TOWARDS AN EFFICIENT AND STABLE FINANCIAL SYSTEM*

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Introduction

Thank you for the opportunity to speak today. With the financial system inquiry now well under way, I would like to focus on why the government intervenes in the financial system, and some of the trade-offs involved in doing so.

I will also discuss some of the key policy issues currently being considered by the financial system inquiry, including too big to fail, superannuation fees and the financial system's capacity to manage longevity risk.

What are the objectives of the financial system?

Before discussing the regulation of the financial system, it is worth reflecting on the main role of the financial system, which is, of course, to channel funds from savers to investors. As part of this role the financial system:

- pools funds and risk — allowing for risk diversification and for larger investment projects to be undertaken; and
- specialises in credit assessment — allowing the economy to better manage risks and returns from investment, at a lower cost.

The financial system allocates capital effectively when it directs scarce financial resources towards those forms of investment that have the highest returns, once proper allowance has been made for risk. A well-functioning, efficient, financial system that fulfils these functions at the lowest cost will contribute to economic growth and living standards.

* I am grateful to Danial Gaudry and Kurt Hockey for much help with this address.

The financial system also has an important role to play assisting Australia manage the demographic transition currently underway. The capacity of the financial system to manage longevity risk and meet the needs of Australians in retirement is something I will come back to later in the presentation.

Why does the financial system warrant special regulatory attention?

The critical implications for the wider economy of the failure of a systemically important financial institution explain why the financial system is accorded special regulatory attention. The cost of major financial instability in terms of lost growth and forgone welfare can be enormous.

All the countries that suffered recent financial crises – which include the US, UK and several smaller European economies – have suffered deep recessions and sluggish recoveries, and in some cases (with the UK perhaps the most obvious example) may have suffered permanent damage to their productive potential. Locally, and thankfully on a much smaller scale, the failure of HIH had a fiscal cost of over $650 million and required the Treasury to run an insurance company – HIH Claims Support Limited – for 12 years.

For this reason a more active regulatory environment is appropriate for the financial system than for other parts of the economy. Nevertheless, regulators should not focus solely on ensuring the stability of the financial system. Instead, government intervention in the financial system should aim to improve both its stability and efficiency. To this end, the role of government should be to encourage a competitive, market-based, system that recognises the private sector's primary role in responding to customer needs.

Regulatory intervention should be targeted at market failures, but also be cognisant of the costs that regulation imposes. Two broad forms of market failure that warrant regulatory intervention specific to the financial system arise from:

- systemic risk, or the negative externalities arising from the failure of a systemically important institution; and
- agency costs that can arise where an agent pursues their own self-interest rather than those of the principal (or owner) because of information asymmetry or other incapacity on the part of the owner to ensure the alignment of the agent's interests with his or her own interests.

Agency costs can occur throughout the economy but are particularly pronounced in the financial system. These concerns are often raised in relation to the provision of financial advice.

What is the relationship between competition and stability?

Let me now turn to one of the trade-offs often raised when considering the impact of regulation, that of competition and stability. Competition is not an end in itself – the point is to create a more efficient financial system better able to support growth and living standards. Generally speaking, competition in the financial system is required to encourage innovation and efficiency.

It is worth noting, however, that the relationship between stability and competition is not necessarily a straightforward one. It is rarely possible to trade-off a given amount of competition for a given amount of stability. The impact of changes in competition on stability will vary on a case by case basis.

In some cases, increases in competition can boost stability, while in others, competition can harm stability. For instance, competition can improve stability by removing less efficient financial institutions from the market, making the overall system more resilient. Alternatively, competition that results in declining lending standards may store up future problems by increasing the likelihood of defaults.

The extent to which competition results in instability is partly dependent on the regulatory environment in which the financial system operates. It is up to regulators to create an environment which promotes competition, supports innovation and efficiency, whilst at the same time ensuring that financial institutions adequately manage the risks they take.

How do we manage systemic risk in Australia?

Managing systemic risk in Australia is the responsibility of several agencies.

- The RBA has longstanding responsibility for financial stability, recently reiterated in the Statement on the Conduct of Monetary Policy;
- APRA is required to take a systemic view when conducting its prudential regulation;
- ASIC seeks to minimise systemic risk in clearing and settlement systems; and
- Treasury has responsibility for advising the Government on financial stability issues.

Agencies coordinate their actions through the Council of Financial Regulators, a body that demonstrated its worth, if any demonstration was needed, through the global financial crisis. At the CFR, members share information, discuss regulatory issues and desirable approaches to those issues that can form advice to government and, if the need arises, coordinate responses to potential threats to financial stability.

In Australia we do not draw a distinction between regulation aimed at ensuring the solvency of individual institutions and regulation aimed at minimizing systemic risk. Regulators should not take an excessively narrow focus and ignore systemic risk when regulating financial institutions and infrastructure. All of Australia’s financial regulators are required to consider systemic risk in their day-to-day activities.

Australia’s regulators have ‘instrument independence’ – that is, the freedom to exercise their supervisory responsibilities in a way they see fit but with the intent of delivering on the Government’s goal of an efficient and stable financial system best able to support growth. This independence, and explicit government support for this independence, is critical to ensuring the effectiveness of our financial regulators.

However, it is equally important that such independence is balanced by effective accountability. That is why the Government has issued a statement of expectations to each regulatory agency, to make clear what their objectives should be and what they will be held accountable for. That is, the regulators do not have goal independence – that is the responsibility of the Government and Parliament.

Too big to fail

One source of systemic risk being considered as part of the G20 agenda is ‘too big to fail’. The Financial Stability Board is developing measures to reduce the need for taxpayer support in the event of failure and at the same time avoid disruption to the financial system and real economy. These measures are focused on global systemically important financial institutions and seek to:

- enhance the capacity to absorb losses when they fail,
- strengthen supervisory intensity and effectiveness, and
- develop credible resolution plans (living wills), including cross-border co-operation agreements to reduce the difficulties of resolving important financial institutions that operate in multiple jurisdictions.

The Financial Stability Board is planning to deliver these proposals to the Brisbane G20 Summit in November this year. It is Australia’s intention that the G20 deliver on the big four regulatory issues arising from the GFC at the Brisbane summit – building resilient financial institutions, ending too big to fail, addressing shadow banking risks and making derivatives markets safer.

Australia does not have any financial institutions identified as globally systemically important. Appropriately, however, our current policy settings respond to the problem of ‘too big to fail’ through the intensity of supervision by APRA and by requiring domestic systemically important banks to hold additional capital. The Financial System Inquiry provides a good opportunity to examine further options to address the 'too big to fail' issue in Australia.

Superannuation

Let me conclude with a few remarks about superannuation, a sector that manages assets worth around $1.8 trillion today and expected to continue to grow strongly.

Superannuation fees

Treasury and the RBA, in their submissions to the Financial System Inquiry, and the Grattan Institute, in its April 2014 report '*Super sting: how to stop Australians paying too much for superannuation'*, all drew attention to the high level of fees in the superannuation industry.[1]

In 2013, Australian superannuation fees ranged from approximately 0.7 per cent to 2.4 per cent of mean fund size, with fees averaging around $726 per year for a member with a balance of $50,000.[2] Although international comparisons are difficult, in 2011, Australia's average superannuation fees were around three times those in the UK.[3] In aggregate, Australians spend around $20 billion annually, or over 1 per cent of GDP, on superannuation fees.[4]

A microeconomic reform that permanently reduced costs across the economy by a few tenths of 1 per cent of GDP would be considered a significant and worthwhile reform. Significant reductions in superannuation fees would have widespread benefits for society as a whole.

This problem is a global one. In 2009, the Squam Lake Working Group – probably the most prestigious group of finance academics ever assembled, with representatives from a variety of different viewpoints, including Frederic Mishkin from Colombia University, Nobel Prize winner Robert Shiller, John Cochrane from the Chicago School and Raghuram Rajan, now the Governor of the Reserve Bank of India – had this to say:

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[1] See http://fsi.gov.au/files/2014/04/Treasury.pdf (page 51), http://fsi.gov.au/files/2014/04/Reserve_Bank_of_Australia.pdf (page 178) and http://grattan.edu.au/static/files/assets/ec3e7945/811-super-sting.pdf

[2] See Rice Warner, 2014, 'FSC Superannuation Fees Report 2013', page 8, and Super Ratings, 2014, 'MySuper sees fees reduce by 30% but not before Australians set to pay an extra $2 billion due to delays', Media Release of 5 February 2014.

[3] See OECD Global Pension Statistics http://stats.oecd.org/viewhtml.aspx?QueryName=14477&QueryType=View

[4] See Grattan Institute, 2014, 'Super Sting: how to stop Australians paying too much for superannuation'.

> 'High-fee funds argue that their fees are justified by superior performance. A large body of academic research challenges that argument. On average, high fees are simply a net drain to investors. While some investors might gain by selecting successful high-fee funds, the negative-sum nature of the process implies that other investors must lose even more. Most employees saving for retirement are poorly placed to compete in this game. They should not be forbidden from doing so, but disclosure of high fees and a "surgeon general's warning" are appropriate.'[5]

The impact on fees of recent initiatives is unclear at this stage. In particular, the introduction of MySuper and Superstream should make the sector more efficient and push down costs — and there is some evidence that this is occurring. Nevertheless, there needs to be policy consideration of further options to increase competition and drive down costs. Given the stakes, this is an important area for the Financial System Inquiry to examine.

Services and products for consumers in retirement

The key focus of superannuation should be on the provision of retirement income, rather than primarily on wealth accumulation. As more Australians move into retirement, it will become increasingly important for the industry to provide the range of products that people need to manage the financial aspects of their retirement.

It will be increasingly important for the private sector to help manage longevity risk through income stream products such as insurance or pooled products. Most life insurance products do not address longevity risk and the individual immediate annuity market in Australia is small. At issue is the availability of a range of products that balance risk transfer and affordability and the identification of any industry, taxation or regulatory impediments to developing cost effective products that enable individuals to manage longevity risk.

Longevity risk therefore is an important issue, presenting an opportunity for innovation by the superannuation industry. It is also an important issue to get right given the rapidly rising numbers of retirees. In particular, we do not want longevity risk 'solutions' that lock retirees into inappropriately high fees and fail to provide sufficient incentives for the superannuation industry to become more efficient.

Thank you.

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[5] See Squam Lake Working Group on Financial Regulation, 2009, 'Regulation of Retirement Saving', Working Paper, July, page 4.