Financial Services Council Leaders Summit

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Address

Hon P.H. Costello A.C.

For nearly 12 years as Treasurer I was responsible for Banking policy in Australia so I want to make some observations today on the present controversy regarding Banks. The views I express are my own and based on my policy experience. I am not representing the views of any other body or Corporation. As you will see, my purpose is neither to praise nor to bury Banks. But I can't help wondering how things got to the state they have.

As Treasurer, I commissioned the Wallis Inquiry into the Financial System. Coming out of that Inquiry, which reported in 1997, the Government established the current framework of financial regulation. This involved setting up a dedicated prudential regulator-APRA- and a Corporate and consumer regulator-ASIC. One of the recommendations in the Wallis Report we rejected was to allow mergers between the big Banks, subject only to assessment by the ACCC. I announced that in-principle we would prohibit mergers between the big four Banks. That policy has been endorsed by all subsequent Governments and today is known as "The Four Pillars Policy"

At present, the Federal Opposition is calling for a Royal Commission into the Banks. A Royal Commission is an inquisitorial process usually designed to get to the bottom of what is alleged or suspected to be a schematic Illegality or abuse of power- for example the Royal Commissions into Child Sexual Abuse, and Youth Detention in the Northern Territory. It is acknowledged that there have been failures by financial advisers associated with Banks, but the purpose of a Royal Commission is to go much further than that. Presumably it is to sheet home personal liability to the senior executives themselves.

In response, the Government has set up a process where Bank CEOs appear before a Parliamentary Committee to answer for their conduct. In the Budget the Government also announced a new registration regime for senior executives and Directors of Banks, a new penalty regime that will allow Directors and senior executives to be removed and disqualified from office, controls on Bank Executive remuneration, and more money to prosecute Banks for failure to "meet expected standards".

It is hard to think of any other privately-owned business in Australia that is regulated to the same extent as the Banks.

Some with longer memories will say that Banks used to be subject to more "product" regulation. Once upon a time, the Government used to set the interest rate that could be charged for home loans and the terms on which a person could qualify for it.

In those days-and this is how I qualified for my first home loan- the Bank would lend a multiple of a person's minimum monthly balance over a twelve-month period. In order to get a loan from a Bank you had to be a depositor. I recall sitting in front of my Bank Manager as he laboriously went through my deposit book looking for the low point of each month, added them up, averaged it over the year, manually multiplied it, and told me I could qualify for a loan, by memory four times the balance. The reason credit was rationed was it was thought that the Government fixed-rate loan was so beneficial, it could not be extended to just anyone. In fact the rate was so beneficial, I got my loan for 12.5%!

No-one would be so crude as to do this today. But the Banks still require a minimum equity contribution on a home loan and it is higher today than it was ten years ago, largely as a result of the Regulator's demands. You may have noticed that the rate for investor-loans has gone up recently, while the rate for owner-occupied loans has not. The cost of raising money for the Bank is the same whether it lends it to investors or owner-occupiers. The increased rate for investors has nothing to do with credit risk. The Prudential Regulator, APRA, has effectively engineered this outcome through a combination of "jaw-boning" and altering the capital requirements that Banks must hold against the various assets on their Balance Sheet. "Jaw-boning" is only effective because the Regulator has the tools to back up its desired outcome. And it does.

So although the Government does not crudely regulate Bank products through regulations and the like, its statutory Agency- APRA- which can set capital charges and requirements on different aspects of their balance sheets, oversees substantial supervision on the end products which Banks offer.

Now if all the Banks are raising money-either from borrowing overseas or from domestic depositors-at more or less the same cost and they have the same identical regulatory capital requirements applying to how they lend it, there should be no surprise that they lend at more or less at the same rates.

It is true that within regulatory confines they compete. But the regulatory system that governs them allows only a narrow band for competition.

Regulation also protects Banks from each other. The big four Australian Banks are takeover-proof and they are merger-proof.

The Financial Sector Shareholdings Act 1998 prohibits anyone owning more the 15% of a Bank without the Treasurer's approval. This is to ensure broad ownership in the interest of Bank stability. It means that a Bank can never be taken over without Government approval and this would likely only occur if it were in danger of failing.

The Four Pillars Policy, which prohibits any of the four big Banks from merging with each other has made a major contribution to stability. No Bank Chief Executive need ever fear a call from a rival offering to merge his Company and do him out of a job. The Chief Executive is immune from the prospect that haunts or motivates every other CEO of an AXS listed company. As long as the CEO knows that the Regulator looking over his shoulder is also sitting on the shoulder of all the other Banks, he can rest assured that his products will be competitive and the status quo will continue for the benefit of all concerned.

In Australia the big Banks were allowed to take over emerging Banks which also diminished potential competition from new entrants. In particular, CBA was allowed to takeover BankWest and Westpac, St George in 2008, at a time when there was a great deal of uncertainty in global financial markets. This was allowed in the interests of stability. In more normal times it may have been ruled out for competition reasons.

So the Banks came out of the financial crisis of 2008 with a greater market share than they had before it. And they were given one other lifeline of fundamental competitive advantage. When the overseas wholesale borrowing markets began to seize up in the wake of the 2008 financial crisis, the Australian Government gave the Banks a Sovereign guarantee. To be fair to the Banks they did not ask for it, but once it was offered, it proved to be of enormous benefit.

So the Banks now know, and investors know, if they really get into trouble they are likely to be bailed out by Government. This is an enormous financial advantage which no other section of Australian business enjoys.

Australia's highly regulated banking system leaves CEOs little room for entrepreneurial activity. The big four Banks are akin to regulated assets-a bit like monopoly infrastructure. Even compared to those assets they have major advantages:- they cannot be taken over, they enjoy an implicit government guarantee, and unlike infrastructure they do not have a capped rate of return on assets.

The very healthy returns the Banks generate under the protective regulatory umbrella get shared around. First to share in the profit, of course, is the Government itself. We do not have the latest figures but the big Bank profits are so healthy they end up paying an extraordinary proportion of the Government's company tax collection. These four companies were paying around 15% of the company tax collected from more than one million companies in 2015 and the combination of increased profits and tax cuts for small business would have increased that in recent years.

These four Banks which are 2% by number make up 25% of the ASX 200 Index by market capitalization. They are (at present) the four largest companies on the Australian Stock exchange. Only BHP comes close. With their strong cash flows (these are not capital-intensive businesses like mining) they pay good dividends which are fully franked. Investors in the ASX could hardly avoid them and in practice do not try as they are very attractive for individuals, institutions,and superannuation Funds. Outside the Banks there are a couple of miners, a couple of retailers, CSL and Telstra that make up the top ten stocks but overwhelmingly the ASX is the big four Banks.

So the Banks are critical for Australia's retirement savings-regardless of who is managing it- because those retirement savings end up being invested in the Banks themselves. I venture to suggest that the largest sectoral investment of a person in an Industry balanced superannuation fund today would be in bank stocks!

So who benefits in this tightly regulated enterprise? Well, the Government and the shareholders, of course, also the senior executives employed on handsome salaries to keep the operation ticking over. It's the consumer that is feeling unloved.

In this highly regulated system the returns by Banks also, critically, depend on the performance of the macro-economy. The Australian Banks are mostly home-lenders. This is the area where they generate exceptionally high returns on equity. There has been no housing downturn for over quarter of a century now, and the rate of mortgage default is exceptionally low. Once you realise this, you realise that the returns for Banks do not rest on the Executives or the Directors that run them but on the Regulatory system that underpins banking and the macro-economic environment in which it operates. Both of those lead back to Government. Sometimes I wonder whether those running the Banks realise how important the Government is to their business.

Despite their differences both sides of politics recently united to support a new tax on Banks. The tax was not justified on policy grounds which would favour broad-based non-distortionary taxes which are efficient to administer. In this case the Government openly justified the tax on the grounds that since the Budget was in deficit, it was entitled to an additional share of the profits that the regulatory system produces from banking.

Will the tax be distortionary? Well the regulatory system has so distorted investment in favour of the big Banks it is hard to say that this measure will counteract that to any significant degree. The worst part would be if it opens a path for feeble opportunists-like the South Australian Government-to get into the business of narrow industry specific taxes. Eventually copycat or follow-up raids will be distortionary.

Given all the points at which the major Banks interact with, and are affected by, the Government and its various forms of regulation, it is surprising that they were completely blindsided by the Government's tax announcement in the Budget. It showed how badly connected the Banks are in Canberra. And how poorly they understand the key factors that drive the business. As I have tried to explain today, Government is critical to the successful conduct of banking in Australia. The CEOs of the Banks, and if not them, their Boards ought to do a post mortem on why they were caught out so badly and what they will do to rectify the situation for the future. This is where a CEO or a Board could really add value.

Australia's experience in the aftermath of the 2008 financial crisis was quite different to the U.S. and the U. K. Our regulatory system-which was focussed on stability- performed exactly as it was designed to do. Apart from the wholesale guarantee I referred to, the Government did not have to intervene to "save" any Bank. No taxpayer funds were required to bail-out any of the Banks. Not one of the Banks made a loss, not even for one quarter let alone a year. And they used the opportunity to increase their market share and competitive position. Nor was there any substantial mortgage default or hardship. This was not a situation where Main Street was pitted against Wall Street, or to localise it, where Macquarie Fields was pitted against Martin Place. I can understand the anger of the people of Ohio and Pennsylvania about the bailouts in the U.S. but that cannot explain the feelings of the people in Oakleigh and Parramatta towards the Australian Banks.

Perversely, a sector that came through a testing time of financial stress with flying colours, has not endeared itself to Australian consumers but sunk in esteem (if we are to judge by recent regulatory responses). How now will it respond?

With the advice of Public Relations “experts”, the CEOs will appear before the Parliamentary Committee and issue the usual mea culpa. They will engage pollsters who will reassure people that all is well. But none of that will change fundamental perceptions. What they need to be able to do is to explain the benefit their industry brings to consumers and to society, and further, to explain how their remuneration packages offer each value for money.