion requirements in bank capital securities.

Imposing a TBTF fee for the major banks also ignores that we are operating in an open and global financial system, competing on a daily basis with banks and other financial institutions around the world. As previously mentioned, most major global banks receive a rating uplift for perceived government support without any fee. Accordingly, any TBTF fee placed on the major banks would effectively diminish the international competitiveness of our least risky institutions – and hence the competitiveness of our system overall.

As concluded by the Federal Treasury in their submission to the Inquiry, this is not an area where Australia should differ from the rest of the world. An effective supervisory framework is the best prevention for excessive risk taking in banks.

CONCLUSION

I've covered a lot of information today so in conclusion allow me to reiterate the key points.

Banks play a key role in providing a broad range of capital for investments in Australia.

In relation to my first question, whether our system is designed to best support optimum investment and economic growth, the answer is that currently it is not, and this issue will become more obvious in a higher credit growth environment.

As we return to this kind of environment, the widest and deepest distribution of credit will require banks to have improved access to high quality funding sources. This could be achieved through equalising the tax treatment of deposits and incentivising increased investment of superannuation savings into bank deposits and fixed income securities.

My second question as to whether government involvement in funding of the system through the FCS and implicit support of banks, especially systemically important banks, has created artificial distortions – I believe the answer is 'not yet' and that the regulatory changes already underway, backed by good supervision, is the most effective form of prevention.

The Inquiry has a significant and important job ahead of it. Westpac will be an active participant in the process, because it is important we achieve the right outcome for all Australians.