Submission in response to Productivity Commission Draft Report of January 2018 on "Competition in the Australian Financial System"

Submission made by:
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Posted short summary:

This submission is made to raise three fundamental reforms to increase competition, lower costs and improve regulation and consumer outcomes in ways neglected by the Draft Report:

(1) Replace the ability of banks to create deposits with all deposits only created by the government;
(2) Introduce the government as an active competitor by providing all Australian voters with basic saving bank services without cost through their MyGov accounts;
(3) Require banks to change their constitutions to remove the absolute power of directors to manage their own systemic unethical counter-productive conflicts that may corrupt themselves, their bank and society.

1. SUMMARY

1.1 This submission is made to raise three fundamental reforms to increase competition, lower costs and improve regulation and consumer outcomes in ways neglected by the Draft Report.

1.2 **The first two recommendations have the objective of mitigating the fundamental anti-competitive nature of the Australian Financial System**. This arises from at least four banks being too big to: fail, regulate, manage or to be held accountable by either their shareholders or their operational stakeholders. The size and dominance issue was noted in the Draft Report but no options identified as to how to make the fundamental changes to: (a) reduce their size and privileges, or (b) introduce new competitors and/or internal division of powers to expose banks to checks and balances from their shareholders and/or stakeholders, or (c) improve shareholder and stakeholder outcomes by them electing advisory boards (independently of management) with the rights to recommend and monitor Key Performance Indicators (KPIs) to protect and further their own interests, the bank and society.

1.3 **The first recommendation is to replace the ability of banks to create deposits with all deposits only created by the government.** This is what many people believes occurs but it does not. The Reserve Bank of Australia (RBA) could be appointed manager to determine the conditions and terms on how government created money was distributed to existing banks and new types of banks that technology now allows to arise. This change would substantially reduce the size and cost of the financial system while removing major systemic risks and reducing regulation costs.

1.4 **The second recommendation is to introduce the government as an active competitor by providing all Australian voters with basic saving bank services**

without cost. This could also lead to major reductions in the role and size of banks to introduce additional major cost savings while also allowing the government to remove its anti-competitive guarantee provided for private bank deposits.

1.5 **The third recommendation is to meet the terms of reference requirements to further "consumer outcomes" and "regulation".** This requires changes in bank constitutions to establish: (a) a separation of powers to remove systemic unethical conflicts ignored by regulators that poison corporate cultures with toxic governance[1] and (b) the establishment of stakeholder appointed advisory bodies to act as co-regulators. A practice introduced into the US by Ralph Nader, to reduce regulator capture of regulated utilities and so improve "consumer outcomes".

2. RECOMMENDATIONS

2.1 **Remove the ability of banks to create deposits** to fund their loans by one or both of the following options:

- 2.1.1 The RBA manages the government creation of the funding required by the banks to make loans. The recipient bank obtaining such government deposits to be a legal entity that does not share liabilities arising from the acceptance of deposits obtained from the public;
- 2.1.2 The RBA manages the creation of funding required by current non-banking institutions that use approved credit insurance facilities[2] to make business loans;

2.2 **Expand the operations of MyGov accounts to provide competition to banks in providing basic savings and payments services** such as debit cards, Internet banking and mobile phone applications payments to third parties. Also to:

- 2.2.1 Allow MyGov accounts to pay interest to depositors at a rate commensurate with obtaining the guarantee of the Commonwealth of Australia that would automatically arise from any deposits in any government accounts, and
- 2.2.2 Remove the anti-competitive government guarantee on private bank deposits.

2.3 **Require banks to change their constitutions to remove the absolute power of directors to manage their own systemic unethical counter-productive conflicts that may corrupt themselves, their bank and society.**

As proven by venture capitalists from the agreements they obtain from shareholders, there is no commercial need for directors to obtain both the power to manage and be conflicted with also the powers to govern. To eliminate the systemic unethical counter productive conflicts, constitutions would need to make provision for shareholders to separately elect a "governance board"[3] on a one vote per investor basis. The board of

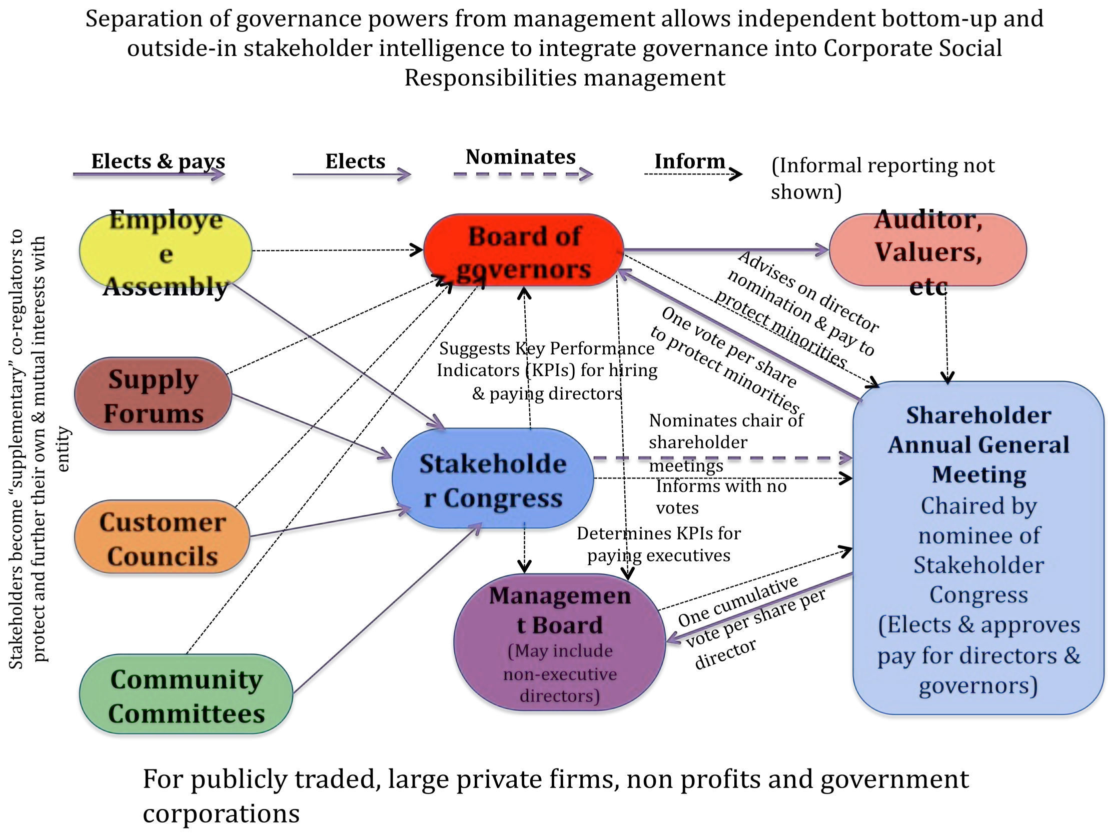
[1] Turnbull, S. 2016, 'Toxic Governance in B Corporations', posted on LinkedIn, December 22nd, <https://www.linkedin.com/pulse/toxic-governance-b-corporations-dr-shann-turnbull?trk=pulse_spock-articles>.

[2] These arrangement are described in a number of papers such as Turnbull, S. 2016, 'Terminating currency options for distressed economies', *Athens Journal of Social Science,* vol. 3, issue 3, July 2016, pp. 195—214, available from: <http://www.athensjournals.gr/social/2016-3-3-3-Turnbull.pdf>. Athens Institute for Education and Research: Working Paper, available from: <http://www.atiner.gr/papers/POL2015-1818.pdf>,

[3] Described by Senator Andrew Murray in his 1998 Parliamentary joint committee on corporations and financial services, Minority report located at: http://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/1999-02/complawreview/report/d02 Illustrated in Turnbull, S. 2012, 'Discovering the "natural

governors would then take over the role of director: audit, remuneration and nominations committees, as well as any other roles that provide directors with self-interested conflicts like controlling meetings of shareholders at which directors are being held to account. Such a division of power would facilitate stakeholders electing advisory boards to become independent supplementary co-regulators to protect and further their interests in expeditious, cost effective and responsive ways to improve both "consumer outcomes" and "regulation". The network of advisory boards indicated in the Figure 1 would have the right to recommend Key Performance Indicators (KPI) to further their various concerns. Stakeholder co-regulators could act in a much more knowledgeable, responsive and nuanced ways than any external regulator to reduce their cost and intrusiveness.

<u>Figure 1, Generic Illustration of network governance</u>



3. Remove the ability of banks to create deposits by making loans

The draft Report of January 2018 did not consider how to remove the privilege of private banks creating public money for private profit.

To avoid the privatisation of money creation by banks, many leading economists, like Irving Fisher[4], Milton Freidman[5] and Martin Wolf[6] have advocated that only the Government should

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laws" of Governance', *The Corporate Board*, March/April, Ralph Ward ed., Vanguard Publications Inc.: Okemos, MI, http://ssrn.com/abstract=2062579.
[4] Fisher, I. 1934, *100% Money*, Adelphi, New York.
[5] Friedman, Milton (1948): "A Monetary and Fiscal Framework for Economic Stability", American Economic Review 38(3), 245-264.

create money. Over the years this proposal has been described as "Sovereign money"[7], "100% reserve money"[8], "The Chicago Plan"[9] or "Positive Money"[10].

The current system is described as "fractional banking". It creates instabilities in the system and so the need in the past to have a "lender of last resort". The Federal Reserve Bank was privately created to provide lender of last resort facilities but failed to do so. The first time was in 1934 when all US banks had been closed by State Governments until the US government bailed out the FRB and so other banks. The second failure of the FRB was in the Financial Crisis of 2008 when the US Government had to again undertake bank bailouts.

In the past when currency notes were convertible into gold some economists described fractional banking as a fraud. This was because banks could print more paper money to lend out than the gold they owned. In other words their gold "reserves" were but a fraction of the notes and so the loans they could make. In any other business the creation of more liabilities than assets would create insolvency. It would be considered fraudulent for any other business other than a bank.

The power of banks to create deposit notes to finance their loans is still not widely accepted by the general public, bankers, politicians and even some economists. This may explain how the matter was overlooked in the draft report? This denial of how banks create deposits to finance their loans is why I wrote a monograph in 1983 on: "*What everyone should know about banking and money: Especially bankers and economists*"[11]. It is why colleagues[12] from the London based New Economics Foundation sufficiently embarrassed the Bank of England to publish on its web pages in 2015: "In the real world, banks provide financing through money creation" [13] They went on to quote on page 6: "Banks do not, as many textbooks still suggest, take deposits of existing money from savers and lend it out to borrowers: they create credit and money ex nihilo — extending a loan to the borrower and simultaneously crediting the borrower's money account."

Many others have confirmed how some textbooks and economist's misunderstand how money is created at: <http://www.fractionalreserves.com/?page_id=81>.

A contributing confusion is that economists, bankers and the public are commonly taught that money has to be saved to finance investment. However, the reverse can arise from an

[6] Patrizio Lainà, 2015, 'Proposals for Full-Reserve Banking: A Historical Survey from David Ricardo to Martin Wolf', <http://etdiscussion.worldeconomicsassociation.org/wp-content/uploads/Laina-30-march-15.pdf>. Martin Wolf video September 9, 2017, "Stop banks from creating money". <http://positivemoney.org/2014/10/martin-wolf-financial-times-stop-banks-creating-money-video/>.
[7] <https://www.sovereignmoney.eu/>.
[8] Op. cit n.1.
[9] Benes, J. & Kumhof, M. 2012, The Chicago plan revisited, International Monetary Fund Working Paper, WP/12/202, August 1, available at: http://www.imf.org/external/pubs/ft/wp/2012/wp12202.pdf.
[10] http://positivemoney.org/
[11] First published by the Australian Adam Smith Club in conjunction with *Optimism* in 1983 and republished in Ward Morehouse, ed., 1997, *Building Sustainable Communities: Tools and concepts for self-reliant economic change*, pp.149-158, Revised Second Edition, Bootstrap Press, New York City. <https://papers.ssrn.com/abstract_id=1128862>.
[12] Josh Ryan-Collins, Tony Greenham, Richard Werner, and Andrew Jackson, authors of: *Where does money come from? 2nd edition, 2012,* Forward by Charles A. E. Goodhart, New Economics Foundation, London, <http://s.bsd.net/nefoundation/default/page/file/b847162e8c996d5e26_fam6bqdx4.pdf>.
[13] Zoltan Jakab and Michael Kumhof, 2015, *Banks are not intermediaries of loanable funds - and why this matters,* May 29, Bank of England Working No. 529, <https://www.bankofengland.co.uk/working-paper/2015/banks-are-not-intermediaries-of-loanable-funds-and-why-this-matters>.

investment creating the savings to fund itself. Moulton[14] described this as "the round about method" of capital formation. Credit creation is required to catalyze the self-financing process. Governments possess the power to create credit and should do so to fund all self-financing projects rather than rely on foreigners[15]. Relying on foreign funds represents economic vandalism as in the words of Professor Edith Penrose it introduces: "unlimited, unknown and uncontrollable foreign liabilities"[16].

Confusion in understanding the role of modern banks is compounded by official language. Banks are described as "deposit taking" institutions when their main role has become "deposit creating" institutions. So much so, that over 95% of all money in modern economies is created not by governments, but privately by banks for private profit.

3. Creating competition

A fundamental problem of Australian Banks, as noted in the Draft Report, is the lack of competition. The Banking Royal Commission is revealing how banks are not only too big to fail or regulate but are also too big to reliably manage the complexity of their operations. So great is the complexity it has become difficult to identify if blame for misdeeds revealed by the Royal Commission can be seen to become the responsibility of any particular individuals, let alone directors.

The present command and control structure of banks makes it impossible to reliably manage their complexity. Why this is so and how it can be overcome by adopting my recommendation three is outlined in my article "Reliably simplifying the management of complexity"[17].

Unlike banks and Central Banks[18] that use double entry bookkeeping, governments alone can create money without also creating additional debt. In Australia the government has already, more by accident than design, built the digital infrastructure to issue debt free money at an interest rate of their choice to citizens.

This facility has been created by the MyGov accounts that now have over eleven million registered users in Australia. While the Reserve Bank of Australia (RBA) lacks such infrastructure it could be appointed the manager of these accounts if some independence of control was thought advisable. This would be a way to mediate the different views of two past members of the RBA board reported by the *Australian Financial Review*[19]. Warwick McKibben, a RBA board member from 2001 to 2011 thought helicopter money[20] should be issued by the Central Bank, while John Edwards, a board member from 2011 to 2016, thought that the government should issue helicopter money. Percy Allen, who headed up the New

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[14] Moulton, H.G. 1935, *The formation of capital*, The Brookings Institution, Washington D.C.

[15] Allan, P. 2017, 'Reduce migrant intake to relieve pressure', *The Australian Financial Review*, 26 April, p. 35, <http://www.afr.com/opinion/letters-to-the-editor/letters-immigration-457-visas-and-fast-rail-20170425-gvs9wr>.

[16] Penrose, E. T. 1956, 'Foreign investment and the growth of the firm', *Economic Journal,* 66: 220–235.

[17] Turnbull, S. 2018, 'Reliable simplifying the management of complexity', Royal Society of Arts, March 9, <https://www.thersa.org/discover/publications-and-articles/rsa-blogs/2018/03/reliably-simplifying-the-management-of-complexity>.

[18] Bholat, D. and Darbyshire, R., 2016, 'Accounting in Central Banks', Bank of England Working paper 604, 30 May, <https://www.bankofengland.co.uk/working-paper/2016/accounting-in-central-banks>.

[19] Greber, J. 2016, McKibbin prefers 'helicopter" option, *The Australian Financial Review*, 19 July, p. 3. <http://www.afr.com/news/economy/monetary-policy/warwick-mckibbin-prefers-helicopter-money-over-qe-in-a-crisis-20160718-gq82r1>.

[20] Freidman, M. 1969, *The Optimum Quantity of Money*, Chicago U.P. Il.

South Wales Treasury department from 1985 to 1994, proposed that the RBA should "directly fund public works" with "helicopter money"[21].

It is time for advisors to government like the Productivity Commission to change their habits of thinking. Technology now allows the nature of money and banking to be redesigned to be better fit for purpose for efficiently sustaining individual or social wellbeing[22]. How this can be rectified from internal changes in the big banks is next considered in the concluding section. But this does not take away the need for introducing competition to shrink the size of banks that are too big by developing the MyGov accounts to create a powerful and compelling option for Australian citizens to support.

4. Improving consumer outcomes and regulation

The terms of reference signed by the Treasurer on May 8, 2017 states includes "consumer outcomes" and "regulation". It then adds: "The Commission should have regard to the Government's existing wide-ranging financial system reform agenda and its aims to inter alia "Support consumers of financial products being treated fairly" and "Strengthen regulator capabilities and accountability".

Why these objective are impossible to achieve reliably is explained by the science of governance[23]. The laws of governance state it is impossible to control complexity without using matching complexity. This is described as "the law of requisite variety"[24]. A corollary of this law is that it is impossible to amplify regulation directly as is currently attempted by a single centralised command and control hierarchy. Likewise it impossible to amplify TV signals directly but this can be achieved *indirectly* with the use of supplementary sources of power. In a similar way it becomes possible for regulators to reliably amplify control *indirectly* by introducing a requisite variety of independent co-regulators.

The problems of regulators directly controlling complexity is also shared by CEO's of, centralised command and control hierarchies. So it is irresponsible for regulators not to require corporations to introduce supplementary independent co-controllers. The point being that it is in the interest of both corporations and regulators to insure that there is a requisite variety of independent supplementary co-regulators/controllers.

Stakeholders provide the obvious source of introducing a requisite variety of independent co-controllers/regulators. Stakeholders can have greater interest in

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21 Allen, P. 2017, Op. cit. n. 15.
Greber, J. 2017, 'Time to think the unthinkable', *The Australian Financial Review*, 26 April, p. 6. <http://www.afr.com/news/economy/its-time-to-think-the-unthinkable-halve-immigration-and-print-money-20170425-gvryyl>.

22 The OECD is developing metrics for individual wellbeing to complement GDP metrics they currently produce. The author's contribution to the OECD workshop last year explained why wellbeing is denied by the existing unethical "toxic" architecture adopted by banks. Refer to "Wellbeing opportunities" posted by the OECD at: http://www.oecd.org/statistics/Workshop-on-Measuring-Business-Impacts-on-Peoples-Well-being-Paper-Turnbull.pdf The author was also moderator of the OECD breakout session on 'Consumers' and society's use of business impact metrics' reporting to the final plenary session.

23 Turnbull, S. 2002, 'The science of corporate governance' *Corporate Governance: An International Review*, 10:4, 256–72, October, 2002 http://ssrn.com/abstract_id=316939
Turnbull, S. 2008, 'The science of governance: A blind spot of risk managers and corporate governance reform', *Journal of Risk Management in Financial Institutions*, Volume 1 No. 4. 360–8, July-September, at: http://ssrn.com/abstract=1742584.

24 Ashby, W. R. 1957, *An introduction to cybernetics*, Chapman & Hall: London, pp. 206 and 211 at: <http://pespmc1.vub.ac.be/books/introcyb.pdf>.

becoming activists than members of non-profit shareholders associations. After all a prime reason for regulation is to protect the interest of stakeholders. So it makes good sense for them to become directly involved not just in their own protection but to promote both their own interests and how their bank can better serve them.

Ralph Nader has demonstrated how a minority of stakeholders are willing to make contributions for a much large majority of "free loaders" in protecting and furthering the interest of all stakeholders. The success of Citizen Utility Boards (CUBs) has been documented[25]. Customers would donate cash to fund watchdog boards to counter the ability of executives capturing their regulator to increase prices rather than becoming more efficient. It became possible for donors to recover their money with reduced utility charges even though they might represent less than five percent of all customers.

In Australia, members of the Australian Shareholders Association[26] donate their time to further the common good of the many. Depositors, borrowers, employees and direct shareholders have much more compelling interests to donate their time to form watchdog boards to further the common good of not just themselves and other similar types of stakeholders but also for their bank.

The February 14th announcement[27] this year of the Government establishing Australian Financial Complaints Authority (AFCA) has little relevance for the win-win outcomes that can be achieved by involving the participation of stakeholders in corporate entities of any type in which they have a stake. Their stake may be as investors, employees, suppliers, customers, agents, distributers, franchisees and individuals in the host community affected by the entity.

There are many ways stakeholders can add value to firms by providing senior management with information that may not be available to front line managers or information that has been distorted, biased or lost from the need to simplify reporting up various levels of hierarchy[28]. Stakeholders can also add industry and competitive intelligence that is not otherwise available to the management. Hierarchies by their nature can only simplify complexity incompletely while networks can simplify complexity as reliably as require by increasing the density of the networks[29].

The author would be pleased to present further information in person either in private or publicly.

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[25] Givens, B. 1991, Citizen Utility Boards: Because Utilities Bear watching, Center for Public Interest Law, University of San Diego School of Law, http://www.cpil.org/download/CUB_Report.pdf
[26] The author was a pro bono director of the Australian Shareholders Association from 1972 to 1984
[27] http://kmo.ministers.treasury.gov.au/media-release/015-2018/
[28] Turnbull, S. 2012, 'Discovering the "natural laws" of Governance', *The Corporate Board*, March/April, (ed.) Ralph Ward, Vanguard Publications Inc.: Okemos, MI, http://ssrn.com/abstract=2062579.
[29] Turnbull, S. 2018, op. cit, n. 16.