Australia's Murray inquiry could transform industry

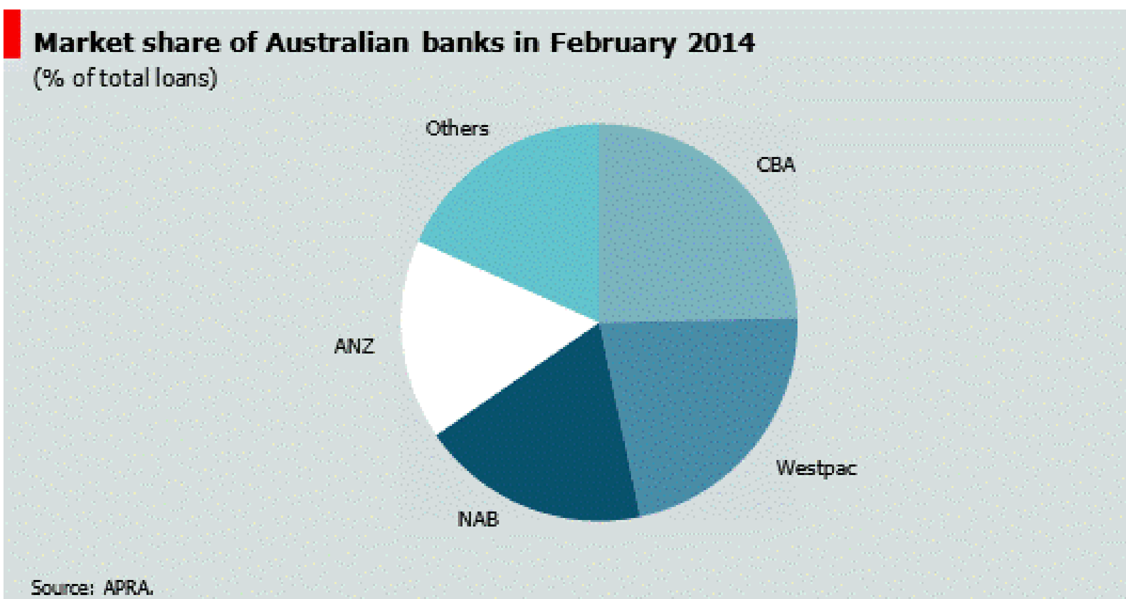
April 17th 2014 | Australia | Financial regulation

The Australian government's Financial System Inquiry is due to be delivered in November 2014. This report—the third major review of financial governance since 1981—could affect lending patterns at Australia's major lenders, and see changes made to the superannuation industry. The extent to which the inquiry's recommendations are implemented, however, will depend on their palatability in an increasingly risk-averse political landscape.

The inquiry—also known as the Murray Inquiry after its head, former banker David Murray—was launched in November 2013. Final submissions were due by end-March, with an interim report expected in mid-2014, before the final report is delivered later this year. The inquiry's mandate is broad and potentially has the power to reshape the industry; Australia's Treasurer, Joe Hockey, has termed it a "root and branch" investigation which will recommend policy options to promote the efficient allocation of capital and overall stability of the financial system. The issue of competition, in a banking landscape dominated by a handful of players, is also likely to loom large over the inquiry.

Addressing the domestic funding gap

Australia is dominated by the "Big Four" major banks, the Australian and New Zealand Banking Corporation ("ANZ"), the Commonwealth Bank of Australia ("CBA"), the National Australia Bank ("NAB") and the Westpac Banking Corporation ("Westpac").



Over the past decade, an estimated funding gap of A$600 billion (US$560bn) emerged between the loan and the deposit bases of Australian banks. The Big Four have filled this funding gap by tapping domestic and international debt markets. However, amid stricter regulations (such as an increase in capital requirements) and pressure from ratings agencies, banks may find it difficult to tap debt markets. Requiring funding from international sources also exposes the domestic banking sector to global capital market volatility. One key focus of the Murray inquiry will be to evaluate ways to minimise this exposure by enhancing other sources of funding.

There are several options for filling this funding gap that the Murray inquiry is likely to explore. This includes providing a tax incentive to increase the pool of deposits in Australian banks. Since the financial crisis, the household savings rate (gross household savings as a percentage of gross disposable income) in Australia has improved dramatically. A new [paper] released by the Reserve Bank of Australia (RBA, the central bank) indicates that this improvement was the result of an increase in saving behaviour, rather than an increase in the number of households which are likely to save. It appears that Australians are quick to respond to economic signals—a promising indication for policymakers.

According to the RBA, bank deposits have also risen, growing by an average of 12% annually in the past decade, particularly in recent years amid private-sector deleveraging. Incentivising people to make deposits could provide a cheaper source of capital for banks; however, this would come at the expense of reduced tax revenue. Indeed, this was one of the several recommendations made in 2010 by the Future Tax System Review (Henry review). However, political factors and Australia's ballooning budget deficits led to most recommendations of the Henry review being shelved. Some of the Henry review's proposals could now be revived under the Murray inquiry, now that a stronger government is in place (the current Liberal-National coalition has a bigger majority in parliament than the previous Labor government).

Another challenge that the Murray inquiry is expected to touch upon is getting Australia's superannuation funds to invest in local debt. The domestic superannuation pool is one of the largest in the world, currently standing at A$1.7trn (US$1.6trn). However, the industry has had a historical bias towards equities, which has been attributed to Australia's dividend imputation credit incentive—under which investors are not taxed on their dividend income—and a shallow domestic debt market.

New financial regulation

The Murray inquiry will also focus on the implementation of Basel III—a set of capital accords due to take effect in 2019. Some submissions to the inquiry argue that the interpretation of Basel III's minimum capital requirements by the Australian Prudential Regulation Authority (APRA) are overly restrictive, distorting both the domestic banking sector and Australia's competitiveness vis-à-vis other financial hubs. APRA, the RBA and the Department of the Treasury, however, counter that these strict capital requirements proved beneficial during the financial crisis. Almost any recommendations on reducing Australia's exposure to global markets will involve tweaks to fiscal policy, and are expected to inform a broader government white paper on tax reform, due in 2015.

Banks, particularly Australia's Big Four, have also been criticised by business leaders for shunning the corporate sector to focus on the more profitable domestic housing market. Increasing access to funding for small and medium enterprises (SMEs) is another objective of the Murray inquiry, and, indeed, a priority for the government.

The shadow of previous inquiries

The impact of previous inquiries and tax reviews has been mixed, depending on the influence exerted by interest groups and political appetite at the time. The previous Financial System Inquiry (the Wallis inquiry of 1997) ushered in significant changes to financial governance. It led to the establishment of APRA, with oversight of the banking, insurance and superannuation industries, as well as the modernisation of the Australian Securities and Investment Commission (ASIC). The Wallis inquiry was commissioned by the new Liberal-National coalition government in 1996, nearly two decades after the original Campbell inquiry (in 1981). Appetite for reform within the financial services industry was high during the Wallis inquiry, and the eventual changes in governance structures were welcomed, partly because they did not pose a substantial threat to any powerful stakeholders.

In contrast, the Henry review (2010) saw only a few of its recommendations—notably the carbon tax and a tax on mining incomes—implemented, and that too only after they had been watered down by political considerations. Indeed, both these measures now look set to be overturned by the subsequent coalition government which came to power in 2013.

The Murray inquiry is expected to touch upon the same fiscal issues raised during the Henry review. Its recommendations will likely affect the banking and superannuation industries, as well as the broader electorate. The banking industry, particularly the Big Four appear to be supportive of the Murray inquiry, especially regarding the review of financial regulation, which could improve their regional competitiveness, and the provision of a tax incentive to deposit holders, which would reduce their cost of capital. A reduction in regulatory capital requirements for banks would likely improve access to debt for Australian businesses, particularly SMEs. A shift towards business lending would bring Australian banks more in line with global trends, but could see a reduction in competition in the housing mortgage market. These moves, should they come to pass, could also open up new opportunities for smaller and regional Australian banks, although they are unlikely to have any significant influence on the inquiry's recommendations.

Overall, the inquiry could introduce shift in the financial services industry, towards more domestically-sourced capital. Adjustments to the implementation of Basel III regulation could also rebalance the lending practices of banks towards businesses, providing a much-needed boost to SMEs. Given its large majority in parliament, the coalition government is also expected to have more success than its predecessors in pushing through reforms. However, the government will need to balance the interests of the financial services industry, and its stated objective of supporting SMEs, against the need to maintain tax revenue, particularly if no large-scale fiscal reform is undertaken alongside the recommendations of the inquiry.

Source: Industry Briefing