PRUDENTIAL CONTROL OVER THE BANKING SYSTEM: FAILURE OR SUCCESS

By

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> "It is the duty of the board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank under this Act, the Banking Act 1959 and the regulations under that Act are exercised in such a manner as, in the opinion of the board, will best contribute to the stability of the currency of Australia; the maintenance of full employment in Australia; and the economic prosperity and welfare of the people of Australia."
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> **Reserve Bank Act 1959**

This Reserve Bank of Australia (RBA) charter is broad and provides the Reserve Bank governor and board with flexibility. This, however, has not stopped commentators questioning controls over the banking system.

The prudential system over the banking sector has been controversial since the white settlement of Australia. We have gone 200 years depending upon market circumstances and the current political philosophy at the time.

There have been calls for greater regulation of banks during the times of financial and economic stress, such as during the 1840s, the 1890s, the 1930s and 1990s. This results from a view that banks should be under the effective control of the political process rather than the bankers themselves. The control of people's purse-strings is always a potent factor in politics because market forces dictate that winners - successful business people and householders who meet their financial commitments -receive preference.

The chief reason for prudential controls over the financial system is to maintain confidence in that system and to ensure, as far as possible, that banks can be relied upon to meet depositors' requests for withdrawals when required. A collapse in confidence in the banking system would reduce economic activity and raise unemployment severely. This would be unacceptable. A free market alternative, therefore, is not favoured lest it lead to the failure of banks. The public still perceives banks, whether trading or savings, as having a Reserve Bank guarantee and, accordingly, government guarantee. This view is incorrect. Effectively, a bank can go theoretically into receivership in this country. The Reserve Bank would avoid this because of the effect on confidence and its own financial acumen.

Since the late 1980s, there has been criticism that the Reserve Bank has been slow regulating the banks and has allowed imprudent bank lending, causing losses to shareholders. The question to be raised is whether banks should be regulated. If not, would the public permit a bank to collapse and depositors to lose possibly all their money?

History shows this country would not countenance the operation of a totally free market in the financial system. It encourages a more collectivist approach whereby banks must obey certain rules and follow Reserve Bank dictates. In return, banks are regarded as the premier financial institutions in the country having a dominant market share.

Many commentators have confused the term "deregulation" of the financial system as argued in the Campbell and Martin Committees of Inquiry to mean the banking system has no rules. This is patently incorrect because the Reserve Bank has merely altered the system from quantitative controls on interest rates and loans to qualitative restrictions such as the capital adequacy rules to improve the quality of a bank's portfolio of assets. It has extended this to annual discussion with banks' auditors and restricted large exposures relative to a bank's capital base.

Our financial system is not deregulated, as many commentators assume. The Reserve Bank has changed its form of regulation to encourage efficiency and provide discipline to financial institutions. What is of proper public concern, however, is how the Reserve Bank should prudently monitor banks and implement monetary policy.

This implies that monetary policy has become broader in effect because of greater price competition. This has allowed the Reserve Bank and, hence, the Federal Treasurer, more influence over the financial system as a whole. It has allowed the giants of the financial system, such as the four major banks and the two major insurance companies, to have a larger share of the market and throttle their competition. They can now outbid their smaller competitors if they do not have a market niche.

Capital adequacy rules

Since 1988, the Reserve Bank of Australia has introduced a prudential rule called "Capital Adequacy Requirement" which all major developed countries have adopted to control their banking systems.

The aim is to encourage banks to become more prudent in their lending by requiring certain classifications of risk-weighted assets to be covered by capital requirements. This implies that certain lending propositions are favoured over others, vis-à-vis:

Asset type	**Capital required**
Owner-occupied housing	4%
Business lending	8%
Claims on governments	0.2%
Claims on banks	2%

The owner-occupier housing requirements have been raised recently by the RBA for borrowers with debt levels exceeding 80%. Despite this, there is still a bias towards housing overall.

The question raised is the impact these requirements have on the financial system. The rule has a deliberate bias toward safe, "unproductive" lending and does not favour business lending. In fact, it does not distinguish between lending to BHP or the corner store in terms of risk on the amount of capital required.

It is ridiculous to evaluate risk in these terms because capital has a scarcity value in this country and, therefore, is expensive. Hence, it is passed on to the customer in most cases.

These broad-based rules were forced upon the banking system by the RBA to ensure the taxpayer more than likely would not have to support a bank financially. The shareholders, not the taxpayer, wear any losses for bad debts made by management. The Reserve Bank can increase the capital required if it considers a bank's portfolio is at risk.

Regulation of the financial system in the past has encouraged relatively large banks to develop because the Reserve Bank prefers to deal with a few players rather than many. The advantage of this is that a bank's lending portfolio is spread over a wide cross-section of industry and geographic base rather than on a segmented, regional base, such as in the USA. This avoids having banks overly exposed to certain industries/regions compared with their capital base.

Of course, this risk was not considered when the Treasurer, Mr Keating, in 1985, permitted more foreign banks to compete against the domestic majors. These newly licensed banks, with expanded capital bases, were permitted to lend but chiefly restricted themselves to lending to the more "entrepreneurial" end of the market. In other words, the foreign banks had a lending portfolio skewed to certain industries such as commercial property and risk-taking individuals.

Hence, the Reserve Bank was not aware, apparently, that this could be a major risk. As the Reserve Bank's activities are shrouded in secrecy, it is not known really whether the Reserve Bank was aware of the content of each bank's portfolio.

Control of a bank

The control of a bank has always been a controversial issue and for this reason it is important to have clear guidelines that everyone understands.

I believe no single individual should influence the destiny of a bank because it receives confidential information from customers and if a large individual shareholder controls a bank via the board, it could use this information for personal gain. The perception of possible conflict of interest must be avoided.

Also, self-gain might influence that shareholder against the community interest. An instance of this recently was the proposal of Mr Kerry Packer and Mr Al Dunlop to the Westpac board to curtail the bank's asset base/staff numbers severely to bolster the Packer interest's recent share purchases for a quick capital gain. The Westpac board rightly rejected the dictates of this highly influential and talented man because it would imply that the community would suffer in a greater fashion than the bank has publicly announced.

It is not pleasant for bank managers to tell customers to repay their debt because the strategy of the bank is to reduce its lending portfolio, that is, downsize because a shareholder/director demands it. Bank staff also become dispensable because of mere circumstance. It might be short-term gain but longer-term disaster for business if banks were run strictly to Mr Packer's whim and not to levels considered prudent, given the customers' and bank's circumstances.

Indeed, what was surprising in this entire issue was the Reserve Bank's willingness to permit Mr Packer and his nominees board representation. The same could be said for the AMP Society board representatives.

No bank board should be influenced by shareholder interest in terms of the organisation that put the director/s there in the first place. It must be seen by the public to be independent. Board members should be diligent, hardworking, impartial members of the community with a firm grasp of business. This is not to say a bank's board should ignore shareholders but directors should be seen to be impartial and independent in their decisions on customers.

The Reserve Bank should be made accountable for permitting the Westpac board to be tied to self-interest. It is reputed that the Reserve Bank did not permit Mr John Spalvins to become a director of the National Australia Bank or Mr John Elliott to establish the Elderbank in Australia during the 1980s because of these concerns.

Also, the issue of impartiality in business dealings raises its head. Mr Packer's interests are known to be those of Westpac's larger customers. There is the problem of avoiding "special deals" based upon a shareholder and directors of a bank and possible abuses in business arrangements. These concerns are theoretical at present. I am not suggesting Mr Packer has done this but there have been cases in the USA where rules are more lenient on shareholder/directors of a bank.

A preferable course in this country is not to allow nominees of major shareholders to be directors of a bank. This avoids potential issues of partiality in business arrangements that could imply corruption and fraud, such as occur in banking circles in the USA.

Central banking legislation

In 1957-1959, Mr Arthur Fadden, the then Federal Treasurer and Country Party Leader, prepared the legislation to establish the Reserve Bank of Australia. He retired in 1959 so his successor, Mr Harold Holt, piloted the banking legislation through Federal Parliament. However, the establishment of our central banking system was the work of Arthur Fadden, who was heavily influenced by Sir Earle Page, another former leader. In effect, the Country Party (later the National Party) organised the development of our financial system and this influence should continue to be beneficial.

In the interests of the public accountability of the Reserve Bank, the National Party should insist that the legislation be amended to ensure that the governor, board members of the Reserve Bank and any other RBA public servants be required, on a periodic basis, to justify the bank's policy stances before Parliament. This would enable the wider public to become aware of how the Reserve Bank was implementing monetary policy and what influences were being brought to bear upon public servants by the government of the day. This change should be enforced by legislation.

Also, it would bring to public scrutiny the views of the bank officials and why they undertake certain tasks and not others. In terms of proper accountability under the Westminster System, this course would be much preferred to the nebulous concept espoused by Dr Hewson of an "independent" Reserve Bank which could still be influenced by the Government through the power/authority of appointment of individuals.

A charter specifying the conditions whereby the Reserve Bank must act in a certain fashion could make it even more non-accountable to the public as it could operate contrary to the public's wishes at the time.

In effect, what is argued here is that the Reserve Bank should be democratised to ensure the public is aware when changes to monetary policy and prudential controls are being made. Had this safeguard been introduced, the then Treasurer, Mr Keating, during the crippling interest rate escalation of the late 1980s, would not have been able to deny for so long that the strategy was to raise rates. The introduction of strict public sessions during which the Reserve Bank must state its case to Parliament and be scrutinised by politicians and, ultimately, media commentators and the public, must be an improvement on the present method by which our financial system is regulated. Public accountability could only enhance this process.

Non-banking financial institutions (NBFI)

The National Party should encourage a uniformity of standards, not just for banks, but for building societies and credit unions. For efficiency and control reasons, they should come under the auspices of the Reserve Bank rather than their respective state jurisdictions.

This would minimise the fiasco of a Pyramid Building Society collapse such as occurred in Victoria as a result of poor administration of prudential rules. The power was there to check the viability of the society but the funding and competency of those in control left a lot to be desired.

To facilitate public accountability, building societies and credit unions, which have the same borrowing and lending functions as banks, should face the same control and those
that fail should be absorbed into other financial institutions or placed under the statutory control of the Reserve Bank of Australia.

Overall banking controls

Any rules introduced to control the banking sector will require continual review and adjustment because markets attempt legally to get around restrictions if there is a profit to be made in doing so. There is nothing wrong in this provided the Reserve Bank of Australia justifies this publicly before Parliament with questioning by our elected representatives.

This form of communication would be assisted with the publication, in edited form, of board minutes after a certain time had elapsed. In that way, Reserve Bank directors would know decisions made would be viewed later by the interested public.

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