Submission

to

Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services in Australia

as a supplementary submission 7

30 July 2009

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ASIC says it believes that "markets operate most efficiently when there is a <u>minimum of regulatory intervention</u>. So, in short-hand form, this might be termed the <u>efficient market theory</u>."

Why is this a potential problem for Australia's future?

Recommendations:

- We need to introduce more regulation of financial markets. Key regulatory reforms to include:
  - Applying Paul Volcker's key recommendations to Australian regulation would change the shape of financial institutions in Australia for the better. These changes would help create a "financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort." (Volcker):
    - **<u>The commercial banks.</u>** The government to provide an explicit guarantee to Australian commercial banks – the core of the system. These commercial banks would simply focus on deposit taking and providing credit. These commercial banks must be more highly regulated. These commercial banks would need to divest all highly risky entrepreneurial activities including proprietary trading and wealth management.
    - **<u>The capital market system.</u>** Capital market players are dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly regulated. They're not at the core of the system, <u>unless they get really big</u>. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too.
    - Since **<u>some Australian insurance companies are "too big to fail"</u>**, they would have to be regulated more tightly too.
  - Banning securitisation of debt.
- To help protect consumers from Storm Financial or West-point style losses, we need to create a **<u>Financial Planner Registration Board</u>** (FPRB) – requiring higher education standards and a requirement that advisor acts in the best interests of the client. The goal would be to register only quality financial planners delivering "acceptable" advice. A discussion paper on how a FPRB might work is attached.

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This submission has been hurriedly thrown together – and is far from polished or complete – as this is a very big topic that requires very detailed analysis and consideration. However, I believe the issues raised here need to be considered by the inquiry, because they have potentially grave implications for the Australian economy.

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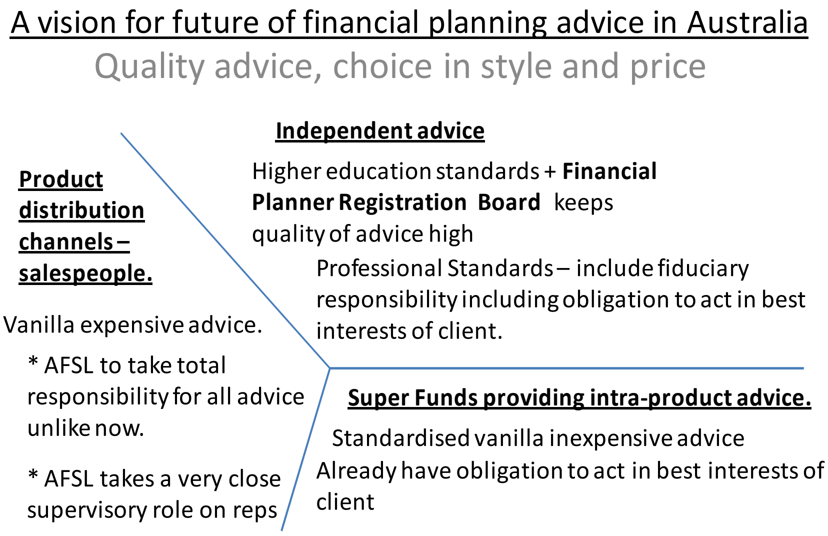
Primary Recommendations:

1. **Adopt Paul Volcker's** (http://en.wikipedia.org/wiki/Paul_Volcker) **recommendations to reform regulations to prevent this style of economic crisis in Australia's future. Also ban securitisation.**
In the West, we have lived through a period guided by a *"philosophy that markets knew best"*. This philosophy was a major contributing factor to the current global economic crisis. Even Alan Greenspan has conceded that his free-market ideology shunning regulation was flawed (see below). I am concerned that from ASIC's opening statements that they continue to rely on this philosophy - that *"markets operate most efficiently when there is a minimum of regulatory intervention"*. However, I note that in his 25/July/2007 essay in the Sydney Morning Herald, Kevin Rudd said *"The central principles of this extreme form of capitalism are that markets are self-regulating; that government should get out of the road of the market altogether and that the state itself should retreat to its core historical function of security at home and abroad. This fundamentalist ideology of self-regulating markets has imploded comprehensively with the current crisis."* Therefore, I would hope that Kevin Rudd looks at the opening statement in the first hearing of this PJC inquiry (see Appendix A) and take the appropriate corrective action.

2. **Support the creating of a Financial Planner Registration Board.**
From ASIC's comments at the first hearing of this PJC inquiry, ASIC seems to be promoting "vanilla" advice (See Appendix J) as a way for consumers to avoid investment losses like that seen with Storm Financial and Westpoint. By "vanilla" advice I am drawing the conclusion that ASIC means index investing – because the advice promoted by the big institutions which ASIC was promoting, recommend index-hugging advice – and most of the funds offered (by dollars invested) by the big institutions are index hugging.



While index investing (at index fund prices of around 0.3%pa) would be better than much advice that is currently on offer, it is still not an optimal outcome for consumers. As you will see from the material provided below, there is a lot of evidence that the efficient market hypothesis is flawed and that there are a range of other competing approaches to investing that have merit. Why, therefore should consumer's be forced down one theoretical potentially flawed path while there are other paths that potentially offer a better approach. To help protect consumers from Storm-style & Westpoint-style investor losses, I recommend the creation of a Financial Planner Registration Board (FPRB)with the following features:

- designed by accounting professional bodies and BFPPG with ASIC input.
- Not compulsory. Many current financial planners would not qualify.
- Higher education and an obligation to act in best interests of the client.
- product manufacturer-owned planners can be registered but have no say in the FPRB because it is critical that the FPRB stay outside the control or influence of product manufacturers and their distribution arms.
- The FPRB to have a panel of professional independent advisors who will form views of what is acceptable advice, what is high risk advice and what is unacceptable advice.
- FPRB would define what is "acceptable" advice and this would evolve as investment theory evolves.

<u>Four Page Summary of this submission.</u>

1. Foreword. Paul Volcker on global financial crisis. "I will not accept the Nuremberg excuse."

2. ASIC's philosophical basis for regulation of financial planners and markets.

- "markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention."
- "the efficient market theory"

Though, we could view these two as one and the same belief, I will deal with these 2 issues separately. This will help lift the discussion above the sometimes emotional debate about Efficient Market Theory.

3. "Markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention".

- **George Soros** "blames many of the world's problems on the failures inherent in what he characterizes as market fundamentalism."
- **Longview Institute** "Market Fundamentalism is the exaggerated faith that when markets are left to operate on their own, they can solve all economic and social problems. Market Fundamentalism has dominated public policy debates in the United States since the 1980's"
- **Alan Greenspan conceded that his free-market ideology shunning regulation was flawed. 23/10/2008**
- **Richard Karn** identifes market fundamentalist polices that have been pursued in the USA over the last ten years
- **<u>Recommendation 1: Apply Paul Volcker's recommendation to Australia.</u> Paul Volcker**'s recommendations to reform regulations to prevent this style of economic crisis in Australia in the future. Specifically in February 2009, Paul Volcker's recommendations distilled down and applied to the Australian context would recommended the following changes to Australian regulation.
  - **<u>The Commercial Banks.</u>** The core of the Australian financial system needs to be built around commercial banks:
    - which the government will protect,
    - whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit. They ought to be the core of the credit and financial system, and
    - that must be more closely supervised and regulated and those institutions should not engage in highly risky entrepreneurial activity.
    - These commercial banks must divest themselves of highly risky entrepreneurial activities such as offering hedge funds, offering equity funds and proprietary trading. Largely these commercial banks would simply focus on deposit taking and providing credit.
  - **<u>The capital market system.</u>** Capital market players are dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly regulated. They're not at the core of the system, <u>unless they get really big</u>. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too.

  - Applying Paul Volcker's key recommendations to Australian regulation would change the shape of financial institutions in Australia for the better. These changes would help create a "financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort." (Volcker):
    - **<u>The Commercial Banks.</u>** The government to provide an explicit guarantee to Australian commercial banks – the core of the system. These commercial banks would simply focus on deposit taking and providing credit. These commercial banks must be more highly regulated. These commercial banks would need to divest all highly risky entrepreneurial activities including proprietary trading and wealth management.

- **<u>The capital market system.</u>** Capital market players are dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly regulated. They're not at the core of the system, <u>unless they get really big</u>. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too.
- Since **<u>some Australian insurance companies are "too big to fail"</u>**, they would have to be regulated more tightly too.

- **<u>Recommendation 2: Securitisation of debt needs to be banned.</u>** The biggest problem with securitisation is that it removed a critical tool from the tool-box of central banks. Historically, one tool central banks have been able to control the money supply with has been by imposing reserving requirements on banks. By doing this, central banks could control the Money Mutiplier (see http://en.wikipedia.org/wiki/Money_creation#Money_multiplier) which controlled how much money could be created through the banking system. However, with securitisation, the lending institutions could get a new loan off their balance sheets and hence the Money Multiplier in effect became infinity. This tool to control the money supply needs to be restored to central banks – by banning securitisation of debt.

3.1. Grantham argues that even Greenspan knew there should be a limit to market fundamentalism – but that Greenspan did not have the courage or the ethics to follow through on his convictions.

- "Nothing threatens economic stability more than the deflating of a major stock market bubble."
- "In 1966 he (Greenspan) had written scathingly of the consequences of weak-kneed behavior by the Fed in 1928 and the dire consequences of delayed and weak action for everyone in the ensuing crash"
- "For his book The Great Crash (John Kenneth **Galbraith**, The Great Crash, 1929, pp. 189-194, New York, Mariner, 1997), concluded his analysis with a resounding vote that the Federal Reserve did indeed have ***the tools to prevent a major bubble but argued presciently it seems that such tools would never be used!***"
- "It will always look, as it did to the frightened men on the Federal Reserve Board in February 1929, like a decision in favor of immediate as against ultimate death. As we have seen, the immediate death not only has the disadvantage of being immediate but of identifying the executioner"
- "Greenspan's remarkable September 1996 statement to fellow Open Market Committee colleagues, '***I recognize that there is a stock market bubble problem at this point. We do have the possibility of increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it.***'"
- "***For a Federal Reserve boss to have volunteered to have taken a lot of political heat and certain short-term damage to his reputation without a realistic hope of offsetting rewards simply because it was the right thing to do would have taken very high ethical standards and considerable strength of character. Paul Volcker perhaps might have made that choice.***"
  - Note: Through the same period where Greenspan has been implementing policies he knew to be wrong, because he was not prepared to accept the consequences of the alternative, financial planners and fund managers were also facing the same dilemma. Many acted against the best interest of their clients for precisely the same reason that Greenspan did – because of what is known in the industry as "**career risk.**"

3.2 **"Greenspan Concedes to `Flaw' in His Market Ideology"** Bloomberg Oct. 23 2008

- "Alan Greenspan ..... conceded that his free-market ideology shunning regulation was flawed."
- "Greenspan acknowledged he was 'partially' wrong for opposing the regulation of derivatives over the years."
- "The admission that free markets have their faults was a shift for the former Fed chairman who declared in a May 2005 speech that 'private regulation generally has proved far better at

constraining excessive risk-taking than has government regulation.'"

- "Waxman echoed that sentiment to Greenspan: *'The mantra became (that) government regulation is wrong. The market is infallible.'*"
- "Greenspan opposed increasing financial supervision as Fed chairman from August 1987 to January 2006. Policy makers are now struggling to contain a financial crisis marked by record foreclosures, falling asset prices and almost $660 billion in write-downs and losses tied to U.S. subprime mortgages.
  Greenspan, 82, reiterated his 'shocked disbelief' that financial companies failed to execute sufficient 'surveillance' on their trading counter-parties to prevent surging losses. The 'breakdown' was clearest in the market where securities firms packaged home mortgages into debt sold on to other investors, he said."

3.3 Kevin Rudd "fundamentalist ideology of self-regulating markets has imploded". SMH 26/7/09

- "As I have argued elsewhere, the boom-and-bust economic cycle of the past decade has been an unavoidable consequence of a decade of neo-liberal free market fundamentalism that reinforced a culture of corporate greed and excess in the financial sector. The central principles of this extreme form of capitalism are that markets are self-regulating; that government should get out of the road of the market altogether and that the state itself should retreat to its core historical function of security at home and abroad.
  This fundamentalist ideology of self-regulating markets has imploded comprehensively with the current crisis."

4. Efficient Market Hypothesis (EMH). The EMH is flawed.

- If markets were efficient, then there would be no stock-pickers like George Soros, Kerr Neilson & Warren Buffett who, over decades, have added value by picking stocks - delivering better than market average performances. Yes, from time to time a fund manager might outperform over a significant period of time – but there are some who do it through stock-picking skill etc.
- Summary of the Efficient Market Hypothesis. http://en.wikipedia.org/wiki/Efficient_market_hypothesis#cite_note-0
- **Jeremy Grantham:** "When you believe in ***market efficiency, it's like being on the railroad watching the locomotive coming toward you. Then you just stand your ground just for the discipline of not moving***. It's ruinously expensive."
- **Bill Gross**, "The efficient market hypothesis was always dead from the get-go, but academic tenure and Nobel prizes were food for the unwilling or perhaps unthinking."
- **AFR. Central banks using flawed models. Regulators need to review assumptions.**
- **Professor Lo of MIT – EMH remained influential because of 'physics' envy.'**
  - "Behavioural finance has grown to become a popular alternative approach precisely because it does appear to explain more clearly how investors, individually and collectively, appear to act."
  - "The real beauty of the efficient markets hypothesis, and the explanation for its longevity in the face of consistent empirical evidence that it is invalid, surely lies in its beguiling simplicity."
  - "The biggest problem with this new approach, as with all alternatives to EMH, including behavioural finance, is that it doesn't give investors a simple metric for understanding what to do. Its great merit, however, is that it appears to relate to the complex and uncertain world that we all actually inhabit, something the efficient markets hypothesis has never done."
- **"Myth of the Rational Market - A History of Risk, Reward, and Delusion on Wall Street "**
  - "The upside of the current Great Recession is that it could drive a stake through the heart of the academic nostrum known as the ***efficient-market hypothesis***. This theory holds that stock and bond markets are nearly perfect -- even during such crazes as the dot-com mania -- and that prices on the exchanges instantly and accurately reflect the available information

about publicly traded securities. After the market crash of 1987, **Yale University economist *Robert Shiller*** called that belief ***'the most remarkable error in the history of economic theory.'*** *He could have said 'most harmful error' as well.* Yet it lived on and contributed mightily to the mortgage bust."

- "How did this faith in the supremacy of market group-think do us harm? For one, as the dot-com and other manias demonstrated, the crowd occasionally gets it wrong. The mistaken faith in markets turned regulators into fawning groupies. Notably, former Fed chairman Alan Greenspan doubted that he or anyone else could detect -- or regulate -- a bubble in advance."
- "In particular, the theory of **option pricing**, the cornerstone of modern finance, **has built into it the assumption that prices are random**. The theory was devised by Fischer Black, ***Myron Scholes*** and ***Robert Merton***. The last two won the Nobel Prize in 1997 and were partners in ***Long-Term Capital Management, the hedge fund that blew up in 1998*****. What happened to LTCM?** It turned out that in financial markets, extreme events do happen."

In summary:

- Many leading thinkers in investment markets & economics believe that the Efficient Market Hypothesis is fatally flawed. As you can see from above, Jeremy Grantham goes as far as to say that it can be very dangerous for investors to believe in market efficiency because "it's like being on the railroad watching the locomotive coming toward you." This is precisely the way many investors have behaved over the last 2 years through this global financial crisis – to their detriment.
- Even Eugene Fama, the father of efficient market theory, has moved on from his thinking in the 1960s. Fama & French is the early 1990s came up with the Three Factor model which better explains the actual behaviour of investment markets. And Fama can see potential for other factors to help explain the actual behaviour of markets eg momentum.
- Behavioural finance is a major emerging framework that clearly can be seen to operate in markets. Markets aren't physics. Maybe no one model explains them.
- Yes, we can see efficient market effects at work in markets. We can also see behaviourial effects in markets. Despite this ASIC seems to be strong promoting/advocating "vanilla" investment advice – based on the flawed assumption that the Efficient Market Theory and the Capital Asset Pricing Model are robust and can be relied on. This is likely to produce a suboptimal outcome for consumers.

  Recommendation 3: A better solution for consumers would be if we created a Financial Planner Registration Board (with a panel of expert independent [i.e. not conflicted] practicing financial planners) which would determine what acceptable advice was – and that this definition of "acceptable" advice could evolve as investment theory evolves – as it continually will evolve. This Financial Planner Registration Board would also help consumer's avoid losses as has occurred with Storm Financial and Westpoint. The Financial Registration Board (FPRB) would have the following features:

  - designed by accounting professional bodies and BFPPG with ASIC input.
  - Not compulsory. Many current financial planners would not qualify.
  - Higher education and an obligation to act in best interests of the client.
  - product manufacturer-owned planners can be registered but have no say in the FPRB because it is critical that the FPRB stay outside the control or influence of product manufacturers and their distribution arms.
  - The FPRB to have a panel of professional independent advisors who will form views of what is acceptable advice, what is high risk advice and what is unacceptable advice.
  - FPRB would define what is "acceptable" advice and this would evolve as investment theory evolves.
- A discussion paper on how the FPRB might work is attached.

5. Fama 11/2007 Three factor model replaces Capital Asset Pricing Model. Sees potential for further evolution of theory.

1. Foreword - Paul Volcker on the global financial crisis. "I will not accept the Nuremberg excuse."

http://network.nationalpost.com/np/blogs/fullcomment/archive/2009/02/17/paul-volcker-the-banking-world-needs-more-canadas.aspx
from 11/2/2009 speech by Paul Volcker on the financial crisis. Paul Volcker was the chairman of the United States Federal Reserve from 1979-1987. He is currently the chairman of the US Economic Recovery Advisory Board. (economic advisor to President Barack Obama.)

"You might ask how it went on as long as it did. The grading agencies didn't do their job and the banks didn't do their job and the accountants went haywire. I have my own take on this. There were two things that were particularly contributory and very simple. *Compensation practices had gotten totally out of hand and spurred financial people to aim for a lot of short-term money without worrying about the eventual consequences. And then there was this obscure financial engineering that none of them understood, but all their mathematical experts were telling them to trust. These two things carried us over the brink.*

One of the saddest days of my life was when my grandson – and he's a particularly brilliant grandson – went to college. He was good at mathematics. And after he had been at college for a year or two I asked him what he wanted to do when he grew up. He said, "I want to be a financial engineer." My heart sank. Why was he going to waste his life on this profession?

A year or so ago, my daughter had seen something in the paper, some disparaging remarks I had made about financial engineering. She sent it to my grandson, who normally didn't communicate with me very much. He sent me an email, ***"Grandpa, don't blame it on us! We were just following the orders we were getting from our bosses."*** *The only thing I could do was send him back an email,* ***"I will not accept the Nuremberg excuse."***

There was so much opaqueness, *so many complications and misunderstandings involved in very complex financial engineering by people who, in my opinion, did not know financial markets. They knew mathematics.* ***They thought financial markets obeyed mathematical laws. They have found out differently now.*** You know, they all said these events only happen once every hundred years. But we have "once every hundred years" events happening every year or two, which tells me something is the matter with the analysis.

So I think we have a problem which is not an ordinary business cycle problem. It is much more difficult to get out of and it has shaken the foundations of our financial institutions. The system is broken."

2. ASIC's philosophical basis for regulation of financial planners and markets.

In its opening remarks at the the first public hearing of Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services, ASIC said (Appendix A):
"I am going to address the general regulatory environmental and look at the underlying economic philosophy that lies behind the relevant part of the Corporations Act. That philosophy is that **markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention**. So, in shorthand form, this might be termed the **efficient market theory**—being a quiet pragmatic reliance on financial markets driving efficiency and with intervention addressing market failures."

I would like to examine this statement, because it states a belief system that may be problematic for Australia in some serious ways.

To examine this statement, I wish to break the above statement into two halves:

- **"That philosophy is that markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention."**
- **"this might be termed the efficient market theory—being a quiet pragmatic reliance on financial markets driving efficiency and with intervention addressing market failures."**

Though, we could view these two as one and the same belief, I will deal with these 2 issues separately. This will help lift the discussion above the sometimes emotional debate about Efficient Market Theory.

3. "Markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention".

To examine this statement, let me provide some statements from others:

- First some views from **George Soros,** probably the world's most success speculator, which requires a very good understanding of markets:
  - "Despite working as an investor and currency speculator, he argues that the current system of financial speculation undermines healthy economic development in many underdeveloped countries. **Soros blames many of the world's problems on the failures inherent in what he characterizes as market fundamentalism.**" http://en.wikipedia.org/wiki/George_Soros
  - "In an interview regarding the economic crisis of 2008, (George) Soros referred to it as the most serious crisis since the 1930s. **According to Soros, market fundamentalism with its assumption that markets will correct themselves with no need for government intervention in financial affairs has been 'some kind of an ideological excess'**." http://en.wikipedia.org/wiki/George_Soros

- Second, some views of the **Longview Institute** (see Appendix E): http://www.longviewinstitute.org/projects/marketfundamentalism/marketfundamentalism
  - "Market Fundamentalism is the exaggerated faith that when markets are left to operate on their own, they can solve all economic and social problems. Market Fundamentalism has dominated public policy debates in the United States since the 1980's, serving to justify huge Federal tax cuts, dramatic reductions in government regulatory activity, and continued efforts to downsize the government's civilian programs."

  http://www.longviewinstitute.org/projects/marketfundamentalism/myth4
  Market Myth Four: Financial Markets Thrive when Regulation is Kept to a Minimum
  - "When the capital development of a country becomes the by-product of a casino, the job is likely to be ill done."... "Market fundamentalists have reconstructed U.S. capital markets along the lines of a casino for the last two and a half decades." ... "Hedge funds - large pools of money that are free to pursue very risky investment strategies because they fall under a loophole in the system of financial regulation - are one of their key achievements."

- **US House Committee on Oversight and Government Reform hearing – Greenspan's free market ideology flawed.**
  http://www.bloomberg.com/apps/news?pid=20601087&sid=an8vy29bsXk8&refer=home
  - "Oct. 23 2008 (Bloomberg) -- Former Federal Reserve Chairman **Alan Greenspan** said a 'once-in-a-century credit tsunami' has engulfed financial markets and **conceded that his free-market ideology shunning regulation was flawed. 'Yes, I found a flaw,' Greenspan said** in response to grilling from

the House Committee on Oversight and Government Reform. ... **Greenspan acknowledged he was 'partially wrong for opposing the regulation of derivatives over the years.** ... Greenspan opposed increasing financial supervision as Fed chairman from August 1987 to January 2006."

- **"Waxman (**Chairman**,** House Committee on Oversight and Government Reform) **said that he believed that the Federal Reserve, which regulates banks, the SEC and the Treasury had all played a role in contributing to the mistakes."**

- Fourth, in his **1/7/2009 paper "Credit and Credibility" Chapter 1, Richard Karn** (Emerging Trends Report) identifies market fundamentalist polices that have been pursued in the USA over the last ten years that have resulted in:-
  - "the unrestricted movement of capital across international borders;
  - the repeal of the Glass-Steagall Act separating commercial and investment banking operations;
    - http://en.wikipedia.org/wiki/Glass-Steagall_Act – The Glass-Steagall Act of 1933 established the Federal Deposit Insurance Corporation (FDIC) in the United States and included banking reforms, some of which were designed to control speculation. The Glass-Steagall Act was a set of measures intended to prevent another major crisis like the Great Depression
  - a congressional ban on credit-default swap (derivative) regulation;
  - a tripling of the amount of leverage allowed by investment banks;
  - the curtailment SEC regulatory enforcement;
  - an international agreement to allow banks to measure their own level of risk;
  - and the diminished capacity of international regulatory bodies to stay abreast with the rapid pace of financial innovation."

- I would like you to compare and contrast these 7 points of market fundamentalism identified by Richard Karn with the **Paul Volcker**'s recommendations to deal with reforming regulations to prevent this style of economic crisis. Paul Volcker is a former **U.S. Federal Reserve Board chairman (1979-1987)** when he is credited with ending the USA's stagflation crisis in the 1970s at a time of the next worse US economic crisis over the last 50 years. Paul Volcker is now a member of President Barack Obama's advisory team on the economy. http://network.nationalpost.com/np/blogs/fullcomment/archive/2009/02/17/paul-volcker-the-banking-world-needs-more-canadas.aspx

1. "In the future, **we are going to need a financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort.** Financial systems always fluctuate and go up and down and have crises, but let's not have a big crisis that undermines the whole economy.
2. And if that's the kind of financial system we want and should have, **it's going to be different from the financial system that has developed in the last 20 years.**
3. What do I mean by different? I think **a primary characteristic of the system ought to be a strong, traditional, commercial banking-type system.**
4. Probably **we ought to have some very large institutions** – or at least that's the way the market is going – **whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit.** They ought to be the core of the credit and financial system.
5. This kind of system was in place in the United States thirty years ago and is still in place in Canada, and may have provided support for the Canadian system during this particularly difficult time. I'm not arguing that you need an oligopoly to the extent you have one in Canada, but **you do know by experience that these big commercial banking institutions will be protected by the government, de facto.** No government has been willing to permit these institutions, or the creditors and depositors to these institutions, to be damaged. They recognize that the damage to the economy would be too great.
6. What has happened recently just underscores that. And I think we're at the point where we can no longer fool ourselves by saying that is not the case. **The government will support these institutions, which in turn <u>implies a closer supervision and regulation of those institutions</u>, a more effective regulation than we've had**, at least in the United States, in the recent past. And that may involve a lot of different agencies and so forth. I won't get into that.
7. But I think it does say that **those institutions should not engage in highly risky entrepreneurial activity.** That's not their job because it brings into question the stability of the institution. They may make a lot of money and they may have a lot of fun, in the short run. It may encourage

pursuit of a profit in the short run. But it is not consistent with the stability that those institutions should be about. It's not consistent at all with avoiding conflict of interest. **These institutions that have arisen in the United States and the UK that combine hedge funds, equity funds, large proprietary trading with commercial banks, have enormous conflicts of interest.** And I think **the conflicts of interest contribute to their instability.** So I would say let's get rid of that. Let's have big and small commercial banks and protect them – it's the service part of the financial system.

8. And **then we have the other part, which I'll call the capital market system**, which by and large isn't directly dealing with customers. **They're dealing with each other. They're trading. They're about hedge funds and equity funds.** And they have a function in providing fluid markets and innovating and providing some flexibility, and I don't think they need to be so highly regulated.
9. They're not at the core of the system, **unless they get really big. If they get really big then you have to regulate them, too.** But I don't think we need to have close regulation of every peewee hedge fund in the world.
   So you have this bifurcated – in a sense – financial system that implies a lot about regulation and national governments. If you're going to have an open system, you have got to get much more cooperation and coordination from different countries. I think that's possible, given what we're going through. You've got to do something about the infrastructure of the system and you have to worry about the credit rating agencies.
10. **These banks were relying on credit rating agencies while putting these big packages of securities together and selling them. They had practically – they would never admit this – given up credit departments in their own institutions that were sophisticated and well-developed. That was a cost centre – why do we need it, they thought. Obviously that hasn't worked out very well.**
11. **We have to look at the accounting system. We have to look at the system for dealing with derivatives and how they're settled. So there are a lot of systemic issues.** The main point I'm making is that we want to emerge from this with a more stable system. It will be less exciting for many people, but it will not warrant – I don't think the present system does, either -- $50 million dollar paydays in that central part of the system. Or even $25 or $100 million dollar paydays. If somebody can go out and gamble and make that money, okay. But don't gamble with the public's money. And that's an important distinction.
    It's interesting that what I'm arguing for looks more like the Canadian system than the American system. When we delivered this report in a press conference, people said, '**Oh you mean, banks won't be able to have hedge funds? What are you talking about?'** That same day, **Citigroup announced, 'We want to get rid of all that stuff. We now realize it was a mistake. We want to go back to our roots and be a real commercial bank.'** I don't know whether they'll do that or not. But the fact that one of the leading proponents of the other system basically said, 'We give up. It's not the right system,' is interesting."

<u>Conclusions:</u>

Clearly, Paul Volcker is not a free market fundamentalists (efficient market hypothesis zealot) like successive US Fed chairmen Alan Greenspan or Ben Bernanke. That is, Paul Volcker knows that the right way forward is for government to implement a well-design regulatory system that can kerb the excesses that can occur in markets – excesses that if left unchecked can cause a global financial crisis like the current global financial crisis that we are currently experiencing!!!!! Paul Volcker has now offered us, the key features of what he regards as a better regulatory framework going forward. Australia needs to take Paul Volcker's advice and implement similar regulatory changes here in Australia – because Australia faces the same risks as the USA.

<u>So in summary:</u>

- Please note that Paul Volcker's recommendations to deal with reforming regulations to prevent this style of economic crisis. These recommendations seek to wind back the excesses of market fundamentalism which are characterised by phrases such as **"That philosophy is that markets drive efficiency and that markets operate most efficiently when there is a minimum of**

regulatory intervention."

- **Recommendation 1: Implement Volcker's recommendation in Australia.** Australia needs to learn from and implement Paul Volcker's recommendations to prevent this style of economic crisis in Australia in the future.

What would implementing Paul Volcker's recommendations in Australia mean in practice?

Let me summarise Paul Volcker's recommendations:

- **"We are going to need a financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort. ..... it's going to be different from the financial system that has developed in the last 20 years.** *A primary characteristic of the system ought to be a strong, traditional, commercial banking-type system. ....***we ought to have some very large institutions** ..... ***whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit.*** *They ought to be the core of the credit and financial system.*
- **you do know by experience that these *big commercial banking institutions will be protected by the government*, de facto.** .... **The government will support these institutions, which in turn *implies a closer supervision and regulation of those institutions, a more effective regulation than we've had. ..... those institutions should not engage in highly risky entrepreneurial activity.*** That's not their job because it brings into question the stability of the institution. They may make a lot of money and they may have a lot of fun, in the short run. It may encourage pursuit of a profit in the short run. But it is not consistent with the stability that those institutions should be about. It's not consistent at all with avoiding conflict of interest. ***These institutions that have arisen in the United States and the UK that combine hedge funds, equity funds, large proprietary trading with commercial banks, have enormous conflicts of interest.*** And I think ***the conflicts of interest contribute to their instability. So I would say let's get rid of that.*** *Let's have big and small commercial banks and protect them – it's the service part of the financial system.*
- And ***then we have the other part, which I'll call the capital market system***, which by and large isn't directly dealing with customers. ***They're dealing with each other. They're trading. They're about hedge funds and equity funds.*** And they have a function in providing fluid markets and innovating and providing some flexibility, and I don't think they need to be so highly regulated. They're not at the core of the system, ***unless they get really big. If they get really big then you have to regulate them, too.*** But I don't think we need to have close regulation of every peewee hedge fund in the world."

So in summary:

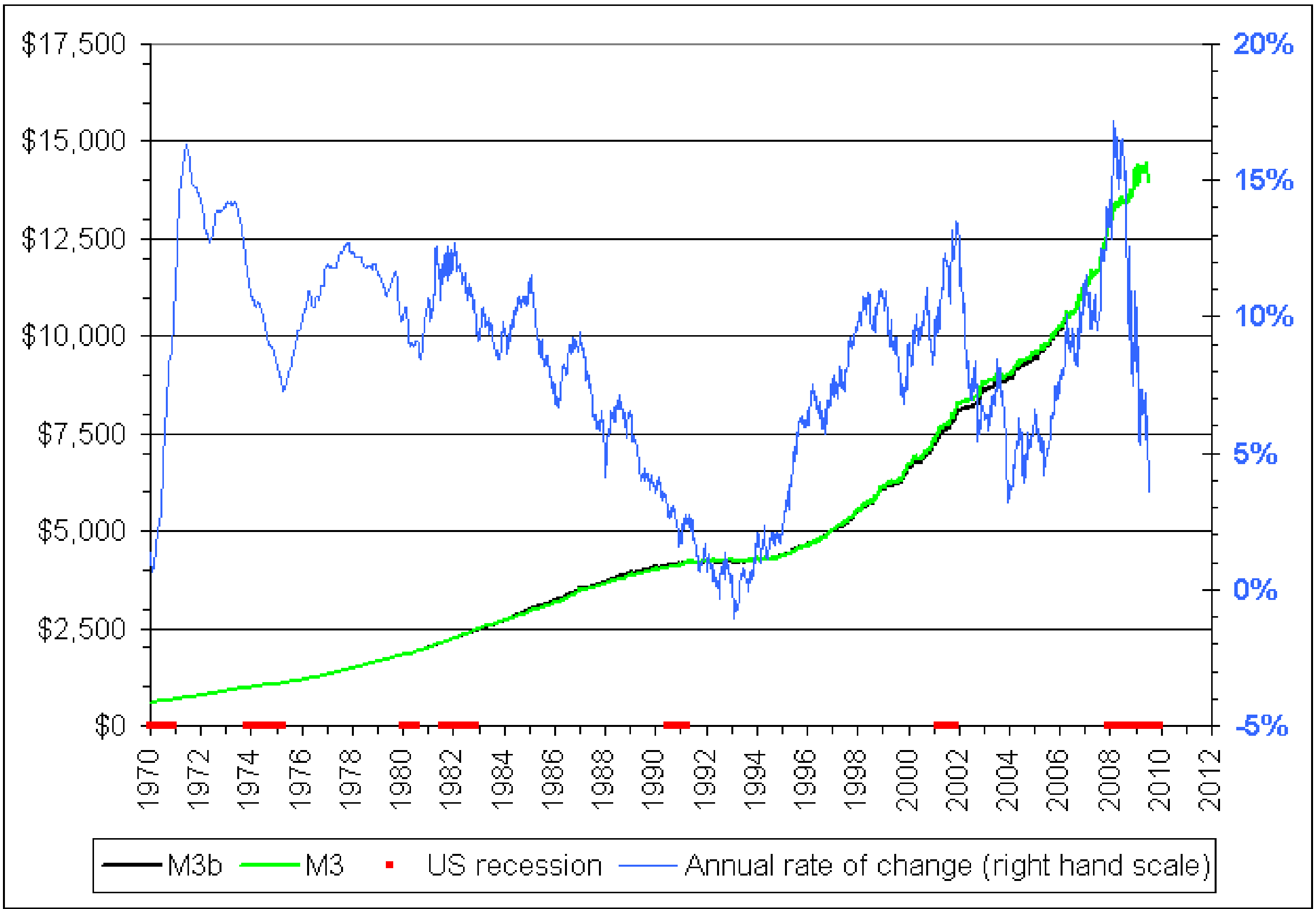
- The core of the Australian financial system needs to be build around ***commercial banks***:
  - which the government will protect,
  - whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by ***providing outlets for their money and by providing credit.*** They ought to be the core of the credit and financial system, and
  - that must be more closely supervised and regulated and those institutions should not engage in highly risky entrepreneurial activity.
- ***These commercial banks must divest themselves of highly risky entrepreneurial activities*** such as offering hedge funds, offering equity funds and proprietary trading. Largely these commercial banks would simply focus on deposit taking and providing credit.
- Then we have the ***capital market system.*** They're dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly

regulated. ***They're not at the core of the system, unless they get really big. (Too big to fail.) If they get really big then you have to regulate them, too.***

Applying Paul Volcker's key recommendations to Australian regulation would change the shape of financial institutions in Australia for the better. These changes would help create a "financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort." (Volcker):

- **The commercial banks.** The government to provide an explicit guarantee to Australian commercial banks – the core of the system. These commercial banks would simply focus on deposit taking and providing credit. These commercial banks must be more highly regulated. These commercial banks would need to divest all highly risky entrepreneurial activities including proprietary trading and wealth management.
- **The capital market system.** Capital market players are dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly regulated. They're not at the core of the system, unless they get really big. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too.
- Since **some Australian insurance companies are "too big to fail"**, they would have to be regulated more tightly too.

- **Recommendation 2: Ban securitisation of debt.**
  http://en.wikipedia.org/wiki/Securitisation Problems with securitisation:
  - Securitisation became rampant in the mid 1990s and was central to the creation of the US$3trillion sub-prime debt problem, an important element of the global financial crisis.
  - One part of the problem with securitisation of debt is the loan originator does not retain the loan on it's balance sheet and therefore can become careless about the quality of loans that it makes. This contributed to the creation of the sub-prime debt problem.
  - However, the biggest problem with securitisation is that it removed a critical tool from the tool-box of central banks. Historically, one tools central banks have been able to control the money supply with has been by imposing reserving requirements on banks. By doing this, central banks could control the **Money Mutiplier** (see http://en.wikipedia.org/wiki/Money_creation#Money_multiplier) which controlled how much money could be created through the banking system. However, **with securitisation, the lending institutions could get a new loan off their balance sheets and hence the Money Multiplier in effect became infinity. This tool to control of the money supply needs to be restored to central banks – by banning securitisation of debt.**



Source: http://www.nowandfutures.com/

As you can see in the chart above, US money supply growth really accelerated rapidly during the mid 1990s and I believe securitisation was an important causal factor. In turn acceleration of growth of money supply was an important ingredient in share market and property bubbles over the last 15 years – and as such is a major contributing factor to the global financial crisis.

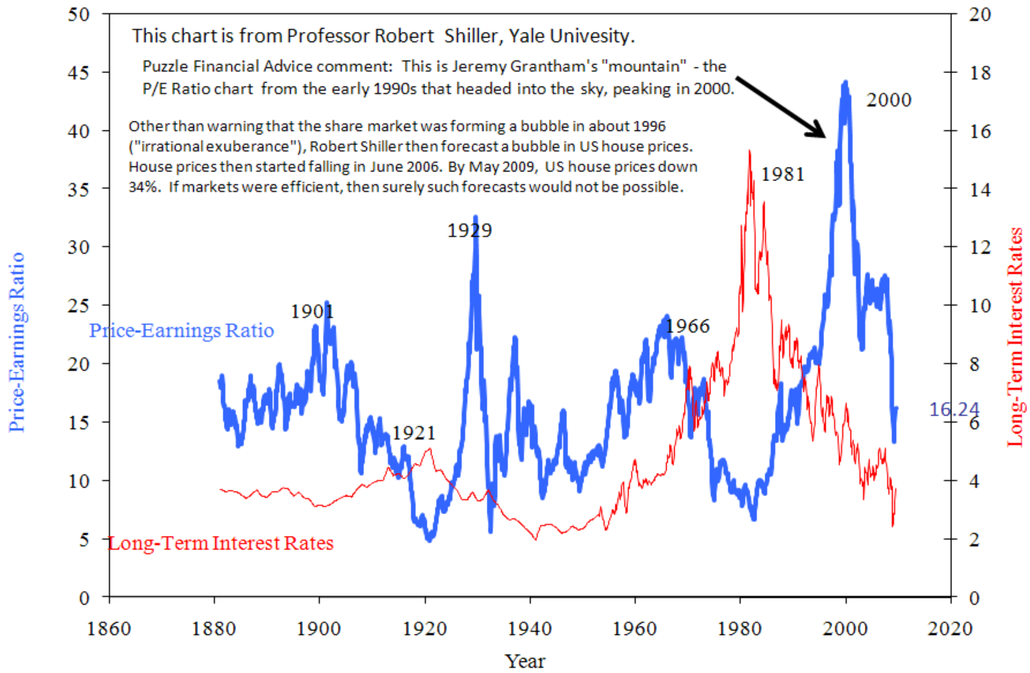
> **Note:** Ideally, over the medium-term Money Supply needs to grow at approximately the same rate as the GDP. Over the last 15 years, Money Supply has grown much faster than that.

3.1 Grantham argues that even Greenspan knew there should be a limit to market fundamentalism – but that Greenspan did not have the courage or the ethics to follow through on his convictions.

Grantham "Feet of Clay. Alan Greenspan's Contribution to the Great American Equity Bubble" 10/2002.

- This document is attached.

- "the underlying **job of the Fed probably is**, and certainly should be, **the maintenance of general economic stability.**
  Nothing threatens economic stability more than the deflating of a major stock market bubble, particularly this time when there was a chance of global deflations even before the bubble broke. **This severe risk brushes aside the argument that bubbles are hard to detect, for the stakes are just too high not to try; great bubbles are, in any case, like mountains sticking out of the plain of normal stock prices.** Comparing 36 times earnings



  to a previous 1929 high of 21 and a 75-year average of 14 times would not seem to take particularly sharp analytical skills. The potential dangers overwhelm Greenspan's defense that the techniques to resist bubbles are not certain, for what in economics is certain? **The stability of the US economy can only be protected against the real dangers of a bubble breaking by the Fed and its Chairman being willing, at rare intervals, to take some substantial political risks**. They must attempt to identify and moderate major stock bubbles and be prepared to bear some consequences. **If they are not prepared to do this, then the risk level of the economy will rise substantially.**
  Setting the Scene
  Major stock market bubbles are indeed about the most dangerous thing that can happen to an economy. They cause wasteful over investment in hot areas. Through the vast paper wealth they create, they substantially increase the amount of greed that is in any case in plentiful supply in a vigorous capitalist system. This in turn increases corruption a little and unethical behavior a lot. **Bubbles also redistribute wealth.**"

- "of course belated ***politicians, who had done little proactively, will jump to correct or over correct the problems***. The downside of the great bull markets will in fact always prove to be a paradise for Murphy's Law: whatever can go wrong will pick this time to do it. The over investment caused by excessive stock prices and excessive lending will be followed by a capital spending bust. ***An investing public who feels to some extent betrayed will lose confidence in investing.***"

- “**When he was not the one dodging bullets, Greenspan himself had a very different view as to the responsibilities of the Federal Reserve and what it could achieve. *In 1966 he had written scathingly of the consequences of weak-kneed behavior by the Fed in 1928 and the dire consequences of delayed and weak action for everyone in the ensuing crash.*** He wrote in his chapter in Ayn Rand’s Capitalism: The Unknown Ideal: *'When business in the United States underwent a mild contraction in 1927, the Federal Reserve created more paper reserves in the hope of forestalling any possible bank reserve shortage. The excess credit which the Fed pumped into the economy spilled over into the stock market - triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in breaking the boom. But it was too late: by 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence. As a result, the American economy collapsed...'* **He is clearly blaming the Fed for both the boom and the resulting crash.**

  J.K. Galbraith, with presumably no axe to grind, having studied the last great equity bubble of the late twenties for his book **The Great Crash (John Kenneth Galbraith, The Great Crash**, 1929, pp. 189-194, New York, Mariner, 1997), ***concluded his analysis with a resounding vote that the Federal Reserve did indeed have the tools to prevent a major bubble but argued presciently it seems that such tools would never be used!*** He argued '**that the chance for recurrence of a speculative orgy** (like that leading up to 1929) **remains good.** No one can doubt that the American people remain susceptible to the speculative mood … **The government preventatives and controls are ready. In the hands of a determined government their efficacy cannot be doubted. *There are, however, a hundred reasons why a government will determine not to use them*** … **Action to break up a boom must always be weighed against the chance that it will cause unemployment at a politically inopportune moment. *It will always look, as it did to the frightened men on the Federal Reserve Board in February 1929, like a decision in favor of immediate as against ultimate death. As we have seen, the immediate death not only has the disadvantage of being immediate but of identifying the executioner*** … One might expect that … The Federal Reserve would be asked by bankers and brokers to lift margins to the limit … The public would be warned sharply and often of the risks inherent in buying stocks for the rise … all this might logically be expected. **However, it did not happen in the go-go years of the late sixties … nor will it ever come to pass** … ***Long-run salvation by men of business has never been highly regarded if it means disturbance of orderly life and convenience in the present. So inaction will be advocated in the present even though it means deep trouble in the future … It is what causes men who know that things are going quite wrong to say that things are fundamentally sound.”*** **This unfortunately for everyone sounds all too like the present Fed Reserve Boss.**

  Greenspan himself back in 1996, when the market at under half its final price was already irrational in his eyes, lets on that a bubble can indeed be broken. Paul Krugman recently pointed out ***Greenspan’s remarkable September 1996 statement to fellow Open Market Committee colleagues, 'I recognize that there is a stock market bubble problem at this point. We do have the possibility of increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it.'*** This is only one of several smoking guns.

  Why did Greenspan not follow through after 'irrational exuberance?' Galbraith probably had it nailed. No one wants to be the one caught 'holding the pin.' No one looks forward to taking a lot of political heat and we know that Greenspan took a good deal because of 'irrational exuberance.'"

- What Was in His Head?

  Greenspan's vacillation and change of heart may have involved some woolly thinking, although **it is hard to separate woolly thinking from a tendency to change arguments to fit the politically convenient position.** There are two prime examples. First, **his view of market efficiency**. His **1966 view is that excesses or bubbles do indeed exist and can be identified and acted on**. After ***having his head slapped by congressmen for his 'irrational exuberance' miscalculation, he hurriedly moves to cover his tail by adopting a view that the market is efficient: 'to spot a bubble in advance requires a judgment that hundreds of thousands of investors have it all wrong.' Yet his suspicions in his earlier 1996 statement did sound like flat-out belief in an inefficient market.*** Now **in the summer of 2002 he returns to his earlier view: 'history attests, investors too often exaggerate the extent of the improvement in economic fundamentals. Human psychology being what it is, bubbles tend to feed on themselves and booms in later stages are often supported by implausible projections of potential demand.' 'Implausible projections!'** ***Here he sounds like a behavioralist who believes the market is a dangerous jungle of psychological impulse!*****"**

- Summary

  In the end, what Greenspan faced was not a moral dilemma. The morality was clear. He had the knowledge, experience, and belief and failed to act. What he had was a career dilemma. If he jumped off the moving bus early, he would have taken some considerable grief. If the economy had slowed, he would have been blamed. ***The timing of occasional ordinary recessions is not of vital importance to society. Indeed, an occasional moderate recession may be necessary for a healthy economy in the long run, although you could find economists who would argue the other side.*** The real cost to society comes from the corruption, disappointments, reduced savings, and the wasted investments brought on by a bubble. **The timing of recessions is, however, of real importance to politicians** who want to be re-elected and who face an electorate whose view of their political platforms is often a simple, 'It's the Economy, Stupid!' **In Greenspan's defense, we can agree he would have received little or no thanks for preventing the evils of a boom and bust for it could never be proved.** ***What we do know is the world's willingness to believe that things would work out well despite the bubble.*** So if he had acted, his reputation and career would have suffered at least temporarily. If he had engaged in wishful thinking, he could believe that there would be either a chance that things would muddle through or a chance that his denials of responsibility, muddled and contradictory as they are, would suffice. ***For a Federal Reserve boss to have volunteered to have taken a lot of political heat and certain short-term damage to his reputation without a realistic hope of offsetting rewards simply because it was the right thing to do would have taken very high ethical standards and considerable strength of character. Paul Volcker perhaps might have made that choice.***

  As for Greenpan's recent defense, in the end what did we expect? That he would repent his lack of character? That he would admit even partial fault? His complete denial on this regard brings to mind an incident in the Profumo sex scandal of the 1960s in England. One of the women involved, Mandy Rice Davis, on hearing that the government minister had denied having sex with her, replied with the immortal words, 'Well he would say that, wouldn't he?' Sometimes the blindingly obvious is funny. This time the equally predictable denial of responsibility and the apparent credulousness of many opinion makers (but encouragingly not all of them) in accepting his argument are merely irritating. Irritating or not, it must be conceded that in terms of avoiding blame he appears to have mostly gotten away with it. You can indeed 'fool most of the people all of the time.' 'Most of the people' this time probably included Her Majesty who recently knighted him for his global services. My secret hope though is that she justified it by having had a good short position for the last

3 years."

- *Note: Through the same period where Greenspan has been implementing policies he knew to be wrong, because he was not prepared to accept the consequences of the alternative, financial planners and fund managers were also facing the same dilemma. Yes, I expect some of them were unaware of the risks – some through ignorance or incompetence and some because of the conflicts of interests "blinded" them to risks which might require actions against their own interests. (rose-coloured glasses). Some fund managers and financial planners were aware of the risks but chose to ignore those risks for the same reason that Greenspan rationalised implementing the wrong policies. Some fund managers and financial planners saw the risks, and acted in the best interest of their clients.*
  - *Note: Acting against the interests of your client, because you are not prepared to accept the consequences of the alternative – related to a concept in funds management and financial planning known as "**career risk**".*
- *Note: It never makes sense for long-term investors to invest in a bubble. Obviously, index investing has you investing in a bubble. **Promoters of long-term buy-and-hold have to believe that you cannot recognise a speculative bubble, if you are to promote long-term buy-and-hold index investments.***

3.2 Greenspan Concedes to `Flaw' in His Market Ideology (Update3)

http://www.bloomberg.com/apps/news?pid=20601087&sid=an8vy29bsXk8&refer=home

By Steve Matthews and Scott Lanman

Oct. 23 2008 (Bloomberg) -- Former Federal Reserve Chairman Alan Greenspan said a ``once-in-a-century credit tsunami'' has engulfed financial markets and conceded that his free-market ideology shunning regulation was flawed.

``Yes, I found a flaw,'' Greenspan said in response to grilling from the House Committee on Oversight and Government Reform. ``That is precisely the reason I was shocked because I'd been going for 40 years or more with very considerable evidence that it was working exceptionally well.''

Greenspan acknowledged he was ``partially'' wrong for opposing the regulation of derivatives over the years. A former Fed chairman normally afforded deference by Congress endured almost four hours of questions from lawmakers seeking a scapegoat for the financial crisis less than two weeks before a national election.

``We have to do our best but not expect infallibility or omniscience,'' he responded under questioning. Part of the problem was that the Fed's ability to forecast the economy's trajectory is an inexact science, he said.

``If we are right 60 percent of the time in forecasting, we are doing exceptionally well; that means we are wrong 40 percent of the time,'' Greenspan said. ``Forecasting never gets to the point where it is 100 percent accurate.''

The admission that free markets have their faults was a shift for the former Fed chairman who declared in a May 2005 speech that ``private regulation generally has proved far better at constraining excessive risk-taking than has government regulation.''

`Paying the Price'

Committee Chairman Henry Waxman, a California Democrat, said today that Greenspan had ``the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis.''

``You were advised to do so by many others,'' he told the man hailed in the 1990s as the ``Maestro'' of the global financial system and awarded a knighthood in 2002. ``And now our whole economy is paying the price.''

Greenspan's devotion to free markets was nurtured in part by his association with Ayn Rand, the libertarian novelist and philosopher who espoused laissez-faire capitalism. He met Rand in the 1950s, becoming part of her inner circle of followers meeting regularly in her Manhattan apartment.

``Greenspan in a very, very kind of unwise, left-brain way, imputed pure rationality to markets,'' said James Grant, editor of Grant's Interest Rate Observer. ``They are just as rational and just as efficient as the people that operated in them.''

Waxman echoed that sentiment to Greenspan: **``The mantra became government regulation is wrong. The market is infallible.''**

Gramlich's Warnings

Former Fed Governor Edward Gramlich, who died in 2007, had urged Greenspan to strengthen oversight of banks during the record U.S. mortgage boom from 2004 to 2006.

Questioned about those warnings, Greenspan said ``Governor Gramlich said to me that he had problems'' and that he left the meeting expecting a Fed subcommittee dealing with consumer and community affairs to present recommendations, which didn't occur. ``I presumed at the time that essentially the subcommittee didn't think it rose to the higher level'' requiring action, Greenspan said.

Responding to criticism that he was too ideological, Greenspan said he sought as chairman to abide by laws passed by Congress, ``not my own predilections.''

He later added that he couldn't respond to every warning. ``There are always a lot of people raising issues, and half the time they're wrong.''

Regulatory Actions

Greenspan pointed out that he voted for every regulatory action the Fed moved on, drawing a rebuke from Waxman. ``On the other hand, you didn't get to vote on regulations that you didn't put before the Federal Reserve board, even though you had the legal authority for those regulations.''

Firms that bundle loans into securities for sale should be required to keep part of those securities, Greenspan said in prepared testimony. Other rules should address fraud and settlement of trades, he said.

Greenspan opposed increasing financial supervision as Fed chairman from August 1987 to January 2006. Policy makers are now struggling to contain a financial crisis marked by record foreclosures, falling asset prices and almost $660 billion in writedowns and losses tied to U.S. subprime mortgages.

Greenspan, 82, reiterated his ``shocked disbelief'' that financial companies failed to execute sufficient ``surveillance'' on their trading counterparties to prevent surging losses. The ``breakdown'' was clearest in the market where securities firms packaged home mortgages into debt sold on to other investors, he said.

Pricing Risk

``In this financial environment, I see no choice but to require that all securitizers retain a meaningful part of the securities they issue,'' Greenspan said. That would give the companies an incentive to ensure the assets are properly priced for their risk, advocates say.

Greenspan said the Fed didn't know the size of the subprime mortgage market until late 2005.

Securities and Exchange Commission Chairman Christopher Cox and former Treasury Secretary John Snow also appeared at the House committee hearing.

`Bad, Bad Path'

Snow said the economy is headed down a ``bad, bad path'' and he endorsed consideration of more fiscal stimulus. For the longer term, **Snow said the global financial system should be reorganized by focusing on increasing transparency of ``excessive'' leverage to prevent institutions from creating too much risk.**

The U.S. needs ``one strong national regulator'' to oversee firms and fix what Snow called ``a fragmented approach'' to regulation.

Addressing the trio that oversaw the U.S. financial markets as the housing bubble developed, Representative John Yarmuth, a Democrat from Kentucky, characterized them as ``three Bill Buckners,'' referring to the Boston Red Sox first baseman whose fielding error some fans blame for the team's loss in the 1986 World Series.

To contact the reporter on this story: Scott Lanman in Washington at slanman@bloomberg.net; Steve Matthews in Atlanta at smatthews@bloomberg.net.

Last Updated: October 23, 2008 15:55 EDT

3.3 Kevin Rudd "fundamentalist ideology of self-regulating markets has imploded".

http://www.smh.com.au/national/pain-on-the-road-to-recovery-20090724-dw6q.html?page=-1
Kevin Rudd's essay "Pain on Road to Recovery" in the Sydney Morning Herald 25th July 2009.

> "As I have argued elsewhere, the boom-and-bust economic cycle of the past decade has been an unavoidable consequence of a decade of neo-liberal free market fundamentalism that reinforced a culture of corporate greed and excess in the financial sector. ***The central principles of this extreme form of capitalism are that markets are self-regulating; that government should get out of the road of the market altogether and that the state itself should retreat to its core historical function of security at home and abroad.***
>
> ***This fundamentalist ideology of self-regulating markets has imploded comprehensively with the current crisis.*** We have seen spectacular market failure requiring equally spectacular government intervention in the economy to effectively save the system from itself."

4. Efficient Market Hypothesis (EMH). The EMH is flawed.

- If markets were efficient, the there would be no stock-pickers like George Soros, Kerr Neilson and Warren Buffett who, over decades, have added value by picking stocks - delivering better than market average performances.
  - This is not to say that the average active manager delivers value for money – as I believe that they do not – but this is for other reasons eg index-hugging and not competing on performance or product but by competing on distribution channels.
  - Yes, from time to time a fund manager might outperform over a significant period of time – but there are some who do it through stock-picking skill etc.
- Let us start with a summary of efficient market hypothesis (EMH). A reasonable summary of the EMH can be found at http://en.wikipedia.org/wiki/Efficient_market_hypothesis#cite_note-0
  - "**The efficient-market hypothesis was developed by Professor Eugene Fama** at the University of Chicago Booth School of Business as an academic concept of study through his published Ph.D. thesis in the early 1960s at the same school. It was widely accepted up until the 1990s."
  - "**Investors and researchers have disputed the efficient-market hypothesis** both empirically and theoretically."
    - "**Behavioral economists** attribute the imperfections in financial markets to a combination of cognitive biases such as overconfidence, overreaction, representative bias, information bias, an inability to use configural rather than linear reasoning, and various other predictable human errors in reasoning and information processing."
    - "Empirical evidence has been mixed, but has generally not supported strong forms of the efficient markets hypothesis. According to Dreman, in a 1995 paper, low P/E stocks have greater returns. In an earlier paper he also refuted the assertion by Ray Ball that these **higher returns could be attributed to higher beta**, whose research had been accepted by efficient market theorists as explaining the anomaly in neat accordance with modern portfolio theory." Note: **Beta is a concept in the efficient market theory – that Eugene Fama's & Kenneth French's long-term historical in the early 1990 showed was not supported by the long-term historical data. Fama & French proposed the three-factor model in the place of beta.**
    - **"**One can identify "losers" as stocks that have had poor returns over some number of past years. "Winners" would be those stocks that had high returns over a similar period. **The main result of one such study is that losers have much higher average returns than winners over the following period of the same number of years. ....** The study showed that the beta difference required to save the EMH is just not there.**"**
    - **"Speculative economic bubbles** are an obvious anomaly, in that the market often appears to be driven by buyers operating on irrational exuberance, who take little notice of underlying value**."**
    - **"Behavioral psychology a**pproaches to stock market trading are among some of the more promising alternatives to EMH**"**

- **Jeremy Grantham, chairman GMO. www.gmo.com** "***When you believe in market efficiency, it's like being on the railroad watching the locomotive coming toward you. Then you just stand your ground just for the discipline of not moving. It's ruinously expensive.***"
  http://www.smartmoney.com/investing/economy/Why-Jeremy-Grantham-Changed-his-Mind/?page=all
  - **SmartMoney: That's the future. But why did so many supposedly smart people miss this disaster over the past two years?**

Jeremy Grantham: The ultimate villain of this is the belief in rational expectations—that the market tends to be efficient. People who have anything to do with investing either believe it a bit or believe it a lot. There are only a few of us ornery disbelievers who don't believe that the market is efficient at all.
SmartMoney: What's wrong with believing that the market is efficient?

Jeremy Grantham: If you believe in it, then you don't see asset bubbles. And there's nothing as dangerous as an asset bubble. If you even slightly believe in it, you believe in [former Federal Reserve Chairman] Alan Greenspan's idea that markets can control themselves. You believe that you should buy and hold the market. You believe you should have a fixed asset mix and you should never change it, because why would you? The market is efficient! ***When you believe in market efficiency, it's like being on the railroad watching the locomotive coming toward you. Then you just stand your ground just for the discipline of not moving. It's ruinously expensive.***

- **Bill Gross**, MD Pimco "**The efficient market hypothesis was always dead from the get-go, but academic tenure and Nobel prizes were food for the unwilling or perhaps unthinking.**" Pimco is the world's largest bond manager. www.pimco.com http://media.pimco-global.com/pdfs/pdf/IO%20July%2009%20WEB.pdf?WT.cg_n=PIMCO-US&WT.ti=IO%20July%2009%20WEB.pdf
  - "**Forecasts based on econometric models inevitably miss these secular/structural breaks in historical patterns** because it is impossible to quantify human behavior, and long-term trends involving risk-taking and in turn derisking are decidedly human in their origin. **Bell-shaped curves with Gaussian/random distributions fail to anticipate that human beings do not make decisions by chance or independently of each other, but in many cases in reaction to one another**. Humanity's personal and social computers appear to be programmed that way. And so, instead of 'normal' distributions, **economists and investors must learn to be on the lookout for 'black swans,' and if not, then certainly 'fat tails,'** which differ from the measurement of natural phenomena accepted in science. 'New normals,' flatter-shaped bell curves, and structural shifts in previously accepted standards become not only possible, but probable as human nature reacts to itself and its prior behavior. ***The efficient market hypothesis was always dead from the get-go, but academic tenure and Nobel prizes were food for the unwilling or perhaps unthinking.*** PIMCO and yours truly are not masters of the antithesis, a subjective approach which might derisively be called 'crystal ball gazing,' but **we try to focus on what might be legitimate changes in the way economies and financial markets are affected by seemingly irrational or 'non-normal' behavior and events.** The ***supersizing of financial leverage and consumer spending in concert with the politicizing of deregulation*** *describes* in fifteen words ***our most recent brush with irrational behavior and inefficient markets.*** Greed will come again. But for now, the trend is the other way and ***it promises to persist for a generation at a minimum***. The fact is that American consumers have suffered a collapse in wealth of at least $15 trillion since early 2007. Global estimates are less reliable, but certainly in multiples of that figure. And **when potential spenders feel less rich by that much, the only model one can use to forecast the future is a commonsensical one that predicts higher savings, lower consumption, and an economic growth rate that staggers forward at a new normal closer to 2 as opposed to 3½%. There's no magic in that number, and no model to back it up, just a lot of commonsense** that says this is how people and economic societies behave when stressed and stretched to a near breaking point."

- **Central banks using flawed models. Regulators need to review market assumptions.** Australian Financial Review 25/7/09 "Old economics under fire". (Attached)
  - "Mainstream economic models were deeply flawed."
  - "'I find it surprising that central banks populated with rational men have thought using these models would keep the economy stable.'"
  - "macro-economics were blinded by the idea that efficient markets would take care of themselves."
  - "Sunstein's views and those of many like him have **big implications for all those who oversee** and take part in **markets**."

- Professor Lo of MIT – EMH remained influential because of 'physics' envy.'

http://www.ft.com/cms/s/0/cf6d096a-6d7a-11de-8b19-00144feabdc0.html?nclick_check=1

See Appendix C. In "What can replace efficient markets theory?" by Jonathan Davis July 12 2009, Johnathan reports

"The most interesting thing about the e**fficient markets hypothesis** is not whether it is valid or not – clearly it is not – but how it has managed to remain so influential for so long. At a recent conference in London on the subject, organised by the CFA Institute, Professor Andrew Lo of Massachusetts Institute of Technology offered the audience a simple explanation: 'physics envy'.

This was a reference back to the early inspiration of the Nobel economics laureate Paul Samuelson, who set out to find for economics a set of fundamental laws that would do for the dismal science what Newton's laws of thermodynamics had done for physics, and from which a rigorous general theory with practical uses could subsequently be developed. "

"The attempt to bring order and an overarching theoretical framework into analysis of the seemingly unruly behaviour of financial markets was a temptation that has for years proved too great for academics (and many market participants) to resist, but it has turned out to be a long and largely fruitless journey."

"Behavioural finance has grown to become a popular alternative approach precisely because it does appear to explain more clearly how investors, individually and collectively, appear to act.

In Prof Lo's words: 'Economic systems involve human interactions, which almost by definition are more complex than interactions of inanimate objects governed by fixed and known laws of motion.'

The real beauty of the efficient markets hypothesis, and the explanation for its longevity in the face of consistent empirical evidence that it is invalid, surely lies in its beguiling simplicity.

As the future is uncertain and many of the key variables that concern investors cannot be predicted with confidence, a theoretical structure that appears to offer a way to live with uncomfortable reality has obvious attractions."

"Most important of all, investors cannot rely on the comforting message of the efficient market hypothesis that all you need to do to obtain an expected return is to take the appropriate level of risk.

The ***biggest problem with this new approach, as with all alternatives to EMH, including behavioural finance, is that it doesn't give investors a simple metric for understanding what to do. Its great merit, however, is that it appears to relate to the complex and uncertain world that we all actually inhabit, something the efficient markets hypothesis has never done."***

- **"Myth of the Rational Market - A History of Risk, Reward, and Delusion on Wall Street "**

http://www.washingtonpost.com/wp-dyn/content/article/2009/06/05/AR2009060502053.html

"On Wall Street, the Price isn't right" discussing a book called **"The Myth of the Rational Market - *A History of Risk, Reward, and Delusion on Wall Street* "** 7/June 2009.

"The upside of the current Great Recession is that it could drive a stake through the heart of the academic nostrum known as the ***efficient-market hypothesis***. This theory holds that stock and bond markets are nearly perfect -- even during such crazes as the dot-com mania -- and that prices on the exchanges instantly and accurately reflect the available information about publicly traded securities. ***After the market crash of 1987, Yale University economist Robert Shiller called that belief 'the most remarkable error in the history of economic theory.' He could have said 'most harmful error' as well.*** Yet it lived on and contributed mightily to the mortgage bust."

"How did this faith in the supremacy of market group-think do us harm? For one, as the dot-com and other manias demonstrated, the crowd occasionally gets it wrong. The mistaken faith in markets turned regulators into fawning groupies. Notably, former Fed chairman Alan Greenspan doubted that he or anyone else could detect -- or regulate -- a bubble in advance."

"Fox tells the story of how financial engineers assumed that markets would behave the same way, with generally predictable variances in prices. ***In particular, the theory of option pricing, the cornerstone of modern finance, has built into it the assumption that prices are random. The theory was devised by Fischer Black, Myron Scholes and Robert Merton. The last two won the Nobel Prize in 1997 and***

were partners in Long-Term Capital Management, the hedge fund that blew up in 1998. What happened to LTCM? It turned out that in financial markets, extreme events do happen. People get emotional and decide to buy (or sell) in unison. All of LTCM's trades went sour simultaneously. Nonetheless, the modelers kept at it. Rating agencies assumed that subprime mortgagees would behave in random fashion -- large numbers of people would never default at the same time, right? (Oops.)"
"Fox recognizes that true believers in the market's efficiency suffered from a "blinkered" mindset and 'tunnel vision.' Yet I think he lets them off too easily. He laments (as if it were necessary) the lack of any alternative 'grand new theory' and finds that the debate has resulted in a 'muddle.' Fox concludes, 'If you do come up with an idea for beating the market, you need a model that explains why everybody else isn't already doing the same thing.' Not necessarily. ***Markets aren't physics. Maybe no one model explains them.***
The emerging school of behavioral finance fills in many of the gaps left by the efficient marketers. Behavioral finance, which Fox discusses at length, holds that financial man -- far from the perfect, mechanical trader depicted in textbooks -- is a rather neurotic fellow. He follows the crowd, fails to plan ahead and often makes mistakes. To think that his every price is perfect is a remarkable error indeed. "

In summary:

- Many leading thinkers in investment markets & economics believe that the Efficient Market Theory is fatally flawed. As you can see from above, Jeremy Grantham goes as far as to say that it can be very dangerous for investors to believe in market efficiency because "it's like being on the railroad watching the locomotive coming toward you." This is precisely the way many investors have behaved over the last 2 years through this global financial crisis – to their detriment.
- Even Eugene Fama, the father of efficient market theory, has moved on from his thinking in the 1960s. Fama & French is the early 1990s came up with the Three Factor model which better explains the actual behaviour of investment markets. And Fama can see potential for other factors to help explain the actual behaviour of markets eg momentum.
- Behavioural finance is a major emerging framework that clearly can be seen to operate in markets. Markets aren't physics. Maybe no one model explains them.
- Yes, we can see efficient market effects at work in markets. We can also see behaviourial effects in markets. Despite this ASIC seems to be strong promoting/advocating "vanilla" investment advice – based on the flawed assumption that the Efficient Market Theory and the Capital Asset Pricing Model are robust and can be relied on. This is likely to produce a suboptimal outcome for consumers.

Recommendation 3: A better solution for consumers would be if we created a **Financial Planner Registration Board** (with a panel of expert independent [i.e. not conflicted] practicing financial planners) which would determine what acceptable advice was – and that this definition of "acceptable" advice could evolve as investment theory evolves – as it continually will evolve. This Financial Planner Registration Board would also help consumer's avoid losses as has occurred with Storm Financial and Westpoint. The Financial Registration Board would have the following features:

- designed by accounting professional bodies and BFPPG with ASIC input.
- Not compulsory. Many current financial planners would not qualify.
- Higher education and an obligation to act in best interests of the client.
- product manufacturer-owned planners can be registered but have no say in the FPRB because it is critical that the FPRB stay outside the control or influence of product manufacturers and their distribution arms.
- The FPRB to have a panel of professional independent advisors who will form views of what is acceptable advice, what is high risk advice and what is unacceptable advice.
- FPRB would define what is "acceptable" advice and this would evolve as investment theory evolves.

- A discussion paper on how the FPRB might work is attached.

A vision for future of financial planning advice in Australia

Quality advice, choice in style and price

Independent advice

Higher education standards + **Financial Planner Registration Board** keeps quality of advice high

Professional Standards – include fiduciary responsibility including obligation to act in best interests of client.

Product distribution channels – salespeople.

Vanilla expensive advice.

* AFSL to take total responsibility for all advice unlike now.

* AFSL takes a very close supervisory role on reps

Super Funds providing intra-product advice.

Standardised vanilla inexpensive advice

Already have obligation to act in best interests of client