

MELBOURNE ECONOMIC FORUM



BANKING

4 September 2018

MELBOURNE ECONOMIC FORUM



Peter Harris and Rosalyn Bell

Productivity Commission



Australian Government

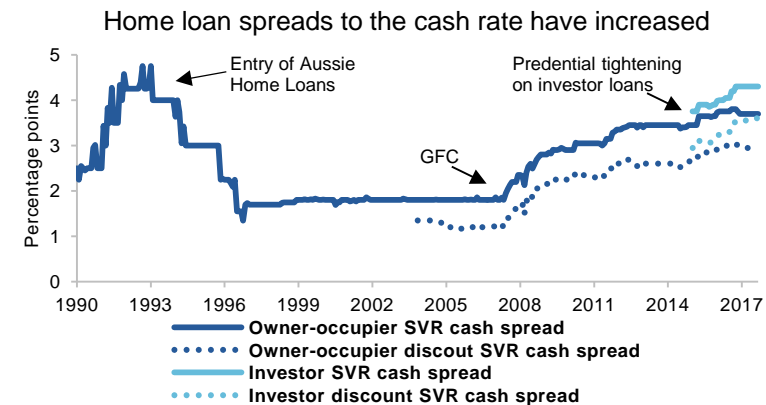
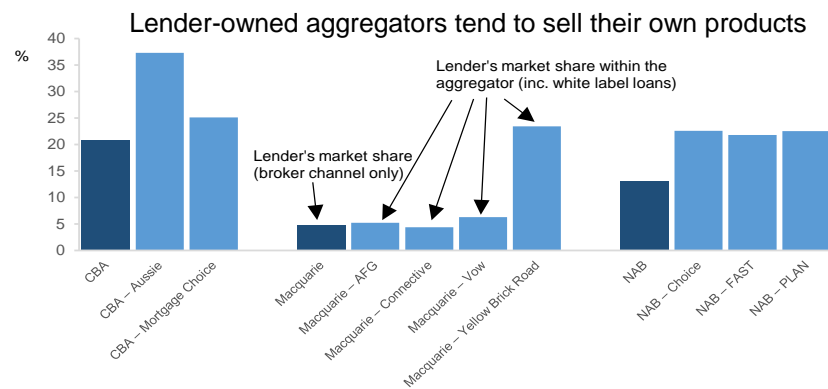
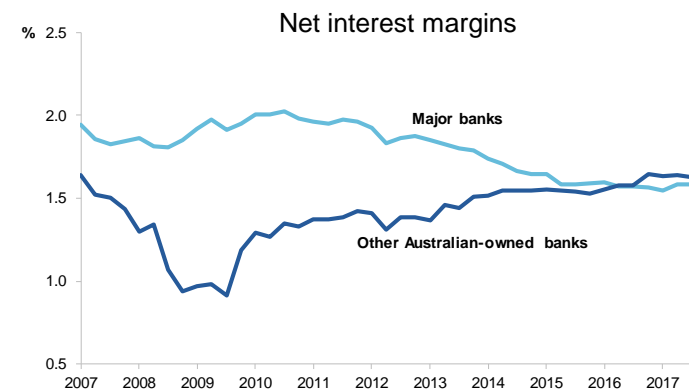
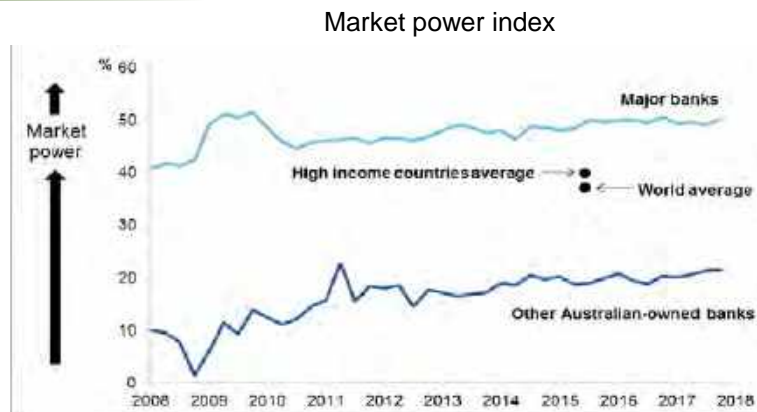
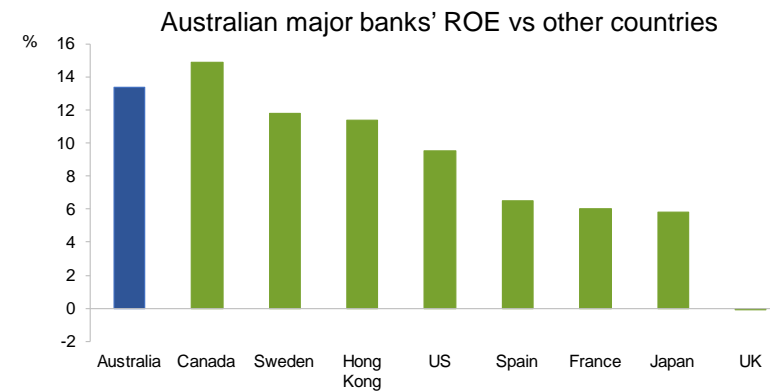
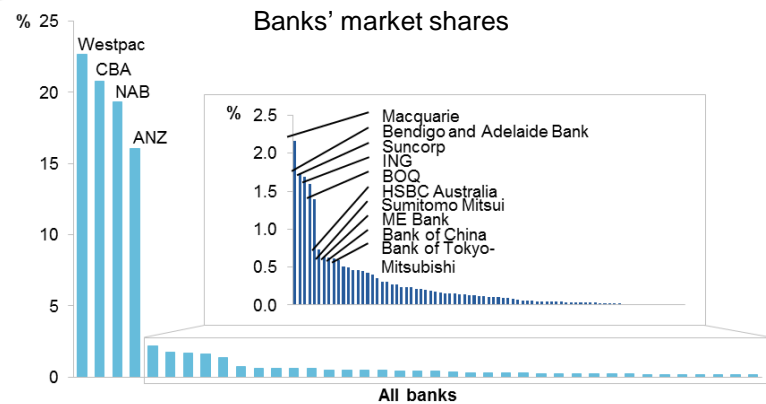
Productivity Commission

Competition in the Australian Financial System

Peter Harris and **Rosalyn Bell**
Chairman Assistant Commissioner

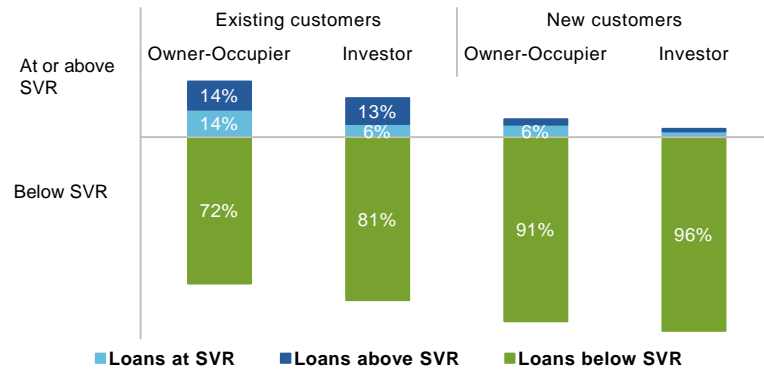


Melbourne Economic Forum, 4 September 2018

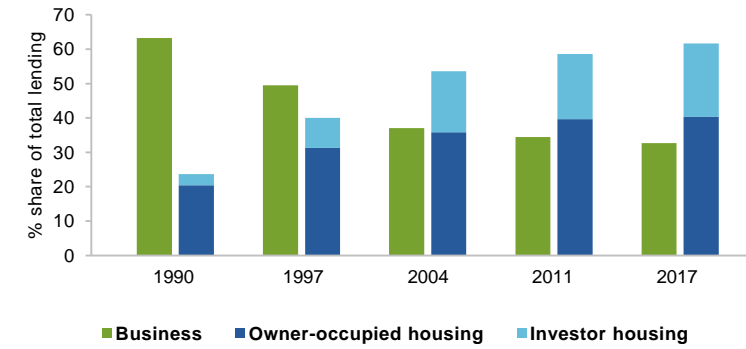


Competition in the Australian Financial System

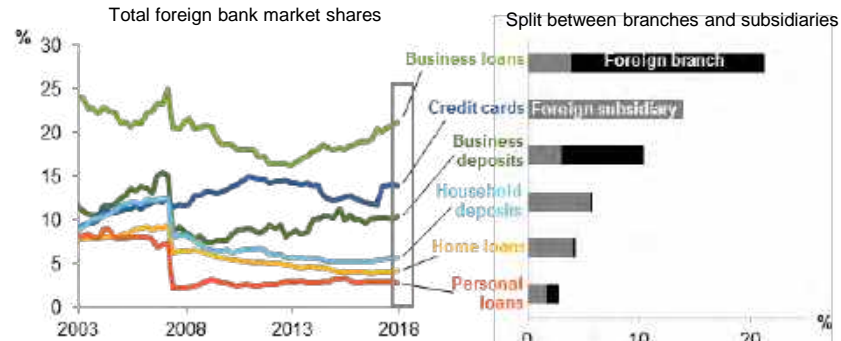
The standard variable rate is misleading



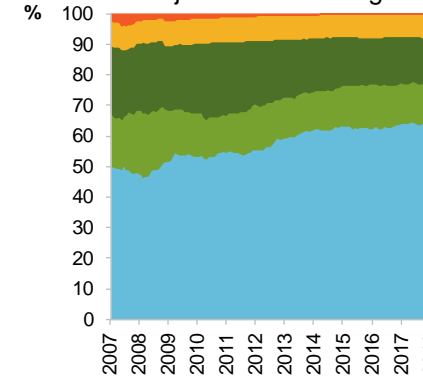
Lending has skewed away from business toward housing



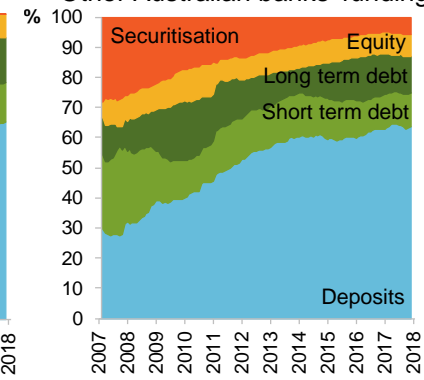
Foreign banks' market shares have declined, except in business banking and credit cards



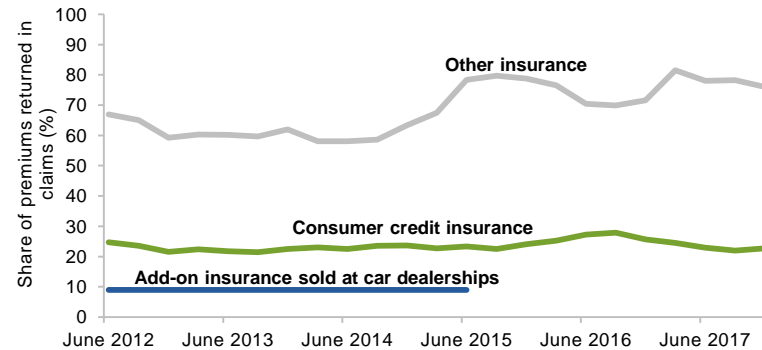
Major banks' funding



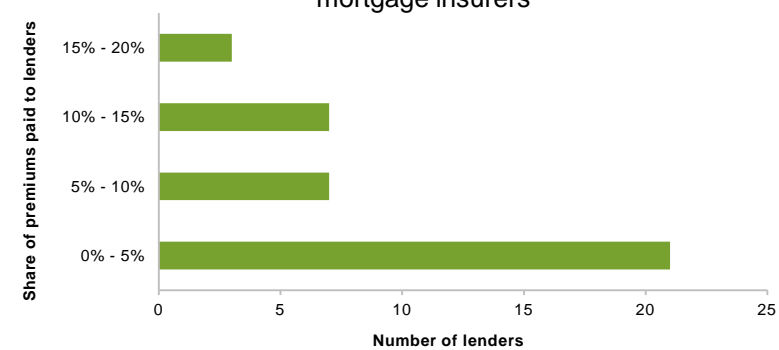
Other Australian banks' funding



Add-on insurance products are poor value for money



Some lenders receive substantial non-claim payments from lenders mortgage insurers



Competition in the Australian Financial System

➤ Key recommendations

Reduce conflicts of interest & enhance competition in home loan markets

- An obligation for all home loan providers (lenders & brokers) to act in the **best interest** of their clients
- An enforceable code **banning mortgage broker trail commissions** & limiting commission clawback period
- All banks should appoint a **Principal Integrity Officer** to minimise risks from remuneration structures & support the best interest obligation
- An **online calculator** to report median interest rates according to loan & borrower characteristics

ACCC as a competition champion

- An entity that is **proactive** on competition, ensures interests of consumers and costs imposed on them are considered, and **challenges** regulators on the costs to consumers of achieving system stability



MELBOURNE ECONOMIC FORUM



Nicholas Gruen

*Chief Executive Officer
Lateral Economics*

Central banking for all:

Ideologically completing the principle of competitive neutrality

In 1918 most people's only idea was to get back to pre-1914.
No-one today feels like that about 1939.

John Maynard Keynes, 1942

Nicholas Gruen
CEO, Lateral Economics

E ngruen@gmail.com
T [@ngruen1](https://twitter.com/ngruen1)



LateralEconomics

Ideologically balancing competitive neutrality

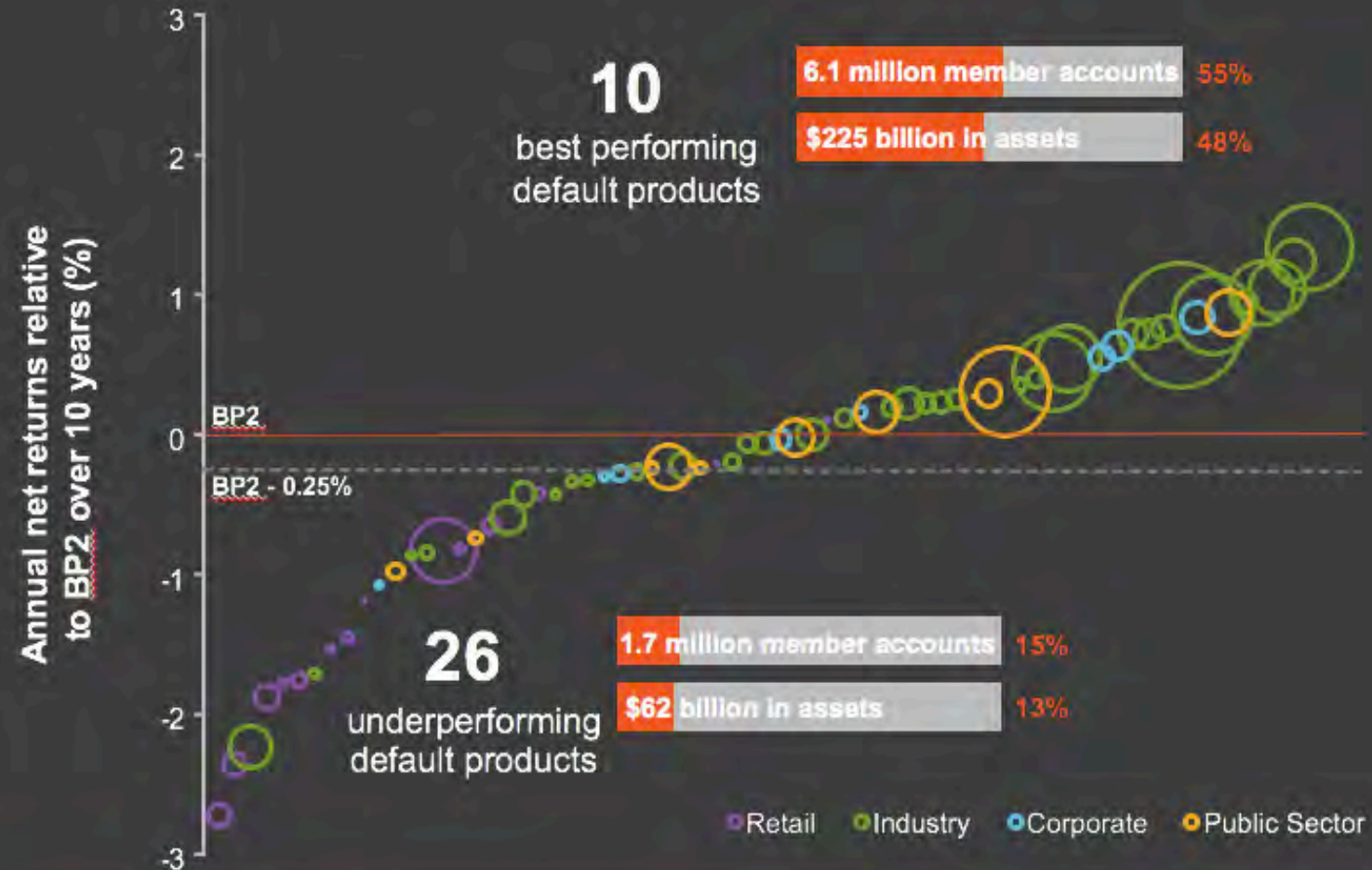
Public agencies should not use their privileges of public ownership to compete unfairly with business

If government provides services to some, it should provide them (unsubsidised) to all



Super and wealth management

➤ 1.7 million accounts in underperforming default (2008–17)



Data source: SuperRatings and APRA data and financial market index data (various providers)
Benchmark: Segment tailored BP2
Coverage: The figure represents 66 of 108 MySuper products covering 75% of member accounts and 73% of assets in all MySuper products as at December 2017 (and is subject to survivor and selection bias.)

Banking

“Of all the ways of organising banking, the worst is the one we have today.”

Mervyn King, Governor, Bank of England 2010



Current problems in banking(some of them)

Commercial banks capture rents from money creation

Too big to fail

- Moral hazard, unaccountability and unjust enrichment
- Implicit subsidies undermine competition

Massively complex and ineffective prudential regulation

Confusopolies blunt avoid competition

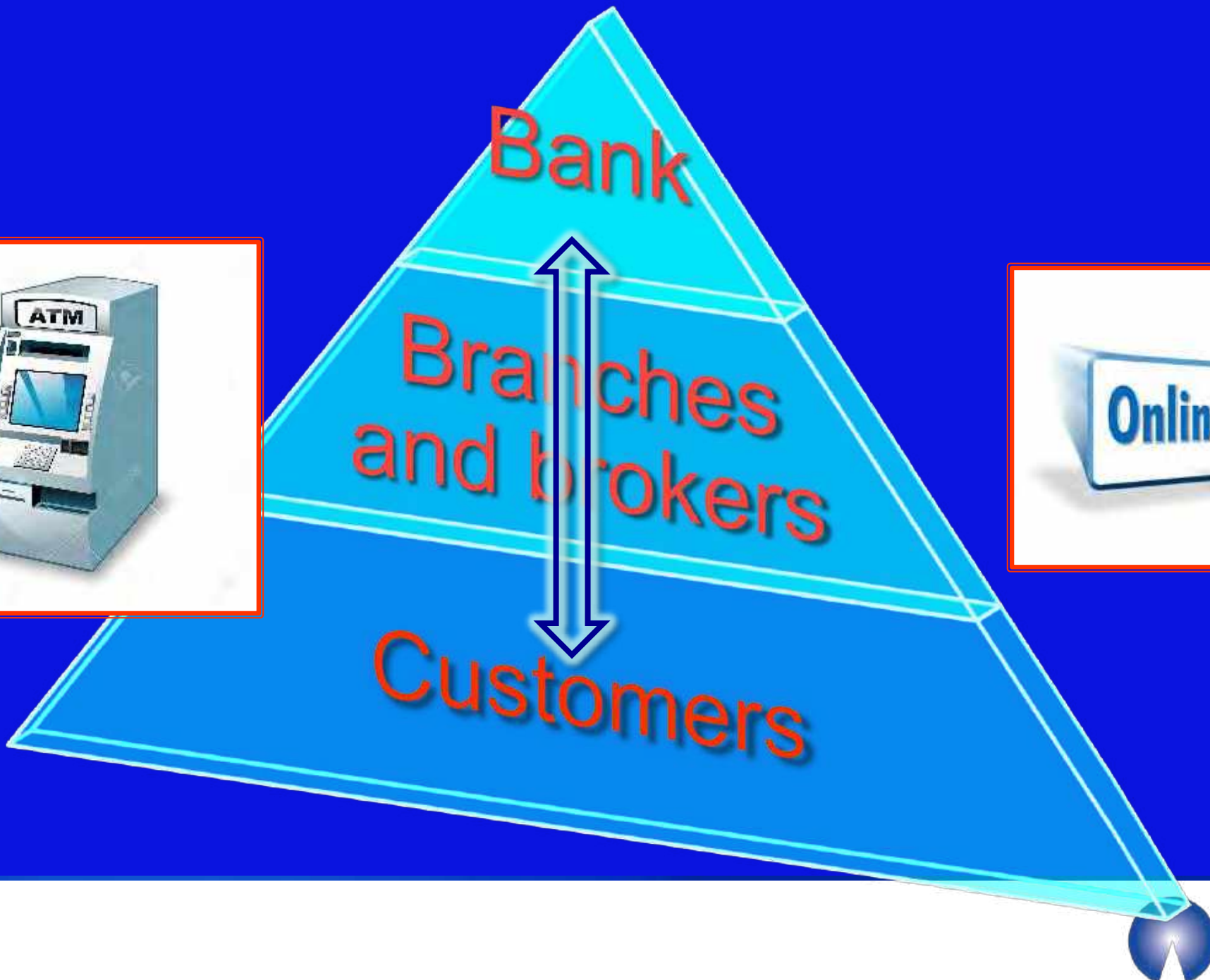
Poor passthrough of monetary policy near lower bound



Wholesaling, retailing and the internet: Re-engineering markets and policy





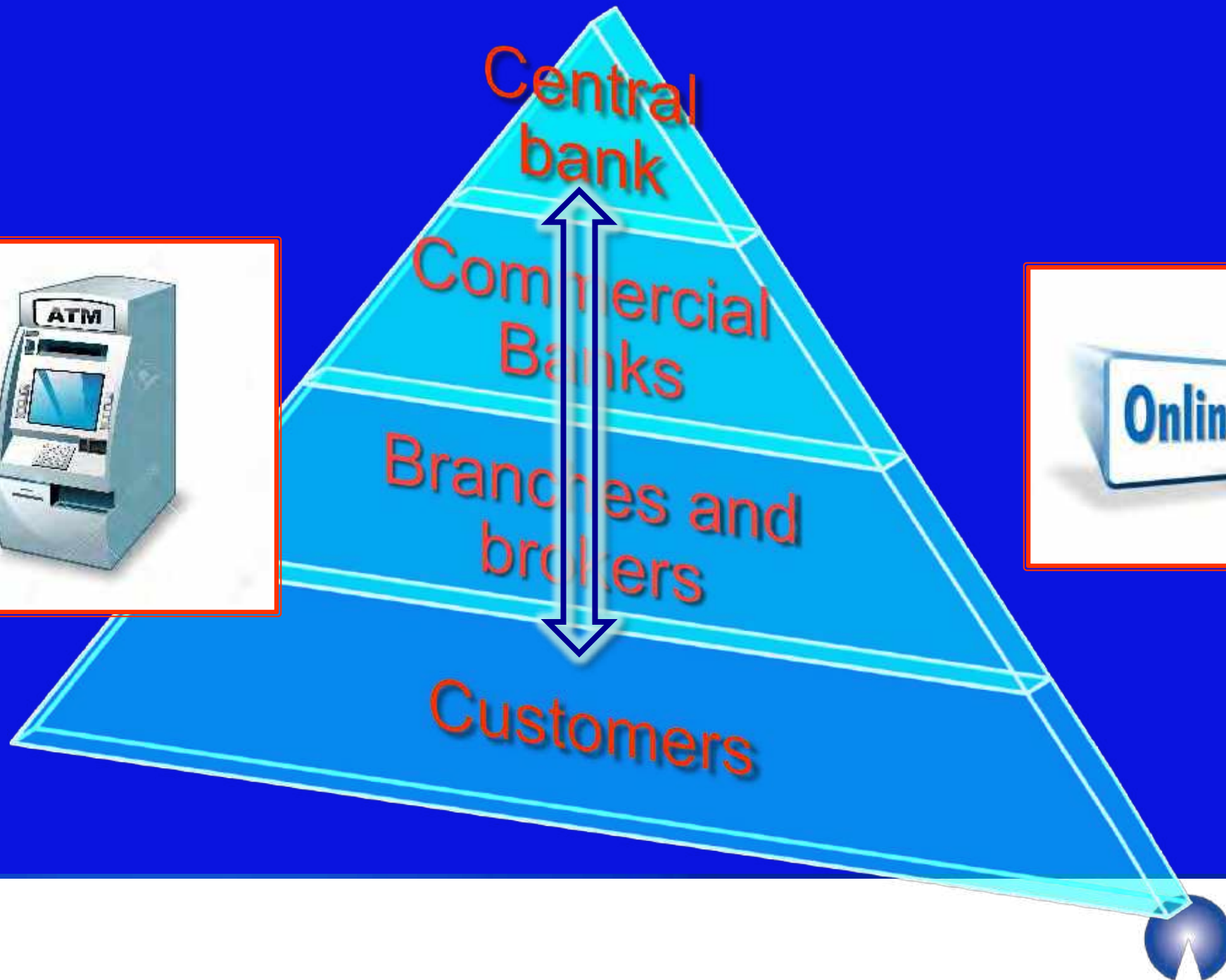


Economic growth is held back by industries where established interests are so powerful that disruptive innovation can be staved off forever.

Financial services is probably one.

John Kay, 2012.





James Tobin, 1987

I have two proposals.

- 1) provide a kind of deposit money so safe that it does not have to be insured.
- 2) make in advance a sharp distinction between insured and uninsured liabilities, and to stick to it.

“The system is drifting toward oligopoly of giant nationwide banks and conglomerates engaged in financial and nonfinancial businesses.

So government would be so fearful of a failure of these giants that their survival would be guaranteed”

The Case for Preserving
Regulatory Distinctions

James Tobin



Central banking for all

Accounts with central bank available to all-comers

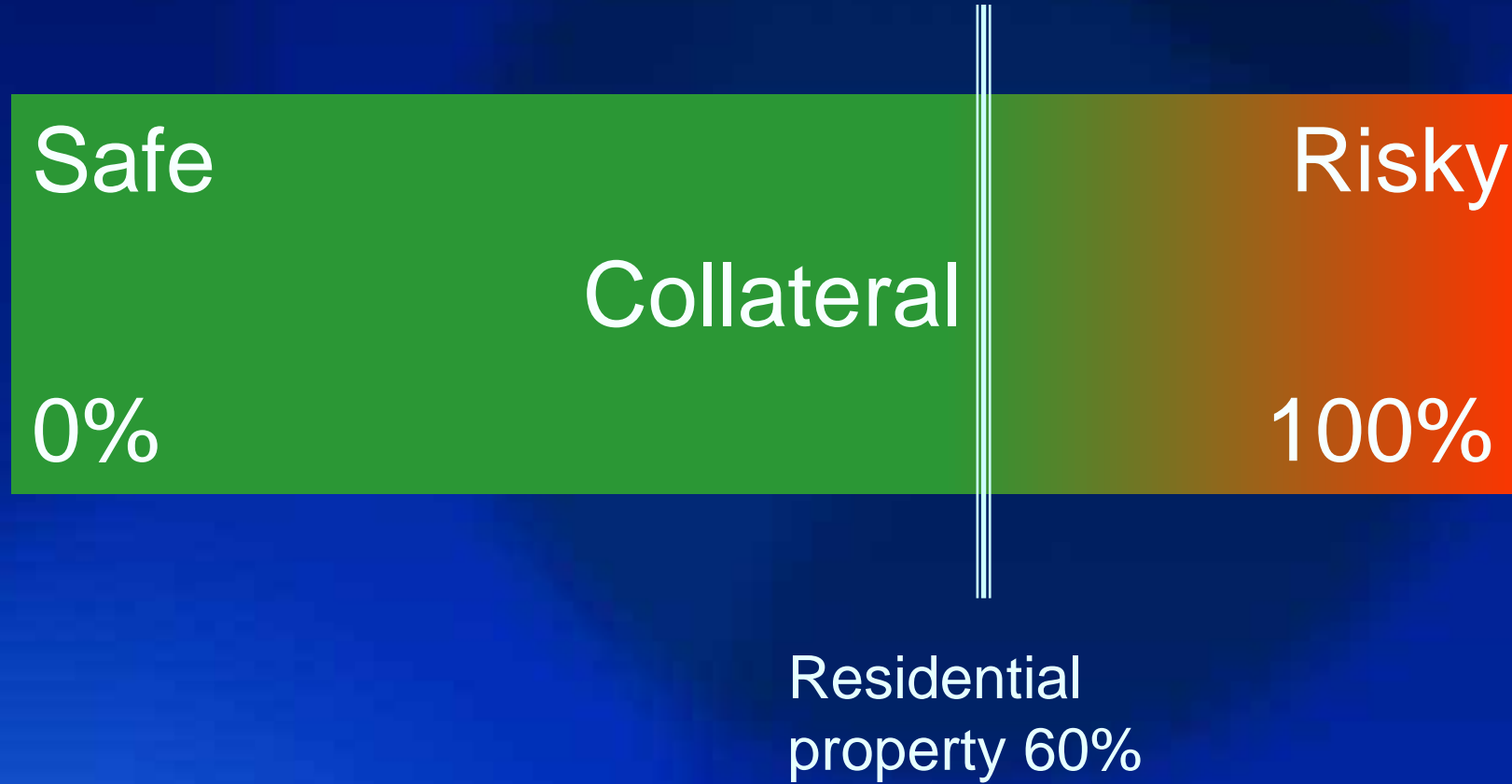
- Central bank takes deposits
- Operates giro-payments system. Any account holder can pay any other
 - Instantly, safely
- Anyone can borrow (against adequately creditworthy assets)

Cash rate is paid or received (less fee reflecting operating costs)

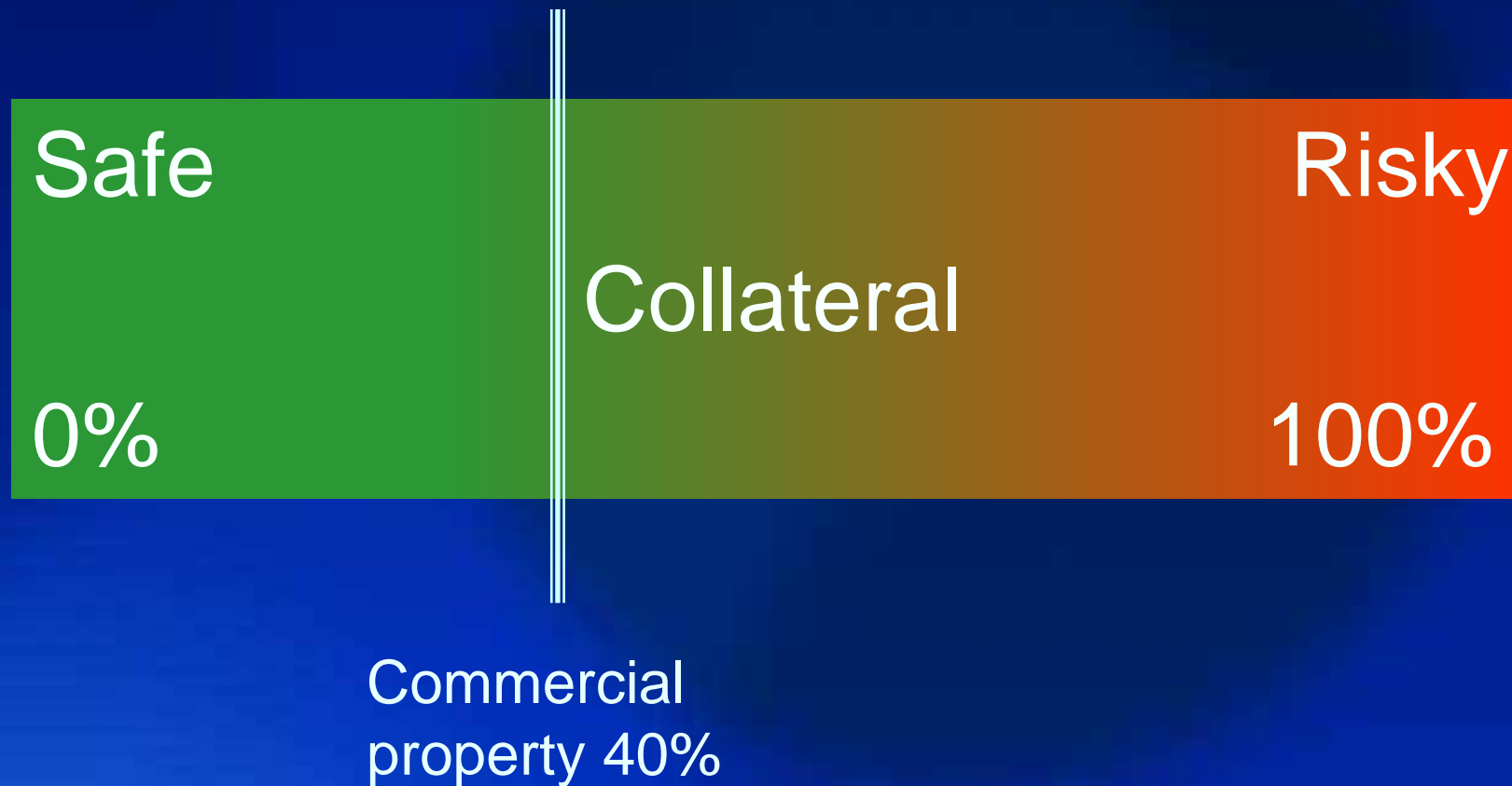
Virtually all additional services contracted out



A universe of super-safe assets

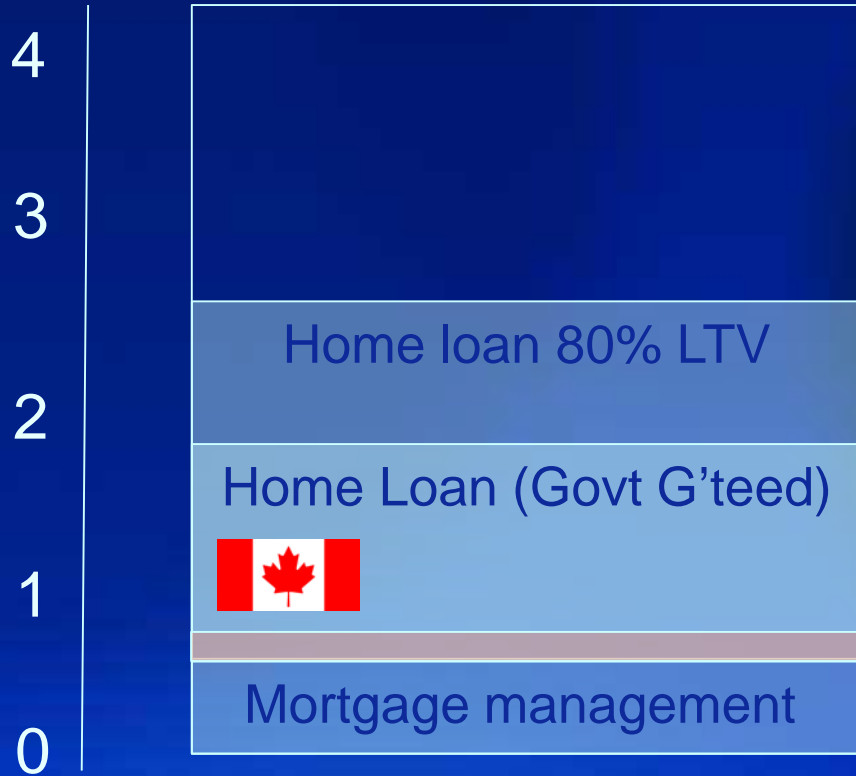


A universe of super-safe assets



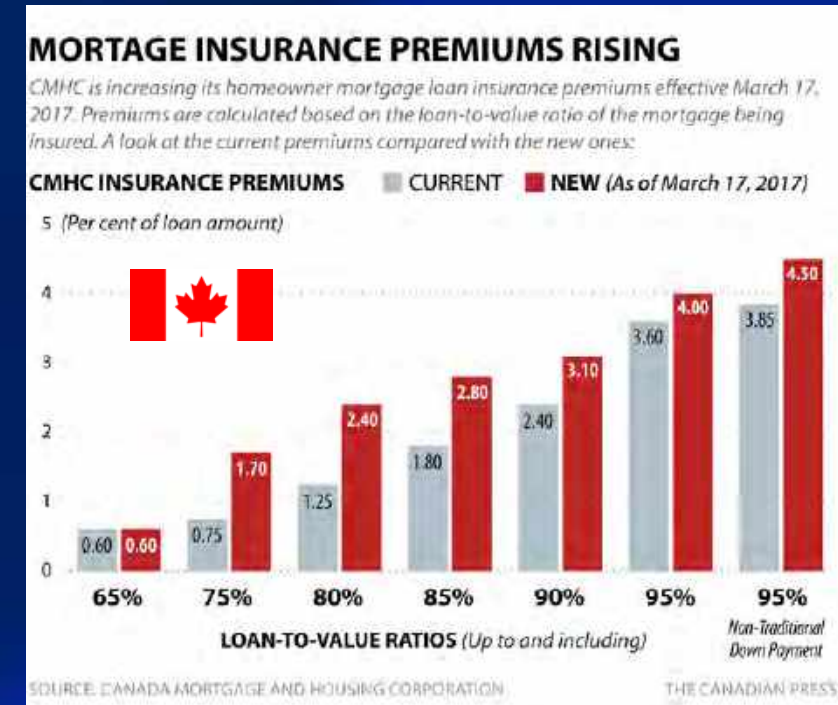
A critical puzzle

Margin (%)



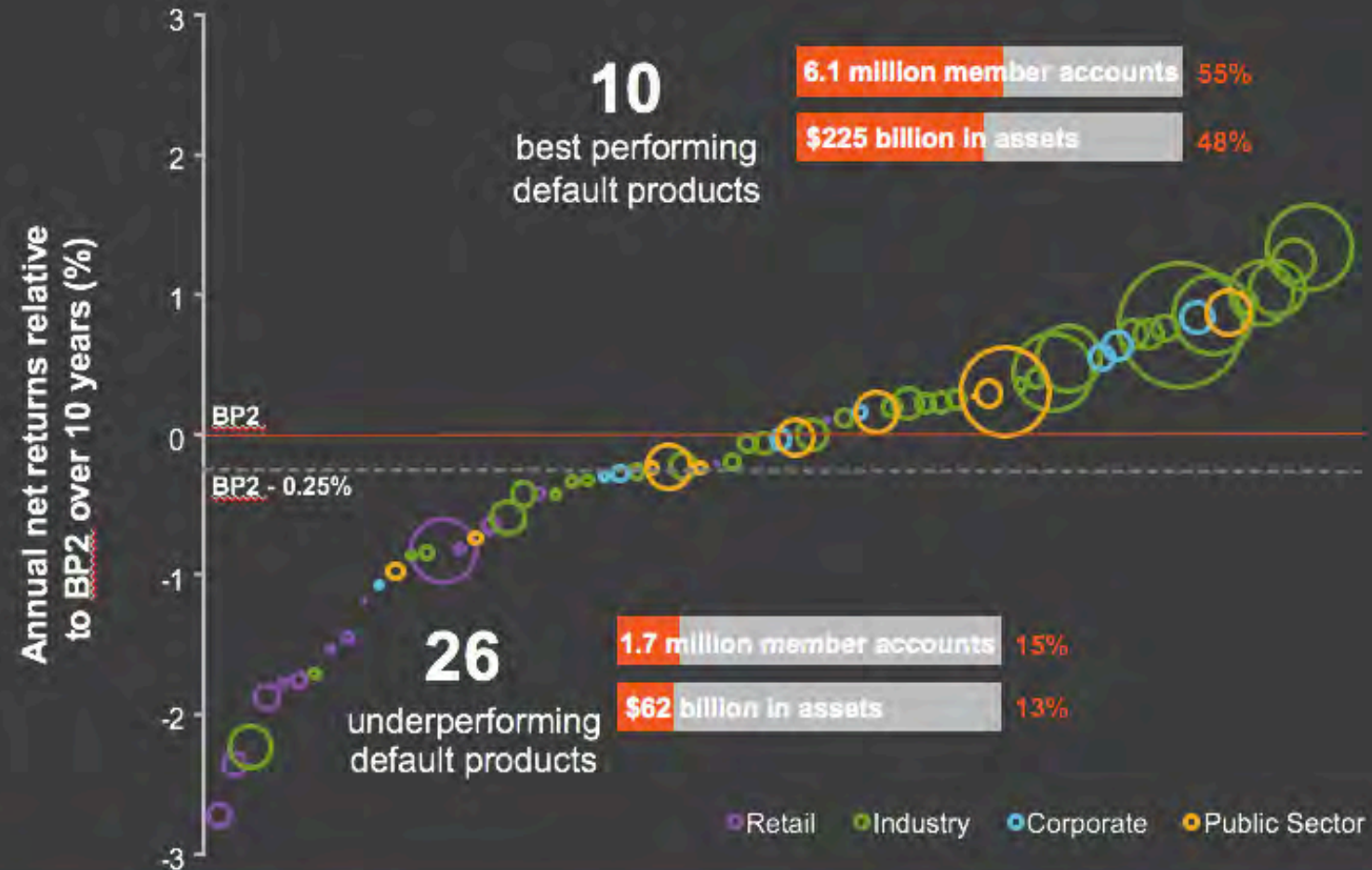
Marketing, advertising, commissions, audit, custodianship, insurance, legal costs, liquidity management + margins throughout production chain

Is this credit risk?



Super and wealth management

➤ 1.7 million accounts in underperforming default (2008–17)

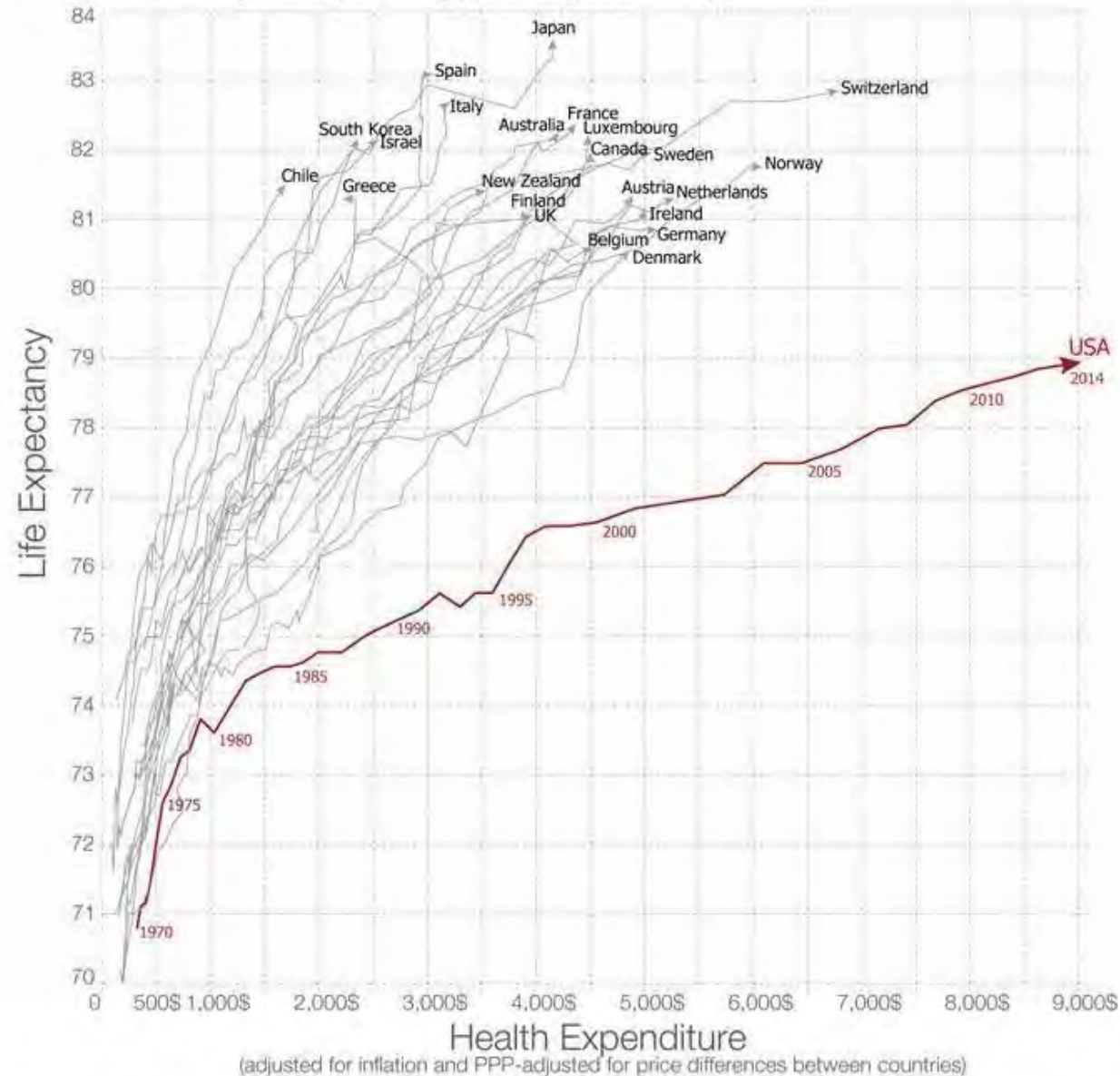


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Coverage: The figure represents 66 of 108 MySuper products covering 75% of member accounts and 73% of assets in all MySuper products as at December 2017 (and is subject to survivor and selection bias.)

Life expectancy vs. health expenditure over time (1970-2014)

Our World
in Data

Health spending measures the consumption of health care goods and services, including personal health care (curative care, rehabilitative care, long-term care, ancillary services and medical goods) and collective services (prevention and public health services as well as health administration), but excluding spending on investments. Shown is total health expenditure (financed by public and private sources).



Data source: Health expenditure from the OECD; Life expectancy from the World Bank. Licensed under CC-BY-SA by the author Max Roser. The interactive data visualization is available at [OurWorldinData.org](https://ourworldindata.org). There you find the raw data and more visualizations on this topic.

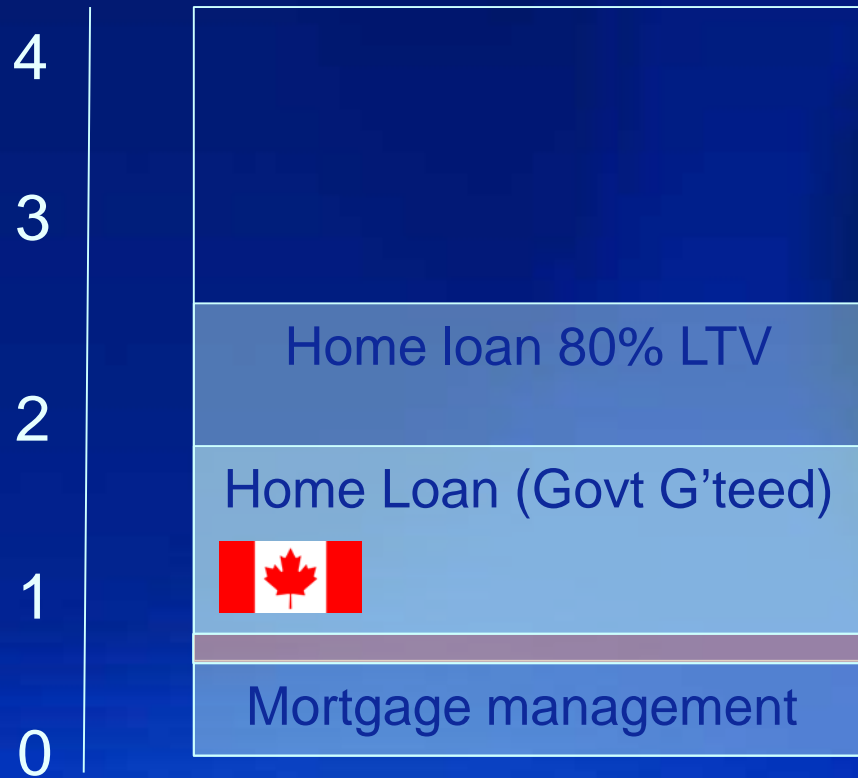
Knowledge
intensive services
and transactions
costs



LateralEconomics

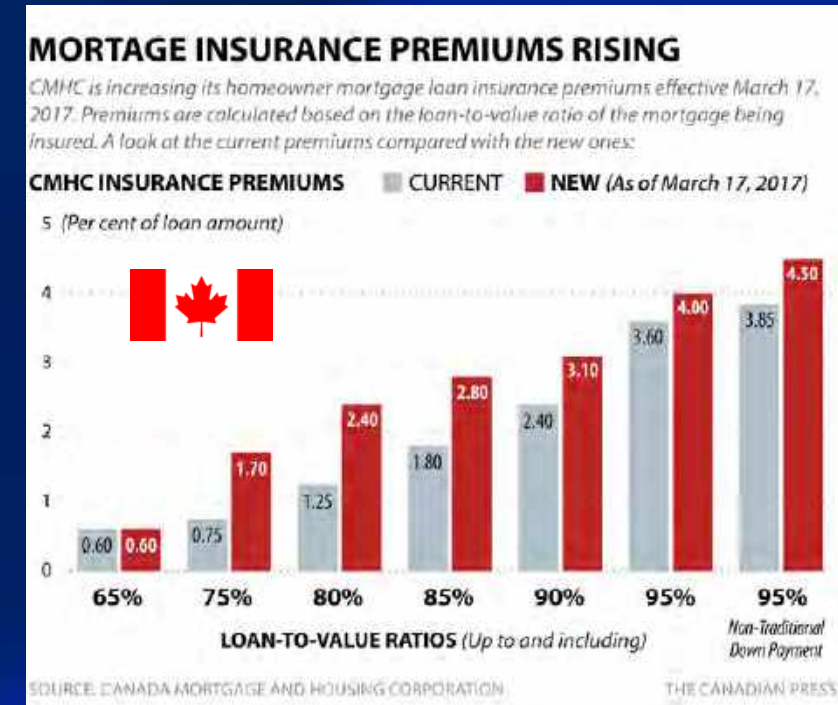
A critical puzzle

Margin (%)



Marketing, advertising, commissions, audit, custodianship, insurance, legal costs, liquidity management + margins throughout production chain

Is this credit risk?



The banks

Refocus on adding value

- Lending across spectrum from safe – but much less super-safe – to risky assets
- Competing for funding
- Their deposit rates likely to rise
 - Unwinding cross subsidies
 - Competing with government for deposits



The particular role of banks is to specialize in choosing borrowers and monitoring their behaviour

Charles Goodhart



MAKING MONEY FROM MAKING MONEY

WHO HAS CONTROL OVER THE SUPPLY OF NEW MONEY AND WHAT BENEFITS DOES IT BRING?

TABLE 1. COMMERCIAL BANK SEIGNIORAGE ACROSS FOUR COUNTRIES

COUNTRY	PERIOD STUDIED	AVERAGE ANNUAL COMMERCIAL BANK SEIGNIORAGE	AS % OF GDP	CUMULATIVE COMMERCIAL BANK SEIGNIORAGE
UK	1998–2016	£23.3 billion	1.23%	£443 billion
Denmark	1991–2015	DKK11.7 billion	0.7%	DKK293.4 billion
Switzerland	2007–2015	CHF2.8 billion	0.6%	CHF34.8 billion
Iceland	2004–2015	ISK14.1 billion	0.9%	ISK169.7 billion

The mother of all spectrum auctions

Government money creation generates large amounts of revenue

Tens of billions p.a.

Depending on interest rates





BANK OF ENGLAND

Staff Working Paper No. 605

The macroeconomics of central bank issued digital currencies

John Barrdear⁽¹⁾ and Michael Kumhof⁽²⁾

Abstract

We study the macroeconomic consequences of issuing central bank digital currency (CBDC) — a universally accessible and interest-bearing central bank liability, implemented via distributed ledgers, that competes with bank deposits as medium of exchange. In a DSGE model calibrated to match the pre-crisis United States, we find that CBDC issuance of 30% of GDP, against government bonds, could permanently raise GDP by as much as 3%, due to reductions in real interest rates, distortionary taxes, and monetary transaction costs. Countercyclical CBDC price or quantity rules, as a second monetary policy instrument, could substantially improve the central bank's ability to stabilise the business cycle.



LateralEconomics

Is this nationalisation?

It's competitive neutrality

So it's a market outcome

Like the extent to which people pay tax through an agent or directly

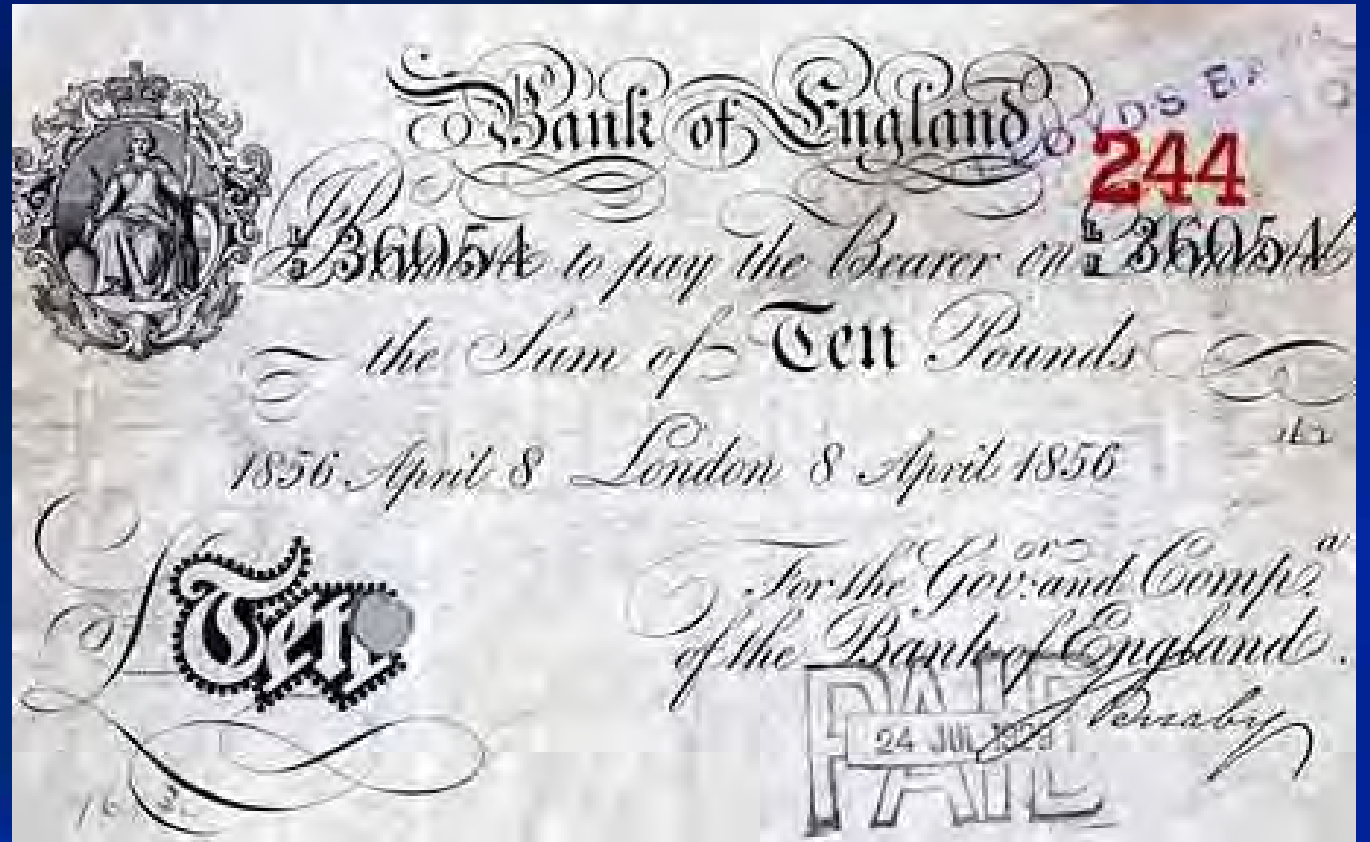
The central banking system doesn't become a private bank or act like one

It provides utility central banking to all



Anything that tends to connect the state with banking has always been productive of disastrous consequences.

Mr. Benjamin Hawes,
Opposition (Whig) Member of
the House of Commons on June
13th 1844 during the second
reading of the 'Bank of England
Charter Bill'.



Current problems in banking(some of them)

Commercial banks capture rents from money creation

Too big to fail

- Moral hazard, unaccountability and unjust enrichment
- Implicit subsidies undermine competition

Massively complex and ineffective prudential regulation

Confusopolies blunt avoid competition

Poor passthrough of monetary policy near lower bound





The end



Central banking





CMHC SCHL
HOME TO CANADIANS

Canada



Fannie Mae®



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Central banking for all: Payments



Government
receives
seigniorage

Citizens
receive
convenient,
safe means of
payments



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Professor Paul Kofman

*Dean, Faculty of Business and Economics
Sidney Myer Chair of Commerce
The University of Melbourne*



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Banks back to basics

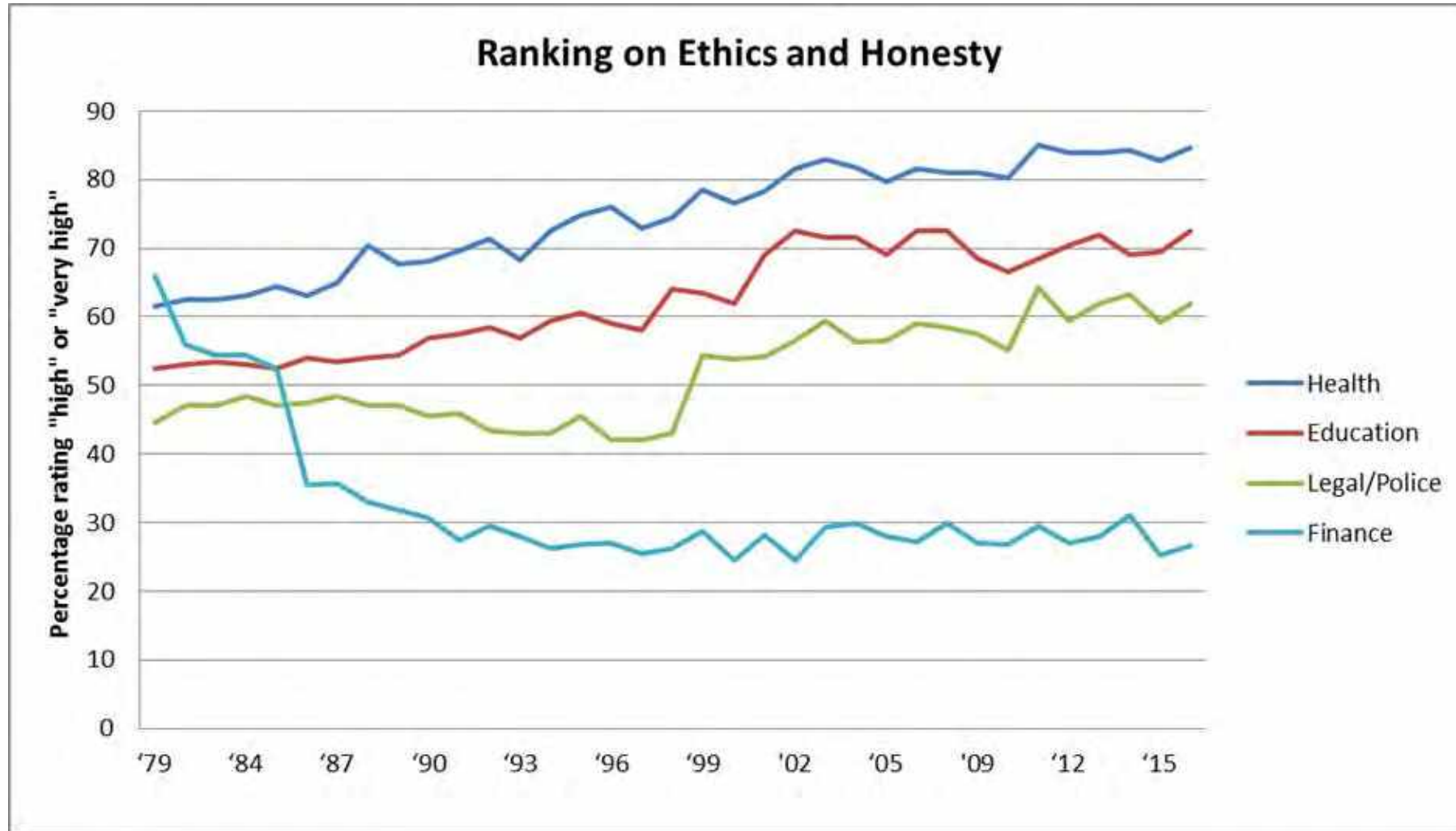
Professor Paul Kofman

Dean of the Faculty of Business and Economics
Sidney Myer Chair of Commerce

With A\Prof Carsten Murawski



What's wrong?



Source: The Roy Morgan Image of Professions Survey



The rationalist model

Shareholder value maximisation

Perfect markets

Perfect information

Efficient allocation

Caveat emptor



Regulation, Education?

Disclosure

Markets in Financial Instruments Directive (MiFID II)

FOFA reforms

FASEA – standards and ethics

Literacy

EconoME – Bank of England

MoneySmart – ASIC

Dollarmites – CBA



Reality check?

- Complexity
- Information Asymmetry
- Familiarity
- Uncertainty

Getting back to basics:

From Inputs (products) to Outputs (financial wellbeing)



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Thank you

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Professor Ross Garnaut

*Professorial Research Fellow, Economics
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Dr Jason Nassios

*Senior Research Fellow, Centre of Policy Studies
Victoria University*

The economy-wide impact of bank capital regulation

Melbourne Economic Forum (Victoria University), September 2018

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Outline

The Royal Commission: Broker incentives not appropriate.

- Impact the asset allocation of Australian banks, heightening mortgage portfolio risk;
- This is a potential source of macroeconomic instability.

The other side of the coin: How do banks finance risky asset purchases?

- Also a source of macroeconomic instability;
- Equity-per-unit-of-risky-assets: set by the *Capital Adequacy Ratio (CAR)*;
 - Global standards recommended by BIS, and set by APRA;
- Exclusively omitted in Royal Commission Letters Patent.

TODAY

What are the macroeconomic impacts of changes in bank CARs?

- METHOD: Simulation-based assessment using financial CGE models of Australia and the US.
- SHOCK: Raise bank CARs by 100bps.
- QUESTION: Are impacts large, and do the cross-country responses differ?

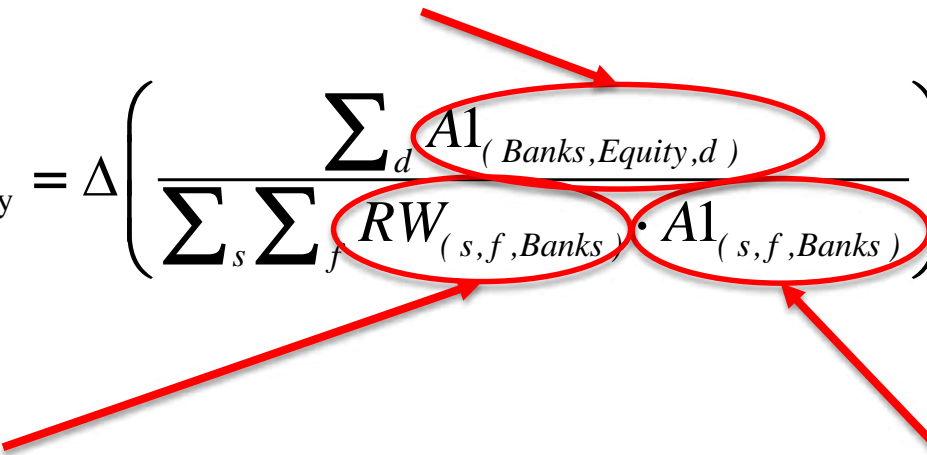
Accommodating higher capital requirements

Anticipated responses

LIABILITY-SIDE BALANCE SHEET ADJUSTMENT

For a given risk-weighted asset base, banks issue more equity.

Reduced reliance on household deposits.

$$\Delta CAR_{\text{Base-Policy}} = \Delta \left(\frac{\sum_d A1_{(Banks, Equity, d)}}{\sum_s \sum_f RW_{(s, f, Banks)} \cdot A1_{(s, f, Banks)}} \right) = +100\text{bp}$$


ASSET-SIDE BALANCE SHEET ADJUSTMENT

For a given level of equity, risky asset mix can be tilted towards lower risk-weight assets.

Compositional shift in supply of bank finance.

ASSET- and LIABILITY-SIDE ADJUSTMENT

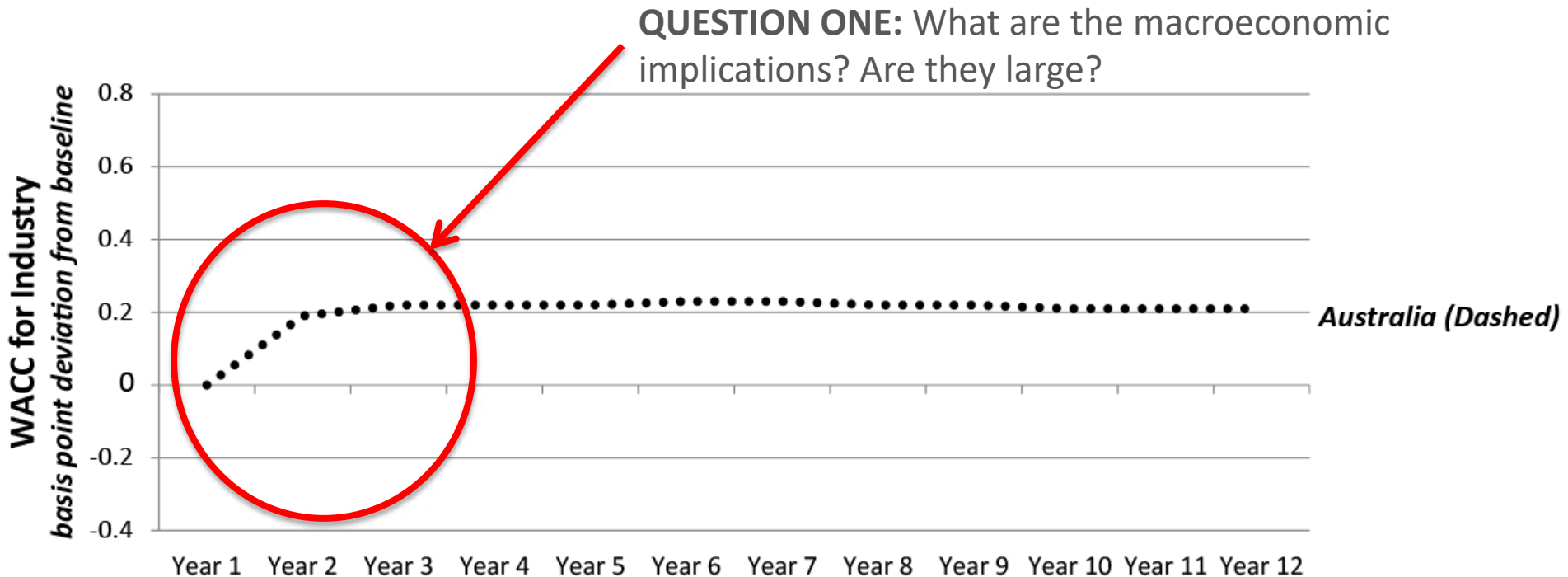
For a given level of equity, banks contract.

Economy-wide fall in supply of bank finance.

The impact of higher bank CARs in Australia

Industry WACC by Giesecke *et al.* (2017)

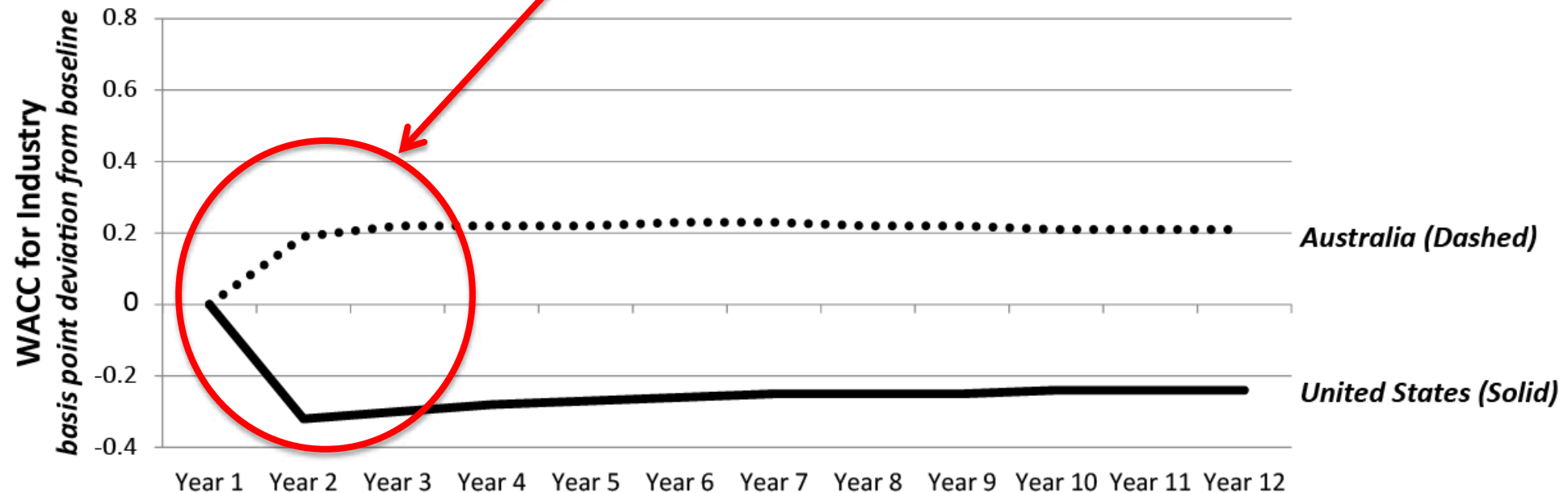
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Same shock, same ruler, different outcome

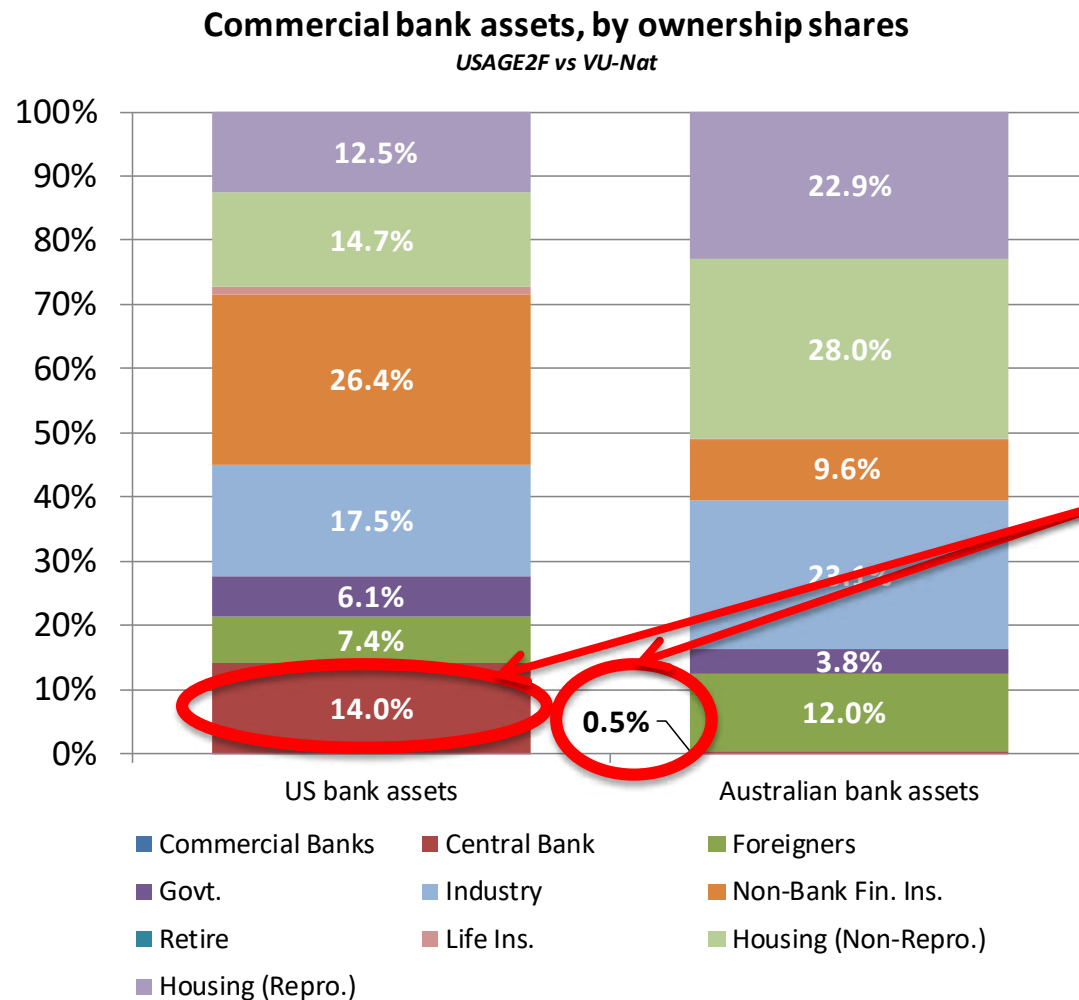
US (solid) and Australian (dots) results

QUESTION TWO: Do differences in the real economy or financial structure drive this behaviour?



Explaining cross-country differences

Do Australian and US Banks have similar risky lending proclivities?

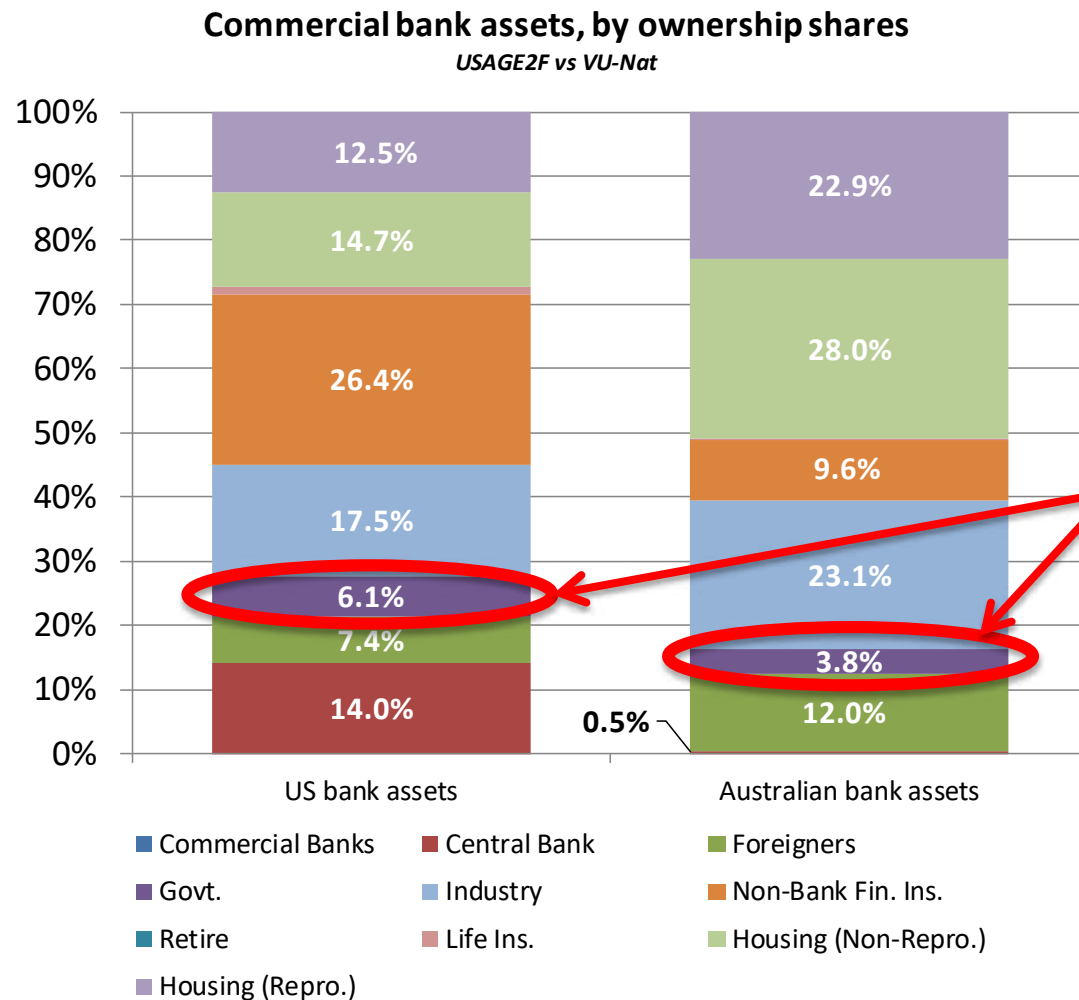


Very different risky lending propensities:

- 14% of US bank assets as US Federal Reserve deposits;
- 0.5% of Australian banks assets are RBA deposits;

Explaining cross-country differences

Do Australian and US Banks have similar risky lending proclivities?



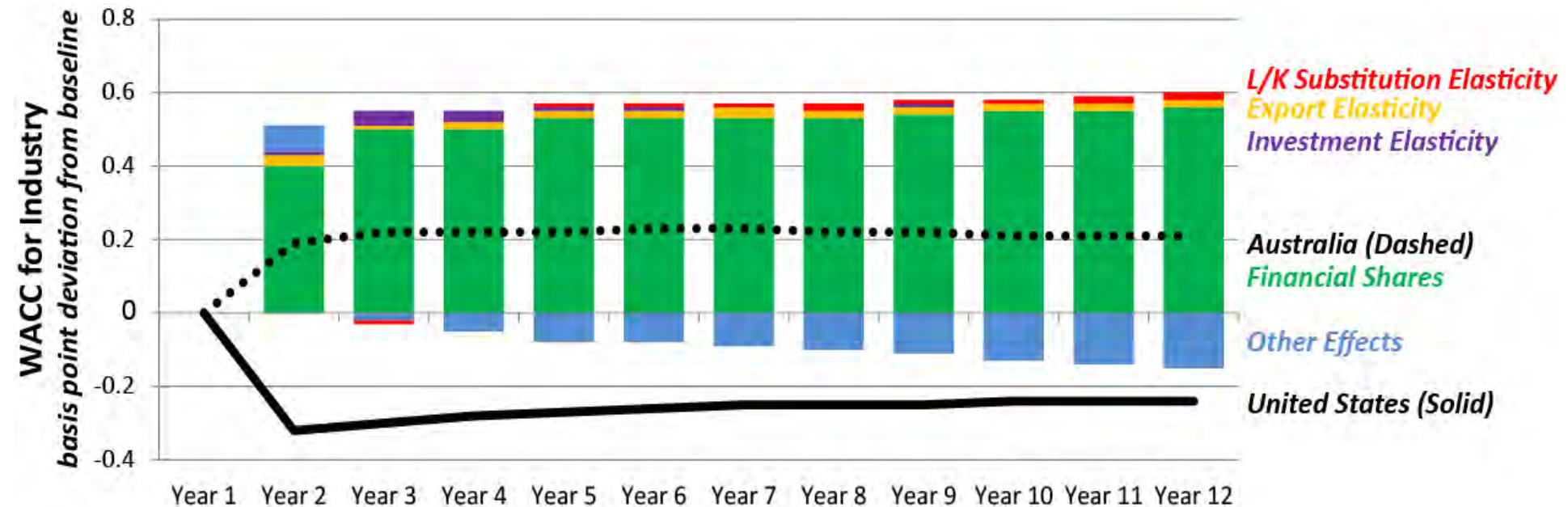
US banks hold a greater share of Government debt than their Australian counterparts.

- An additional \$1 of US bank liabilities funds 80 cents of risky investment.
- An additional \$1 of Aus. bank liabilities funds 95 cents of risky investment.

Industry WACC

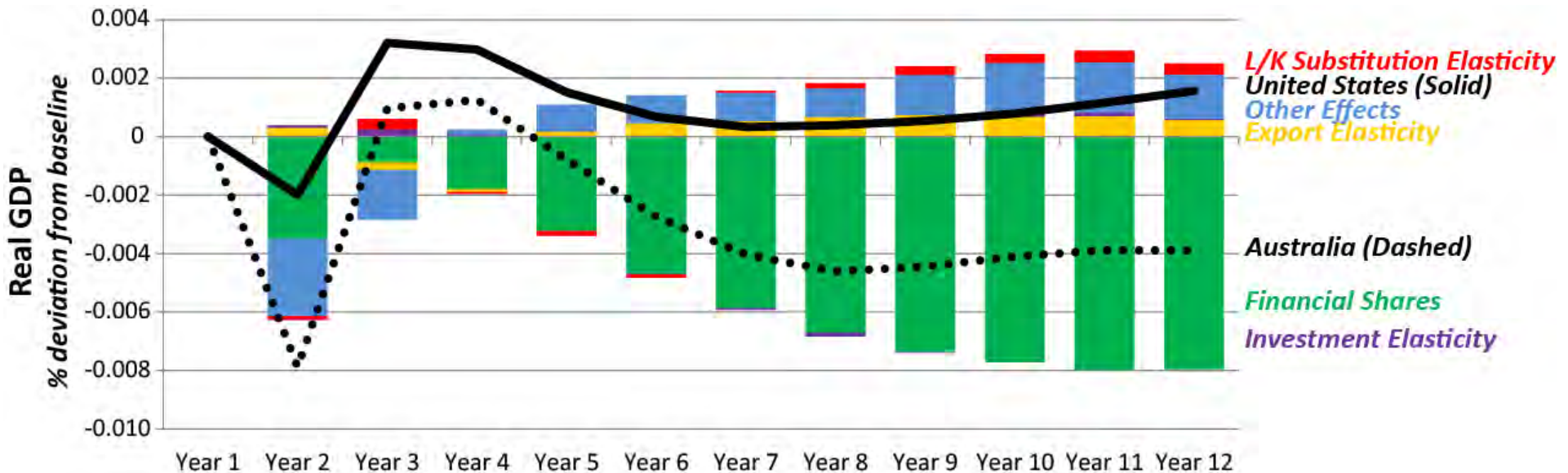
Decomposition of the variation between the US (solid) and Australia (dots)

Basis point deviation from baseline



Are the macroeconomic responses large?

Real GDP, percentage deviation from baseline
US (solid) and Australia (dots)



SHOCK-YEAR: Capital is fixed. Employment response drives similar real GDP movements.

LONG RUN: Employment at baseline. Capital response (driven by differences in WACC responses) drives an inhomogeneous real GDP response.

Conclusion

Are the costs of increased capital adequacy on commercial banks significant?

- Our analysis suggests the impacts are small.

Some impacts of increased capital adequacy are insensitive to financial structure.

- Expansion in equity raisings, balance sheet contraction and portfolio rebalancing by commercial banks.

Inhomogeneities in macro responses are driven by **financial structure**.

- Potential for sign reversal when the regulatory frameworks are identical.

Why do capital regulations differ across jurisdictions?

- Perhaps regulators take account of financial structure differences.

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4 September 2018