PERSPECTIVE

More reforms could mean

Regulation targeting perceived problem areas could be detrimental, write **Patrick Durkin** and **John Kehoe**.

While consumers and politicians celebrated victory over the Big Four banks this week when the National Australia Bank, Westpac Banking Corp and Commonwealth Bank of Australia took a $1 billion hit to revenue by cutting their fees, insiders sounded a note of caution.

Rather than altruism, a driving factor behind the surprise cuts was getting in before the Rudd government's new unfair contract laws which meant from January next year, the fees could be challenged in the courts. The fees cuts will be passed on to customers elsewhere, they warn.

Leading bankers say the public should be made aware that a direct impact of unfair contract laws and other financial regulations will be tighter lending conditions for business, commercial property and other borrowers.

Bankrupt developers such as Barry Ingleton have already been hit by the banks raising the bar on lending. He claims his "still viable" $140 million project just south of Brisbane at Springfield Lakes was almost complete when the loan to valuation ratios shifted and the bank called in the receivers last month.

In the final instalment of the

billions of dollars in working capital to the sector.

Prominent Perth property developer Luke Saraceni, whose company is completing a $500 million office and retail tower in the heart of the city, says a reluctance by banks to lend on property developments will starve the city of new projects.

"By the middle of next year there will be no more cranes on the skyline," he said recently.

Developers across the country have watched similar projects delayed or frozen as the banks tighten their lending conditions, including Melbourne's $700 million Bourke Junction ISPT/Cbus Property joint venture, and in Perth 100,000 square metres of planned office developments have been suspended.

Banks complain they are already dealing with a wave of new regulatory reform, including

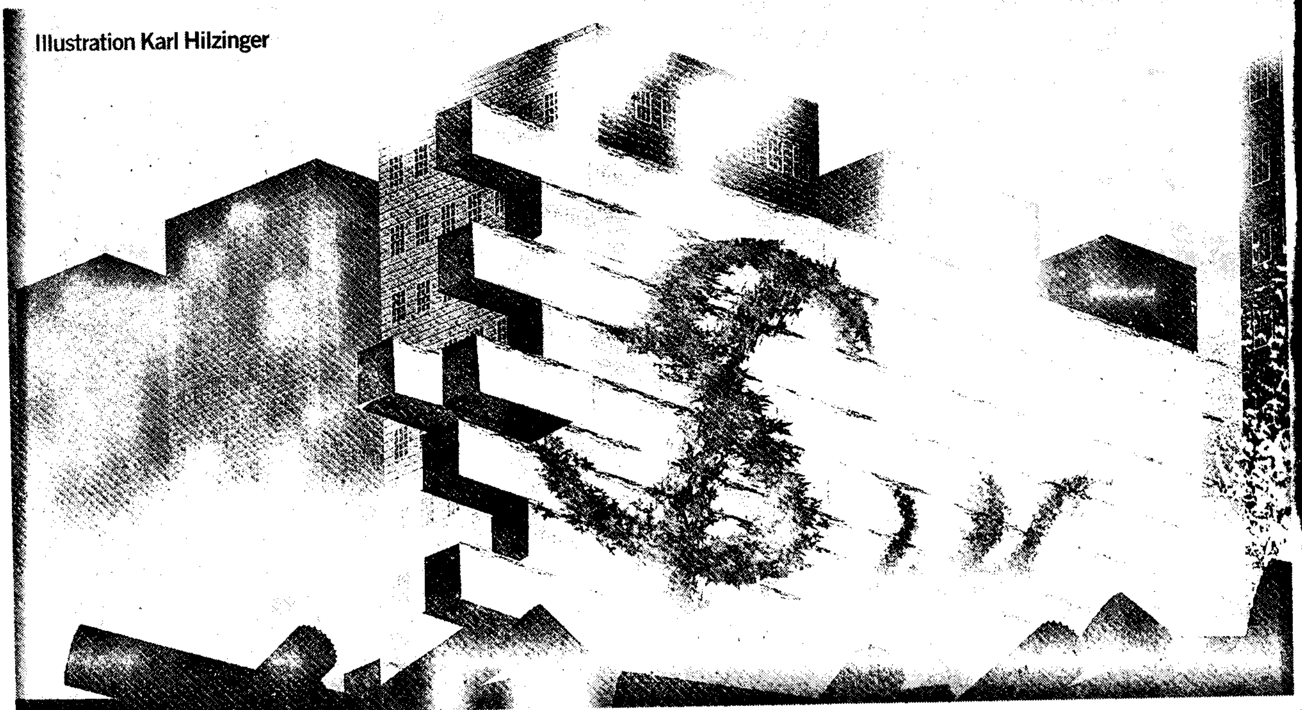
Illustration Karl Hilzinger

1997 Wallis inquiry. Wallis inquiry member and the inaugural chairman of the Australian Prudential Regulation Authority Professor Jeffrey Carmichael says Australia was "going to have to live" with some of the international "backlash" on financial regulation stemming from the crisis.

"Regulation is costly both in terms of direct agency costs to set up APRA and ASIC and also the indirect costs of the buyers and sellers of regulated products," he

NAB finance director Mark Joiner says that if there was an overreaction on the detail of regulation, the government would thwart its stated objective of becoming a financial services hub in Asia.

"Australia has this aspiration to become a banking centre and that is another reason for regulators and the government to find a happy medium, between what is good for the system and what is safe for the system," he says. "If

other, you are never going to achieve the aim of encouraging people to set up here."

The government is in the process of taking over responsibility from the states for all forms of credit lending, including mortgage broking, trustee companies, margin loans, non-deposit institutions and consumer credit.

The consumer credit regime introduces new licensing conditions, harsher civil and

the loan to valuation ratios shifted and the bank called in the receivers last month.

In the final instalment of the three-part *Weekend AFR* series, leading bankers and company directors warn while the initial slowdown in lending has been driven by the global shortage of credit, new financial regulation could further constrict lending, raise the cost of capital and stop new businesses starting up or expanding at the very time funding is most needed to kickstart the economy.

Governance experts argue reforms are necessary to ensure greater protection for investors who have lost billions.

The commercial property sector is concerned about looming higher bank capital buffers and the imposition of heavy-handed regulation in the wake of a string of high-profile collapses involving managed investment schemes, unlisted property funds and mortgage trusts, that provide suspended.

Banks complain they are already dealing with a wave of new regulatory reform, including responsible lending provisions, unfair contract laws and international changes to capital requirements to take more account of risky assets.

There is concern that political momentum is building for more change.

Macquarie Group director and Origin Energy chairman Kevin McCann warns there is a "blizzard" of regulatory proposals that will heighten the risk of stifling credit markets.

"We need to make sure the regulatory responses are appropriate and do not have a chilling effect on innovation in financial service provision or place Australian companies at a disadvantage," he says.

Australia's financial system has not come under such close scrutiny since the collapse of HIH Insurance eight years ago and the "Regulation is costly both in terms of direct agency costs to set up APRA and ASIC and also the indirect costs of the buyers and sellers of regulated products," he says. "That's the one that is very hard to measure and very often overlooked."

ASIC recently launched an investor awareness campaign to classify financial products as "between the flags" or "outside the flags". The $7 billion unlisted and unrated debenture sector, mortgage trusts, illiquid assets, undiversified investments and leveraged products have been deemed to be outside the flags.

A parliamentary inquiry is scrutinising managed investment schemes, financial products and commission payments, in the wake of the collapse of MIS such as Timbercorp and Great Southern, property finance companies such as Westpoint and Fincorp, stockbroker Opes Prime and Queensland-based Storm Financial.

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Martin Fahy, Finsia

non-deposit institutions and consumer credit.

• The consumer credit regime introduces new licensing conditions, harsher civil and criminal penalties for lender misconduct and a set of responsible lending conduct obligations that take effect from January 2011. For the first time, the laws require the banks to "prove" what steps were taken in lending finance, imposing a new onerous record-keeping regime. Strict laws for the $30 billion margin lending industry have also been introduced.

The government says it is cutting red tape. It has made changes so 20 per cent of foreign investors may sidestep the Foreign Investment Review Board approval process and ASIC has boosted – to $15,000 – the amount of stock retail investors can buy through companies' capital raisings. These measures should assist in injecting equity capital.

However, banks warn the new

Striking the right balance between

ASIC chairman Tony D'Alosio
FBA 030

Comment
Tony D'Alosio

There have been calls for changes to financial sector and capital markets regulation since the global financial crisis, with some suggesting substantially more protection for retail investors.

The current approach to regulation and its underlying philosophy emanates from the terms of reference for the Campbell and Wallis inquiries, which emphasised competition, efficiency, neutrality, integrity and fairness as well as financial stability and prudence.

The nub of the terms of reference was a search for a lower cost of capital and an increase in the availability of funding sources, which were seen to combine to increase Australia's sustainable economic growth rate.

The means of achieving such a desired outcome was deregulation, allowing markets to work and participants to decide on investments in their own best interest after suitable disclosure, with regulatory intervention confined to the extent possible to correcting instances of market failure. This was embodied in the "twin peaks" model of regulation between the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission.

The underlying philosophy has been "efficient markets theory", the great body of finance and economic thought that emerged in the era after World War II. Within this general rubric comes portfolio theory, the efficient markets hypothesis, the capital asset pricing model, insights on option pricing and corporate finance and more. The assumptions underlying the theories of course seem extreme – as with any simplifying model – including zero transaction costs or taxes; many market participants all with similar complete information; no collusion or abusive behaviour; no finance constraints; a complete range of risk products; and so forth.

The point to focus on is not the difficulties. Instead the point is that the assumptions underlying efficient markets theory are inherently fair as well as idealistic and are therefore a legitimate aspiration or goal for regulators.

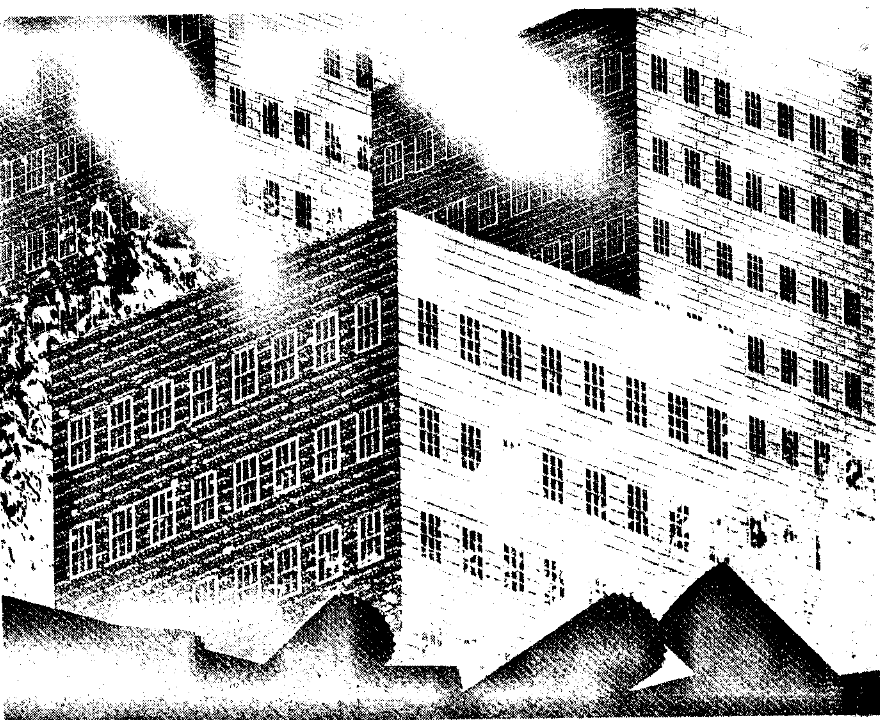
What could be fairer, so the proponents argue, than requiring continuous disclosure to inform all investors equally, enforcing laws against insider trading, encouraging access to all forms of investment products for all investors after proper disclosure of risks and so on?

It is for the government to decide whether to shift the philosophy underlying the Corporations Act.

In making that decision, the government of course would have regard to the trade-off between safety for investors and efficiency for the markets.

The government needs to assess the likely impact on the cost of

tighter credit



regulatory laws tabled in parliament for far-reaching unfair contract protection will introduce significant uncertainty and costs for the financial services sector.

Experts say the upcoming changes have put pressure on three of the Big Four banks to cut penalty fees and the Australia and New Zealand Banking Group is expected to follow.

While the cuts have been widely applauded, some warn that

reduce debt capacity in the system and can only increase the cost of debt."

But Michael Wood, a capital markets analyst and partner at Quadrant Real Estate Advisors, says most of the property sector over the past few years had ignored the looming Basel II capital adequacy requirements at their peril.

"Real estate is generally an unrated security and so the capital

appeared before a parliamentary inquiry into MIS last month. He also questioned whether retail investors should be banned from investing in some opaque linked market investments.

The Property Council's Fitzgerald warns any extension of prudential regulation into MIS would increase the cost of capital and reduce Australia's global competitiveness.

"There are over 5000 registered managed investment schemes in Australia with $1 trillion funds under management. This covers all mainstream asset classes including cash, bonds, equities, mortgages and property.

"There are less than 500 agribusiness schemes which have raised less than $10 billion. Any reform debate should be taken in this context."

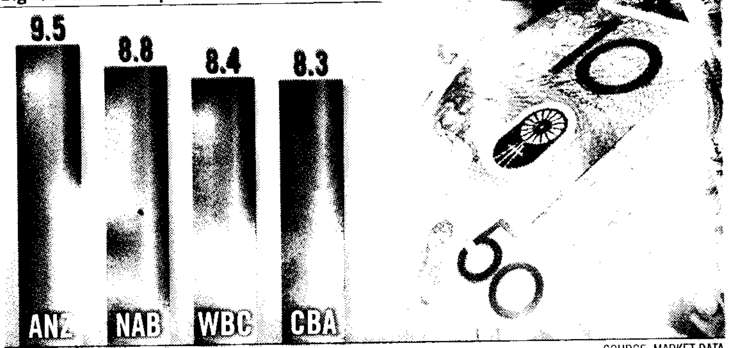
But Andrew Griffin, chief executive of Balmain Trilogy, which has taken control of collapsed Gold Coast-based financier City Pacific's First Mortgage Fund, said that, paradoxically, some extra light touch regulation of mortgage funds and MIS could boost investor confidence and increase the flow of funds to reputable entities at the expense of less scrupulous players.

"Otherwise, managed investment schemes will remain second-class corporate citizens and that's not what they should be."

His position stems from concern over related party transactions that plagued Westpoint and City

Target practice

Big four tier one capital ratios (%)



SOURCE: MARKET DATA

Too much of a good thing may do harm

Bank capital

Katja Bührer

When it comes to the regulatory backlash facing banks in the aftermath of the financial crisis, Australian lenders find themselves in an unusual position.

While northern hemisphere regulators seek to lift mandatory capital levels to prevent a repeat of the crisis, the local regulator has cautioned that too much capital may restrict lending.

Australia's major lenders sit comfortably above the regulatory minimum and most bank analysts agree they are sufficiently capitalised.

Recent equity raisings by

consistency but has actually resulted in greater diversity among regulators," he says.

Basel 2 is the second set of recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. They are designed to create an international standard that regulators can use to determine bank capital levels.

NAB group treasurer Eric Williamson agrees tier one capital should be a dynamic measure. "The future regulatory response will be a factor here but on balance it is not unreasonable to expect banks to hold more capital on average through the cycle under Basel 2."

While the move by Australian lenders to bump up their capital ratios is regarded as a prudent

and the Australia and New Zealand Banking Group is expected to follow.

While the cuts have been widely applauded, some warn that borrowers would be naive to think the changes won't flow through to tighter lending conditions.

Legal director of the Australian Bankers Association Ian Gilbert says that ASIC guidelines on what will constitute responsible lending will hold the key to whether the right balance is struck.

"As the demand for credit is slowing, the worst thing that can happen is you come in on the supply side and crank up excessively the supply of credit."

The commercial property sector is already reeling from the soft economy, depressed asset prices and tight-fisted banks. It's worried the looming higher bank capital buffers will further constrict the flow of finance.

Property Council of Australia capital markets director Roberto Fitzgerald says: "Any increase in banking regulation would further ignored the looming Basel II capital adequacy requirements at their peril.

"Real estate is generally an unrated security and so the capital adequacy requirements of Basel II are far in excess of any other exposures the banks have," he says. "I think it will have a significant impact on real estate as we come out of this cycle."

The demise of Fincorp and Westpoint, which collapsed three years ago owing 4300 investors more than $390 million, have compounded the loss of investor confidence in the property financing sector.

The property industry believes the intense regulatory scrutiny now being applied to MIS following the collapse of agribusiness players could give further rise to a cut in available capital.

ASIC chairman Tony D'Aloisio raised the possibility of expanding prudential regulation – which applies to banks and insurance companies – to other forms of investment such as MIS, when he schemes will remain second-class corporate citizens and that's not what they should be."

His position stems from concern over related party transactions that plagued Westpoint and City Pacific, where those financiers were, in effect, lenders and shareholders in the same project.

Leading industry body, the Financial Services Institute of Australasia, is concerned more piecemeal regulation targeting perceived problem areas including mortgage trusts, hedge funds, contracts for difference and securitisation, could be detrimental if undertaken without considering the broader structural framework that has served Australia well during the financial crisis.

"These were black swan events," Finsia chief executive Martin Fahy said.

"Do you want to build your regulatory system for those black swan events and carry all the cost of that or is there a sensible [alternative]?"

Australia's major lenders sit comfortably above the regulatory minimum and most bank analysts agree they are sufficiently capitalised.

Recent equity raisings by National Australia Bank and Australia and New Zealand Banking Group lifted their capital ratios closer to 9 per cent, compared with an average of about 8.3 per cent for the remaining Big Four, which is seen as sufficient to buttress them against uncertain trading conditions.

But even though the local banking system may have emerged relatively unscathed from the global turmoil, Australia will inevitably have to respond to international reviews arguing for a higher capital buffer and a narrower interpretation of tier one capital.

Most regulators think building up capital buffers as the economy recovers is the best tactic to safeguard the banking system.

The Australian Prudential Regulation Authority (APRA) wrote to banks last month informing them it would implement rules determined in Switzerland that would force banks to set aside more capital and make more disclosure on complex investments such as collateralised debt obligations (CDOs) and off-balance-sheet entities. Local bank treasurers support the changes.

"We'd generally agree with the philosophy of putting aside more capital in the good years to compensate for losses in the bad years," ANZ treasurer Rick Moscati says. "The challenge arises in setting the appropriate size of that buffer."

Moscati says ANZ is supportive of a standardisation of capital rules and the definition of capital, which would enable investors to compare bank capital ratios across different geographies and regimes.

"It is critical we have a level playing field. Basel 2 promised to expect banks to hold more capital on average through the cycle under Basel 2."

While the move by Australian lenders to bump up their capital ratios is regarded as a prudent approach to a tough economic environment, the longer term effect on the economy is a source of concern to regulators.

APRA general manager Wayne Byers told an overseas audience recently that market pressure to keep capital ratios high following the 1990s recession had slowed recovery. It is a sentiment echoed by APRA chairman John Laker, who in February cautioned banks against "getting caught up in a macho race to the top simply in reaction to market sentiment".

The concern that banks may have to curtail their lending – constraining a broader economic recovery – to support higher capital ratios is not one shared by the Big Four's treasurers.

"The recovery will be dependent on the willingness and ability of banks to lend and this is only possible if banks are well capitalised," ANZ's Moscati says.

"Discussion about banks being overcapitalised or holding too much capital is probably a little academic, particularly at this stage of the economic cycle."

Increasing capital levels have put a focus back on bank profitability, as surplus capital places downward pressure on a lender's return on equity.

The official tier one standard is 4 per cent. Rather than raising minimum capital requirements, the impending rules on complex financial instruments such as CDOs are expected to lower tier one capital ratios slightly, in particular for ANZ and NAB, which have exposure to these instruments.

Kevin Davis, who holds the Commonwealth Bank chair of finance at the University of Melbourne, says the changes may eliminate any need for an increase to the local regulatory minimum capital ratio.

regulation and efficiency

capital and on potential economic growth if the thrust of regulation is shifted from its reliance on markets to a greater role for the regulator as a driver of behaviour. The chances are that less efficiency would raise the cost of capital and lower the potential growth rate. However, the upside would be better investor protection and this goal is important when one sees the damage caused to retail investors by recent collapses.

Changing the approach to regulation towards greater regulatory intervention and less reliance on markets could risk making regulation more arbitrary.

The arbitrariness is clear if we ask just how "risk-less" a product needs to be so that it can be described by the regulator as "safe". What if someone lost money on such a product? How "safe" is that?

When trying to influence investor behaviour, it should be no surprise if investor behaviour changed – possibly quite perversely – as apparent responsibilities for investment decisions change.

In ASIC's view, altering the mandate for regulation should be a decision of the government, not the regulator. Until that happens, ASIC will continue to work with the current policy settings.

That is not to say that we, ASIC, cannot do better. We have reassessed and introduced a number of improvements, the benefits of which have been coming through.

There are several inquiries on regulatory issues that are in train or in prospect which can review the trade-off between stability/safety and efficiency in the area of regulatory change that those inquiries are investigating.

They should assess that trade-off before making their recommendations to government. ASIC will cover that in its submissions to those inquiries and include options to better protect retail investors.

Until ASIC's mandate is changed, an efficient and a fair market remains its goal with a focus on protecting retail investors.

Tony D'Alosio is chairman of the Australian Securities and Investments Commission.

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