The Australian

Swan and Hockey's half-baked solutions

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- From: **The Australian**
- November 05, 2010 12:00AM

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THE problem is the government guarantee which hasn't been properly designed.

A CRISIS is a terrible thing to waste. Luckily, our big banks have done no such thing. Before the global financial crisis, the four pillars were crumbling into sand, as competition slashed the majors' margins and market share. Now, they seem stronger then ever. And with interest rates rising, the heat is on. But political posturing can't change economic realities, and knee-jerk responses are only likely to be counterproductive.

To see why, it's important to know how we got here. And that means starting from the beginning: from what banks do.

Banks primarily provide intermediation services: they attract funds from those with funds to spare and "rent" funds to those who can put them to valuable use. This increases efficiency, redirecting liquidity from lenders, to whom it is currently less valuable, to borrowers to whom it is more valuable. Banks get part of that gain in value through the spread between lending and borrowing rates and through transactions charges, providing the income with which they cover their costs.

Historically, three factors made banks uniquely well-placed to provide these intermediation services.

First, extensive branch networks gave banks unique access to the physical distribution then required to collect and disburse funds. Those branch networks also ensured banks could monitor local developments, which helped in assessing credit risk.

Second, having a large book of long-time clients, banks had unique access to customer information. This gave them an advantage in dealing with the "information asymmetry" problems that characterise markets for loans: the risk, for example, that the person willing to pay the highest rate is the one who knows, but has no incentive to reveal, that he or she is likely to default; or the risk that a borrower will have reduced incentives to keep their small business afloat, since the costs of failure will be partly borne by the lender.

Third, regulation protected banks from competition by other financial services providers, as well as providing an implied guarantee against failure, entrenching the banks' other advantages.

These advantages interacted to make banks the primary suppliers of financial intermediation services. For example, given very large customer numbers, the risk of many depositors withdrawing their funds simultaneously was low. Banks, and banks alone, could therefore combine the function of assuring short-term liquidity to depositors with that of providing borrowers with long-term funding for illiquid assets, such as houses. The high social value this created assured banks' prosperity.

However, these sources of competitive advantage eroded in the 1990s.

To begin with, branch networks were no longer essential for collecting or disbursing funds, as ATMs became ubiquitous, online accounts flourished and networks of agents and brokers (many retrenched bank staff) developed.

Technological change also reduced the significance of the information asymmetry between suppliers and users of finance. For example, new techniques that evaluate the likelihood of default through statistical profiling seemed able to manage

credit risk without detailed information on borrowers.

Finally, regulations restricting competition were almost completely removed in Australia and overseas.

These changes significantly reduced entry barriers. With physical distribution and customer information no longer key bottlenecks, new competitive models emerged that placed immense pressure on incumbent banks. Common elements to these differing models were access to low-cost product distribution and to low-cost wholesale funds.

An entrant could, for example, use the internet to attract online deposits with which to back a portfolio of mortgages it distributed through agents or brokers. It would then securitise those loans as residential mortgage-backed securities (RMBS): that is, by pooling cashflows from a bundle of individually illiquid assets (the individual mortgages), it created a tradeable asset that could be sold to investors. This further reduced funding costs, allowing it to compete even more aggressively in the supply of loan products.

The impacts were dramatic in the markets for mortgages and for deposits. But the major banks advantages' never entirely disappeared, and in some areas, especially small business lending, remained entrenched. And then came the GFC. The crisis knocked the stuffing out of wholesale funds markets on which entrants relied. And it made it clear that when push came to shove, governments would not let major banks fail.

In Australia, the implied guarantee was therefore made explicit for deposits of up to $1 million and other measures adopted to help banks access wholesale funding. The guarantees also applied to building societies and credit unions. But private lenders probably inferred that loans to larger institutions were the safer bet. Combined with industry consolidation, including Westpac's takeover of St George and the Commonwealth's of BankWest, the majors were firmly back in control.

Faced with that change, the responses recently floated by the government and the opposition seem half-baked.

Ill-specified, unenforceable, social compacts are a feelgood sop that, as in the US, can lead banks into very poor quality loans. Further, government purchases of RMBS would doubtless benefit bankers but are an expensive, untargeted way of reducing households' mortgage costs. Reducing switching costs has little impact and can increase upfront fees. As for laws outlawing price signalling, an undefined and undefinable offence, these are merely a bid by the competition regulator to expand an already bloated empire.

But that doesn't mean all is for the best. The guarantee creates a real danger that banks will take undue risks at taxpayers' expense. Limiting the activities banks can undertake is not an effective way of controlling that danger: that only shifts risky activities into unregulated institutions, which themselves grow too big to fail. Rather, where taxpayers provide insurance, they should charge for it, and as with other insurance contracts, use deductibles, co-payments and penalties to make excessive riskiness unattractive.

Ultimately, the GFC did not reverse history. Although tougher prudential regulation may increase entrants' costs, the structural forces that reshaped banking in the 1990s will reassert themselves as markets recover.

But that won't happen overnight. Nor will it be a cure-all. Small business banking, where risks are high and information problems pervasive, will remain problematic. And if macro-economic conditions mean rates must rise, no amount of huffing and puffing will prevent that, nor do anything about bank margins. So get used to hating the major banks: those pillars won't be crumbling any time soon.

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