THE CRISIS AND THE AUSTRALIAN FINANCIAL SECTOR

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Much material has been published on the 'global financial crisis', especially on its US roots. In Australia, there is a peculiar tension in the commentary that remains unarticulated. There co-exists a general complacency or optimism, especially in official circles, with documentation of a string of financially linked failures. The latter have been mostly treated in isolation (and mostly by journalists). [1]

This article summarises a representative range of business failures. The boom years facilitated widespread bravado, incompetence and unconscionability in Australian businesses that the finance sector has fostered and nurtured. A new class of unsophisticated investors has become victim of the rosy promises of 'shareholder capitalism'. One perverse byproduct has been the further consolidation in the Australian banking sector itself. The financial regulatory agencies are found to be inadequate. Recent mooted regulatory changes reflect the need felt for action by the Rudd Government, but the changes are piecemeal and have been contested by the relevant vested interests. The article concludes with the view that no deep inroads will be made into dysfunctional elements in Australian business culture, that the Australian financial sector will continue to abuse the public interest in the service of private

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1 There is an atypical dependence in what follows on journalistic accounts, essentially for detail. Academic commentary has been meagre and generally sanguine, comparable to the literature emanating from the regulatory agencies. Hawtrey (2009) is representative – a technically admirable coverage of nation-specific data, but which fails to delve into the murky depths that generate dissonance from the official happy story.

profit, and that the structure and culture of the financial regulatory agencies will continue to be inadequate.

Broad Dimensions of the Crisis

At the macroeconomic level, the finance sector in Australia has been less badly hit than has been the case in the US or the UK (or Iceland). There have been no Lehmann Brothers / Bear Stearns / Merrill Lynch, and no Northern Rock / Royal Bank of Scotland / Halifax Bank of Scotland (HBOS). There have been claims that the lesser financial fallout is a product of a superior regulatory framework, and of greater self-discipline by the lending institutions.

Both these claims have merit but are over-stated. The disastrous practices and poisonous portfolios of Wall Street investment banks are a reflection of the centrality of investment banks on Wall Street.[2] The more subdued adverse experience in the Australian finance sector is partly due to its predominant domestic orientation, and the concentration of power at the top. Simply, there was too much easy revenue to be made on the home turf (*c/f* Verrender, 2009c).

The overseas failure that bears the closest resemblance to Australian conditions is that of HBOS. HBOS expanded rapidly its business loan book with inattention to quality, especially in the graveyard that is property development. As a consequence, HBOS accumulated £19 billion of bad debt charges in 2008-09, 8% of its relevant business loan book (Peston, 2009).

Australian banks did not succumb to that degree of excess, but they are guilty of similar practices, and locally unique ones as well (margin lending in particular). For example, the NAB had a significant portfolio of US-sourced collateralised debt obligations, and wrote down the bulk (over $1 billion) of their book value for 2007-08.

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2 Given that character, it is true that the 1999 abolition of commercial bank / investment bank separation and the 2000 entrenchment of an unregulated derivatives market, both resulting from industry lobbying pressure, facilitated the ensuing crisis.

Analyst estimates of total loan losses by the big four banks for calendar 2009 range from $12 billion (KPMG) to $16 billion (UBS), with UBS expecting comparable *pro rata* losses through the first half of 2010. Australian Prudential Regulatory Authority figures highlight that, at end of June quarter 2009, bank 'impaired assets' stood at $28.3 billion, 1.08% of total assets.[3] Two years previously, the comparable figures were $4.0 billion, 0.20% of total assets.[4] At June 2009, the banks had made provision for bad and doubtful debts of $20.4 billion, up from $7.8 billion two years previously.

Large corporate exposures were the major culprit. The big four banks all had exposures to ABC Learning and Allco Finance Group. The CBA and NAB had additional exposure to Babcock and Brown, and the CBA (the predominant 'loose lender') had exposure to Lehman Brothers. Westpac, CBA and NAB had $400 million total exposure to Commander Communications.

Journalist Stephen Bartholomeusz has claimed that banks had moved commercial property loans off their books through securitisation to listed property trusts which have borne the brunt of falling property values (Bartholomeusz, 2009a). Yet the commercial property impaired asset ratio was at 4.5 per cent as at June 2009, having soared from trivial levels over the previous 2 years (Reserve Bank of Australia, 2009: 20). In December 2008, domestic banks held 86% of a $190 billion commercial property exposure (Cummins, 2009).

Listed property trusts did lose heavily. The top 16 trusts on the S&P/ASX A-REIT index produced losses over 2008-09 totaling $13.6 billion, with property assets being devalued by over $10 billion (Nicholls, 2009). REIT management has responded merely by engaging

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3 RBA, Statistics: Banks – Consolidated Group Impaired Assets – B5. Accessed 2 October. Comparable figures (impaired assets as percentage of total assets) for the early 1990s recession are 3.46% as at June 1990 (the first consistent data available), rising to a maximum of 6.91% by March 1992 (data obtained from the RBA).

4 In the two year period to June 2009, the quarterly changes in impaired assets totalled $24.3 billion, comprising $42.4 billion in new impaired assets, minus $10.1 billion in impaired assets write-offs, minus $7.9 billion in 'cured' loans removed from impaired asset status.

in a 'capital-raising frenzy', and promising industry consolidation to head off future market pressures.

All the banks have substantial exposure to the failed shopping centre owner/manager Centro (the CBA's exposure is a rumoured $1 billion). With major exposure to the US property market, Centro was a fragile entity. Yet the major banks readily provided the debt. The ANZ CEO, Mike Smith, referred to it as an 'emblematic exposure', with the banks having to support it or face a general commercial property wipeout (Bartholomeusz, 2008). Atypically, bank lenders have decided to support Centro's rehabilitation.

There is also the 'pub' sector, to which the banks have a massive exposure ($7 billion in NSW alone), having seen it as a milch cow built on poker machine revenue. Hotel valuations, on which the major banks readily expanded credit, were ludicrously inflated. Specialist vehicles, owning securitised hotel assets, have been major casualties.[5]

There are grim stories in the residential mortgage domain. By June 2009, loans in arrears (by loan value) on bank balance sheets reached 0.62% of such loans (0.9% for securitised loans), rising steadily since 2004 (Reserve Bank of Australia, 2009: 47).[6] An estimated 25,000 households were 90 or more days in arrears on their housing loans (*ibid*: 48), up from 13,000 eighteen months previously. Home mortgage difficulties arrived several years earlier than difficulties of business loans, reflecting the peak of the respective bubbles.

Dry statistics come to life with home repossessions. Supreme Court figures show a dramatic rise in claims for possession in New South Wales to almost 5,500 in 2006 (significantly higher than during the early 1990s recession), falling to 4,000 in 2007; in Victoria there was a continuous rise to 3,000 in 2007 (Berry, *et. al.*, 2009). National figures are not readily available for claims or repossessions. South-western Sydney is known to be a particular problem area. However, the media has regularly reported on widespread distress elsewhere – particularly in the Illawarra and the Hunter in New South Wales, and in South-eastern

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5 For example, the ING Real Estate Entertainment Fund (Carson, 2009).

6 Non-bank mortgage brokers have a higher arrears rate, whereas building ocieties and credit unions have significantly lower arrears rates.

Queensland. Claims and foreclosures across the country have climbed again in 2008, and persist into 2009, not least in Western Australia. This second surge, given lower interest rates, appears to be the result of rising unemployment.

The pain of household financial crisis centred on housing mortgage costs is reflected in a header from a provincial newspaper – '1/4 % Such a small figure, such a HUGE effect' (Farrington, 2007). Intolerably high base housing prices coupled with a succession of RBA-induced interest rate rises (see below) put many mortgage holders at or over the threshold of payment sustainability. The scandal, as the article highlights, is that not only are there no figures on home repossessions, but the figure of forced house sales is certainly a multiple of court-registered figures. The terms on which failed mortgagors relinquish their homes remains unknown and unexamined. Substantial administrative costs are incurred in Supreme Court foreclosure action.

Several Disasters Deserving of Selective Attention

Three failed investment schemes deserve special emphasis – Lehman Brothers Australia, Opes Prime, Storm Financial – because they highlight the adverse effects of the cynical marketing of 'innovative' financial products to unsophisticated investors.

In early 2007, the American investment bank Lehman Brothers bought a local funds manager, Grange Securities. Grange Securities immediately started peddling the sort of toxic assets that helped bring down its parent in September 2008. Collaterised Debt Obligation packages were aggressively marketed to municipal councils (especially in NSW and WA) and non-profit organisations. Over 40 councils placed about $625 million in such instruments. The CDOs were in turn linked to Credit Default Swaps, whose returns were dependent on the health of American corporate and mortgage markets. These bizarrely complex instruments were sold as 'safe as houses', with favourable ratings from the ratings agencies. This unconscionable phenomenon was compounded by the administrators of Lehman Brothers Australia which forged a 'deed of company arrangement' in May 2009 – the major creditors (Lehman

affiliates) and staff of the Australian operations extracted close to 100% of their claims, whereas the councils ('contingent creditors') were shut out, receiving anything between 2c and 13c in the dollar on their purportedly 'plain vanilla' investments.[7]

From 2003 onwards, the ANZ bank lent hundreds of millions of dollars to 'stockbroking' firms that were in reality firms dealing in margin loans for speculative share purchases and in share borrowing/lending with hedge funds. The most significant of these firms was Opes Prime, to which the ANZ committed $650 million (and Merrill Lynch $350 million). The share portfolios included some listed stocks, but were replete with 'hundreds of tin-pot stocks' (West, 2008) generating no revenue. The innately flawed Opes' business model was premised on a permanently rising stock market – more, on dealing only in shares of well-managed firms. With Opes in trouble, the ANZ 'advanced' Opes $95 million on 20 March 1998 in return for Opes directors granting the ANZ belated security over Opes' assets.[8] Opes was put into receivership a week later. The ANZ then appropriated $1.6 billion worth of Opes' clients shares (including those of clients in good standing), and offloaded them at significant discounts. Opes was lending its own clients' shares for short selling, the drop in share prices triggering the margin calls, which brought down Opes itself. A subsequent deal forged by the Australian Securities & Investments Commission between bank lenders and Opes' administrators had the banks agreeing to pay out $253 million in return for closing off all potential suits from disgruntled clients. It is estimated that Opes' clients will receive little more than 30c in the dollar from the fiasco.

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7 Remarkably, on 25 September the Federal Court of Appeal overturned the deed, holding that the attempt to release the Lehman group from liability was invalid under the Corporations Act. The litigating Councils had assistance from litigation funder IMF and opinion from the Australian Securities & Investments Commission. The Lehman group and administrator are expected to seek redress in the High Court (Yeates, 2009b).

8 This phenomenon of banks attempting to appropriate security over assets of a failing business, given that the initial loan(s) were made with limited or no security, is a regular practice. A comparable phenomenon occurred with the failing Babcock & Brown, with shareholders left cocooned in a worthless holding company (John, 2009).

Storm Financial collapsed in January 2009. Storm, formally a financial advisory firm, aggressively sold a one product package – the use of debt to speculate on the permanent upward movement of share prices. The package comprised a home mortgage loan taken on the client's residence (occasionally investment properties), complemented by a margin loan, the total to be placed into an indexed fund designated by Storm, with the loan quantum to be further enhanced if the nominal share value increased or if any slack appeared in the loan to valuation ratio. The customers were perennially low income, retirees, on a disability pension or unemployed; they were generally ill-informed as to the details of their 'investment'. Necessary information was supplanted by the mesmerising charm of Storm principals, Emmanuel and Julie Cassimatis.

Emmanuel Cassimatis had been a long-time financial advisor and agent, located in Townsville, North Queensland. The transformation of a conventional business into a fantasy operation headed for certain failure and irredeemable suffering for many clients appears to be based on two factors. First, roughly between 2003 and 2007, a large number of previously independent advisory businesses brought themselves under the Storm umbrella, with the resulting operation run in a highly centralised fashion.

The second factor was Storm's close relationship with the CBA. The bank had been involved with Storm since 1994, but the transformed Storm was evidently viewed within the bank as a profit bonanza. The CBA fuelled Storm's fantasy – home loans, margin loans through subsidiary Colonial Geared Investments, and 'wealth management' of the loans into index funds through Colonial First State. The CBA-Storm relationship encompassed between 4-5,000 clients. The CBA's desktop 'VAS' remote valuation system, introduced in March 2008, gave increasingly generous valuations of client property, readily leveraged into a higher margin loan and more fees for Storm. The CBA extended Storm clients' loan to valuation ratio to an unprecedented 80% plus 10% 'buffer', and a unique office outlet was established in Townsville to service Storm business (countering competition from the Bank of Queensland). The Colonial arms even paid for a 'gala ball' in Italy in 2008 for the smooching of clients. Such was the success that the CBA yearly raised sales targets of the Storm-servicing cell, including for 2008-

09. The complacency was smashed with the falling share market in late September 2008.

Storm advisers and staff independently claimed that CGI's software failed in the mayhem that ensured in October and November, with Storm and clients incorrectly advised or uninformed of developments. In early December, the CBA declined a Cassimatis request for a tide-over loan to assist clients with margin calls. On 10 December the bank unilaterally shut down all Storm-badged products, closing off without consultation all client investments, and effectively defaulting Storm from that time.

Upon examination of some client records, the CBA has subsequently claimed responsibility for some 'irregularities', nature unspecified, with promises to make amends, details unspecified. The bank has scapegoated local staff, when clearly the entire model had senior level approval. Its senior representatives dissembled before the Parliamentary inquiry hearings in Sydney on 4 September 2009.[9] Journalist Alan Kohler (2009) astutely summarised the unholy alliance between the CBA and Storm:

> Storm Financial in Townsville was not so much a Ponzi scheme, where new money finances the returns on old money, as a scandalous partnership between spivs and a bank, that should have known better, to place ordinary people in harm's way.

A Wider Panoply of Unsavoury Practices

The crisis has left exposed a wide range of unsavoury practices whose essential character deserves summary.[10] The collapse of several sizeable 'managed investment schemes' (Timbercorp and Great Southern) has exposed their dysfunctional character. The MISs oversaw the planting of large-scale plantations of agricultural and forestry commodities. But tax avoidance was the dominant motif. Management structures were neglected; capital planning non-existent, short-termism prevailed in

9 The author was present at these hearings.

10 Schwab (2009b) conveniently lists a large number of failed companies and the sources of their demise, some of which are treated below.

sectors where long term planning was paramount; fees were gouged. In the case of Great Southern, the 'advisers' to potential clients were all paid agents for the company. Stupidly, Bendigo and Adelaide Bank has an exposure of $550-600 million to Great Southern 'investors'.

On Queensland's Gold Coast, City Pacific Limited was a combined funds manager and property developer. Its life span (1997-2009) encapsulates the fragile species – built on easy credit for boom times only. City Pacific gouged fees from its First Mortgage Fund, but lost control of the Fund in July 2009. The intrinsic non-viability of its Martha Cove project in the sober climate of Victoria's Mornington Peninsula highlights that City Pacific was built not to last. The CBA, with a $100 million exposure to the company, evidently thought otherwise.

Also notable is the collapse of the Gold Coast-based large-scale MFS funds manager and holding company. MFS, with myriad satellites, was a complex entity attracting investors through commission-based 'advisers'. High risk investments and fee extraction brought a major subsidiary, with 10,000 investors, to freeze redemptions in January 2008. The entire group, having changed its name to Octaviar, was forced into administration in October 2008, with unknown losses (one estimate at $1.6 billion) to hapless investors.

Chartwell Enterprises was a small-scale investment company located in the hapless provincial town of Geelong. One man brought in savings from 'Mum and Dad' investors on the strength of personal charm alone. A second placed the savings in extremely high risk outlets, mostly sophisticated futures contracts – save for sums siphoned off into the salesman's extravagant lifestyle and sums unknown siphoned into tax havens. The game was up by September 2006, but the duo delayed the inevitable for another 18 months by bringing in new investors to prevent immediate collapse. Approximately $70 million of hard-earned savings has disappeared with the collapse of Chartwell.

Perhaps exemplary of the extravagance of the boom years was the attempted private equity buyout of Qantas Airways by a consortium that included Macquarie Bank and Allco Finance. The bid was premised on indefinitely cheap debt financing costs, and indefinitely expanding air

travel. The bid collapsed, albeit by a whisker, in May 2007. A successful takeover would have burdened Qantas with intolerable debt financing commitments (an $11 billion takeover based on $10 billion of debt), with subsequent bankruptcy a certainty (Schwab, 2009a).

BrisConnections was a trust floated in July 2008 by joint underwriters Macquarie and Deutsche Bank at the behest of the Queensland Labor Government. Its function is to preside over the building of three arterial roads out of Brisbane, particularly an airport link. BrisConnections is an exemplar of cynical and dysfunctional financial imperatives in the provision of infrastructure. The largest float of the year, at $1.2 billion, failed spectacularly, predictable given the adverse environment. 400 units were offered at $3, spread over three instalments. The $1 listing immediately fell to 41c. Macquarie, which had extracted $110 million in fees for the listing, ended up with 26% through various vehicles, which it proceeded to sell down, with the units tumbling to 1c. Ill-informed scavengers picked up truckloads of the 1c. units, ignorant of the further two calls at $1 in the fine print. Chaos has ensured, with attempts to wind up the company, an attempt by Macquarie to cancel the small fry's obligations, and attempts to pursue the small fry to the last drop of their blood. The conflicted Chairman of BrisConnections was also Chairman of BrisConnections equity holder (about 10%) Queensland Investment Corporation, until pressured to quit the latter role in September. Rowe had made improbable revenue projections. Dividends were to be initially paid out of borrowings. Meanwhile, big name banks were lined up to provide $3 billion in debt; but, having been hit by the crisis, many want out. The Queensland government refuses to bail out the project. In short, it has been a debacle.

Finally, there is the fault line in that major buttress of the Australian finance sector, the superannuation industry. The crisis-driven decline in returns has amplified longstanding criticism of the fees rort that permeates the compulsory superannuation regime in Australia. The central problem is that fees have been appropriated as a percentage of the client's assets. There is no necessary relation between fees and quality of service and client returns. Large funds have performed more poorly than smaller funds, in spite of presumed scale economies. For-profit retail funds charge generally in the range of 1-2% of assets, whereas industry

(*i.e.* union-sponsored) funds charge generally in the range of 0.5-1% of assets. Moreover, the former have performed worse than the latter; nevertheless, both systems have in common an asset-based fee structure. There is a round-robin relationship between lower return for-profit retail funds, the large banks and insurers as dominant owners of the funds, commission-based advisers, and the direction of clients by such advisers to in-house funds (Keane, 2009). There is a marked lack of transparency of the total fee cost to clients of their superannuation assets. The regulators' sole concern to date has been to enhance transparency of information rather than to address the scale and character of fees *per se*.[11]

Behind this series of misfortunes are key dimensions of the Australian financial environment. The abundant pool in which predators flourish is fed by at least three factors. The first factor is the compulsory superannuation scheme. As at June 2009, superannuation funds stood at an estimated $1,076.7 billion.[12] The figure reached $1.2 trillion by June 2007[13], so the crisis has knocked over $100 billion off the total, but the pile grows inexorably – an estimated $70 billion each year, amongst the fastest in the world.[14] Neglected is the nature of the outlets for this endless flow. Are there sufficient materially productive investments to absorb the capital? The answer clearly is no, with expanding capital serving to inflate asset prices, not least of share prices and real property.[15] The super funds thus exacerbate the financial sector's contribution to booms and busts.

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11 Two other issues mar the integrity and efficiency of the superannuation regime. First is the widespread practice of 'flipping', whereby an employee previously in a corporate super fund who loses his/her job or moves employment is automatically moved into accounts with higher fees (Johnston, 2009). Second, the fragmentation of superannuation payments associated with high job mobility has resulted in escalating billions sunk into 'eligible rollover funds', with small sums being subject to fees in the range of 3-7% (Anon, 2008).

12 APRA Statistics, Quarterly Superannuation Performance, June 2009.

13 APRA Statistics, Annual Superannuation Bulletin, June 2008.

14 Longtime superannuation journalist Barrie Dunstan, reflecting a recent survey, remarkably claims that growth per se is an indication of the strength of the Australian financial sector (Dunstan, 2009). The survey does not distinguish the separate impact on funds' asset growth of investment returns and capital inflow.

15 ABS figures, at June 2009, have an estimated $200 billion of Australian managed funds allocated overseas (down from $275 billion at December 2007), the bulk of which would be superannuation assets. ABS, cat. no. 5655.0, Managed Funds.

The second and third factors are the pervasive fear (fuelled by propaganda, as in Storm) of the potential inadequacy of personal retirement provision, and the marketing of the so-called democratisation of capital in the neoliberal age (compounded by the privatisation and listing of public infrastructure). These factors have generated waves of financially unsophisticated lemmings as prey to potential and real predation. The series of misfortunes in aggregate point to the spectacular failure of 'shareholder capitalism' that has been sold to the public in the last twenty years as the inclusive vehicle both for the security of individual families and the regeneration of the domestic economy in general.

Byproducts of the Financial Crisis

A hardline view of economic crisis is that it desirably 'cleans out' the system, with the inefficient falling by the wayside. Rather, crises generally eradicate the less powerful rather than the less efficient. But in this case there have been some worthy corporate deaths. Notable and deserving failures were ABC Learning, Allco Finance and Babcock and Brown (B&B). Only Allco, as representative, will be summarised here.

Allco was a financial engineer, with B&B a would-be Macquarie Bank copy-cat. Allco and B&B had in common labyrinthine structures of investment trusts, extravagant gearing premised on permanently low interest rates, fee gouging from these satellites, and executives living in opulence. Apart from leasing operations of aircraft and shipping. Allco delved into sub-prime and loc-doc mortgages. Three Allco principals complemented the insouciance of the attempted Qantas buyout with the late 2007 sale of their predominantly privately-held Rubicon Holdings (property trusts operating in Japan, Europe and the US) to Allco itself at the vastly inflated sum of $277 million; $64 million in cash was extracted by the threesome. Rubicon had previously been inflated with debt for the purchase of over-valued real estate, from which the same

(Footnote 15 continued): Note that ABS figures understate superannuation assets compared to APRA figures. Capital invested overseas, in the face of competition with global superannuation capital in pursuit of finite productive outlets, also tends to push up asset prices and compound the boom/bust cycle.

principals extracted over $100 million in fees (Verrender, 2009a). Allco listed in 2001 and collapsed in early 2008.

Macquarie Bank itself survives and is reinventing itself. Its share price has recovered from $15 in early March 2009 to safely over $50 in September, not least because it was saved from hedge fund predation by the banning of short selling by ASIC in September 2008 and it raised almost $12 billion (to mid-September 2009) in capital under the Government's bank guarantee. But the model by which it became the fabled 'fee factory' or 'millionaire's factory' is dead. Macquarie bought infrastructure assets, loaded them into satellites with substantial debt acquired at historically low rates, from which were appropriated a full range of fees. Assets were revalued upwards, and fees increased for 'enhanced' management performance. With revenues delayed, dividends were often paid from new investors' capital.[16]

The model had its built-in use-by date. Revenues started to fall, and the bank faced 'a mass exodus of investors from the debt-laden vehicles' (Verrender, 2009d). Some satellite share prices had fallen dramatically, facing increasingly critical analyst ratings. There followed share buybacks, asset sales (albeit some early sales were to related parties) and asset devaluations, with both Head Office and satellite management opting for separation. Even a jewel in the crown, Macquarie Airports, is to be separated. But Macquarie is extracting a spectacular pound of flesh in the form of a $345 million payment for the buyout of management rights – this after pulling out over $520 million in management and performance fees since MAp's listing in 2002, part of a total estimated fee extraction of $940 million (Verrender, 2009f). The majority non-Macquarie security holders apparently felt blackmailed with the need to avoid a hostile dissolution of the complex relationship (Bartholomeusz, 2009b). The payment was approved at a 30 September meeting, albeit against a strong protest vote – a rich nightcap sayonara to the Macquarie model.

16 In late June 2009, Macquarie '… announced it no longer would be paying dividends from debt, and made the radical suggestion that in future it would be a better idea if dividends reflected earnings' (Verrender, 2009d).

In terms of the financial dimension, the most substantial adverse effect of the crisis has been the concentration of power in the banking sector. The dominance of the 'big four' banks in Australia is without precedent. The big four monopolised new mortgage issuance during 2009 (Drummond & Bührer, 2009). Starting life as (specialist) trading banks, the now *allfinanz* institutions have swallowed up finance companies and savings banks, and their reach now extends to investment banking, insurance, wealth management and stock broking.

The spectacular rise of mortgage brokers on debt funding and asset securitisation was perhaps destined to be checked. Unexpected was the extent to which the Rudd Government and the regulators were prepared to foster greater big four dominance. The Government early proposed (following NAB pressure) creation of an Australian Business Investment Partnership to subsidise the big four's ongoing exposure to the overblown commercial property sector – a proposal fortunately rejected in the Senate.[17].

The Government introduced a bank deposits and capital raising guarantee in October 2008. The big four banks, with AA ratings, have to pay an extra 70 basis points (*i.e.* 0.7%) for access to guaranteed capital, but the second tier (and credit unions, etc.), with lower ratings, have to pay an extra 100 to 150 basis points. To mid-September, the big four plus Macquarie Bank had raised $94 billion in debt under the guarantee. The smaller banks have been complaining about the unlevel playing field without effect. A recent Parliamentary inquiry and report has recommended that the Government redress the imbalance (Senate Economics References Committee, 2009).

However, the biggest sop to the big four has been the regulatory support of takeovers and the subsequent consolidation of market power. The ACCC under Chairman Allan Fels tolerated Westpac's takeover of Western Australia's Challenge Bank in 1995 and the Bank of Melbourne in 1997 (both ex-Building Societies), and the privatised CBA's takeover

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17 The federal government's public sector superannuation Future Fund has also plunged significantly into bank debt securities, enhancing bank liquidity (Yeates, 2009a). This development may be strictly commercially-driven, but it is not improbable that it is a strategic backdoor mechanism of further propping up major bank balance sheets.

of Colonial in 2000.[18] In late 2008, the ACCC under Chairman Graeme Samuel and the federal Treasurer, Wayne Swan, approved Westpac's takeover of St. George and the CBA's takeover of BankWest. Swan talked of the need for stability and the ACCC maintained that competition would not suffer. The claims were fatuous (Jones, 2009). The loss of an independent St George, in particular, is a scandal. St George, partly by the takeover of fellow ex-building society Advance Bank in 1997, had transcended its second tier status, and was threatening the cosy world of the big four, especially in small business lending (Jones, 2008a).

Market power has been readily translated into higher margins. The market power not sighted by the competition regulator has been explicitly flagged by analysts and explicitly welcomed by the banks themselves. UBS analyst Mark Rider recommended buying (big) bank stocks because of the 'structural change' going on: 'What they are doing is they are getting pricing power; they are widening margins' (Washington, 2009; Gluyas, 2009). Bank executives talk about the necessity to re-price risk, but profitable companies talk about arbitrary hikes in their conditions. Small and medium enterprises have been hard hit in terms of access to credit and its pricing (Fenton-Jones, 2009). In effect, the big four banks are now utilising 'administered pricing', available only to those with unrequited market power, in which a desired profit rate or mass is determined, and products are priced accordingly. Return on equity might fall, as in 2007-08, but the retreat is minor. The rest of the economy, heavily dependent on the big four, pays the price.

Several vignettes highlight the asymmetry of the banking relationship. In February 2009, the (mostly) clothing manufacturer Pacific Brands announced seven plant closures in Australia and New Zealand, and the retrenchment of 1850 and almost 100 workers respectively. Reports were clouded by questions regarding sustainability of the company's product diversity, and why any company was manufacturing anything in Australia. But the immediate force behind the retrenchments was Pacific Brands' banking cabal, which wanted rapid repayment of debt, higher

18 Colonial was, in turn, the product of a giant insurer, Colonial Mutual, turned bank, and its subsequent takeover of the State Bank of NSW.

rates and tightened covenants. The normally priggish journalist Elizabeth Knight commented (Knight, 2009):

> Being subject to this trifecta of onerous bank conditions suggest pretty clearly that the banks are calling the shots. … Banks now have legions of operatives calling the shots behind the scenes, taking control of corporate strategies in order to avoid having even larger bad debt provisioning.

An even more striking manifestation of the same phenomenon is the forced sale of prime assets by Australia's third largest mining company OZMinerals.[19] The equally conservative journalist Robert Gottliebsen was appalled (Gottliebsen, 2009):

> … Australian superannuation funds and other investors in OZ Minerals are being taken to the cleaners. They are being asked to approve the sale of prime, highly profitable mineral assets to the Chinese owned Minmetals group at a fraction of their worth. …
>
> The 2009 OZ Minerals disaster is simply about deplorable banking. … OZ Minerals owes local and foreign banks about $A1.2 billion and the company is generating cash in excess of $300 million a year. The total value of the OZ Minerals assets is several times the amount owing to the banks so these are loans covered by cash flow and asset values. However, the bank chief executives are effectively telling OZ Minerals shareholders that unless they sell key OZ Minerals mining assets to the Chinese at a fraction of their worth then "we will pull the plug on the company and effectively ruin you by flogging the assets off at low prices". … We are handing the Chinese an immediate paper profit of $US400 million simply because of bad banking.

Both Pacific Brands and OzMinerals have complex histories, and they had expanded debt by acquisitions. But the banks were supportive parties to these acquisitions and debt expansion, and have shown that the relationship, presumed to display mutual concern for long term viability,

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19 A similar process occurred at PaperlinX with the company forced by its bank to divest paper manufacturing assets at under value to Nippon Paper (McIlwraith, 2009).

is merely one of expediency. The lesson is clearly that he who sups with the devil must have a long spoon. Australian banks simply cannot be trusted.

Weaknesses in the Regulatory Agencies

The regulatory agencies each have their own problems. The Reserve Bank has been reduced to a single policy instrument – the overnight cash rate. The RBA raised the cash rate by 0.25% on 12 successive occasions, between May 2002 and March 2008, the rate rising from 4.25% to 7.25%. The most sustained rises were in the 3-year period from March 2005, the rate rising from 5.25% to 7.25%. By the standards of the appallingly high rates of the 1980s, these rises seem relatively benign. Yet the country was facing asset price inflation, and the cash rate is unsuitable to the task.[20] Variation of the cash rate has no positive impact on asset bubbles – indeed, it may even exacerbate them (Jones, 2007). Housing price rises are a complex story in their own right, not least because owner occupation has such a strong impulsion. Myriad desperate home-owners have been pincered by intolerable house prices, rising interest costs and subsequent under- or unemployment.

Recently, with enhanced bank debt sourced globally, even bank lending rates have become detached from the cash rate. There seems little chance of the RBA acquiring additional instruments to offset the current dysfunctionality of monetary policy. The elaborate research output of RBA staff points to mere hiccups, emphasising overall stability. The RBA's herculean indifference, embodied in its biannual *Financial Stability Review*, is based on its benchmarks for 'genuine' crisis being the calamities of the early 1990s recession in Australia and current calamities overseas.

20 The RBA's previous Governor, Ian Macfarlane, had made subdued statements along these lines, but both he and his successor (since September 2006), Glenn Stevens, have carried on with the blunt cash rate mechanism regardless. Curiously, Macfarlane is quoted as claiming that giving the RBA powers to target asset prices "… was unlikely to be accepted by the community and therefore would not be achievable at least for the next decade." (Kehoe, 2009). The first part of this claim is spurious.

The Australian Prudential & Regulatory Authority essentially administers Bank of International Settlements standards on prudential capital holdings – the primary product of the 'hands off' ersatz regulation at the centre of the globally deregulated financial system.[21] APRA has received much credit for the mildness of the Australian crisis.[22] Yet much of the substantial capital raised by the big four under the government's guarantee scheme, and at unsavoury haste (offered at discount and privileging the institutions over individual shareholders) highlights the unsatisfactory character of the BIS/APRA regime.[23] APRA also formally monitors bank bad debts but declines to intervene in bank practices (in spite of formal powers) to redress the culture that generates them.

The real failure of APRA (and of the BIS model) has been with regard to bank wholesale debt (and equity/debt hybrid capital). As at June 2009, deposits constituted only 60% of the liabilities of Australian-based banks associated with domestic operations (totaling $2,272 billion). 15.2% ($346 billion) of such liabilities were due to non-residents.[24] The debt erected on customer deposits is a natural consequence of the transformation of Australia's core banks from trading banks to *allfinanz* institutions. Timely re-financing of this debt (and on reasonable terms) is fundamental to Australian bank liquidity, in turn more fundamental to systemic stability than are capital ratios. Bank liquidity risk was precisely why the Government established the bank guarantee while hiding the reason – the guarantee provides *prima facie* proof that the APRA monitoring structure is inadequate.

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21 APRA was created in 1998 when the prudential monitoring role for Deposit Taking Institutions was carved out of the RBA.

22 In particular, APRA has been praised for several 'stress tests' of ADI's, especially in raising the capital requirements for higher risk housing loans in 2004 (Reserve Bank of Australia, 2009: 21).

23 The NAB, in particular, was under-capitalised. It raised $11 billion in the 12 months to September 2009, roughly one-third of its then capitalisation. Although some of this capital has been fuel for further acquisitions, the NAB was forced by the UK Financial Services Authority to allocate £1.4 billion pounds in extra capital to its UK subsidiaries (over three tranches in October 2008 and February and May 2009). The NAB has consistently misled the market on the extent of its bad debts and on its capital raisings.

24 RBA, Statistics: Banks – Liabilities – B3. Accessed 2 November.

The Australian Securities & Investments Commission is the predominant financial services regulator. The ASIC Act requires the Commission to 'promote confident and informed participation by investors and consumers in the financial system'. Australia does not enjoy such a situation, so who or what is to blame? Reasonably, ASIC can only investigate a small proportion of the thousands of complaints it receives each year. The scale of the problems is an issue, even with 1,200 staff, and the expense of major actions is prohibitive. For example, in late 2007 ASIC initiated action against principals, financial advisers and KPMG auditors associated with the property empire Westpoint and its collapse in late 2005. ASIC finally achieved a ban on auditors in August 2009 and compensation against one advising firm in September. After four years ASIC is still dealing with earlier malpractice in the financial products sector, and with none of the penalised parties admitting culpability. But how was Westpoint (and its comparators Fincorp and Australian Capital Reserve) able to achieve the scale and wreak such damage in the first place?

ASIC had previously had complaints about Storm's founder, Emmanuel Cassimatis, and Storm Financial, but it claims (minor) problems were resolved following 'routine ASIC surveillance in Queensland on financial planners' (Australian Securities & Investments Commission, 2009: 14). ASIC decided to investigate Storm only in late December 2008 after it had collapsed. ASIC ought to have scrutinised the Storm model when Storm submitted operational details in November 2007 preparatory to a proposed public listing, a proposal that could find no underwriting brokers. Everything about the Storm model oozes fraudulence. The ASIC submission to the Parliamentary Storm inquiry simultaneously denies regulatory failure, insists that ASIC has been vigilant, yet claims that it has been dramatically restricted by an inadequate legislative brief.

ASIC's difficulties demand to be seen in the light of its treatment of its legislative responsibilities for unconscionable conduct in financial services. ASIC acquired such responsibility with respect to retail clients in July 1998 and small business clients in August 2001, operative in March 2002. A decade of research and advocacy by this author has highlighted that unconscionable conduct by major banks against small

business clients is endemic. Admittedly, the hurdle in the courts to winning a business to business unconscionability suit is formidable. Nevertheless, ASIC has mounted no case in this domain, nor has it lobbied regarding surmounting of the presumed judicial hurdles. Rather, it has variously denied responsibility, and responded to small business complainants that it will not pursue the matter, misrepresenting to them that it has examined closely their situation (Jones, 2008b).

ASIC, as with its institutional predecessors, was born with a regulatory emphasis on enhancing disclosure and transparency in the financial marketplace, and has acquired a dominant culture that underpins that emphasis. ASIC has yet to acquire a culture commensurate with the cowboy frontier environment that it is expected to regulate.

Finally, the Australian Securities Exchange as a profit-oriented publicly-listed monopoly is structurally incapable of adequately enforcing its formal responsibility for stock listing probity. In September, ASIC's 'annual report card' to the ASX listed 13 areas where enforcement procedures had been inadequate (Williams, 2009). ASIC queried whether the ASX's listing criteria was too lenient, asking whether 'particular business models are suitable for listing on the ASX's market'. ASIC was particularly critical of ASX's neglected gate keeping over the BrisConnection listing debacle.

ASIC's concerns are valid, but the ASX's failings are linked to the weaknesses of the accuser itself. Journalist Ian Verrender makes the point (Verrender, 2009e):

> ASIC has hardly covered itself in glory in recent years. It is slow to react, if it bothers to react at all. It has an appalling record on charging miscreants, let alone getting convictions. And it always goes for the easy target – individuals, and not-so-powerful individuals at that. Investigations of corporate collapses are now left to receivers and liquidators. Litigation funders such as IMF are more effective than our corporate watchdog in extracting penalties from the big end of town … Last year, the ASX handed ASIC 31 referrals on insider trading and 14 cases of market manipulation. Whatever happened to them? Or the ones that were referred to ASIC the

> previous year? ASIC is a mixed metaphor lover's dream – a lame-duck watchdog.

In short, we have a massively staffed but fragmented regulatory apparatus – partly steeped in automaton-like application of narrowly devised rules, partly mired in passivity punctuated by belated action to clear up the mess.

Crisis-Induced Regulatory Changes

The crisis has induced some changes and the promise of others. In mid-September 2009, APRA recommended stronger liquidity provisions for banks, in effect a revamping of the 1960s 'liquid and government securities' requirement. The measures include a narrowing of what assets can be so classified, and the lengthening of the liquidity coverage period from 5 to 30 days (Glynn, 2009).

In August 2009, the Government foreshadowed removal of the ASX's regulation of market traders to ASIC and has given ASIC powers to directly investigation insider trading (Verrender, 2009e). In October, the Government foreshadowed a disclosure regime for stock short selling, to be monitored by ASIC.

Of substantial formal importance is the Government's attempt to move all regulation of consumer credit to the federal level. Formerly the States and Territories' Uniform Consumer Credit Code regulated consumer credit but not credit for investment purposes. Under the National Consumer Credit Protection Bill, introduced into Parliament on 25 June 2009 and pending its delayed implementation in July 2010, all credit providers will be subject to a consistent licensing regime (although it is not clear how this differs to the present), and lending for investment in residential property will be regulated.[25] The Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 will ensure coverage of margin loans under the Corporations Act as a financial product.

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25 Subsequent amendments will generalise regulation of consumer borrowing for investment purposes.

This legislation will bring new formal responsibilities within ASIC's purview, but will there be a qualitative regulatory transformation? ASIC has claimed that margin loans as credit were already covered under the ASIC Act (Australian Securities & Investments Commission, 2009: 88), but it does not explain why its coverage of this innately dangerous facility remained inoperative.

There is a pervasive ambivalent tone to the ASIC submission to the Storm inquiry. It tacitly acknowledges the retail investments sector as corrupted, yet it refers merely to '*potential* [my emphasis] systemic issues that have arisen in relation to the role played by lending institutions in recent retail investor losses' (p.87), and generalises early 'that the current standards in the advice industry are adequate' (p.37). ASIC only weakly recommends that the government consider legislating for fiduciary duty, while noting its existence in jurisdictions overseas that Australia regularly takes as models. The new legislation will not impose a fiduciary duty of care on financial advisers, a major weakness.

The scale and character of the Storm debacle was fundamentally dependent on intimate CBA involvement. But the prospect is that ASIC will fail to include the CBA in any culpability and compensation in the case against Storm Financial being pursued in the Federal Court. Late in a large submission ASIC summarises the reigning ethos (p.181):

However, the basic philosophy of the Australian financial services regime is that any product can be sold to any investor provided the nature of the risks, fees, etc. are disclosed. In this context, ASIC's role is to oversee and enforce compliance with the conduct and disclosure rules enacted in the Corporations Act. The regime relies on market participants to comply with the law and places the onus for assessing risk on the investor.

ASIC does make straightforward recommendations to eradicate the corrupted financial 'advisory' remuneration structures (p.53). The Government has established an inquiry (under previous ASIC Deputy Director Jeremy Cooper) into superannuation funds management. But Cooper's record at ASIC has not been illustrious, and the forces mitigating against substantial change are powerful. The industry 'professional' associations, essentially lobby groups, have been

unrepentant in defense of the *status quo* – the Investment and Financial Services Association[26], the Association of Superannuation Funds of Australia[27], the Financial Planning Association[28], and the Association of Financial Advisers.

A qualitative regulatory transformation requires not merely statutes but aggressive enforcement and cultural change. ASIC Chairman, Tony D'Aloisio, is gradually assuming a more interventionist stance.[29] D'Aloisio has attacked the systematic failure of 'intermediaries' – auditors and credit rating agencies as well as financial advisers. Delay is inevitable, partly because of the need for international cooperation, but partly because of the complexity of prospective reform of deeply compromised institutions whose member companies remain belligerent in the face of their own crucial contribution to the crisis (Drummond, 2009). The prospect is for a long wait for a transformation of substance beyond rhetoric.

Conclusion

A rational examination of the evolving forces leads one to conclude that regulatory reform in the financial services sector will be substantively marginal. The new dominance of the big four banks as *allfinanz* conglomerates has been legitimised in the political and regulatory arenas. The banks' leverage to extract booty from their customers has been enhanced. The dimensions of their operations that embody recklessness, incompetence and unconscionability will go unchecked. At the other end of the spectrum, the bottom feeders will continue to spawn and wreak

26 An IFSA sponsored report in late September by Deloitte notes higher costs for funds under management in Australia than overseas, but claims that the costs are due predominantly to more active and higher-return oriented management than comparators overseas, and to regulatory compliance costs.

27 ASFA has recently lobbied to deter government support for retirement savings options other than the superannuation system (Patten, 2009).

28 Under pressure, the FPA announced in October a recommendation to members that commission-based payments end after July 2012.

29 D'Aloisio was appointed Chairman in May 2007 to replace his do-nothing predecessor, Jeffrey Lucy.

havoc on the gullible. Every reform proposal has been opposed by the vested interests, with proposals delayed, compromised or abandoned.[30]

In the not too distant future, a new generation of independent parliamentarians will force Parliamentary committees of inquiry, whose recommendations will be watered down or not acted upon. And the cycle will continue, with previous crises and their cast of villains lost to memory.

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30 ASIC attempted in July 2008 to raise the monetary limit to $280,000 for compensation against financial planners, but retracted following an industry backlash – ASIC is now trying again (Yeow, 2009). Big business and its supportive law firms are engaged in ongoing lobbying to emasculate consumer credit reform, their first success being the excision of any inclusion of small business concerns from consideration.

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