Stability versus competition

Since the Global Financial Crisis, financial stability has been at a premium compared with financial innovation and competitiveness. This is not just because financial regulators have had the upper hand as governments move to restore public confidence in their battered financial systems. Market players have themselves sought out security and stability, delivering in the process some of the lowest yields on government securities ever seen.

With the shock of convulsing financial markets fresh in the collective memory, it is hardly surprising that safe harbours are in demand or that reminders of the need for competition and innovation in financial systems fall on deaf ears. It is also no surprise that the swing towards stability favours financial institutions that are already large, either because size itself renders them less susceptible to the vicissitudes of the market or because, explicitly or implicitly, they are seen as 'too big to fail' by governments.

Yet what makes for stability in financial systems can dampen pressures for competitiveness and efficiency – there is a balance to be struck. The difficulty in striking this balance is that the costs of instability are all too apparent, often taking the form of failed financial institutions imposing substantial losses on investors, savers and taxpayers, whereas the costs of too little competition and innovation take longer to emerge.

The costs of intrusive regulation of Australia's banking system following World War II took thirty years to emerge and prompted a re-think only when people tired of high-cost, unresponsive and uncompetitive banking services. This was despite the obvious truth that no depositor had lost a cent through bank failures during the same thirty-year period. When the system was deregulated following the Campbell Report in the early 1980s, it became both more competitive and more innovative but also less stable – the first bank failures in decades were recorded in the early 1990s.

The hard yards Australia's non-banks have put in to make competitive headway since the GFC are one indication of the triumph of stability over competitiveness. The competitive edge that mortgage securitisers brought to home-lending markets has all but disappeared. Mutuals, including credit unions and building societies, have struggled to remain competitive as markets raise their wholesale funding costs relative to larger institutions, perceived as more stable; and regulators, in the name of stability, resist accommodating mutuals by allowing them to raise common equity to meet stricter capital standards.

The result is a steady consolidation of mutuals, as the small and the weak abandon the chase. No doubt some of this would have occurred anyway but, like the canary in the coal mine, it could also signify a deterioration in competitive conditions in Australia's financial system as economies of scale are reinforced by market and regulatory preferences for stability and size.

The Australian Government is not unaware of recent trends and has sought to redress the imbalance with a number of initiatives, including support for securitisation markets through the Australian Office of Financial Management and measures to support consumer choice in mortgage and deposit markets. These measures have been well intentioned but appear to have made little difference to the outlook for securitised lenders and mutuals.

For this reason another inquiry into the Australian Financial System along the lines of the Campbell and Wallis inquiries has been called for. Re-setting the balance between stability and competition cannot be done by piecemeal intervention but requires a system-wide approach. The various measures that might be tried must be considered in the broader context of the desirable trajectory for Australia's financial system over time if the chances of unforeseen consequences are to be minimised.

In any case, it's now fifteen years since the Wallis Inquiry reported in 1997. Much has happened in financial markets since then, including the GFC, and not all of this was anticipated by the Wallis Committee. While it is true that our financial regulations held up extremely well by international standards during the GFC, we are nevertheless acceding to regulatory reforms required by international agencies designed to remedy ills from which we did not suffer.

Without a blueprint for financial regulation, such as that supplied by the Campbell and Wallis Committees, how can we be certain that the regulatory demands of global regulatory agencies are taking the Australian financial system where we want it to go? We could always leave such decisions to the experts within our regulatory agencies but regulators will always set greater store by stability than competition.

Very few regulators have ever been sacked for overseeing a system which lacks competition and innovation. Promoting efficiency and productivity in Australia's financial system, without compromising its stability, is the ideal brief for a new financial system inquiry.

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