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ON THE DRY SIDE 426

Re-regulating the Banks

John Hyde

The debacles among financial intermediaries---ranging through State Banks, merchant banks, property trusts, building societies and insurance companies---has encouraged calls for re-regulation of the financial markets. The sort of regulation being demanded is, however, about as useful as a security blanket and much more stifling.

Without doubt the 1980s saw some very silly lending and borrowing. It is easy to marvel at the lack of discipline of Tricontinental, Pyramid, the State Bank of South Australia, Rothwells and others. And it is true that more rigorous prudential control---whether from internal or external sources---could have prevented some of the particular errors that led to the mess that these institutions got themselves into. It does not follow, however, that government regulation would have, in fact, prevented the collapses. It did not, after all, prevent such spectacular failures as Reid Murray, Mainline, Cambridge Credit and FCA---all of which occurred before deregulation. Neither does it follow that the benefits of deregulation---a narrower spread between borrowing and lending rates, for instance---are not substantial, nor that the winking out of badly-managed intermediaries is not a good thing. And it certainly does not follow that the cost of financial re-regulation would be negligible.

There was a certain inevitability about what has happened. As Mr Des Moore of the IPA was pointing out long before the current spate of 'non-performing loans', the ACTU, by telling the Government not to reduce award wages or employ fiscal means to cool an overheated economy, was in effect telling it to rely on high interest rates. The elected arm of Government, in fact, did the ACTU's bidding under the aegis of Accord Mark whatever. And Mr Keating tells us the Reserve Bank does his bidding. Some business failures were what we had to have.

The existence of regulation often gives investors a false sense of security. While the Victorian legislation did not guarantee deposits in the Pyramid building societies it, and the unwise statement by the Treasurer, Mr Jolly, conveyed the impression to unsophisticated depositors that it did. Rothwells and Teachers Credit stories provide further examples of public belief that the existence of government supervision implied the existence of effective supervision. Regulation discouraged depositors from asking about the security of the deposit-accepting organisation.

Nor should we assume that regulation reduces skulduggery. Legal complexity often creates loopholes through which people with good lawyers and flexible ethics gain advantages over people with less accommodating morals.

The last thing Australia needs is regulation that puts capital formation into a strait-jacket. Far better for the economy that unwise depositors should lose money than that risk-taking is discouraged to the point where new ventures are unduly discouraged. High-risk financing has an undoubted economic function. (Long ago my grandfather declined to back HV Mackay the Sunshine Harvester manufacturer. It is well for Australia that somebody backed him.)

High-risk investments should not, however, masquerade as low-risk. And market-based institutional arrangements should help investors distinguish between the two. Unfortunately, regulation and public ownership have just the wrong effect.

John Hyde is Executive Director of the Australian Institute for Public Policy

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It is noteworthy that in this recession the public sector financial institutions have got themselves into rather more trouble than the private sector institutions. With the possible exception of the State Bank of NSW, and conceding that the R & I Bank in WA appears well on the way to recovery, the recent record of State Banks has been dreadful. It has been so bad because the State Banks backed semi-politicised local pipedreams. Perhaps they would not have done so if public ownership had not given their managements a false sense of security and a wish to please their particular government.

The public-sector executive who failed to give adequate attention to a report of non-performing loans because he had to attend the football was no more cavalier than the private-sector chief executive who went boat racing while his house of cards was collapsing. It is, however, sufficient for my case to note that being in the public sector does not necessarily entail responsible behaviour.

Late last year Des Moore made a compelling case that the financial sector's recent troubles were caused by too little, rather than too much, deregulation. More recent events do nothing to weaken that case.

Moore said then that while most controls have been lifted on the volume, direction and price of lending, other forms of government involvement---over and above the (unwise) management of wages and monetary policy---are undoubtedly distorting the decisions of financial intermediaries.

About one third of the assets in the banking system is in government-owned and controlled banks whose depositors have specific taxpayer-backed guarantees---hardly a 'level playing field'. Such guarantees encourage excessive risk taking. Further, State banks have consistently shown poor returns on their capital, which implies over-servicing or under-pricing. Fortunately, the Commonwealth Bank seems to have refrained from joining the State Banks in exploiting the guarantee. Goodness knows what financial mayhem may have been wreaked had it followed the example of, say, the State Bank of Victoria. To compete with the State banks, private banks must have behaved, as though they also enjoyed access to the taxpayers' pocket.

When the government-owned Bank of New Zealand got into deep water the Labour Party Minister for Finance of that it "was a classic case of what happens when there is no incentive to high-quality management of an enterprise. This is a textbook case for privatisation..." How true! And it is not the whole story.

Whatever the truth of the matter, it is widely believed that political considerations influenced the lending of at least Rothwells, The Teachers Credit Society of WA, the R & I Bank and the State Bank of Victoria. Ministers who do not control commercial organisations cannot be tempted to lean on managements. Nor can they be accused of doing so when, in fact, they have not.