

PERSPECTIVES



**Commoditising Banking:
refashioning the private
public partnership of
banking around the
relative strengths of the
private and public sectors**

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Whitlam

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Dr Gruen was a member of the Cutler Review into Australian Innovation leading the Review's deliberations on information and innovation in government and tax incentives for R&D. He has been involved with the Commonwealth, Victorian, South Australian, NSW and Western Australian governments in the area of innovation in government with a particular emphasis on internet technologies and social media. He participated in the 2010 Commonwealth MAC report on innovation in Government. In 2009 Dr Gruen chaired the Federal Government's Government 2.0 Taskforce producing a report which garnered high praise from leading international figures. The Federal Government has essentially accepted its recommendations.

Dr Gruen is recognised as a strong public advocate for economic reform, innovation and open government all in the context of grasping the extraordinary opportunities which burgeon online.

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Foreword

On 15 July 2010 the Whitlam Institute with the School of Economics and Finance at the University of Western Sydney convened a high level symposium on 'Delivering a 21st Century Economy for a Fair Australia'. Not surprisingly questions of taking competitive neutrality seriously, risk management and regulation of the finance sector figured prominently. Indeed, one speaker, Chris Joye, made a convincing case that reform of our financial system was at the very core of constructing a fair society.

Since that time finance sector reform has become a matter of heightened public interest and few things incite the passions as much as the profits and behaviours of 'The Banks'. The danger of course is that the heat being generated sheds no light whatsoever.

Yet these are serious issues and they do demand thorough debate.

This *Perspectives* paper by Nicholas Gruen, commissioned by the Whitlam Institute, not only offers an analysis of the commodification of banking in the shadow of the Global Financial Crisis, but posits a comprehensive micro-economic reform of banking that holds out the promise of simultaneously delivering greater financial security and substantially increased competition.

While not to the exclusion of broader economic reforms, its focus on micro-economic policy is attractive for the very reason that it addresses several key challenges through a reform proposal that is capable of being applied with relatively little systemic disruption.

Gruen's insight is that the Canadian arrangements enabled the major elements of the mortgage market (including the market for securitisation) to continue to function throughout the Global Financial Crisis, and in that sense performed better than the Australian market. The proposal that follows takes that experience and applies it in a prudent manner to the Australian conditions.

Nicholas Gruen is well known and greatly respected among economists and policy makers inside government and beyond. He has advised two Cabinet Ministers and sat on the Productivity Commission. He is currently CEO of Lateral Economics, a regular columnist and prolific blogger. He chaired the Federal Government's 2.0 Taskforce in 2009 and is a strong public advocate for economic reform and innovation.

We have moved quickly to the publication of this particular *Perspectives* paper conscious of the rising expectations that the recent rhetorical banter around banking must be matched by the development of genuine policy options.

The option detailed here establishes a benchmark in the imminent policy determination.

Eric Sidoti
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Commoditising Banking: refashioning the private public partnership of banking around the relative strengths of the private and public sectors

1. Introduction

While the financial crisis cut swathes through the financial sector and real economics of developed countries generally its effect in Australia was to illustrate a grand paradox. Our banks were revealed to be amongst the strongest in the world, profitable beyond the wildest dreams of the pre-deregulation era. At the same time they were dangerously fragile, requiring unprecedented guarantees not just on deposits but also for wholesale creditors. If the analysis offered in this paper is sound the policies it proposes will make our financial system not just less fragile, but also substantially more competitive.

There has been no shortage of proposals for comprehensive re-regulation of finance. Yet even relatively like minded experts who can often broadly agree on the causes of the crisis still disagree on the correct solution. Thus for instance John Kay, Paul Volcker, or even the Bank of England Governor, Mervyn King, appear to back strong action to return the core banking system¹ to 'narrow banking' and avoiding the problem that some banks are 'too big to fail' whilst Nobel laureate Paul Krugman is not so sure.² Many prescribe substantial increases in capital adequacy by banks. But while this may improve the robustness of our banks, it would do little to improve competition between them and nothing for the competitiveness and stability of alternative sources of finance such as securitisation.³

The approach in this paper is slightly different. It does not propose a new regulatory regime arising from a comprehensive view of finance. Instead we go looking for hundred dollar bills on the pavement: That is, areas of inefficiency whose source can be easily seen in both theory and empirically and which can be improved by the application of simple principles and procedures of micro-economic reform.

1 By the core banking system I intend to refer to deposit taking banks which are subject both to the close scrutiny of both prudential regulators and the central bank and which can draw upon liquidity facilities of the central bank. There is a general expectation within the community and amongst depositors that their deposits are safe in the core banking system, that regulation ensures that safety, and that implicit government guarantees stand behind those deposits. Those expectations were realised in 2008 when guarantees were made explicit. By implication the 'shadow' banking system is that part of the finance industry that provides services similar to and in competition with banks and yet which do not operate and are not regulated as banks. For the purposes of this paper this can be taken to be mortgage originators and securitisers.

2 In Australia, Quiggin and Joye have advanced the case for narrow banking, while regulators such as APRA and the RBA have so far shown tepid support if that. More generally see De la Torre and Ize, (2010)

3 Which term is defined below.

This does not produce root and branch reform of finance, but it stands to generate large and worthwhile micro-economic reform of banking which reform would also make a substantial contribution to the problems that beset finance more generally.

The paper focuses on lending to households in Australia and particularly on the largest household debt market - the one trillion dollar home loan market which constitutes around sixty percent of Australian banks' assets. However the principles articulated here would apply to any area of banking which is susceptible to disintermediation through market-traded portfolio funding (also known as 'securitisation').

The central motivating concerns of the paper are these:

- Most finance is 'commoditised' – as defined below. Yet in contrast to an industry like IT, where a service being 'commoditised' leads to dramatic price falls, in finance this has not happened.
- As the crisis demonstrated, banking is a public private partnership. Banks risk capital to earn profits. But given their capital adequacy will always be limited, catastrophic downside risks are assumed by governments. No amount of denial, or policy ambition will remove the government's guarantee. And even if it were possible to remove it, it is not possible to prevent depositors and money markets from perceiving it as likely that bank guarantees would be activated in a crisis.
- While the dilemmas of banking will always involve difficult tradeoffs, the current architecture of banking is inefficient, inequitable and fragile. The real economic payoff is in finessing the contours of the private/public partnership that is banking. The assignment of roles should be the product of careful, practical and principled thought rather than ideological predisposition which privileges the role of either public or private sectors.
- Given the complexity, importance and politically contentious nature of finance, there is a premium on evolving industry structure through choices in the presence of competition.
- Crucially, competitive neutrality is invoked not just to protect private competitors from subsidised competition from the public sector, but also to ensure that the contribution public sector assets and capabilities can make to productivity are not artificially withheld.
- To prevent moral hazard and to manage its own exposure, governments heavily regulate banks. There have been similar calls for governments to regulate shadow banking built on securitisation.

However given the advantages of limiting regulation to where its benefits outweigh its costs, an alternative is to allow those in the shadow banking sector to purchase the liquidity provision and risk bearing services of governments. Thus 'regulation' occurs, but on an opt in basis and only on products that a government agency considers appropriate risks.

- New technological possibilities, particularly on the internet have powerful implications for the way this public/private partnership of finance should be crafted. This point will only live in the background in the analysis here but will come to the fore in a subsequent companion paper.

2. The possibility: commodified banking at a competitive cost

Competition plays two fundamental but somewhat contrasting roles in our economy. Firstly, if sufficiently vigorous, competition drives prices down to the lowest level consistent with attracting and retaining the resources necessary for sufficient production. Secondly, businesses don't like competition and will do anything to escape its rigours. Most particularly they will search for new, better ways of doing things. As they develop, new markets are often hotbeds of innovation. As they mature, unsuccessful innovations are weeded out and standard ways of doing things are established and come to dominate their industry with innovation occurring around the edges. In the language of this paper, such a market is becoming 'commoditised'.

A great deal of finance is 'commoditised' in this way. Perhaps the best and certainly the most important example is the housing loan market. Here the essential financial aspects of the vast bulk of activity do not differ between competitors in the market notwithstanding attempts at product differentiation between competitors. Often commoditisation is reinforced by regulation which itself reinforces existing industry practices and makes it difficult if not impossible for competitors to vary basic routines. Thus in the Australian housing market banks typically lend up to a loan to valuation ratio (LVR) of 80 percent and, if they wish to lend more, require the borrower to fund 'lenders' mortgage loss insurance' (LMI) to cover the lender for default by the borrower.⁴ Surprisingly, and presumably inefficiently, credit risk on prime loans both below and above the 80 percent LVR is not priced by the banks, though such pricing occurs above 80 percent by virtue of LMI premiums rising with LVR. Each lender lends against very similar criteria for appropriate serviceability and the quality of security.⁵

4 The market for LMI is itself a near pure duopoly between Genworth and QBE (with a small amount of insurance from in-house bank insurance).

5 Even in the absence of explicit regulation of these points, of which there is plenty, staying within the bounds of accepted industry practice clearly lowers risk of successful legal action for financial firms and the individual decision makers within them.

Two forms of financing home lending compete in the Australian market. The first, most time honoured form is funding from the balance sheets of banks and other similar intermediaries like credit unions and building societies. These intermediaries take deposits and raise money on wholesale markets and recirculate them as loans. Securitisation on the other hand has played an important role since the 1990s in Australia. It involves the parceling up of commodity financial assets into portfolios for direct sale on wholesale money markets. Buyers of these pools are typically longer-term investors, such as super funds and sovereign wealth funds seeking access to safe, stable cash-flows (the Future Fund and various pension funds are large investors in securitised home loans).

3. Wallis: The mission and missteps

A central objective of the Wallis Report was to facilitate more vigorous competition between these modes of finance. Though Wallis was assiduous in its attempt not to prejudge the industrial evolution of finance, and genuinely agnostic about the pace of change, it saw securitisation as enjoying powerful advantages over balance sheet banking because of its capacity to spread risk more effectively and to economise on capital, particularly given the rise and rise of the internet.⁶

However there was a mote in Wallis's eye. As Harper has subsequently conceded,⁷ the Wallis Report was in thrall to the efficient markets hypothesis. It was also caught up in the deregulatory zeitgeist of the time. Although Wallis emphasised the importance of competitive neutrality between market mediated and balance sheet lending, its recommendations did little if anything to address the profound departures from competitive neutrality represented by the institutions of central banking and it simply gainsaid the implicit government guarantee in times of crisis. The message from Wallis was that governments should just say 'no'.

6 Harper, a signatory to the Wallis Report and Thomas explain (2009, p. 199), Wallis's central recommendations:

"These built on the notion that financial markets would play an increasingly important role within financial systems over time at the expense of traditional financial intermediaries. Behind this conclusion lay the observation that *securitisation* – the conversion of non-traded financial claims (e.g. mortgages) into marketable securities through bundling and credit enhancement – was rapidly gaining acceptance as a means of accessing capital markets directly rather than indirectly via traditional financial intermediaries. This in turn was linked to steady reductions in the extent and severity of information asymmetry flowing from the ubiquitous rise of information and communications technology (ICT)."

See also Wallis, 1997, p. 10.

"Over time, the processes of disintermediation and securitisation will increasingly offer households alternatives to balance sheet contracts like deposits. For example, more accurate pricing of individual risk categories facilitates the retail packaging and offering of low-risk securities such as those backed by insured home mortgages. An implication is that deposit taking intermediation is likely to shrink in relative importance within the financial system, albeit at a pace that is difficult to predict."

7 *Ibid.*

The history of the Global Financial Crisis (GFC) has demonstrated the quixotic nature of Wallis's hope that guarantees would not be extended to the arteries of the economy in a crisis. Further, the banks received not just the usual assistance with liquidity, but a wide array of supports to liquidity and solvency improvised by the Reserve Bank and indeed the Government itself. The wholesale money markets, already devastated by the crisis, were further disadvantaged as funds leaked out in search of the safety of government support (including government guarantees of deposits and wholesale funds). Securitised funding for new loans duly collapsed with numerous mortgage originators relying on securitised funds closing. Many months into the crisis, securitisers received limited support in the form of Australian Office of Financial Management (AOFM) participation in the purchase of securitisation issues.

In our search for more competitive commoditised banking, the next section explores the strengths and weaknesses of balance sheet and securitised lending. While it will be clear that each form of lending has its strengths and weaknesses, it is also clear that securitisation offers a way to bring balance sheet lenders to competitively price their services. Given the forces intensifying concentration in banking, it is not easy to think of other sources of competition. This is the motivation for ensuring that securitisation plays its role in the financial eco-system in bringing the pricing of commodity lending on bank balance sheets back towards the costs of production.

4. The difficulties in getting to competitive commodity banking

This section reviews three obstacles to competitive commodity banking as a prelude to proposing improved arrangements in the next section.

4.1 Balance sheet lending cannot be fully competitive

Once commodification emerges, the role of competition is primarily to discipline prices. Yet though a large part of the housing loan market is effectively commoditised, margins remain surprisingly high. The contrast to the way 'commoditisation' works in the world of IT is striking. There a vast store of software, content and other resources is accumulating on the internet available at the marginal cost of such activity – which is zero. By contrast the price of very large swathes of banking remain well above the cost of their supply.

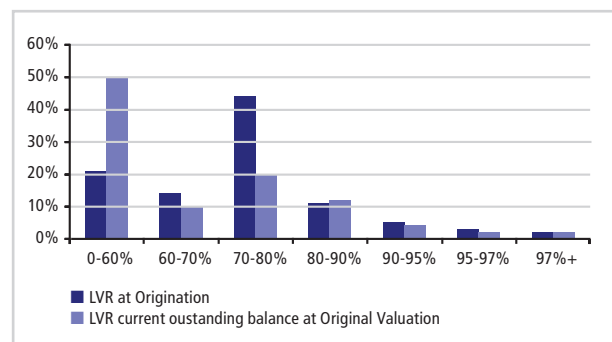
Consider for instance that 60-70 percent of all new housing debt is secured at LVRs well below 80 percent.⁸ An even larger proportion of outstanding, as opposed to new, housing debt has very low LVRs given that loans are repaid over time while the underlying collateral values tend to appreciate.

⁸ UBS 2010.

Below some point – which, for the sake of illustration here we can take as 50-60 percent,⁹ a diversified portfolio of home loans offers a level of risk that is broadly comparable – one might even argue lower than – that of a government bond.¹⁰

Not only would most borrowers in the portfolio have to default and be unable to meet their repayments, but their homes would need to fall in value by substantially more than has occurred in one of most distorted housing finance markets in the developed world (the United States) during its worst financial catastrophe since the Great Depression after its biggest ever housing bubble.¹¹ The 'system wide' LVR across Australian housing is below 30 percent.¹² Risk disclosures by the major banks suggest that the current dynamic LVR – that is the current mortgage debt owing divided by the *current* value of the home – is some 40-50 percent.¹³

Figure 1. Westpac loan to Valuation Ratio



Source: UBS, 2010.¹⁴

Thus in Canada a loan with an LVR of less than 65% can be insured against borrower default by the government backed Canada Mortgage Housing Corporation (CMHC) for a one off payment of just 0.5% of the loan amount.¹⁵ Once insured the loan can trade as a financial asset with the same security as a government bond.

⁹ This figure would to some extent depend on the state of the market and might be lower where dwelling prices are at above trend averages.

¹⁰ Note that the maximum house price falls APRA assumes in its bank stress-tests is 25-30 percent (Laker, 2010). A government bond requires a government to repay a loan, which at some stage it may face incentives to default on or to inflate away. By contrast while the recovery of principal from a mortgage is also likely to require the complicity of governments, this will involve the government enforcing property rights amongst others, rather than funding repayment itself. Also while inflation can undermine the value of a mortgage as surely as it can undermine the value of a bond, the government faces no direct incentive to inflate the currency to devalue mortgages the way it faces incentives to devalue the currency to reduce its own liabilities.

¹¹ According to the Case-Shiller 20 City index the peak-to-trough fall in US home values during the recent sub-prime crisis was approximately 33%.

¹² That is, total mortgage lending is less than 30 percent of the total value of the housing stock. 2010 Financial Stability Review.

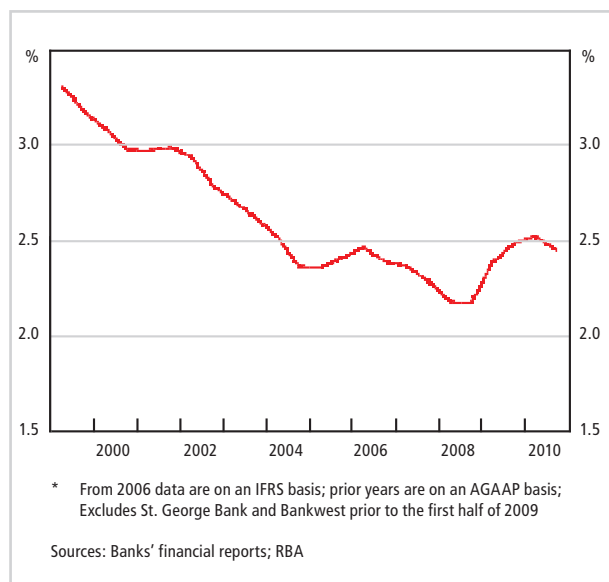
¹³ Commonwealth Bank reports its global LVR of 43 percent. Commonwealth Bank, 2010. "Debt Investor Update, August 2010, p. 25 accessible at http://www.commbank.com.au/about-us/group-funding/articles/Debtroadshow_presentationv1.pdf accessed on 12th November 2010.

¹⁴ It is difficult to get the aggregated numbers across banking, but these numbers for Westpac are indicative.

¹⁵ See below.

Indeed, prudential regulation permits the loan to be carried on bank books without further capital backing and such loans are traded over an open exchange. And yet, in Australia, in addition to fees, the annual net interest margins on such exceedingly low risk loans, is over two percent. That is \$8,000 per annum on a \$400,000 loan and precisely the same margin on a much higher LVR loan which does bear some genuine risk. Indeed, the major banks' net interest margins look to be at their highest levels since 2004.

Figure 2: Bank net interest margins



RBA, *Financial Stability Review*, November, 2010, p. 42.

This is way above the cost of supply of such a loan which amounts to just the management of maturity transformation (with the help of the central bank) and administration.¹⁶ If we can observe such a discrepancy between cost and price in practice, why haven't banks competed this away? Firstly sheer inertia plays a role. In the 1990s increasing market entry in banking did little to dent banks net interest margins until securitisers began stealing market share from banks. More importantly, banking is increasingly dominated by four conglomerates. This is paradoxical. On the one hand the academic consensus is that beyond a quite modest size, there are no operational scale economies in banking (see Appendix). Indeed, strong evidence has been uncovered of a 'diversification discount' in the share-prices of financial firms.¹⁷ Thus Schmid and Walter (2009) explored U.S. data from 1985-2004 finding "substantial and persistent" conglomerate discounts in finance corroborating similar findings from other studies.¹⁸

16 For the avoidance of doubt, where this paper speaks of the cost of providing a particular product this would involve a normal commercial return on capital.

17 The "diversification discount" literature was launched by Lang and Stulz (1994), which was the first of a range of studies that diversified firms were valued at a discount on the market, because of the costs of diversification outweighing the limited benefits in risk reduction which can in any event be achieved by investors diversifying their own portfolios rather than purchasing diversified pools of assets in the form of shares in a financial conglomerate.

18 This was broadly consistent with Laeven and Levine (2007) who found strong evidence of a conglomerate discount in a sample of 836 banks from 43 different countries.

But while equity investors in financial firms see diversification as harming returns, wholesale lenders to financial conglomerates view them as safer bets, lending to the conglomerates at lower interest premiums than they do to smaller regional banks. Thus Australia's conglomerates continue to enjoy substantial advantages in wholesale funding costs both over securitisers and also over smaller regional banks. In fact, any one of the four major banks can raise AA-rated debt at prices lower than a AAA-rated securitised home loan portfolio.¹⁹ This special banking variant of the debt-equity premium puzzle is resolved if the market preference for Australian conglomerates' paper is driven by something else – a perception that being 'too big to fail', such that conglomerates enjoy implicit government guarantees. To the extent that this is what is driving the divergence in funding costs between the conglomerates and the regional banks, the Australian government's use of such market signals to price its own guarantee to banks for wholesale fund raising has simply reinforced a market failure.

It is possible that this reflects some genuine market preference for the conglomerates' greater diversification over the smaller regional banks which tend to more closely resemble the traditional 'savings and loans' style of banking. Against this, the complexity of conglomerates makes them harder for lenders, investors and regulators to scrutinise from the outside. And buyers of financial assets can diversify within their own portfolios and so do not need them diversified for them on bank balance sheets.

This analysis above uncovers a serious problem. Probably because of their perceptions that they are 'too big to fail', wholesale money markets favour large conglomerate financial intermediaries and so competition between balance sheet funders of commoditised financial markets cannot on its own drive prices down to fully competitive levels.

4.2 The promise and perils of securitisation

Private securitisation began in earnest in the US in the 1980s, though the once publicly-owned then privatised semi-government agency Fannie Mae effectively used securitisation to develop long term housing finance from 1938 on.

4.2.1 The promise

The competitive promise of securitisation was evident from the outset of its use in Australia where, despite nearly a decade of increasing competition between banks, the period of its introduction saw margins on home loans slashed by over half.²⁰

19 RBA, *Financial Stability Review*, Sept, 2010, p. 27.

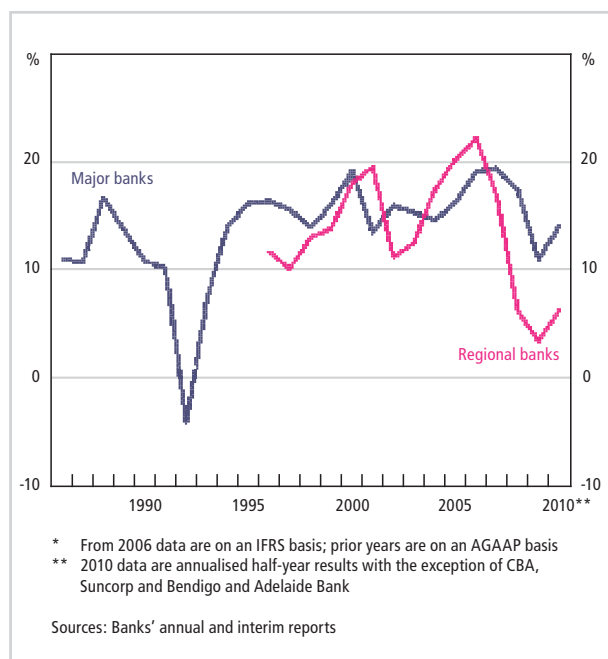
20 As Liu and Skully (2008, p. 2) note:

"The bank market share of newly-originated loans declined from 90 percent in 1994 to 77 percent in 2003. To respond to increasing competition, bank yield spreads (over 90-day bank bill rates) of nearly 4 percent in 1994 dropped to 1.5 percent by 2003."

The importance of securitisation for price discipline was further demonstrated as the GFC hit and the market for residential mortgage backed securities (RMBS) seized up. With funds virtually impossible to raise through the wholesale markets, banks both diverted their existing capital, and raised additional capital (initially purchasing specially provided Government guarantees to enable them to do so). Offsetting dramatic falls in business banking profitability as impairment rose, the banking conglomerates compensated with increased home lending margins.

In the new fearful environment, money flowed out of the shadow banking sector and into banks along with additional savings as households and businesses hunkered down. The banks also reduced their costs by cutting sales commissions to mortgage brokers by around thirty percent.²¹ Remarkably, even while the financial crisis was continuing to work itself out with major losses or at least falling margins for virtually all banks around globally, the post-tax return on equity of Australia's major banks never fell beneath 10 percent before heading back up towards the 15 percent and above zone where they had sat since the previous recession of 1991-2. The current reporting season sees return on equity rise comfortably above 15 percent before substantial increases in margins if the RBA is to be believed that funding costs have not risen.

Figure 3: Banks' post tax return on equity



RBA, 2010, p. 21.

Securitisation has a range of additional attractions.

Diversification of risk is one of the fundamental functions of finance. Yet diversifying risk via banking conglomerates is a highly constrained affair. Their balance sheets blend vast amounts of different financial assets which bank managers hope will suit the risk-return preferences of large numbers of investors. By contrast securitisation offers the prospect of matching the risk preferences of individual investors with specific classes of assets.

Adam Smith put the division of labour at the heart of his thinking about what drives economic development and this insight has never been more important than in the age of the internet with its ability to enable the 'mass customisation' of much production and its capacity to facilitate gossamer like connections between buyers and sellers in a market, or participants in a conversation from anywhere in the world. Just as open source software was unable to really take off until the internet came of age and enabled the construction of large virtual teams constituted from all parts of the globe, just as the internet made servicing the 'long tail' economically viable,²² so securitisation enables pools of risk to be parceled up and distributed to those best placed to bear them wherever they are in the world.

Further, securitisation is, in principle, built for external scrutiny. The bank offers its shareholders its skill in acquiring and managing a diversified portfolio of financial assets to maximise risk adjusted return. The problems of external supervision acquire additional significance in the context of financial regulation and prudential regulation in particular. Contrasting supervision with the (usually more straightforward) regulation of utilities, John Kay explains what is at stake in the external supervision of complex financial entities (2009, 33):

Supervision is, by its nature, wide-ranging: regulation is focussed. Supervision is subject to creep – a tendency for its scope to grow. Supervision involves a form of shadow management; but it is almost inevitable – and wholly inevitable in the financial services industry – that shadow management will be at a disadvantage to the real management in terms of the competence of its staff and the quality of information available to it. Despite the wide scope of supervision, it is not an effective method of regulation. Supervision is subject to regulatory capture, an inclination to see the operation of the industry through the eyes of the industry and especially through the eyes of established firms in the industry.

By contrast the securitisers operating in the Australian RMBS market are offering something much simpler – an assurance that the assets are acquired in accordance with and as described in a trust deed with whatever standard industry practices are deemed suitable to persuade buyers of the assets of their fidelity to the trust deed.

21 Declaration of interest, the author is a shareholder in Peach Financial which amongst other things conducts mortgage broking activities.

22 Brynjolfsson et al, 2010.

Unless they are engaging in the narrowest of banking, there will usually be myriad aspects of a bank's balance sheet which are opaque to the outsider, for instance riskier proprietary trading, offshore operations, funds management activities, the vagaries of future management decision-making, and so on. This is much less true of a securitised pool of loans. Short of fraud, for which there are myriad protections, possible surprises are largely limited to the way these well defined assets might perform.²³

In addition, the process of maturity transformation, which converts short-term loans (eg, deposits) into long-term assets (e.g., home loans), has always been central to traditional balance sheet credit intermediaries but is also a central source of the banking system's fragility. In fact maturity transformation of this degree would be unworkable if it were not for central banking institutions designed to promote liquidity and address confidence in intermediaries' solvency at times of nervousness.²⁴ As Joye and Gans point out (2008), enjoying no such luxury, securitisers perform much less heroic maturity transformation via the wholesale money markets with the purchasers of securitised paper parting with their 'at call' access to their funds.²⁵

4.2.2 The perils of securitisation

Those with some passing familiarity with the history of finance should be unsurprised that the widespread adoption of securitisation was the prelude to crises and abuses. Just as the reciprocating piston engine remains a dominating standard within the car industry at least in part because, being the established incumbent it enjoys huge industry wide economies of scale and a vastly greater body of development than more recent engines like the Wankel engine, balance sheet lending has all the advantages of around five hundred years of development as the incumbent. And since the problems of balance sheet lending are not at heart technological problems but the socio-political problems of governance incumbency counts for a great deal. Today banking is a sophisticated public private partnership involving very well resourced and connected financial conglomerates, highly evolved central banking institutions and regulatory arrangements, all engineered and managed in a self-consciously risk averse manner.

²³ It should be clear here that we are talking of securitisation as a vehicle for risk pooling, rather than the more exotic uses of securitisation practised in the US where specific risks within the pool were 'sliced and diced' into exceedingly complex instruments which were then bought by investors whom it is clear did not, and indeed could not conceivably have understood them (see below). Though it is no doubt possible to add value by 'slicing and dicing' specific pooled entitlements into 'tranches', far more value was destroyed than created because of flawed incentives and practices existing in the financial markets at the time.

²⁴ Without the crutch of central banking, credit intermediaries would descend into self-reinforcing periods of crisis as they did before central banking took its mature modern form after the Great Depression.

²⁵ Of course a liquid RMBS market could lead investors in RMBS to consider them 'at call' funds. But in fact many RMBS investors are longer term investors, and even those who are not, are risking access to their money in the event of liquidity drying up.

Contrary to the previous hopes of some,²⁶ securitisation does not slay that beast which lies in wait for the unwary in financial markets – moral hazard in the presence of asymmetric information – a concept more pungently expressed in the folk saying "when the cat's away, the mice do play". Still it cannot be stressed too strongly for the purposes of this paper that however much securitisation failed as a vehicle for financial innovation, and its failure was spectacular, it did not fail as an instrument for pooling simple, well understood investments and in so doing intensifying competition in commodity lending.

After a prolonged period of unusually low interest rates, the market was hungry for higher yielding low risk assets. There was a correspondingly large amount of money to be made in satisfying it. The usual combination of ingenuity and depravity then culminated in a boom and crisis that looks inevitable enough, at least with hindsight. In the US, pools of high risk assets like sub-prime loans were 'structured' or 'sliced and diced' into 'tranches' of claims such that investors in the senior tranches were entitled to priority of payment. Done properly such financial engineering might, by appropriate diversification and prioritising of claims, have been able to enhance the credit risk of at least some of the resulting paper.

Though there was value to be added by such manoeuvres – at least in principle – any such healthy effects were swamped by the mutually reinforcing pathologies of finance. The availability of large amounts of highly risky housing debt written by an industry which had failed to address the obvious conflicts of interest inherent in originating loans to sell them to others and the way those loans were 'booby trapped' with 'teaser rates' created the raw material. The financial obligations thus sold were thence 'sliced and diced' into tranches to generate less risky assets from the highest priority claims on the assets.

Ratings agencies lent their AAA credit ratings to these assets based on time series which demonstrated the near impossibility of catastrophic events largely by methodological caprice. They were based on time series which didn't stretch back far enough to accommodate past catastrophic events and built from economic models that assumed that markets conformed with strong versions of the efficient market hypothesis. In any event, the ratings agencies, like others in the chain, were conflicted, profiting handsomely from the sale of their imprimatur, not unlike the Catholic Church once profited from the sale of indulgences.

So long as the music kept playing this new breed of AAA rated assets became highly profitable on balance sheets around the globe and of course for those in the production chain that manufactured them. Undoubtedly many financial managers saw themselves as doing the right thing, but whatever lay in their hearts, their bonus swelled wallets prospered as they played 'heads I win, tails you lose'.

²⁶ Eg Harper and Thomas, 2010.

And so the herd like, commodified nature of finance came to vitiate one of the chief 'in principle' attractions of securitised finance – its capacity to spread risk. The toxic paper was both created and purchased in vast quantities by banks thus concentrating rather than spreading risks which, as confidence evaporated rapidly, became systemic.

We should no more conclude from this litany of woe that securitisation is worthless than we should conclude from the various disasters to which banking and other forms of finance have given rise that private financial intermediation is worthless. Indeed, financial history is replete with many more examples of traditional bank failures around the world – including, most frequently in the epicentre of the securitisation meltdown, the US where, remarkably, bank failures are a frequent occurrence even during periods of prosperity.²⁷

On the other hand, despite the drama and turmoil of the financial crisis, the technique of using securitisation to simply pool parcels of well understood products has, remarkably enough, continued to demonstrate its worth right throughout the crisis. Indeed, while the investors in exotic securitised paper which by slicing and dicing appeared to make a AAA silk purse were losing their shirt, and even as the securitisation market collapsed for lack of buyers or lenders against the paper, investors in securitised Australian prime home loans have never suffered a loss of principal in the history of the market (Debelle, 2009). Thus, though there may be evidence of a small degree of adverse selection and/or moral hazard creeping into Australia's RMBS market,²⁸ the organic incentives for integrity appear to have remained largely intact.

4.3 Heads financiers win, tails the government loses

Maybe not explicitly, but what are the chances that TD Bank is not going to be bailed out if it did something stupid?

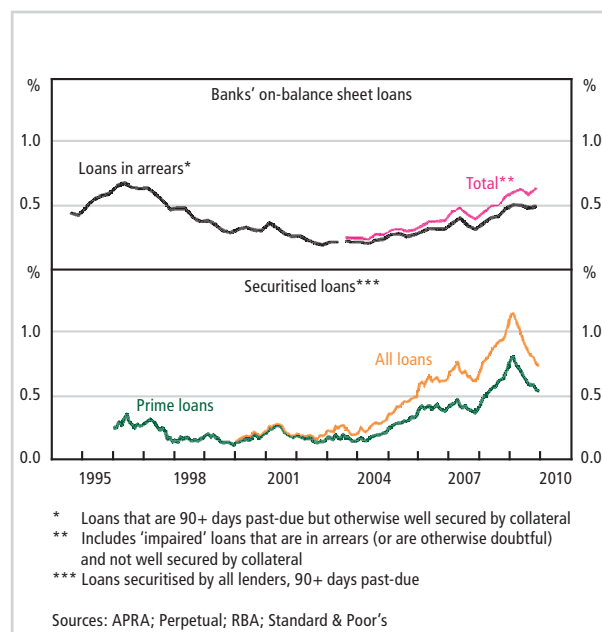
CEO of Toronto Dominion Bank, speaking to investors, 2009.²⁹

As regulators increase the protections against the possibility of bank insolvency – by increasing capital adequacy and regulating to restrict banks' freedom to take risks – the cost of providing finance rises, imposing real costs on the economy.³⁰ For this reason regulators should not try to reduce the risk of financial catastrophe to zero. Thus for instance the most stringent stress test that the Australian Prudential Regulation Authority (APRA) has imposed on banks is a house price fall of 25-30 percent (Laker, 2010). And, as we have seen during the crisis, notwithstanding previous intentions or announcements, once systemic risk raises its head, the government is ultimately forced to bear the risk of any loss which is beyond the capacity of banks' balance sheets to bear.

27 Of the 2,698 bank and thrift closings caused by failure during the entire period 1984–2003, almost 75 percent of them occurred in the five years 1987–1991, when failures averaged 388 per year. In contrast, from 1994 to 2003 only 66 institutions failed—a figure that reflects greatly improved economic conditions and stronger safety-and-soundness regulation. Jones and Critchfield, 2005

28 Thus non-performing prime loans spiking slightly higher for securitised loans than on-balance-sheet loans. Nevertheless there may be other explanations for the different performance. The only really substantial deviation was the sharp jump in financial year 2008-9 which has now largely dissipated. Further, the loans banks have left on their balance sheet may be unrepresentative in some way. If the banks are selling their worse loans, this may be reflected in the future prices at which they can be sold into the RMBS. If this will not happen of its own accord in an unstructured market, governments may be able to improve the informational quality of such markets making them function better – a matter to which we return in the final section.

Figure 4: Non-performing Housing loans
(% of outstandings)



Source: Financial Stability Review – March 2010, Graph 71 at <http://www.rba.gov.au/publications/fsr/2010/mar/html/graphs.html>

29 In Boone and Johnson, 2010, p. 259.

30 Though as Hellwig (2010) notes, the extent to which higher capital requirements on banks imposes economy wide costs is frequently misunderstood and as a result greatly overstated. See also Admati *et al* (2010).

The best we can do with this dilemma of the residual risk borne by the state is simply to acknowledge it. Indeed, one of the central roles of government both in finance and elsewhere (such as in defence and in health) is to collectively bear those risks which cannot be borne privately. Because private banks cannot bear the whole of the systemic risk their activity generates, it makes sense for governments both to regulate bank conduct and to price the residual risk that it is ultimately left with – by requiring banks to pay governments some charge in the nature of an insurance premium.

Further, this residual risk of catastrophic loss marks a distinction between the capabilities of private and public insurers. Where private insurers pool common risks and also carry sufficient capital on their balance sheets to bear substantial risk, some risks are so catastrophic that private agents cannot bear them. This is true both of privately owned banks and lenders' mortgage insurers; a fact which is evident in the behaviour of both regulators and investors. Thus, though RMBS are typically insured with Australia's private lenders' mortgage insurers, this did not stop RMBS spreads from spiking during the financial crisis nor has it brought down RMBS spreads to anywhere near the level they were before the crisis. Likewise when banks buy LMI, the prudential regulator APRA does not give them credit for this in determining their capital adequacy.

Often risks that exceed the capacity of the private sector to bear will ultimately be borne by the state in one way or another. There are thus some unique advantages in the state explicitly going insurer and pricing its cover accordingly. In that regard the Wallis Report's one recommendation explicitly justified by competitive neutrality between securitisation and bank lending is ironic indeed. In a minor and cursory section headed "Neutrality in Mortgage Markets" the report observed that LMI was the "the principal means for securitisers and traditional mortgage lenders to shift the risk of default in home mortgage markets to another party" (1997, p. 526). The Commonwealth owned Housing Loans Insurance Corporation (HLIC) offered LMI in competition with other insurers and paid the Commonwealth a premium for the use of its guarantee to raise funds. Reporting that "private sector insurers argue that the Commonwealth guarantee of HLIC's borrowings confers a competitive advantage on the public insurer because the borrowing charge undervalues the guarantee", and without further investigating the claim, Wallis determined that there was no public interest rationale for continued government ownership of the HLIC and recommended its privatisation (1997, p. 526). The recommendation was promptly acted upon.

It is possible that the privatisation of the HFIC may have enhanced competitive neutrality in the sub-market for lenders' mortgage insurance. But it did so at the cost of making it less rather than more competitive. Whether or not the HFIC should or should not have been privatised according to Wallis's justification, given that securitisers put greater reliance on credit enhancement via LMI than balance sheet lenders did, the privatisation would have exacerbated rather than ameliorated the competitive disadvantages suffered by securitisers compared with banks, perhaps substantially so. LMI was dominated by four providers when Wallis reported. It is now dominated by two insurers – PMI and Genworth.

5. Securitisation, competitive neutrality and the crisis

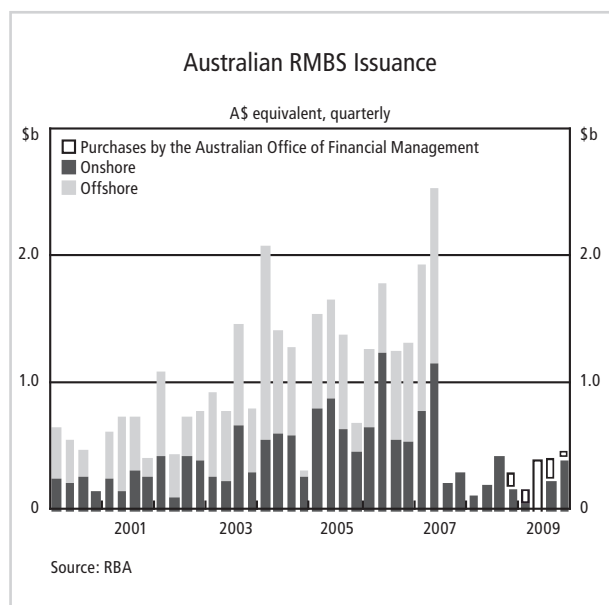
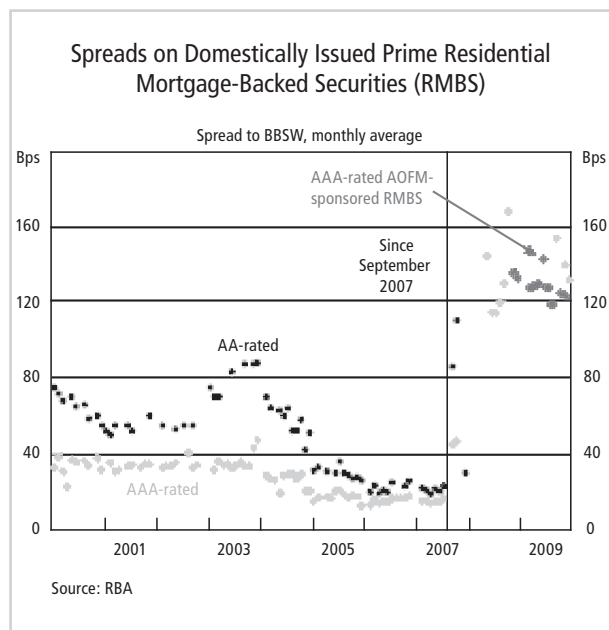
The principle of competitive neutrality got short shrift as Reserve Bank and Treasury officials improvised their way through the drama of the crisis keeping in much closer touch with the banks than they were with the firms most exposed to the shadow financial sector. As John Kay observes immediately after the passage of his we quoted above (2009, 33):

Because the supervisor's conception of best practice is necessarily drawn from current practice, supervision is supportive of existing business models and resistant to new entry.

And so it proved. Virtually every step the government and its agencies took during the financial crisis was done to shore up 'core banking' with limited regard being given to the issue of competitive neutrality between it and the recently emerged shadow financial sector. When Joye and Gans (2008) and I³¹ pointed to the collapse of securitisation in 2008 proposing direct government support of securitisation, officials temporised, not so much rejecting the argument as suggesting that it might be returned to if things got worse. By the time real action was taken the RMBS market had largely collapsed. The government committed to purchase \$4, then \$8 and finally \$16 billion in RMBS through the Australian Office of Financial Management (AOFM) (See Figure 5).

31 Published as "Not all Government Intervention is Bad" in the Age, 13th May 2008 at <http://business.theage.com.au/not-all-government-intervention-is-bad/20080512-2dfp.html?page=1>

Figure 5



Source: Kirkwood, p. 330.

However in the scheme of things it was desultory, a fraction of the \$60 odd billion of new money annually before the crisis and a far cry from the assistance banks received from free government guarantees on most deposits, the ability to purchase government guarantees for fund raising in wholesale money markets and indeed emergency liquidity provisions by which banks could raise funds to meet liquidity concerns against the security of prime housing loans! Rather than being capped as in the case of RMBS support, the banks' support was 'scaleable' to its recipients existing size and indeed to their appetites for raising wholesale funding for expansion.

6. What might be done

The argument in this section can be summarised in the following propositions:

- Much – indeed most – banking involves the provision of 'commodity' services.
- Such products should be provided at close to their cost of production.
- However, financial conglomerates enjoy substantial advantages in raising money from wholesale markets which appear not to reflect production efficiencies but rather the market's perception that they enjoy implicit government guarantees.
- Thus advantaging large banking conglomerates limits the number of competitors giving them access to supernormal profits.
- Securitized financing of loans is clearly viable particularly when used principally for pooling similar financial assets rather than to transform those assets with complex structuring. But securitisation is not on a level playing field with banking.
- However governments are condemned to insure financial intermediaries and those dealing with them for catastrophic risks.
- Governments should make a virtue of this necessity and offer such insurance explicitly and for an appropriate fee.

6.1 Making the implicit explicit, leveling the playing field, intensifying competition

From the perspective developed here the Commonwealth owned HFIC was part of the solution rather than part of the problem. First, the HFIC could have dealt explicitly with the question of insuring against catastrophic risk. It could have sold such risk cover at an appropriate (cost reflective) premium. The private providers of LMI could have continued with the more limited level of the cover they are capable of providing being made more explicit.³²

Further, as Wallis argued, LMI was important to the functioning of the securitisation market. But this was an understatement. LMI was *the* major means by which those selling RMBS could reassure buyers that someone with skin in the game had satisfied themselves as to their integrity. Thus, in contrast to the frequent practice on bank balance sheets, even low LVR loans are typically insured for securitisation.³³

32 A further policy question not addressed here is whether, given the likelihood that the state would end up bearing the risk of catastrophic loss on mortgages, borrowers and/or those selling LMI might be required to purchase catastrophic risk cover from the HFIC.

33 Typically, where LVR is below 80% premiums are absorbed by lenders, rather than being explicitly passed on to lenders. (Whilst Australian experience suggests that our RMBS market is surviving without it, another means by which buyers of RMBS could be reassured as to their quality would be for those who are selling the loans to leave some 'skin in the game' in the form of some investment they retain in the RMBS whereby they take priority in bearing the first losses from the pool.)

Explicit government insurance against catastrophic risk would provide a way of building a market that commoditises low risk lending not just in practice but also in pricing. Once such risk had been explicitly priced and paid, such loans could circulate as securitised pools in the wholesale market at very low margins. Those margins would no longer reflect any risk of default – this having been fully passed to the insurer – and the price of provision of a low LVR mortgage could be expected to fall to the full cost of managing lenders' liquidity and administration (sending largely automated correspondence to borrowers, receiving repayments and accounting for incomings and outgoings). This could be done at a fraction of the margin charged on loans today.

Intriguingly, the architecture of the Canadian mortgage market resembles this vision. There the Canada Mortgage and Housing Corporation (CMHC) offers mortgage insurance at risk based premiums.³⁴ And, once it has insured a loan that loan is treated for virtually all purposes, both commercial and regulatory, as being as risk free as government paper. In consequence CMHC insured loans are treated as equivalent to bonds for capital adequacy purposes. The CMHC also packages loans for securitisation as do Fannie Mae and Freddie Mac (though the CMHC's mission and nature are not perverted as they were in the US with Fannie and Freddie being privatised as well as being encouraged to chase high risk lending. This enabled their owners and managers to benefit from taking on more risk while the public remained – implicitly – on the hook should anything go badly wrong – a mix of incentives which virtually guaranteed the eventual sorry outcome).

However to be true to the themes of this paper, one should borrow from the basic architecture of the Canadian model whilst shielding the public from the magnitude of risk that the CMHC has gradually taken on. Like Fannie and Freddie the CMHC has recently begun insuring much riskier loans with politicians cheering them on.³⁵ I suggest that an Australian government entity offer mortgage insurance on prime home loans but only up to some level judged to have negligible risks (involving LVRs of say 50-60 percent) or alternatively some obviously low risk rate (involving LVRs of say 80 percent).³⁶

In each case the insurance would be priced to cover all relevant costs and not at subsidised rates. The private market would then be free to provide additional cover enabling people to obtain loans with LVRs higher than 80 percent.³⁷ And given that this insurance would now only need to cover a portion of the loan, the private sector would be better placed to actually provide it in the event it was called for. In fact this is broadly speaking the division of responsibilities between public and private sectors before the privatisation of Fannie and Freddie with the Federal Government owned Federal Housing Administration (FHA) insuring loans up to 80 percent LVR with private insurers offering further enhancement for higher LVR loans (Mohindra, 2010).

Under the model being proposed, all lenders could avail themselves of the government's and the private sector's insurance cover whether the loan was on or off balance sheet. And, as in Canada, where the loan was on a balance sheet, that portion of the loan insured by governments could be treated as equivalent to a government bond for the purposes of capital adequacy. This last regulatory move effectively removes the government's prudential regulation of low LVR prime home loans from the supervision of bank balance sheets. Instead the issue is dealt with internally to the assets themselves. At least as far as these assets are concerned, this obviates the need for any further prudential supervision of the balance sheets those assets find their way onto.

Meanwhile with private insurance credibly backing higher risk loans, as in Canada a vibrant, deep and accordingly very liquid RMBS market could thrive on a level playing field with balance sheet lending.

34 Table 1: CHMC Insurance Premiums

	Premium on Total Loan		Premium on Increase to Loan Amount for Portability and Refinance	
	Standard Premium	Self-Employed without 3 rd Party Income Validation	Standard Premium	Self-Employed without 3 rd Party Income Validation **
Lean to Value				
Up to and including 65%	0.50%	0.80%	0.50%	1.50%
Up to and including 75%	0.65%	1.00%	2.25%	2.60%
Up to and including 80%	1.00%	1.64%	2.75%	3.85%
Up to and including 85%	1.75%	2.90%	3.50%	5.50%
Up to and including 90%	2.00%	4.75%	4.25%	7.00%
Up to and including 95%	2.75%	N/A	4.25%	*
90.01 to 95% - Non. Traditional Down Payment ***	2.90%	N/A	*	N/A
Extended Amortization Surcharges				
Greater than 25 years, up to and including 30 years: 0.20%				
Greater than 30 years, up to and including 35 years: 0.40%				
(Source: http://www.scribd.com/doc/36097163/A-Canadian-Leading-Indicator)				

35 In 2007 the Government authorised the CMHC to insure loans at 100 percent LVRs repayable over 40 years though it has now drawn back to a ceiling of 95 percent LVRs with terms up to 35 years, though the borrowers' deposit can also be borrowed, effectively permitting Canadian homeowners 100 percent housing loans even if the Government only guarantees 95 percent of that lending. If such policies are justified by equity objectives of increasing home ownership, it would be better to separate equity and efficiency issues and deal with them separately.

36 These figures should be determined with reference to the cycle and should vary with it. Doing so would produce a worthwhile and more targeted form of macroeconomic stabilisation policy than is available through targeting the cash rate.

37 It says something about official confidence in the Australian mortgage insurance market that, in contrast to the analogous situation in Canada, where Australia's banks take out (private) LMI on their mortgages, they receive no credit in the capital adequacy weightings of Australian regulators for having done so.

At the same time, by accepting the inevitability of the government's going risk bearer of last resort, we can price that risk, and manage it effectively (or at least *more* effectively). The public private partnership that is finance would thus acquire an architecture which played to the strengths of each sector without fooling ourselves as to their weaknesses.

The model proposed here involves the private sector taking the smaller more calculable risks – the first losses from a loan, particularly arrears which can be recovered from. Meanwhile the public sector takes on catastrophic risk (as it will be forced to do in some form if there are large and widespread losses on loans) in return for an appropriate insurance premium determined at arms length from government. In most years the body providing such insurance would make large surpluses. The CMHC's most recent annual surplus was around CA\$2 billion³⁸ and it holds \$9 billion in reserves (Mohindra, 2010). Like the Reserve Bank's trading on foreign exchange the government can expect substantial net revenue from the activity over time, but at the price of taking on more risk.

The model finesses another issue. Because it can be systemically important, many commentators have called for prudential regulation of shadow banking. However regulation can stifle innovation. The model being proposed here offers the prospect of minimising regulation and focusing it on areas where such prudential supervision is necessary and/or adds value. According to this model, securitisers would remain unregulated for prudential purposes, but in that (very large) part of the market where they purchased the insurance cover of a government agency like the former HFIC or the CMHC, they would need to conform to whatever practices were required by the insurer. This would likely involve professionally auditable procedures satisfying the insurer of the creditworthiness of the borrower and the value and liquidity of the security.³⁹

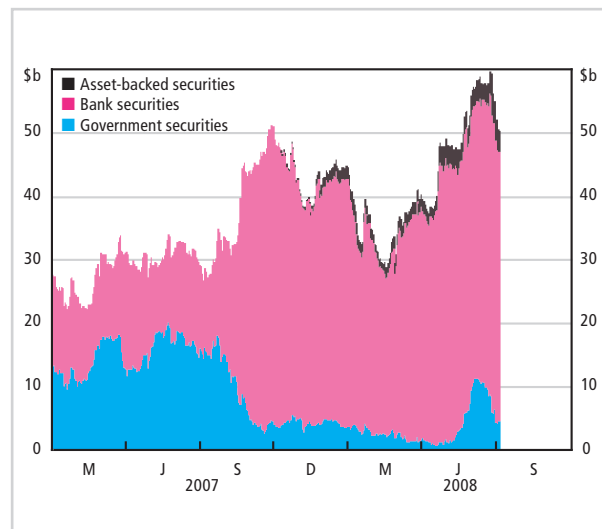
6.2 A digression on deepening liquidity

As an aside it is worth noting that low LVR loans offer a pool of potential liquidity that has hitherto remained largely untapped except for some limited transactions during the global financial crisis. Accessing it can not only help us utilise a valuable resource more fully than we have hitherto, but it can also help intensify competition in banking services more broadly. It will be recalled that during the financial crisis the RBA was prepared to meet banks' demand for liquidity by lending against the prime home loans held on bank balance sheets under repo arrangements.

³⁸ <http://openparliament.ca/hansards/2284/21/>

³⁹ We leave unexplored in this paper the extent to which one might want to compel lenders to insure their loans with the government, at least up to 60 percent of their security value on the grounds that the government may be forced to bear such risk in one way or another if it materialises.

Figure 6: RBA Repo Assets



Source: Kearns and Lowe, 2008, p. 159.

This departure from usual practice was a pragmatic adaptation to a crisis. And as Kearns and Lowe (2008, p. 159) stress this departure was in no sense 'bailing out' the banks but was rather reducing its own call on the most liquid assets at a time when liquidity was at a premium in the private sector and that in so doing it could "reduce the amplitude of swings in the price of liquidity. . . without taking significant risks". Incipient in this reasoning is the prospect of taking the same approach in more normal times.

Kearns and Lowe (2008, p. 161) go on to advert with some sympathy to the view that:

. . . in principle, all assets on the balance sheets of financial institutions should be eligible, subject to the risks to the central bank being adequately addressed. By accepting all assets, illiquidity premia that exist because of a lack of market infrastructure or market turmoil would be reduced, and the banking system would be less susceptible to liquidity crises, with both effects potentially increasing welfare. According to this perspective, the risk issue is best addressed, not by the central bank refusing to deal in some asset classes, but by setting appropriate haircuts, advancing fewer funds against more risky assets.

Certainly such a view raises the spectre of a pool of assets becoming available to increase the stock of liquidity. Further, where such assets were held by non-bank financial institutions it is hard to see why they should not be permitted to provide liquidity services as banks do today, with the central bank standing behind them assisting them in providing that liquidity. If the RBA took only loans with LVRs of 50-60 percent it would be augmenting liquidity – and the competitiveness of the market for providing liquidity – at an exceptionally low risk of loss to itself or of increasing systemic risk.

6.3 Improving information flows, deepening liquidity

Finally, although financial markets are already crawling with regulation, much of it very burdensome, we can substantially improve critical information flows within finance at moderate, low and in some cases even negative additional cost. Indeed, regulating for better information flows might permit the reduction of the regulatory burden. As markets develop and private bargains are struck, information emerges – such as the price of exchange – which if published becomes a public good.⁴⁰ The liquidity of a market too partakes of the qualities of a public good available to all. And good information flows are the foundation of liquidity for they enable short term borrowers who supply much crucial liquidity to differentiate between a loss of liquidity and a loss of solvency, particularly at times of uncertainty. Typically, liquidity crises are information crises.

There is merit in encouraging a range of practices to improve the transparency, liquidity and depth of markets in financial assets. Standardisation is important to this agenda. We should be encouraging the standardisation of lending terms and encouraging (or possibly requiring) the trading of securitised pools of assets to take place over an exchange where the volume and price of transactions was published.⁴¹ Standardisation of mortgage terms and documentation could make switching between lenders as simple as requiring one's current lender to assign their mortgage to a competitor on settlement of the requisite funds obviating the cost and frustration involved in each lender working on its own bespoke contracts and process. Not only would this reduce cost, but in reducing the costs of switching loan providers (including the non-financial costs of inconvenience to the borrower) it would intensify competition, perhaps substantially.

If we are to encourage skill and innovation in financial provision we need systems which enable us to track the quality of performance over time. In home loans the principal skill is in loan origination.⁴² But originators and others in the financial value chain could have their performance tracked. The names of individual officers and originator firms could be preserved in information as loans are traded through exchanges and/or move between mortgage managers with regular reporting on their performance as events unfold. Indeed one could seek from originators their own predictions as to the likelihood of default on the loan and compare this with the ultimate result as I have suggested in other contexts.⁴³

On the other side of the market we have borrowers. We need a mechanism which can operate to turn information about the trustworthiness of borrowers into a public good in the way that exchanges turn other aspects of commercial transactions into public goods – like information about the volume and price of transactions. Accordingly we could create opt ins for borrowers to have some simple ongoing summary of their reliability in meeting required re-payments tracked so that the information was recoverable on receiving permission from the borrower. This would improve the integrity and quantity of information and lower transactions costs in moving when borrowers moved from one lender to another.

For in the presence of human nature financial markets are necessarily markets for information. And we've barely begun to think of how we can use our hard won experience and the remarkable opportunities which burgeon online to improve the market for information and so to improve the efficiency of our economy and the convenience with which we live our lives.

40 This is true in the technical sense that it is non-exclusive and thus potentially joint in consumption – everyone can get access to it – and it is non-rival which means that the access of one is not at the expense of the access of anyone else.

41 Blinder (2010, p. 900) suggests means of 'persuading' market operators in derivatives to transact via an exchange.

"I have argued for years that the most important step the world's governments could take in regulating derivatives would be to push as much trading as possible into central clearinghouses and onto organized exchanges — whether by cajoling, regulatory incentives, or regulatory coercion. Cajoling might mean letting banks know that their regulators view OTC derivatives as far riskier than exchange-traded derivatives. Arched eyebrows often work. Incentives might mean higher capital charges on OTC derivatives than on exchange-traded derivatives, so that regulatory arbitrage might actually enhance rather than undermine safety and soundness."

See also Goodhart. (2010, p. 180).

"Christopher Joye has also suggested requiring the managers of such products to report the state of their loans to a central authority which would publish it in anonymised form, and, along with anyone else who wished, analyse it to more fully understand the unfolding of risks and risk management in the market. <http://www.businessspectator.com.au/bs.nsf/Article/banks-debit-credit-loans-risk-management-pd20101104-AUU5V?OpenDocument&src=rot>."

42 It might be argued that there is also some skill in the management of a loan but, at least where it comes to consumer loans including home loans, service providers routinely ignore the scope for the skilful management of loans to add actual financial value. Judging by standard industry practice, the most efficient way to avoid ongoing risks is a policy of benign neglect where borrowers are left to their own devices without further inquiry into any changing financial circumstances unless and until they draw attention to themselves by falling into arrears.

43 See "Gruen Tenders" at Club Troppo, May 16, 2006 at <http://clubtroppo.com.au/2006/05/16/gruen-tenders/> and also Gruen

Glossary

AOFM	Australian Office of Financial Management
CMHC	Canada Mortgage and Housing Corporation
GFC	Global Financial Crisis
FHA	Federal Housing Administration
HLIC	Housing Loans Insurance Corporation
LMI	Lenders mortgage loss insurance
LVR	Loan to valuation ratio
RMBS	Residential mortgage backed securities

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Appendix:

Economies of scale and scope in financial services

In a very recent survey of the literature over the last fifteen years or so, Walter observes that while scale economies could be expected from the fixed costs of information and management systems the empirical evidence suggests that, at least with large firms, economies of scale do not outweigh *diseconomies* of scale such as “disproportionate increases in administrative overheads, management of complexity, agency problems and other cost factors”.

The studies are not conclusive owing to methodological difficulties but Walter (2009, p. 597-9) reports as follows:

Cost estimation has uniformly found that economies of scale are achieved with increases in size among small commercial banks (below \$100 million in asset size),⁴⁴ while a few studies have shown that they may also exist in banks in the \$100 million to \$5 billion range.⁴⁵ However, there is limited evidence to date of scale economies in the case of banks larger than \$5 billion, and although there has been some recent scattered evidence of scale-related cost gains for banks up to \$25 billion in asset size,⁴⁶ there is none such for very large banks (exceeding \$25 billion). Some studies have found the relationship between size and average costs to be U-shaped, suggesting that small banks can benefit from economies of scale as they grow bigger, but that large banks seem to suffer from diseconomies of scale and higher average costs due to factors like complexity as they increase in size. The inability of empirical research to find significant economies of scale among large financial services firms is also true of the larger insurance companies and broker-dealers.

Citing DeLong, (2001), Walter goes on to observe (p. 599) that “like economies of scale, cost-related scope economies should be directly observable in costs of financial services suppliers and in aggregate performance measures. But empirical studies have generally failed to find significant cost-economies of scope in the banking, insurance or securities industries”.

The literature on mergers indicates that mergers are often a general response to a major economic shock, but that on average shareholders in the acquiring company do not receive improved share value. Transitional and transactional costs can often outweigh the expected real economic benefits, and further that the expected benefits are overstated in that management have different drivers to shareholders.

Before the recent financial crisis there were numerous studies that consider this relationship between benefits and costs of mergers for the banking and the finance sector. Ng and Baek (2006, p.1) suggest that “Results show that the market neither rewards nor punishes consolidation with non-significant returns. Diversification is related to loss in shareholder wealth. The market does punish foreign mergers and acquisitions with negative abnormal returns.” (p. 1). Amel, Barnes, Panetta, and Salleo (2004, p. 2493), conclude that “There is a general consensus that consolidation in the financial sector is beneficial up to a certain (relatively small) size in order to reap economies of scale; this holds in particular for commercial banks and insurance companies. There have been few studies on economies of scope, due to a lack of data and to measurement problems; the results are inconclusive as to whether they exist and whether they have been exploited by mergers. As for improvements in managerial efficiency, there is no clear evidence that mergers and acquisitions result in cost reduction”. (p. 2493).

By contrast to the absence of *cost* based economies of scope being available to fund the diversification and growth of financial conglomerates, Walter (2009, p. 599-600) cites some evidence of *revenue* based economies of scope which arise from the advantages of being able to ‘cross-sell’ more than one financial product to the same customer. As he observes this is most likely to be at the retail level. But while this certainly lowers costs for the incumbent firm it is far from clear that the influence a financial firm will have on a customer in ‘cross-selling’ products to a client should be regarded as of wider benefit to the society. Indeed one would have greater confidence in the outcome of a customer’s choice if it were made in response to the advice of an expert fiduciary, which is directly at odds with cross-selling.

44 Cornett and Tehranian 1992

45 Cornett, Hovakimian, Palia and Tehranian, 2003

46 Houston and Ryngaert, 1994.

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