Mr. John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100, Parliament House
Canberra ACT 2600, Australia

Phone: +61 2 6277 3540
Fax: +61 2 6277 5719
Email: economics.sen@aph.gov.au

10 August 2009

Dear Mr. Hawkins

RE: Bank Funding Guarantees

Thank you for this opportunity to comment on the above and related matters that have been referred for examination to the Economics References Committee.

Background
The Bank Funding Guarantees (Guarantee) was provided to all Authorised Deposit Taking Institutions (ADIs) to support both retail and wholesale banking activities. The current regulatory framework tends to favour the banks not by way of public policy but by the nature of the current market trends. In effect, the current regulations will allow the major four banks to emerge from the current crisis to be near oligopolies with significant impact on the economic life of the nation.

There is little doubt that the current regulations have strengthen the sector due to the efforts of APRA, however, it must be recognised that the worlds' financial system will change.

It is within these new circumstances which require a new strategic plan to evolve to meet the public policy goals.

The current system with the big four banks is not sustainable from a competition model or a regulatory model let alone in terms of economic benefits.

It would appear that the greatest recipients of the benefit provide by the Bank Funding Guarantees has been the limited number of stakeholders and proprietors of the four banks. This sector is far to critical from a legal and economic perspective to be operated for the benefit of a few, protected by the tax payer each time they feel the need for such action. If every major supplier to the economy had such a benefit to fall back on, it would simple not be sustainable. A banking licence since 1949 carried social and financial obligations, it was a privilege granted by the public. The current review is a unique opportunmoity to examine how these obligations can be enforced.

ADI social duty report
The law does not provide an ADI licence with indefeasible rights and in perpetuity; it is conditional and subject to Parliamentary scrutiny. Till date, there is very little review of the ADI discharging all their duties including social duties as providers of credit to the economy.

Perhaps it is opportune for Parliament to consider a formal, public "state of the banks" statement / report to be tabled each year.

Financial System Inquiry
The current rules were framed in a different era of economics and law. Like the Great Depression of the 1930s regulators and the legislature understood that facing the issues was short sighted and tend to favour entrenched interests. Perhaps the current circumstances provide a unique opportunity to re-engineer the entire regulatory framework so that a guarantee would rarely be in the minds of regulators and the community in the future.

Using Price as strategy / policy
The government needs to design the regulation not to out price the $40-50 billion per annum residential mortgage-backed securities (RMBS) and credit union sector. Cost is always the easiest way to ease out a policy objective. However, all exit strategies must have a public policy objective. Simple removing the Guarantee without a strategy in place is to ignore the events of the last 12 months.

Encouraging Alternatives
There is a real need for the regulation to reflect a public policy objective to encourage significant alternatives to the major banks whether as regional banks, credit unions or building societies. There is some concern that the Guarantee was initially offered only to the banks not to their competitors. Putting aside the veracity of these claims, the review of the Guarantee and its exit is a unique opportunity to encourage alternatives to the banking sector. If diversity is the key to fostering competition, then the existence of the mutual and other financial sectors is critical to ensure small and medium size businesses have access to credit at competitive terms.

Assuming that the law focus on the importance of encouraging competitive forces, there should also be consideration to enact laws that would create a form of "affirmative" action type policies to encourage alternatives to the banking sector.

This need not be discriminatory in nature or provide less stringent capital adequacy and liquidity rules on the bank competitors. Parliament has the sophisticated tools of law and regulation to send the signal to the market place without interfering with the credit provider's bottom line. It will require clever innovative public policy thinking and the draft of laws to enable perhaps the current regulator APRA with an additional objective "to regulate within the limits set by law and Parliament to encourage a sustainable alternative to the banking sector"

Exit Strategy
The introduction the of the Guarantee served a specific purpose. It was taken advantage by predominantly the four big banks; they have improved their books, absorbed the bulk of the liquid funds and may have been the cause of the failure if not the freezing of a range of investment funds. Although Treasury has indicated some form of exit from the Guarantee there does not seem to be an overall exit strategy. That is, a strategy to exit the Guarantee, and manage the vacuum that would inevitable exist thereafter. In short there does not seem to be a comprehensive post guarantee strategy or any clear public policy outcome. This adoption of a "non interference with the market" is not a policy outcome. The regulation must now be driven less by ideology and more by the lessons learnt from the crisis. Of particular concern is what will the government do with the banking sector Australia ends up with after the

removal of the Guarantee? Should anything replace the Guarantee? There is little doubt that both the retail and wholesale Guarantees had served an important purpose. Likewise, the banks have been the greatest beneficiaries of this policy. The mutual sector was less likely to benefit from this in particular in the wholesale markets. What policies will be in place thereafter? How should Australians rate their banks now in the post Guarantee period?

There needs to be intervention to ensure Australia does not end up with a banking system that is of benefit to few stakeholders.

Co-ordinated Regulation

There also needs to be co-ordinated regulation on all aspects of raising funds from the public and a closer examination to regulate over the counter derivatives. Perhaps the government should consider some form of capital charge so that risk can be best linked with the ADIs performance. Perhaps its time to re-visit the idea of a statutory reserve or some form of financial stabilisation scheme to insure against liquidity stress. Perhaps Parliament should consider regulating all securitisation activity in line with the proposed USA laws

Encourage Innovation not speculation

There needs to be a clear signal that innovation is encouraged and speculation is not, that performance not based on fee structure but cost to funds through financial engineering is preferred.

For instance all ADIs should be compelled to provide standard mortgage terms and follow that through to the instruments they use to create the securities to raise the funds. There needs to be transparent, consistent and user friendly templates from the retail to the wholesale end of the market to discourage abuse of legal technicalities that have clouded the nature of the instruments, distorted risk, valuations and obligations. In short there needs to be transparency as to the precise nature of the underlining security offered at all times.

Impact of USA proposed Regulation

The 2009 London Conference heralded that a new global regulatory regime is likely to emerge as a consequence of the crisis.

There is little doubt that the current regulations have strengthen the sector due to the efforts of APRA, however, it must be recognised that the worlds' financial system will change, driven by the most part by the proposed packaged of USA legislative measures announced by the USA President in July 2008.

In the current draft the proposed US laws will have perhaps the greatest impact since the early 1930s on the way all aspects of finance and credit is dealt with in the USA and beyond. As Australian banks purchase a significant portion of their funds in USA based markets and from USA based institutions its is likely that the USA proposed banking and financial market regulations will take on the same significance as the Sarbanes-Oxley Act 2002. There needs to be a thorough examination of how this proposed USA laws will impact Australian ADIs and a review of existing regulations and laws must be undertaken in light of these proposed changes.

Regulating Reward
In relation to bonus/ commission structures it is understandable that employees would seek to maximise their remuneration based on their performance. It's the criteria which defines performance which is of concern. The creation of "paper wealth" through various securities created by the banks were value and risk are factored out is of particular concern. When such "wealth" creation is then linked to performance the consequence is the crisis the USA delivered in 2008.

Although interference in the remuneration policy of any business must always be avoided the unique character of the bank and the fact they operate through a public licence creates a justifiable legal obligation for the public to provide a clear guidance as to remuneration components, not necessarily quantum.

Level playing field
In the rush to support the legitimacy of market forces and discourage intervention by the legislature in this sector, the idea of the level playing field absence in the current debate is of concern.

Without a level playing field competitive forces to encourage efficiency and diversity are less likely to occur. This requires a firm public policy decision whether to provide a form of "affirmative" action type policies to support the mutual and non banking ADI sector. Without this support there cannot be a level playing field.

Further, despite recent amendments to the *Trade Practices Act* and the recent announcements by the ACCC as to price fixing, terms of credit manipulation and abuse of market power, it is unlikely that such policies will have a measurable impact on the behaviour of sophisticated well placed oligopolies.

The writer is a lecturer in Business Law, School of Business Law and Taxation Australian School of Business University of New South Wales admitted as a solicitor and barrister of the Supreme Court of New South Wales, High Court of Australia, Arbitrator to the Local Court of NSW (Civil Claims) 2003-007, member Law Society of New South Wales Arbitration President Arbitration Panel, is on the board of a mutual ADI, and is an author of a number of commercial law texts, chapters, articles, conference and discussion papers.

Yours sincerely,

Michael Kyriacou Peters

Lecturer
School of Business Law and Taxation
Australian School of Business
University of New South Wales