Financial System Inquiry

Banking in Australia

Competition Policy Review

John Dahlsen LLB, MBA **27th March 2014**

Private Citizen

Interest in Business and Regional Banking (particularly at the small end)

CV attached

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Thursday 27th March 2014

Why am I making this submission?

I have been very fortunate in being at a senior position in three Sectors: banking, media and retail. In two of those sectors I have been Chairman and an active one probably, exceeding on occasions the role of a conventional Chairman.

In Banking I was a Director of ANZ for 20 years, commencing in 1985 and retiring February 2005 with many years as Chairman of the ANZ Audit Committee. Having retired more than nine years ago, I believe I am now free to speak my mind.

In retail, I have been involved at the bottom and top end as owner of a relatively small retailer, Dahlsens Building Centres Pty Ltd. It is Australia's largest independent timber and hardware retailer, with stores and manufacturing plants across Victoria, metro Sydney and the north of WA and NT.

In Media, I co-founded Southern Cross Broadcasting (Australia) Ltd which grew from a small company ($3 million in equity and $27 million in debt) to a company that was sold to Fairfax for approximately $1.7 billion with the share value increasing from about 30c to over $17 per share. This could be the first of the leveraged buyouts in Australia.

In this paper, I explore whether the national interest is served by:

- *the current structure of banking in Australia*
- *the prevailing approaches to risk management in the sector*
- *the current regulatory regime*
- *the impact of international developments such as the Third Basel Accord*
- *current arrangements around access to information*

I take a broad view of the national interest: not just Australia in relation to the rest of the world, but also the impact on small to medium business and regional economies.

My own experience in the small end of the banking sector is a recent failed, but valiant, attempt to save a small non-banking financial institution, Gippsland Secured Investments Ltd. GSI was based in East Gippsland, Victoria, where my family company, JC Dahlsen Pty Ltd, was founded over 138 years ago. With the huge time spent on this I have learnt a great deal about the problems facing small financial institutions compared to the Big Four trading banks. This experience goes beyond what has been set out in the attached GSI paper.

I hope that my combination of top and small-end experience is of value to this discussion.

In my semi retirement, I have maintained my passion and interest in the issues facing small business, particularly regional areas. My family has a strong connection with East Gippsland. The Dahlsen Family has lived in the area for five generations and been heavily involved in business and the local community.

There is little need to articulate why it is important to develop policy for small business — that has been done many times by many people over many years. Both sides of politics want solutions.

The difficulty is finding practical ways to help. With Government inquiries on Competition and Financial System, it might be possible to find some practical outcomes. These outcomes should not be based on any form of subsidy or concession by the taxpayer, but rather, establishing even playing fields and removing roadblocks (including red tape), to give small business a chance. The issue of an even playing field and regulation is different in every sector. The excellent Productivity Commission Research Report on Regulator Engagement with Small Business, September 2013, which had to be broad based, recognises that the issues are different sector by sector.

I am open to further discussion to amplify some areas where the Inquiry might have an interest. It is difficult given the wide terms of reference, to judge where the Committee's real interest lies, and what other submission, information and research are available to it. I expect if there is any other information sought, it will not be in a paper but in focused discussions.

I have taken a holistic approach. I recognise that the material within crosses the boundary of Competition and Banking Policy and the Audit Inquiry as well as Law Reform.

People tend to be frightened and intimidated by large companies, institutions and agencies. This is usually justified as these entities have huge resources to deal with disagreement and conflict.

These institutions are not perfect and they get it wrong just as individuals do. Scale and size do not eliminate mistakes.

It is clear the banks are putting in place teams headed by senior executives to deal with possible changes emerging from the Inquiry. These teams are large, very well resourced and have great research capacity. They will analyse every submission and if these are deemed not appropriate, or in their interest, they will be rebutted either by the Bankers Association or the individual banks.

For this reason, this material is not for publication in any form. If the committee wishes to release parts of it, then it is requested that permission is sought.

This paper has been prepared with limited resources from a small office in suburban Melbourne, with no library or similar resources, no staff and just a part time personal assistant. Several people have been very helpful, particularly former professional colleagues. Elisabeth Lopez has helped with the editing. Nevertheless, all views, opinions, assertions, and statements of fact are mine alone.

John Dahlsen.

PART 1 - The State of Banking

What are banks for?

The Structure of Banking in Australia

Bank Failure

APRA – Protection at a Price

Risk

The Role of APRA

More Bank Regulation and Barriers to Entry

Basel

What are banks for?

The banking system is fundamental to our society. Banks drive our market economy and exert a massive influence over its shape, direction and development.

As with utilities, communications and transport, we cannot do without banks: they are like the air we breathe and are fundamental to our well being. Failure of the banking system would cause chaos and bring the world economy to a standstill crisis of massive proportions.

The banks have played a key role in Australia's explosive economic development:

- the integrity of our economy
- how we run our business
- the internationalisation of the economy
- how we compete
- how we allocate our resources,
- which of us can grow with the help of a bank,
- where the economy and various sectors will move.

Banks are subject to many regulatory controls beyond those that apply to ordinary companies. While they complain bitterly about the value and cost of the regulatory intrusion, there is an argument — given their current behaviour, — for more intrusion. This would aim not so much to control activity but to ensure greater disclosure to the market, enabling customers to make more informed decisions.

This information, for the many reasons elaborated here, will enhance competition. We need not merely to change the structure or use anti-competitive tools, but to redress the huge imbalance between the banks and customers when it comes to information and power. It is not costly to deliver this information.

We cannot simply let the market dictate the structure and behaviour of our Banks. Competition policy alone is not adequate to this task — further intrusion on the sector's activities is necessary.

The Structure of Banking in Australia

Australia has a huge concentration of banks. The banks are at the top end of 20 of the world's banks in terms of profitability — an extraordinary result, given Australia's size relative to the other top 20 OECD economies. Yet far from diversifying Australia's banking landscape, globalisation and the entry of foreign banks seem to have made no impact on the system's overwhelming centripetal force.

Two of our top four trading banks are among the world's top 10 biggest lenders. In the past three years, figures for the Bank of International Settlements Australia show the Big Four have been the most profitable in the developed world, with a Return On Equity (ROE) of 15.9 per cent (with CBA at 18.4 per cent).

Standard & Poor ranks the Australian trading banks AA, a rating that is rare among the world's top 50 banks. Of 86 countries ranked, S & P found Australia has the fifth-safest banking system in the world.[1]

Domestically, the Big Four trading banks represent 26 per cent of the ASX 100. CBA, ANZ and Westpac are in the top five listed Australian Companies.

The Big Four's assets have grown from 94 per cent of Australia's national income in 1995 to 190 per cent today.[2] They account for a huge share of Australia's national product, outstripping mining, health and education combined.

The Big Four banks have 78 per cent of bank assets (total sector $3 trillion) and 80 per cent of deposits. Foreign banks have 11.4 per cent and second-tier banks 8.7per cent of bank assets.

With the lion's share of residential mortgages – 88 per cent- the Big Four look and behave too much like building societies, arguably at the expense of the corporate, small business and other sectors.

Since the GFC, the Big Four have:

- increased their share of wealth management significantly;
- look more like a bank assurance model;
- acquired St George Bank;
- Acquired Bank West / BOSI;
- Acquired many mortgage originators (Rams, Aussie Home Loans, etc);

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[1] Liondis, George, 'Australian banks among world's safest: S&P', *Sydney Morning Herald*, 17 February 2014 http://www.smh.com.au/business/banking-and-finance/australian-banks-among-worlds-safest-sp-20140217-32ufy.html

[2] Creighton, Adam, 'Bloated Busines of Banking', *The Australian*, 17 August 2013 http://www.theaustralian.com.au/news/features/bloated-business-of-banking/story-e6frg6z6-1226698681657

Many would argue that, but for the GFC, these transactions would not and should not have taken place. Prior to the GFC, the Big Four had acquired the state banks of Victoria, South Australia and New South Wales.

We have also seen a huge withdrawal of liquidity from the foreign banks. The foreign banks would not be interested in small business. According to APRA, domestic assets held by foreign banks have shrunk from $400 billion in 2008 to $330 billion today.

The market share data for the Big Four banks and others for deposits and loans reveals the increasing concentration by the Big Four in the 2013 year both nationally and in most states. These are significant market share percentage gains:

- National deposits for retail deposits by the Big Four gained 0.1 per cent and business by 3.6 per cent,
- National loans for retail loans dropped by (-0.8 per cent) and business loans gained by 5.9 per cent.

Table 1.1

MARKET SHARE GROWTH DATA **BIG FOUR v OTHERS**

	DEPOSITS		LOANS	
	RETAIL	BUSINESS	RETAIL	BUSINESS
Total Population				
Total Big Four	0.1	3.6	-0.8	5.9
Other	-0.1	-3.6	0.8	-5.9
NSW / ACT				
Total Big Four	-1.4	3.1	-0.2	13.3
Other	1.4	-3.1	0.2	-13.3
VIC / TAS				
Total Big Four	1.2	3.0	-2.3	6.7
Other	-1.2	-3.0	2.3	-6.7
QLD				
Total Big Four	2.1	2.8	0.1	-4.5
Other	-2.1	-2.8	-0.1	4.5
WA				
Total Big Four	-1.0	1.4	-0.5	-0.7
Other	1.0	-1.4	0.5	0.7
SA / NT				
Total Big Four	-3.6	6.8	-0.6	8.6
Other	3.6	-6.8	0.6	-8.6

No other sector — not even media and retail — come close to the high level of concentration in Australia's banking system. Media and retailing are in no way as large in world terms as our banks. This is particularly so for retail, when you strip out of Woolworths and Wesfarmers' non-retail activities. Further in this paper, I compare the retail and banking competitive environments, as there are transferable lessons.

The limited size of our market makes it hard for competitors. Any new entrant comes up against the Big Four would competing as a bloc, resisting the entry segment by segment. Moreover, it is questionable whether the Government would allow a foreign takeover of one of our banks.

In 2012, Labor Treasurer Wayne Swan tried to promote competition by banning exit fees, creating the mortgage-backed market for small lenders, and allowing deposit-taking institutions to issue covered bonds. Although welcome, these changes have made little difference.[3] In 2012 / 2013 the Big Four made profits from $25 billion to $27.3 billion.

According to Perpetual, banks have increased dividends over the past three years by $5.8 billion, of which $1.8 billion came from lower debt, $1.9 billion from increased dividends and $2.1 billion from cash profits.

UBS Analyst Jonathan Mott has noted that the growth in bank profits has come from lower provisions. Pre provision profit growth to share was 0.2 per cent.[4] Journalist Clancy Yeates argues this comes from more cautious borrowing. I would argue it is the Bank initiative in lowering risk.

Australian banks have been trailblazers in their capital management, allocating capital to reduce risk to increase profit against sluggish credit growth.

Given the banks' focus on ROE, why would they use the higher risk-weight capital, which costs more, to fund products other than the lower risk-weighted capital involved in housing?

ROE is the game and the banks compete with each other to increase this percentage. Moreover, management reward systems are designed to maximise ROE.

As I discuss further into this paper, the final Basel Rules are not due until 2016, and extra capital will now move by .05 to 1.5 per cent. Basel wants the Australian Banks to have more capital and be less leveraged to preclude bailout – to be too big to fail.

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[3] Editorial, *Australian Financial Review*, 25 November 2013

[4] Clancy Yeates, "Why Australia's bank profits defy hard times",*Sydney Morning Herald,* 11 November 2013 http://www.smh.com.au/business/why-australias-bank-profits-defy-hard-times-20131110-2x9zs.html

Our banks currently have tier 1, 2 and 3 capital of about 8.2 – 8.7 per cent (minimum 7 per cent). Under Basel, this is likely to go to 9 per cent. If a bank does not action this, then APRA will stop it paying dividends.

By 2016, the banks will be able to comfortably achieve this, although it will marginally lower % ROE, the key measure of bank performance.

If APRA followed the same bank rules, equity would rise from 11.4 to 12.2 per cent.

The smaller financial institutions are being squeezed. They have a number of inherent competitive disadvantages. The Big Four have to hold less capital against mortgages, thus increasing their own earnings. This puts them at a competitive advantage to the Regionals such as Suncorp and Bendigo Bank.

An issue is the mix of home loans to business loans. According to Creighton the safe business loans in 1990 have dropped from 270 per cent of the total value of loans to 50 per cent today. This is influenced by the risk weighting of assets, where housing requires less capital than business loans and where there is a great deal of parallel behaviour in this segment.

But what is in the national interest? Home lending is a simple product which could and is being provided by smaller, Non-Bank Financial Institutions (NBFIs), but there are too many entry barriers.

By contrast, business banking is more complex and any institution needs the knowhow and experience of the big trading banks to undertake this activity. However, it is understood that the margins for business lending, large and small (including SMEs), are higher than in US and foreign markets.

The growing cost of regulating banks advantages the larger players. With the higher fixed – as opposed to variable – costs of regulation means the large trading Australian banks can fractionalise the fixed costs and spread these costs across a wider base and number of customers. The smaller banks do not have the same opportunity to fractionalise these costs. And the regulator does not differentiate between the big and small banks in regard to regulation: one size fits all.

Given the high profits of the mortgage market, why haven't other Banks entered the market? Some have, by syndicating books of mortgages, enabling profits to be made by the syndicator and the syndicated.

The difficulties for a bank in entering the originator market and the syndicated market are quite different. The entry cost is high in the originator market and the established banks have too many advantages.

While regulation may not advantage the banks, technology does. Again, larger banks can afford a huge investment in technology, as a greater number of customers enables the spread of the fixed-cost component of technology.

Economists would argue that the banks are not competing enough on price. One should add they are reducing the risk and so increasing their profits and returns by much lower write-offs. The tightening of bank risk criteria leads to lower capital spending by our businesses, particularly SMEs and the mid-sized companies that have nowhere else to go.

What this means is that it is important to understand how the banks exercise their massive power, and what counter power customers have as a group or as individuals. As will be seen later, the architecture of bank supervision does little to help competition or increase the power of the consumer. APRA and the Reserve Bank in particular reinforce that state of affairs The ACCC and the Bank Ombudsmen with their current tools can do little. The architecture is skewed too much away from the consumer.

Bank Failure

The four trading banks' deposits, of up to $250,000 have been guaranteed at a cost. This offers them a massive advantage over those banks that do not have, or pay a higher cost for, guarantees of their customer deposits. This concession by the Government reinforces the view that banks are simply too important to be allowed to fail.

Governments argue that it is not guaranteeing the banks as such, and assert that should a bank fail, they would not bail it out. This is disingenuous — the Government could not let any one of the Big Four banks fail because their interdependence is such that should one fall, the others would be likely to follow.

If one bank were to fail, it would be in the interest of the others to take over that bank, wiping out its shareholder funds to the advantage of the acquiring bank. Clearly the Reserve Bank and the Government would intervene to encourage or demand this. This is reinforced by the fact that the concentration of the Big Four Banks in Australia is one of the highest in the developed world. The concentration risk is huge.

Whether, as in the US, the Government would help a bank by taking up a large equity is not known. Clearly there is a greater chance of the smaller bank being allowed to fail or take over than a large one.

The massive cost and disruption of failure is a reality so far as big banks and customers are concerned.

This raises some serious questions about the structure of banking in Australia.

The banks continue to grow in size, profitability and share of national income and it is hard to see what will change and what the position would be in say 10 years' time.

Clearly, small NBFIs are at a massive competitive disadvantage. Further in this paper, I discuss at length the case of Gippsland Secured Investments (GSI). It would have been relatively easy for GSI to be saved by one of the larger financial institutions, but this has not happened.

An institution like GSI can fail and will not hurt the other banks because there is not the interdependency that exists between the four trading banks.

The Coalition Government realises as does the former Labor Government that there is a need for a root and branch review of the banking system, given the state of competition. Many politicians of all persuasions are concerned about the lack of competitiveness and structural issues within the banking system.

Our competition laws are old and tired, and the market has moved on to a point where the ACCC needs new tools to deal with these competition issues.

The last banking inquiry in Australia, the 1997 Wallis Inquiry, assumed there would be significant competition from international banks. Not only has this not happened, but the international banks have retreated, in many cases with their assets acquired by one of the Big Four, thus increasing concentration.

APRA — protection at a price

APRA has been a great success in protecting the Australian bank sector from dislocation, particularly during the Global Financial Crisis. However, this has come at a price.

APRA is responsible for the Banking System's stability; it does not matter to APRA if loans are not made and the consumer is disadvantaged.

The Australian banking system has been admired internationally. It is a competitive advantage for Australia as a country to have a sound banking system in a fiercely competitive international environment.

Standards & Poors recognises Australia as one of four countries where constitutional frameworks render banking industry low (the others are Canada, Hong Kong and Singapore).

The IMF deemed in 2012 that Australia's financial sector was sound, resilient and well managed.

While these are important achievements, APRA must accept some responsibility for distortions in the system. There are parts of the system that have grown to the enormous advantage of the Big Four and others have not fared so well.

The Big Four dominate the housing market with:

80 per cent of all housing loans

30 to 56 per cent of their business;

Some business leaders (such as David Murray and Don Argus) complain that the Big Four are in reality building societies and neglect other areas, including business.

Home lending represents a huge slice of their business:

Table 1.2

Bank	%
ANZ	29
Westpac	55
CBA	56
NAB	32

The risk weighting and capital allocation drive this result, again influenced by APRA.

It is not in our national interest that other areas, such as small business banking and corporate lending, should be slipping as a total percentage of business:

Table 1.3

Share of Total Lending %				
	ANZ	**CBA**	**NAB**	**WBC**
SME	1%	2%	2%	1%
Business Banking	18%	11%	21%	19%
Corporate Other	23%	14%	14%	10%
Business & Corporate Banking Combined	41%	25%	35%	29%
Home Lending	29%	56%	32%	55%

Incidentally, one observation on the above table is the opportunity for CBA to change the game by lifting its share of the corporate market.

WBC could do the same, but many will recall when WBC aggressively reduced its share some years ago, and did itself some serious reputational damage.

Theoretically, risk weighting is based on the experience of default and loss, but what is the publicly available information on this?

If it is evidence based, then one can argue the market is working. But the public and analysts are entitled to have more information.

The banks appear to be reluctant to differentiate by taking different approaches on risk. That is why the banks are so similar. In its dealings with banks, APRA often alludes to the fact that one bank might have higher risk standards in one area. This induces the bank in question to increase its risk controls, usually by taking on the new risk metric from the other bank.

This uniformity is exacerbated by the banks' principal objective to increase percentage of Return on Equity (ROE). Although this is a derivative calculation, it is followed slavishly by all the banks.

Banks have rigorous processes and disciplines that follow from the risk weighting and allocation of capital that discourage exceptions. There is a lot of noise about the banks' burden and cost of reporting to APRA. APRA requires a huge amount of data both on a continuing and one-off basis. No doubt the gathering and dispatch of the data has become more cost efficient over time.

Has an independent cost-benefit analysis been done on this? This information could be opened up for public debate and scrutiny. It would open up for consideration the burdens of small banks who have less customers to fractionalise with fixed costs involved.

Is there any reason why APRA should be treated differently in this regard?

This would open up for consideration the burdens of small banks who have fewer customers to fractionalise with fixed costs involved.

What analysis has been done on defaults and losses in terms of Risk Weighting?

What is the correlation between reasons of failure and risk weighting?

I discuss this further in the section on Information Required and Risk.

Risk

The introduction of risk into banking has a long and meandering history. In the past, risk evaluation and the lending relationship with the customer were much more intertwined and integrated than they are today. Over time, these activities have become quite separate and in some cases ring fenced;

There have been other trends, like the rise of technology, risk metrics and cost reduction. Technology and software have enabled the elimination of a great deal of labour in credit processes, and this trend will continue.

Risk metrics have become much more sophisticated, removing labour and narrowing down the decision making.

Like retailers, financial institutions watch their costs and for the same reasons, banks are heavy users of consultants to undertake cost reduction. The numbers employed by Banks relative to their book values would have dropped dramatically over the years.

This trend of metrics intersecting with technology has enabled greater influence on decision making, and changed the nature of labour. It has also led to the development of rules or benchmarks when lending will or will not be made.

The problem is that rules or regulations tend to bring about a "one size fits all" approach, making exceptions more difficult.

One size fits all applies to geography, product and customer segments. It is understood, however, that some of the software metrics are able to deal with geography and size.

To make an exception means that someone has to take responsibility. In the current climate, with banks shedding labour quite dramatically, fewer people like to risk their careers and make exceptions which do not satisfy all the benchmarks.

Non-financial criteria like integrity, commitment to repay no matter how difficult the conditions, honesty, and similar characteristics have been all but taken out of the equation. There is greater weighting placed on quantitative analysis than quantitative aspects.

Given the broad or universal nature of the products sold by the banks, a lot of overall Portfolio Risk analysis is being undertaken. This means that certain segments can become quite unpopular with the bank, reducing its exposure in that segment, to the disadvantage of customers in that segment.

It is fashionable for a bank to gain advantage by finding a new risk metric that will help it analyse its exposure. Consultants who have developed new risk metrics have made substantial fees by taking that methodology from one bank to another.

The old fashioned Bank Manager, particularly the rural and regional bank manager, no longer exists. Rural bank managers had:

- Local history
- Respect in the community
- Awareness of new projects within the community and what should be encouraged or discouraged
- History of the borrowers and their values
- Time in the job.

Often the Bank Manager was well integrated into the community and was well known and respected for their activities outside banking. This knowledge was better than some of the metrics that now drive banking on a state or national basis and which are unable to recognise or cater to the exceptions.

There must be some exceptions. There is no "exception management". Once an area is adjudicated as too risky, the possibility of an exception is very low. Another way of expressing this is "a pocket of lending opportunity" but these are now rarely taken up.

The new mantra is, 'Risk at all cost'. But is this being abused?

How can we undertake new loans if we don't know much about their risk?
What is the probability of the risk occurring?
What are the consequences if the risk occurs?
What is the time dimension of the risk calculations?
There seems to be no overall assessment of whether one or more of the risks is real, or is remote. Each one is looked at separately.

It is interesting to look at the 2013 ANZ Annual Report, which identifies 30 risks for the bank.[5] It is a laundry list to ensure there are no surprises with risk identification. But it is of little assistance, at it lacks ranking, discussion of probabilities and consequences, and there is no overall architecture or analysis.

There is little analysis of the upside of opportunity: no agreed categories of upside, or even any contemplation of the possibility of upside occurring, let alone the consequences of that.

Surely the upside must be compared with the downside?
The trouble is that the risk becomes a part of the culture, values and processes of the organisation, and there are no exceptions. In a sample of 10, surely there must be some exceptions to the risk occurring. But that is not the way banking works.

The credit control cells are currently very powerful in the banks. The Relationship Manager has less authority with the credit cells having total control, even to the extent of minor

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[5] 2013 ANZ Annual Report, p 191

changes. While each bank might have a different organisational model, there is no exception management save by appealing to more senior people in the credit chain.

One bank, ANZ has acknowledged in its 2013 Annual Report 2013, that it's Risk Framework is top down, being defined by credit principles and policies[6].

It could be argued that the 2012/2013 bumper profit season for the four trading banks has been substantially influenced by the lowering of risk, with consequently fewer write-offs and as a result, cost reduction. After all, there has been little volume growth, minimal if any margin growth and if any, a decline in some asset values.

It is interesting to review the role of APRA in respect to the levers of bank profitability (see table at the end of this section). This can be readily expanded.

The underlying reality will not change: credit executives are now a protected species and isolated from the lending functions. There is no cost or loss of promotion opportunity or salary by saying no.

Some credit events can be observed in the field and it is thee on-the-ground observations and reality that are often missing. It is irrelevant to the Bank's approval process which transactions fail and which proceed.

One of the problems with aggregate risk controls is that if the bank (irrespective of whether influenced by APRA) decides to reduce exposure in one main sector so that the overall reduces, then the other sectors have to reduce their amount lent to bring their percentage within the overall limits.

An example of this was during the GFC when larger companies were paying down a lot of debt and not borrowing much. The aggregate exposure to the corporate areas was reducing. This forced the banks to reduce their exposure in the other areas to get the overall percentage mix right.

This was particularly bad during the GFC at a time when the banks should have, wherever possible, supported lending.

The above is a typical example of some of the crude, arbitrary and poor aspects of credit metrics. Was it really necessary to reduce the risk with other areas? Was the risk in the other areas serious enough? Did it not matter that the aggregate percentages were skewed for a while?

In short the banks did not help during the GFC. If anything, they exacerbated the crisis.

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[6] 2013 ANZ Annual Report, page 26

The banks did not have the same sense of responsibility that the Government had in seeing Australia through the crisis.

Risk weighting depends upon the product or segments' default and loss history over an agreed period. It assumes that history will repeat itself. This may not be so — the prior loss experience could be based on unique and non-repeatable factors.

Nor does it take into account satisfied and unsatisfied demand — positive and negative factors which may or may not emerge, or possibly different geographies, size and loan covenants.

How does one deal with new products with no default or loss rate to determine risk?

Has there been an assessment of whether the banks' methodologies have led to lower risk? What are the consequences of lowering risk in relation to unsatisfied demand?

There are possibly myriad other factors which would give rise to modification of the actual risk, including change covenants and asset values.

We do not know how successful it is and to what extent history repeats itself.

Table 1.4

The Role of APRA

Levers on Bank Profitability and Return on Equity A	APRA Direct Influences B	APRA Indirect Influences C	Bank Position D
1. Margin and Pricing		Margin / Pricing drives volume but must be within the Risk Framework and capital	Banks are similar, helped by minimums under the Risk Framework
2. Volume		Volume can be driven by lowering Risk but APRA sets the minimum standards	Banks have different appetites for volume in the various segments, influenced by market share gains & losses and priorities for capital eg. ANZ / Asia subject to APRA overall caps
3. Interplay of Volume and Margin		Same as 1 and 2	Same as 1 and 2
4. Risk Weighting & the Allocation of Capital	APRA decision, is vital		Risk allocation of capital to achieve high returns because of different risk weighting but there may be other factors as in 2
5. Leverage in Equity / Debt Mix	APRA sets the minimum tier one, tier two capital which limits leverage		Banks are similar because of APRA minimums or tier 1 with capital
6. Return On Equity	Is a bi-product or outcome of 5 and 4		This is a derivative outcome but nevertheless Banks are similar in that their principal objective is to improve the % Return On Equity
7. Cost Reduction		Lever of bad debt provisions and impairments are monitored by APRA , otherwise Bank free	Banks differ but all strive to reduce costs to achieve productivity & efficiency gains . But significant cost of impairments are a function of risk performance and APRA

More Bank Regulation and Barriers to Entry

Since the GFC, there has been a deliberate shift toward global coordination of financial regulation. Basel III appears now to be a reality for Australia banks.

Australian banks had hoped that by virtue of their strength and capitalisation, Basel III would not apply in its entirety, but instead in some modified form. They argued that they were well regulated and thus did not need more capital.

More capital would impose more costs, which would have to be passed on to bank customers.

The consequence was that the banks would be less efficient in the use of their scarce capital resources. This would feed into the community, with higher costs given that interest on deposits costs less than with tax deductibility than share capital.

So why pick Australia? Basel III is being driven by international agencies which, like all regulators, want a one-size-fits-all approach and a global level playing field.

In the light of the Global Financial Crisis, they wanted to be certain that banks could survive, hence the desire to de-risk the international banking system.

Basel

It is accepted that on a global basis, the Basel banking reforms were needed. Globally, there were practices which, especially to Australian eyes, if not dealt with could have a serious impact on the world economy. The Basel Committee on Bank Supervision (BCBS) charter mandate is:

> To be the primary global standard base setter for the prudential regulation of banks and provide a forum for cooperation on banking supervision matters. Its mandate is to strengthen the regulation, supervision and practice of banks worldwide with the purpose of enhancing financial stability

An important point is that BCBS does not have any legal or formal authority within each country, nor indeed Australia. Its decisions do not have legal force. Rather, BCBS relies on its members' commitment to achieve its mandate. It is clear that APRA takes Basel deliberations very seriously, almost as if Basel has the force of law. Indeed, APRA has volunteered a member for the Basel Committee: Australian (Wayne Byres) is the next Secretary General.

As a general proposition, credit awareness and assessment needed to be significantly upgraded on a global basis, uplifting the standards of some countries significantly.

The only practical way that could be done was by establishing global benchmarks. If countries could not meet those benchmarks, changes would need to be made. No longer could a country's banking system and architecture be a differentiating factor in assessing a country's competition advantage or otherwise.

For a country, minimum standards become mandatory. A country's risk profile had, in the interest of avoiding worldwide financial disaster, to meet international levels. In other words, some countries exchanged their competitive advantage for securing the safety of the world economy. Australia was in that position.

Although there was some evening out of competitive advantage to exceed the Basel benchmark, this could only help the assessment of safety risk view by the country rating agency.

This does raise the question of how important it is to receive the top result for Sovereign risk. What does that mean in terms of benefits and costs to Australia, and for companies, foreign investors and those wanting to do business with Australia?

The Basel III agenda and objectives are clear, but we now have another layer of regulation about to descend. What is it? **DEPOSIT, WITHDRAWAL, RISK WEIGHTING to establish a Deposit Coverage Ratio.**

The regulators are now devising another measure of liquidity and one relating to cash-flow stress from deposit withdrawals. The underlying principle is that the banks should be able to cover for a period of 30 days the demand for the repayment of all deposits at risk.

This requires the banks to assess how sticky their deposits are, which ones are likely to be recalled and which are likely to remain.

The regulators are driving another form of risk weighting: the likely risk of withdrawal for up to 30 days to be covered by liquid assets.

All deposits are risk weighted as a percentage, and this is aggregated to determine how much can be withdrawn and how much is likely to be withdrawn within 30 days. If this is, say, 10 per cent of all deposits, then the bank will have to hold this as a 10 per cent percentage in liquid assets. This will lead to change in margins on the various deposit maturities.

If the bank cannot meet the test, then more tier 1 and tier 2 capital will be required.

From the point of view banking system safety, this is good. But it does represent another layer of regulation, which has other consequences.

It is another step towards increasing the banks' concentration, raising the barrier to entry for new players and making it more difficult for the smaller players. This compounding regulation has serious competitive ramifications worldwide.

Creighton (The Australian, 2013)[7] claims regulators have unduly influenced approaches to capital, rather than a bank's assets or book.

However, Capital Ratio says nothing about how risky the actual assets are. The assets are risk weighted, with lower risk assets having a lower weighting (RWA), but capital ratios are calculated from RWA, not just their face value.

Leverage drives ROE but because of that leverage, small changes in the capital contributed by a bank have nowhere the same effect as the same percentage change in asset values.

Thus, 20 times leverage equates to a 20% reduction in assets, equivalent to 1% change in capital.

While the regulator attempts to deal with Risk Weighting, a number of assumptions that risk weighting is dependent upon, may or may not be correct.

Also capital is a liability which needs to be serviced. It is a market-based source of funds but with a different profile to borrowings.

APRA put its Advanced Measurement rules on risk assessment in place before the GFC. At that time, the smaller banks were unable to meet the higher risk weighting standards, and so

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[7] Creighton, Adam, *The Australian*, 6 December 2013.

had to contribute more capital. As Drummond asks (AFR, 2014), is this fair or good for bank competition?[8]

According to Eyer (AFR, 2014)[9], the bigger banks could afford to invest more in technology and systems, and did so.

[8] Drummond, Shaun, *Australian Financial Review*, 22 January 2014
[9] Eyer, James, *Australian Financial Review*, 22 January 2014

PART 2 - Banking Competition

Banking vs Retail Competition

Where the Banks are Joined Together

The Causes of Parallel Behaviour – People and Metrics

International Competition Policy

References: International Competition Policy

Banking vs Retail Competition

The Banks compete through engaging in parallel behaviour and colluding with each other to the disadvantage of the consumer. Consumer choice is limited because the lack of differentiation.

Many factors contribute towards this limited choice, such APRA's influence over banks on risk weighting their assets and the capital required to support the different asset classes. Given the importance of risk weighting, it seems to an extent inevitable that APRA's influence would be apparent in product design.

This collusion or cooperation is reinforced by the incestuous nature of banking where:

- Executives move from one bank to another;
- There is a lot of sharing of information – for example, syndication loans which lend themselves to cooperation on margin covenants;
- Bankers, particularly the senior bankers meet at forums and conferences around the world.

It is collusion, not collision. And it is collusion against the interests of the consumer.

This is in direct contrast to what occurs in retailing. Retailers compete vigorously with each other to advantage the consumer, but to the disadvantage of the supplier. They try to differentiate their offer by 'home branding' to make comparison more difficult.

Retailers attempt to earn more consumer dollars by chasing volume, thus earning more gross profit dollars at the expense of a lower percentage margin. I have coined this the "tyranny of percentages" and written a paper on this subject.

To deliver great value and gross profit dollars, retailers put massive pressure on the suppliers to deliver that margin.

This is often funded in whole or part by the supplier, with the retailer capturing the advantage of more gross profit dollars and return on investment in stock. The retailer argues that the supplier is also getting an advantage of volume and more production efficiencies. This is often right, but the balance is questionable.

In so doing, retailers are colliding with each other and competing vigorously, albeit at the expense of the supplier and to the benefit of the consumer. This is by contrast to what happens in banking.

One Bank CEO wants the Four Pillar Policy to be reviewed. He is pessimistic about the outcome but believes we should have the debate and discussion.

I agree that we should. We need a fifth pillar, a bank that will inject true competition into the market place.

Banks do not like customers having a choice. They want to reduce customer choice, so they like bank consolidation: *"We are professional and you should accept what we offer as we are professional and it doesn't matter that you have only three choices not four."*

In business, tendering is routine, and tenderers often have to deal with many more than four competitors. For banks, this is anathema, and they take many steps to avoid it. I will elaborate on this discussion later.

Where the Banks are Joined Together

The banks are joined together by payment card and other systems. There are many other areas where it is in their joint interest to work together, sometimes called "co-opetition". The community derives benefit from the common systems, and it follows that genuine competition does not exist in many parts of banking.

As an executive works through an organisation, he or she moves through phases of working with other banks and not competing.

It is no wonder that these issues tend to drive banks to cooperate and work together rather than compete vigorously, except in limited areas. For instance, home loan marketing conveys to the public the idea that the competition is real. In reality, bank margins in home lending are similar and some of the highest in the world. Home loan divisions are hugely profitable.

The consequence is that the banks' share of the mortgage market has increased at the expense of NBFI's. Further, with the collapse of the mortgaged-backed securities market, the ability of NBFIs to lay off loans has diminished.

As between the Big Four and the second-tier banks, a 30 to 40-point advantage is very significant.

The role of APRA is to protect the banking system, not the consumer: APRA is all about setting minimum risks and forcing the banks to act in a similar manner. Accordingly, exceptions and differentiation are not encouraged.

Governments do not object this because APRA ensures the safety of the banking system, which is important for one country competing against another.

The Causes of Parallel Behaviour: People and Metrics

There is a great deal of parallel behaviour — conscious and unconscious — in the banking world. Much of this occurs through movements of people between institutions, and the metrics banks use.

Over the years, banks accumulate huge knowledge of the market and their customers in the various segments. Banks also have a huge investment in technology, systems and product knowledge. A great deal of this knowledge resides in the executives and staff and it is for this reason that bank staff are paid well and better than most other sectors, because of their attractiveness to competing banks.

Once upon a time executives would rarely move between banks, but now this is quite common. When one executive moves to another bank, whether it is at the level of the CEO or the coalface, he or she takes with him a great deal of information that is beneficial to the recruiting bank.

An executive has a better chance of promotion and pay increases if he makes himself marketable to another bank. For some, this is the only way of moving ahead and earning more.

Similarly, consultants and accountants move from one bank to the other carrying with them a lot of information from other banks' consultants. There is a lot of knowledge transfer.

A great deal of management know-how and customer knowledge spreads, leading to similarity between banks. Australia is simply too small for this not to happen.

A disturbing consequence of this is when a senior executive moves from one bank to another, taking with him negative information about a customer's credit history. There are well known instances where this has resulted in the new bank changing its relationship with that customer, either by trying to remove or lower its exposure to that customer. This scenario could well highlight deficiencies in Australia's privacy laws. Should information be used for a collateral purpose?

Metrics also drive uniformity. APRA's focus on credit risk means it often suggests minimum loan conditions as best practice. The banks fall into line.

As I have discussed earlier, it is apparent that most banks concentrate on increasing their Return On Equity. Executives are rewarded for achieving this, so the banks' policies and actions in achieving this are very similar.

ROE is influenced by the mix of equity and debt. The higher the level of tax-deductible debt, the less costly that debt is to the bank. There is a sameness about the Bank strategies in this area.

An emerging argument in this area is that competition – reward should be based on Return on Risk Weighted Assets (RoRWA), not on ROE.[10] The experience of Bain & Co indicates RoRWA makes reward schemes more logical and better conceptually.

In RoRWA, banks risk-weight the asset, which means that lower-risk activities such as home loans require less capital. So became the influence the risk weighting so Banks have a similar approach to risk and the nature of business metrics.

The Banks use similar levers to drive profitability:

- Price margin / volume; the interplay between the two;
- Cost;
- Risk and capital allocation.

Syndicated loans are an area of great concern. A syndicated loan involves several banks joining together to fund a large corporate. In the process of putting the loan together, the banks reach agreement on the terms and interest to be charged. Because of the size of the loan, the client cannot deal with just one bank. And because there are so few international banks in our marketplace, clients are faced with near-identical loan terms. In theory, these terms could be different, but in practice they never are.

While the ACCC has been unable to find evidence of improper behaviour or interest-rate setting, the reality is that the outcome of RBA announcements is that banks' responses are very similar.

While direct collaboration or parallel behaviour is difficult to prove, it is a common characteristic of oligopolistic industries.

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[10] Sinn, Walter, D'Acunto, Rocco and Oldrin, Andrea, 'European banking: Striking the right balance between risk and return' (Bain & Company, July 7 2013). http://www.bain.com/publications/articles/european-banking-bain-report.aspx

International Competition Policy

A 2009 IMF working paper on competition policies in the financial sector set out the tensions between the desirability of competition and the need for financial stability:

> "The view that competition in financial services is unambiguously good, however, is more naive than in other industries and vigorous rivalry may not be the first best... Specific to the financial sector is the effect of excessive competition on financial stability"[11]

The common measures of entry and/or contestability are difficult to apply because of the complexity of the financial sector.

Other objectives have to be considered, such as:

- Financial sector efficiency;
- Access to financial services for various users;
- Systematic and financial sector stability;
- And consider trends often between these objectives.

So far, greater competition has been achieved by traditional means:

- Removing barriers to entry;
- Reviewing packaging;
- Some barriers to exit / entry.

However, globalisation has given rise to complexities, regulatory issues and new products, making traditional means more difficult. In comparison to other sectors, competition policy is behind, and competitive policy will be difficult to organise across countries. Increased competition has led to excessive risk, so one needs to consider broader issues, including the problem of over-regulation.

After considering a great deal of research and competition policy strengths and weaknesses of many of the tools of competition in the environment, the IMF papers put forward three approaches:

1. Ensuring that the entry / exit rules facilitate contestability;
2. A level playing field so that there is intra-sectoral competition;
3. Ensuring that the institutional environment eg payment, card systems etc, are contestable. The environment in this case includes taxes, regulatory architecture, disclosure requirements and capital adequacy.

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[11] Claessens, Stijn, 'Competition in the Financial Sector: Overview of Competition Policies', International Monetary Fund Working Paper, 2009, http://www.imf.org/external/pubs/ft/wp/2009/wp0945.pdf

In terms of level playing field, much was made of the need to give consumers more information. This would help consumers understand uncompetitive products and expose inadequacies. This in my view is where competition can be enhanced in Australia by making more information available, and I discuss this further.

Claessens concludes that experience and evidence on competition on the finance sector is scarce and not yet clear. He argues that the banking sector can learn from other sectors that have experienced relatively sophisticated problems, and are far more advanced in terms of competition policy.

This paper discusses and compares the issues surrounding competition within banking and retailing. The terms ‘collusion’ used for banking and ‘collision’ for retailing are emotive and may be exaggerated, but they do describe two different concepts of how companies compete and they do give rise to particular analysis.

For collision the power between retailers and suppliers is out of balance and that is why the situation is unfair. The problem will only get worse with current regulatory tools.

For collusion between the banks, the way to break this is through encouraging new entrants. How can barriers to entry be removed and the banks’ responses change? If this is not solved, then the established banks will go from strength to strength and are unlikely to change behaviour.

A key objective of this inquiry is ensuring Australia’s banking system remains globally competitive. Competition policy is fundamental to the inquiry so questions need to be asked:

- Are the existing competition principles appropriate for banking?
- A study on the main principles and sub-principles of the legislation needs to be done to assess the adequacy of current legislation
- Is there a case for separate principles as contemplated overseas because of the interdependency of banking and the role of the Supervisory Agencies and Regulators?
- If so, how would the competition issues be determined with the non banks?
- Is the case committee going to make recommendations to the ACCC enquiry?

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PART 3 - Banking vs Retail

Banking Collusion - Retail Collision

Big Retail and Big Bank Performance

Production / Market Driven Strategy and Organisations

Banks – Organisational Climate

The Case of ANZ: a small-cell approach

Case Study: BHP

Dictatorship of Data

Financial Ombudsman Service

Comparison with Airlines

Competition Policy: Intent vs Impact

Banks – Barriers to Entry

Digital Disruption

Deregulation

Retailing – Barriers to Entry

Banking in Regional Australia

Non Bank Financial Institutions (NBFI)

Banking Collusion - Retail Collision

Retail customers enjoy a great deal of power, and they exercise choice and make decisions every day. They benefit from what we call collision – where retailers compete vigorously with each other, often to the detriment of suppliers, but to the benefit of consumers.

Contrast this with banks, where customers make much fewer decisions and have much less information enabling informed choice.

If we were to represent this as a spectrum, banks would be at one end and retailers at the other. Within that, the various segments and products would rank differently on the indices. The correlation between where you are on the information index and power index would be interesting.

In retailing, it is a challenge to control costs, whether they be fixed or variable. Success in retailing relies on understanding cost behaviour, particularly its relationship to sales. Because costs tend to rise, retailers need to be driving sales and gross profit dollars, not the percentage, so that they can continue to fractionalise fixed costs. By contrast, falling volume raises fixed costs and is a recipe for disaster.

Driving sales and gross profit dollars usually means increasing or protecting market share and gaining more customers and / or more share of the customer's spend.

If the retailer does not satisfactorily and quickly respond to customer trends, market share will be lost. The consumer chooses between location, products, brands and price.

It is similar to the ratings of television and radio. The consumer is choosing a store on the basis of advertising. The consumer in all these cases has a lot of information — if anything, too much.

The retailer collides downstream against the supplier (the manufacturer and the new material supplier, such as farmers) for the benefit of consumers, and

so capturing the available rent by using their volume and market power to demand lower buy prices.

The more floor space, shelving or footprint and consequent volume, the more the retailer can force suppliers into dealing with a limited number of retailers'. This is happening in Australia, where the two major supermarket have an 80% share of hard groceries, one of the highest concentrations in the world.

For banks, it is quite different. The scope for collision is limited but the scope for collusion against the customers for the benefit of each other is significant in terms of increasing performance.

In banking there are so many ways of gaining advantages by lag times, poor or delayed information or the ability to compare margins and deals, given the complexity of the product.

Remember that the banks are dealing with large money values or the volume of small monies. Small changes in percentage can mean huge dollars for large value. Small changes in the amounts levied on the volume of small transactions also mean huge dollars.

To put it another way, bank clip ticking occurs where there are small fees paid and rapid turnover of small transactions, or a small percentages on large amounts.

Banks are adept at passing on their costs or material penalties into fees paid by customers. With all the banks doing the same, consumers become captives, and their choice is limited.

Large retailers are able to charge suppliers fees for:

- Advertising / promotions
- Shelf and introduction space
- Premium, including end and eye-level space
- Information
- New Stores
- Shrinkage costs

Brands or suppliers must accept these charges — they do not have choice. Where percentages are used, inflation is protected.

The most recent change is information gathered by the retailer for its own benefit at a much lower cost than the supplier can obtain elsewhere. The revenue for the change to the supplier is incremental and very profitable.

For a supplier not to avail itself of such information would indicate to the retailer that it has no interest in understanding consumers' actions.

The supplier's only response to pressure from the retailer is for long production runs to lower their fixed and unit costs. But most suppliers are not given contracts beyond 12 months' duration (although there are some exceptions), which would enable them to get a return on their capital.

As a result, suppliers rightly question whether the capital required for longer runs or more efficiency is likely to match the return on the capital invested for such time uncertainty. Once long production runs for volume are entered into, the supplier is vulnerable should the supermarket decide to switch to its own branded product.

A recent development is supermarkets using consolidation to make sophisticated demands of their suppliers. For example, when supermarkets rationalise Stock Keeping Units (SKUs) within a category, they claim this will be better for suppliers as the number of pallets they order will rise and create production efficiencies. The supermarkets then want to be rewarded through special rebates or lower prices.

Where the supermarkets can show a supplier more efficiency, they want a share of that efficiency gain. Where supermarkets orders by pallet or truck load, again, they want the benefit of the supplier efficiency gains. The supermarket will establish what that efficiency gain is and if the supplier does not agree, the supplier must supply confidential facts and information to justify a different view.

Where consolidation is taking place in most categories, leaving only two suppliers who can survive. These suppliers in turn squeeze the primary producer. In other words, consolidation is taking place right throughout the supply chain to the continuing disadvantage of not only the primary producer but the small suppliers and the suppliers of raw material.

Although some suppliers share information on supermarket tactics with other non-competing suppliers through the Grocery Council, this is fairly ineffective.

One of the reasons why suppliers do not want to level with the public, the Grocery Council of Australia or other non-competing suppliers is that the characteristics of each category are quite different. It is easy for the supermarket to tell who is talking or protesting. Word gets around. So in order to protect their business, suppliers do not talk or if they do, they cannot afford to be completely transparent.

There are numerous examples of suppliers having their supply threatened or cancelled, and to be taken to the brink. With the consolidation at the supermarket level and among the suppliers, concentration of power is only growing and will continue to do so unless some quite dramatic action takes place. Banks could, but cannot, tell you of the damage to some suppliers. Banks would certainly be putting a risk factor on lending to a supplier.

When there are, as in most other markets, four to five big players, then the supplier is much more able to say "no" to one retailer when volume profit cost issues arise. Where he has only a choice of two, he destroys his business. That says it all about the power balance and the capacity to capture the rent.

If the public were truly aware of the reality of what is happening and this could be communicated and marketed, then small retailers or suppliers might have a chance of surviving. In the meantime, there will simply be a bubbling on the surface of these tough practices, which many would say are un-Australian. For many, sheer price and convenience is the overpowering driver.

Coles and Woolworths are good for each other. The intense competition means that the leaders of each organisation can use this competitive pressure to drive improvement, innovation and consumer values in the organisation.

Banks, by contrast, drive risk improvement, not consumer value. In some sectors, such as mortgages, some information is available. But we know little about what pricing is used in Loan to Valuation Ratios (LVR) and the interest covered.

More information could change banking competition. It is not more regulation that is required, but information, so that the consumer can understand and choose better.

Retailers capture the rent by colliding with the supplier. Banks capture the rent by starving the consumer of important information.

The difference is that banks and retailers have a different way of capturing the rent. The supplier is in a weak position and in many bank segments — especially some business banking products — the consumer is in a weak position.

If the pubic knew how the retailers were squeezing suppliers and primary producers and the consequent fall in profitability, they would be outraged.

Proper information in the market place would offer a better chance, through customers changing their buying habits or new competition tools, to deal with the situation.

Big Retail and Big Bank Performance

Recent financial results show that the banks, Wesfarmers and Woolworths are very profitable and large by world standards:

- Woolworths' margins rose from 2.56 per cent five years ago to 2.94 per cent this year. This 1.28 per cent difference is equal to $749 million in gross profit;
- Coles improved its figures on the last year from 3.97 per cent to 4.28 per cent;
- Woolworths ranks no.17 and Wesfarmers no.19 globally in sales.

If one were to remove Walmart from the rankings, Woolworths and Coles are much closer in size to the others. As with the banks, it is extraordinary that in a country our size, the four banks and two retailers are so large and successful by world standards. This is both an advantage and a disadvantage.

Over the past five years, banks' share of profit gain and dividends have produced total shareholder returns of 134 per cent — twice the return delivered by the top ASX 200 index as a whole.

The banks have returned 44 per cent the past year, outpacing the ASX 200 index by 26 per cent.

Production / Market-Driven Strategy and Organisations

A culture of responsiveness to the consumer is key to success of companies like Walmart, Woolworths and now Coles Supermarkets. Sadly, on a consumer response index, retailers and media would rank at one end and the banks at the other.

One way to look at current banking strategy is the dichotomy between production driven and market or consumer-driven strategies. A production-driven approach affects the values and culture of an organisation in quite a complex way.

In retailing and media, strategy is driven by the market or the consumer, not by the producer of the goods. Consequently, the organisation's culture is geared to the consumer, and the organisational structure can be simpler: it is built form the consumer down. The organisation tends to have greater clarity.

In banking, the strategy is diametrically opposed, driven by the producers, i.e., those producing the banking product or service. This is partly due to the huge regulatory influence over the design of banking products. Regulation requires huge costs, resources and people, technology and capital. The internal organisation, design or architecture of the bank will be heavily product focused, with minimum regard for consumer needs. There are more likely to be silos involved in producing goods and services. It is often difficult to integrate these silos and align them to servicing the customer.

From the consumer's point of view, banks have traditionally been difficult in relating to customers. It is common knowledge that customer relations staff at the bank do not have much power. The information flow from the customer up through the ranks of the bank is poor and little knowledge is extracted from that flow of information.

Most retailers hold regular meetings (some daily, some weekly) with floor staff to enable management to obtain meaningful insights into customers, and this information is taken seriously. Liquor retailer Dan Murphy's, for instance,

requires checkout staff to write up meaningful interactions with customers, whether good or bad.

When the CEO of Woolworths visits stores, he uses a dictaphone to record all the comments made to him by staff or customers, which then goes to support office for immediate attention. This is checked the following day to see that action is taken. A surprising number of these comments raise important issues rather than minor complaints of inconvenience. It is difficult to imagine this happening in a bank.

I am not necessarily suggesting a bank CEO could replicate a retail CEO. This is not a game of symbolism but one of relating to the consumer, and recognising the reality of the consumer and their general power.

Sam Walton, the founder of the world's largest retailer, Walmart, was legendary for his store visits, which he made even as he was dying of cancer.

The motivating effects on staff of such behaviour were incredible, and flowed through to attitudes to the customer. Valuable information was gained from listening and then taking action.

The innovation in banking that could flow from this kind of culture, as well as actions more specifically designed for the various banking segments, would be significant and a path worth travelling.

A case in point that bridges both sectors is the success of the heirs to Sam Walton. They have invested their wealth outside Walmart by acquiring a number of small private banks in the US, evidently with dramatic success by applying the same retail principles.

By contrast, in banking, frontline staff are probably tired of listening to customer complaints.

Banks waste a great deal of effort trying to promote their customer empathy credentials. In reality, there is little empathy: the culture, values, organisation, design and power militate against that.

The driver in the banks is ROE, and a consequence of that is that expenses rather than customer issues and cost efficiency are at the forefront. No bank likes an inferior ROE.

Banks - Organisational Climate

Some argue there is a close correlation between staff and consumer satisfaction. Customers can sense staff disenchantment and they see how it affects their service. On the whole banks are not great places to work. Policy tends to be top-down, with little notice taken of customer-facing employees. This exacerbates the production-driven atmosphere. Many bank staff live in fear of losing their jobs because of a convergence of developments:

- De-risking with lower bad debt;
- Recent flat demand;
- technology efficiency gains;
- Policies of driving down the cost of income ratio and income per employee.

Former ANZ CEO John McFarlane realised this and introduced many innovative policies to motivate staff. During his tenure staff engagement and customer satisfaction rose during his regime. These policies have subsequently been abandoned.

Because of the size of our economy and the size of the banks and the lack of competition, it is difficult to innovate in this area. The banks are universal with their market offering and it does not matter if one area is down: there are others to compensate. There is no need to innovate. As long as the oligopoly is working, it doesn’t matter.

Even at CEO level, banks spout customer platitudes, use all the right words and signs but the genuine customer empathy is low. Three of the Big Four bank chief executives often talk about consumer issues. The fourth has a huge case of CEO Disease and is unlikely to change. CEO Disease is where a CEO no longer listens to his staff or the people at the coalface. He is merely interested in his own positioning.

One bank CEO bemoaned to me that people should not complain about a $2.50 transfer fee. Yet this would be a very significant cost for a pensioner or low salary earner.

One bank engaged in an efficiency drive discovered that only one in four employees interacted with customers. So it created a program to remove layers of non-customer relations people, with no reinvestment in the front line.

Visionary leadership is by no means a guarantee of a consistent culture of engagement through the ranks. National Australia Bank CEO Cameron Clyne has garnered praise in the media for his drive to improve customer and staff engagement to improve business.[12] Clyne has much more weight in his saddlebag with legacy issues than any other bank CEO.

But has this cascaded throughout the bank? It will take more than the CEO and symbolism.

It is commendable that Clyne tries to talk to customers through talk radio and other media outlets, and has not lectured politicians on policy material but deals and talks directly.

Clyne accepts the reality that if the banks do not act to earn respect, the community and banks are both worse off. Too many people think the banks are trying to outsmart them with fees and whacking them hard for small oversights.

My view is that this is more than a niggle — it is the legacy of cost cutting and a 'no-one cares' attitude. Staff engagement would lower complaints and stop them becoming a spreading disease.

NAB Group Executive Personal Banking chief Gavin Slater sees bank service as a snappy television campaign to win customers and sell more product.[13] The issue is much deeper than this.

There also needs to be a different approach to hiring. One way for the banks to engage and disrupt the status quo is to blend their credit teams with businesspeople who have not come up through the banking stream or silo.

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[12] Eyers, James, 'Not done yet', AFR Boss Magazine, Australian Financial Review, 14 February 2013, p 17. http://www.afr.com/p/boss/cameron_clyne_not_done_yet_BYiggPeFSGODIE1anyjOOP

[13] Yeates, Clancy, 'Hot home loan competition leads to lower NAB rates', *Australian Financial Review,* 3 March 2014.

Banks could learn from the Woolworths Refresh Program instituted customer-staff listening and feedback programs, as well as management listening to staff. Project Refresh identified that everyone knew there was a huge reservoir of untapped information available at the coalface, from staff via customers. To harness it, the trick was to:

- discipline and segment that information;
- cost and capex it;
- prioritise it;
- convince staff that management was serious and actions would follow;
- Determine how to keep the information flowing;
- Decide on the best reporting format so people could follow what was happening;
- change the focus and the culture of staff engagement;
- give staff ownership;
- embed this as an everyday obligation to engage with the customer, think about innovation and change, and how to improve efficiency and customer service;
- identify how initiatives should be rolled out; should they be trialled, and if so, where and how?;
- Should they be rolled out by region, state or across Australia or should they be further researched etc.

These principles apply not only to retail banking but to other parts of banking, eg. business banking. The banks are miles away from this, but more importantly, there does not appear to be little appetite for it. Until there is, customer complaints will continue and the banks' public reputation will continue to be tarnished and rank behind other sectors.

The case of ANZ – a small cell approach

While translating something like Woolworths' Project Refresh to the banking sector appears risky, banks can achieve a great deal in staff engagement by trying ideas out in small cells. This avoids putting the bank at risk or going to the expense of a huge consulting project.

During my time at ANZ, I count as my greatest achievement persuading the then CEO, John McFarlane, that a lot of customer improvement could be made without any cost or capex. Given the immensity of the problem, I argued huge changes could be made by just listening to staff regularly (from memory, weekly).

We experimented with small cells, i.e., a region or group of about 15 branches, and using what became an operations team. The ops team had to meet with staff to identify changes and follow through. The ops team was given wide latitude and what it could and could not do.

The success of one cell was so rapid (weeks) that it was rolled out elsewhere. The ROI was huge and spread right across the division. The Operations team was essentially driving customer satisfaction and innovation via staff engagement and empowerment. The organisation was biased in favour of the customer.

This dovetailed with McFarlane's staff engagement project, with the result that the statements and symbolism from the top aligned with the coal face.

In banking, the power of the Credit Committee, with its rules and no exemptions policies, makes genuine customer relations more difficult.

Lydon (Lydon, AFR, 2014) sees another wave of consulting opportunity for the banks, in an interview with the new managing partner of McKinsey Australia[14]:

> Squeezing the lemons just won't work anymore... Just cutting staff numbers means customers are disadvantaged. This is a vicious cycle you just finish up with unhappy staff and unhappy customers.
>
> "You need to encourage employees and take greater ownership. Engaging employees asking them for help to change the culture

Unfortunately, there is a very un-virtuous circle right now: the media has not been successful in driving any change. Politicians want change but do not know how to go about it; the Ombudsman is way too busy. The banking system and architecture need recalibrating. Competition is not helping the consumer. Meaningful change will entail much more than tinkering with competition policy.

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[14] Lydon, John, 'Ready to Roll up his Sleeves', *Australian Financial Review*, 3 February 2014.

Case study: BHP

BHP is one of Australia's most enduring companies that has made extraordinary achievements through corporate scale. It has enjoyed massive growth and cash flow in its journey from being Australia's dominant steel maker to the world's biggest miner. Yet the same factors responsible for its success have contained the seeds of failure. The new CEO, Andrew MacKenzie, has signaled a new focus on the company's internal culture, which may have some salutary lessons for the banks.

BHP has historically been a very top-down, production-oriented company and autocratic in style to both internal and external stakeholders. It has been bloated and more focused on its own longevity than shareholder interest. Its attitude has been: "If you don't like the current regime, invest elsewhere".

BHP has been a lucky company, blessed with outstanding leaders. Essington Lewis pursued and developed the steel business and acquired BHP's major competitor, Australian Iron and Steel Ltd. Ian Munro McLennan pursued oil and gas, entering iron ore and exporting it. James Charles McNeil expanded the iron ore business. Chip Goodyear and Paul Anderson jettisoned steelmaking.

Paradoxically, the huge cash flows generated by this success have to some extent been a disadvantage, and wasted because of corporate/shareholder conflict.

Further, strategy has been fundamentally compromised by a belief that scale by corporate activity is all that matters. Both the Board and Management are responsible for this. The flaws in this strategy are evident in the failed attempt to merge with Rio Tinto and a failed attempt to acquire a Polish company. Likewise, the dual structure with Billiton meant BHP shareholders conceded huge shareholder value to the Billiton shareholders.

Throughout 2013, Andrew MacKenzie visited BHP facilities around the world. The changes he is contemplating could rank in equal importance to the four big waves of BHP growth.

MacKenzie has concluded that at the coal face, BHP staff have great ideas for change and improvement and want to be involved with that. The intellectual property of the people at the coal face is huge. McKenzie's view is that these growth opportunities are limitless yet may not require huge amounts of capital.

This is a stark change in BHP's potential positioning. BHP will achieve growth through its drive for productivity of its people, and capital management, rather than through large corporate plays.

While Westpac is looking at disruptive technology, BHP is looking at disruptive people practices. Non-strategic activities are being jettisoned. MacKenzie is eliminating the bloating and presumably listening and learning more from the coalface and managing capital in the interest of shareholders, not the company itself (if we cannot get a good return on capital, we should return it to shareholders). Investors and analysts have good ideas, and investors are to be nurtured; BHP now seems to want more of them instead of encouraging them to quit and run if they do not like the strategy.[15]

This approach by BHP, along with the drive for productivity of its people and capital management will go a long way to improve shareholder return. It is an extraordinary change for a company this size, and with BHP's history.

Similarly, banks need to disrupt the current conventions about credit assessment, the role of credit metrics and their attitude to their customers.

[15] Freed, Jamie 'BHP's MacKenzie hopes to motivate people', *AFR Boss*, March 2014

Dictatorship of Data

Some of these principles can apply to the banks. Banks need to disrupt the current conventions about credit assessment and the role of credit metrics.

Mayer-Schonberger and Cukier (2013)[16] illustrate the risks and even dictatorship of data through the story of former US Secretary of Defence, Robert McNamara. McNamara argued that only with statistical rigor could decision makers understand complex situations and make the right decisions. Yet McNamara he failed at Ford and with the Vietnam War, failing to incorporate the knowledge and insights of line managers and generals. He failed to recognise the limitations of big data – that it is not necessarily high quality, that it can be biased, and used to mislead.

My thesis is that the same applies to banking, where risk assessment, with the sophistication of metrics, is becoming black and white, with no grey areas. The GFC has smothered the customer, as risk and risk weighting dominate. These factors are all top down and do not recognise public policy and country differences, or the needs of the economy or particular sectors.

The situation is compounded by APRA, which takes the banks' focus away from consumers and their staff. APRA should change as well and I deal with this in a later section.

At the bank level, staff had to accept the metrics and little thought is given to the customer. No one has or wants the power to exempt because the consequences of being wrong.

The banks' brutal self interest and drive for ROE means risks are not taken because they don't have to be. The other banks all have the same processes and attitude so the customer has no alternative.

It is little wonder there is no drive in the banks for genuine customer satisfaction.

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[16] Mayer-Schonberger, Viktor, and Cukier, Kevin, 'Big Data, A Revolution That Will Transform How We Live, Work and Think', Houghton Mifflin Harcourt, 2013, p 163. See also Mayer-Schonberger, Viktor and Cukier, Kevin, 'The Dictatorship of Data, *MIT Technology Review*, May 31 2013, http://www.technologyreview.com/news/514591/the-dictatorship-of-data/

This is not just limited to the grant of credit, but also to delivery where there are no advantages in excellent delivery because the other banks are the same.

The question is never asked, What do we need to do to truly serve the customer? What are the customer's expectations? What do the customers actually want? How do we design products to actually match the customer's needs?

Clearly, technology is driving a great deal of design of banking products (because that means lower cost), but genuine customer issues are being left behind.

Customers have become brow beaten by the banks and in many respects have given up, accept the situation: Why change? Why do anything? Nothing is going to change.

While individual bank strategies are probably outside the scope of this inquiry, their dampening effects on innovating and change are stifling competition. Something has to give.

If BHP is willing to change, why can't the banks?

Financial Ombudsman Service

While Australia has an excellent Financial Ombudsman Service (FOS), it is powerless to deal with all the issues. The FOS is doing an excellent job on dispute resolution with a well designed and effective delivery system. The service is approved by ASIC and is free to consumers. It is a non-profit organisation funded by its members and is effective because of its specialisation.

It's 2012/13 Annual Report, *Focused on Delivering*, highlights the huge number of disputes it resolves, many involving the banks. These would never have occurred in the first place if the banks had had the genuine interests of consumers in mind.

Within the scope of its mandate, it is a very good service and I would argue beyond reproach. However, the service does not deal with unsatisfied demand. Many people throw their hands in the air and accept the reality of the banks' behaviour and / or do not know about the service.

It also cannot accommodate larger-scale disputes where either party would not accept its legitimacy because of complexity and dollar amounts at risk.

It is also not equipped to scrutinise transactions which are less than a dispute but involve poor, inconvenient, inefficient or one-sided (to suit the bank) delivery.

This raises the question of whether a Facebook-type specialised website could be established, enabling customers to lodge complaints and communicate with other disaffected customers. This has happened in other sectors and would be illuminating if it were to reach banking.

Comparison with Airlines

While retail and banks are about collision and collusion, airlines are about capacity: that is, utilisation and yield.

Airlines have high fixed costs at various levels: central administration, routes and planes/flights. Consequently, they require a volume / pricing mix to get the best yield on their capacity.

When there is excess capacity, the consumer is the beneficiary and as with retailing, the airline consumer has adequate information and choice. There is collision not collusion between the airlines on the amount of capacity. The airlines find it very difficult to capture any of the rent in the airline supply chain with the consequence the industry is volatile with little profit made.

Most efficiencies lie internally:

- Fleet and network optimisation
- Workplace productivity and effectiveness
- IT architecture systems and processes
- Group procurement and leveraging scale[17].

While I do not know the details of how airlines allocate revenue, cost and capex/capital to central, routes, flights and other activities, it is clear there are considerable fixed costs in these activities — for example, fuel used on flights has little relevance to the number of passengers.

However, volume / price decisions have to be made within the limits of airline capacity.

Where as is often the case, airline capacity exceeds demand, then there is volume / price pressure. Thus, decisions on airline capacity are crucial to yield. Airline capacity cannot be turned on and off. Purchases of fleet and associated infrastructure take a long time.

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[17] Virgin Prospectus, December 2013

The airline supply chain and the ability of the airlines to capture rent from the supply chain are not dissimilar to what occurs in banking.

Airlines' main costs, apart from labour, are fuel and the capital cost of the aeroplane. As with supermarkets, suppliers of both these products have plenty of customers, so the airlines have limited ability to capture rent and this is why the airline industry is not very profitable.

Competition Policy: Intent vs Impact

Current competition policy is based on purpose. This creates significant evidentiary problems for the regulator. Many argue that it should be an effects-based policy. The latter is more of a structured test; it is the very nature of market share that creates the competition policy tension, while purpose is a behavioural one. The latter is very subjective whilst the effect test is less so.

Supermarkets argue that their purpose is not to destroy the supplier or the small retailer but to provide value to the customer — which they have certainly done over the last few years. Both with their pricing policies hold back inflation. However, they are blind or do not want to acknowledge the impact they have on suppliers. This is not necessarily the purpose but it certainly is the consequence of their actions. The retailers would have forced considerable innovation on suppliers, but at what cost?

The problem is not answered by requiring an effects test alone. There needs to be an evaluation of purpose. This is complex, and brings regulators up against vested interests. Big business wants a purpose test, and small business wants both, or at least an effects test.

The purpose test plays into the hands of big business because it can appoint an array of lawyers, economists and forensic accountants to make it difficult and expensive for the regulator to establish anti-competitive intent.

The same applies to banking.

Banks – Barriers to Entry

Banks' share market value reflects a premium over book value — that is, value which exceeds the loan book. The premium arises partly from the fees and the spread they earn over interest paid and interest earned. Unlike the spread, fees are generated without the need of capital, with only some labour and technology costs. This is one of the reasons why Banks shares are at a premium over book value.

It is interesting to note that at the end of the 2013 reporting season, the banks' price to book multiples were as follows:

CBA	2.5 times
WBC	1.9 times
ANZ	1.7 times
NAB	1.6 times
....	
MQ	1.2 times
BOQ	1.0 times
BB	0.9 times

A further interesting observation from this table is that scale improves the multiple. CBA at 2.5 and BB at 0.9.

The four big banks' offer to the market in Australia is fairly universal by comparison with banks in other countries.

This breadth of offer so far as new entrants are concerned is a paradox. To a new entrant, it would appear to be a vulnerability on the part of the Big Four, but it is not.

It would be difficult for a new entrant to enter an established market such as Australia even with a specialised offer, because any one or more of the banks can rapidly cross subsidise a product or business segment. This would make it difficult for the entrant to deliver the product at a profit. They could enter the segment, but only at a huge cost.

If a foreign bank has materially lower funding costs and/or significant advantages in some bank products or segments, it may be so able to induce competition.

Given the existence of universal banks with many products and segments, it is easier for the Australian banks to cross subsidise and compete with a new entrant, attacking a particular segment or product.

The alternative view is that the foreign banks will like the oligopolist nature of the Australian banking system and join the club — maybe only attacking when they have a strong international client banking relationship.

A foreign bank will have the opportunity to undertake a lot of profit and tax shifting, which is easy for an international bank with international links in many countries.

It is an open issue whether a Foreign Bank will create more competition. In the absence of action by the local banks, it has the potential to attract a number of dissatisfied staff and customers.

Any federal treasurer granting permission for a foreign bank takeover could stipulate some conditions, but this may not be very practical.

Digital Disruption

The main threat to the Big Four is technology. Although technology was mentioned in the 1997 Wallis Inquiry as a threat, its potential had not crystallised to the extent now possible with the advance of online technologies. Digital disruption has caused upheaval in both media and retail, and may yet transform banking.

A technology advantage in banking can be significant, but it assumes that there is only one company with that technology advantage. New technology tends to be available to other technology companies fairly soon, so the opportunity for an exclusive extended period of advantage is often not material.

The consequence of this is that a technology company is more likely to want to link with a particular bank so it can get to the market quickly and gain a first-mover advantage for the time it takes for the technology to spread and be available to the other banks.

Given the value to a bank of technology it makes sense for a technology company to work closely with a bank so that they can jointly realise the advantages.

Bartholomeusz (The Australian, 2013) claims the big digital business and smart phone companies - the likes of Google, Amazon, Apple, Facebook and Paypal — are on the edge of financial services. These companies have massive global customer brands and customer information. They all have very good payment systems.[18]

But will the regulators let them enter into banking? Right now, the easier path is to link up with a bank. This can happen in many areas of the bank. It would be interesting to analyse whether it is better for a technology company to go it alone or join the banks. Only time will tell. Numerous discussions are

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[18] Bartholomeusz, Stephen, 'It's time to pause before digital tide knocks bankers off their feet', *The Australian*, 22 November 2013, http://www.theaustralian.com.au/business/opinion/its-time-to-pause-before-digital-tide-knocks-bankers-off-their-feet/story-fng7vg0p-1226765599910

no doubt taking place, but clearly a significant part of the uniqueness of banks (which is the competitive advantage) will be eroded if the banks are not intimately involved in these conversations.

Banks are likely to use and portray technology companies as the new entrants to challenge the banks. You don't need more players in banking, as the technology company will provide the competition and new entrant.

This argument has a greater force in some bank segments than in others. Presuming it is a threat to all banks, then it is a sector issue and an inter-bank issue. Given that most banks are attempting to monitor the situation carefully, non-competing banks could be working together to share their knowledge and thinking. The same applies to the consultants dealing with this issue. There is considerable ability to share resources.

Given the relationship between banks and the various supervisory authorities, no doubt these authorities will be monitoring very carefully the entrance of the technology companies to ensure they do not disrupt the banking system, causing the rising of risk. To reiterate, not all of the sectors of the bank are vulnerable and no doubt this is being monitored and modelled.

It will be interesting to see over coming years whether there will be any structural players such as technology companies acquiring banks and using them as a platform for their activities. Certainly, a technology company could afford it, and customers could be captured outside that country of that particular bank via the internet.

It is unlikely the reverse scenario would play out — a bank taking a major interest in a technology company. Technology companies worthy of acquisition are too large and in any event are forever changing. The wrong decision could easily be made, and that technology company would lose access to the rest of the banking community.

Given customers are becoming more comfortable with transacting and buying financial services electronically, will the market practices of traditional banks

and insurance be disrupted?[19] Will the financial value chain be dismediated and customers able to become managers of higher risk areas?

The relevance of these comments is that of gauging the possibility of new entrants to stimulate competition in the banking segment technology, which may or may not compete.

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[19] Eyre, James, AFR, 24 January 2014.

Deregulation

Banks are seeking relief from regulation. Regulation is, in contrast to technology, a definite barrier to entry. Any change of regulation should at least result in creating an even playing field, particularly for the smaller banks so that regulation change should be seen as enabling.

Parliamentary Secretary Josh Frydenberg, who is driving the Government's deregulation agenda, faces a massive task in coping with all the legislation to be introduced to achieve even a modest amount of deregulation.

The Productivity Commission Report on Regulation in Small Business amply describes the mess of regulation in Australia:

> It is extraordinary and the legislation of dealing with it is very challenging. There is so much that has to be organised and processes challenged, it will take a long time to make serious progress. Huge numbers of people, companies and sectors want relief.

What should the inquiry's attitude be to technology? I refer the Committee to comments by Robert Thompson, CEO of News Corp (*The Australian*, 2014):

> Every Government in the world, when you ask, is in favour of small business. Some people are a little sceptical that small business will get successful and become a big business but generally people will try to take sufficient measures.[20]

It is important the Government tries to create opportunities and an environment that allows the creation and growth of small business. China realises this and the Chinese people have created one of the most remarkable transformations in the history of the world. Government should make it easy to start up and improve businesses and get regulation out of the way. The emphasis should be on reward. The banking world is a long way removed from all this reality.

The current Government attitude on these issues is correct, but can it deliver?

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[20] Thomson, Robert, quoted in Elliott, Geoff, 'Technology a Platform, not destination', *The Australian*, 24 January 2014. http://www.theaustralian.com.au/media/technology-a-platform-not-destination-news-corp-chief-robert-thomson/story-e6frg996-1226809011006

Retailing – Barriers to Entry

There have been several successful new entrants into the Australian retail market, such as Costco, Aldi, JB Hi-Fi, a number of specialists, and clothing retailers.

It is already clear that there has been a great opportunity for some time for new formats such as Costco and Aldi. Indeed, any of these formats could have been introduced by Wesfarmers or Woolworths, but it is difficult to launch a new format within these firms. There are issues of cannibalisation, values and culture.

Each of these formats is distinct with a clear product offering with tight demographic and geographic positioning. For existing operators, establishing a new format to compete against one of its own formats requires a willingness to ring fence the new format, allow it considerable independence and the opportunity to develop its own culture and values. It also unleashes huge internal conflict.

Incumbent firms can better achieve this by joining a foreign player and using the outsider to achieve that independence.

WOW's acquisition of Dan Murphy is a classic way to enter the market. Dan Murphy was very low-cost entry but with huge scale opportunity. WOW let it grow in its own right without trying to change its strategy, disciplines, values and systems.

Costco could have been established in the Australian market by either WOW or Coles, but this did not happen. The problems of cannibalisation and cross-division conflict would have simply been just too great.

Myer realised the opportunity to establish a Costco alternative in Australia but backed off for reasons other than the above.

Banking in Regional Australia

The parallel behaviour of the major banks causes a lack of differentiation in regional areas. The big banks do not have great knowledge of regional areas and their nationally focused policies and practices often work against particular regions.

It is too expensive for a bank to support local presence where this might result in greater sensitivity to local needs. The volume of business may not justify the expense.

Yet there is much we do not know. It is important to understand how big a bank needs to be to survive and whether there are any potential entrants waiting in the wings. There is a lot we do not know about the potential for new regional entrants.

I see the need for at least two studies in this area:

- There are a number of software programs that could be used to run some modelling to establish the minimum size needed for a bank to have sufficient profitability for a reasonable Return On Equity. This would be useful to establish the viability of small Australian banks;
- A study on the effect of regulation on smaller banks and whether there is a case a different regulatory regime. This would make it possible to get some measure of the cost of regulation for a new entrant.

Regional banks tend to concentrate on lending locally and where there is need, often offering bank deposit facilities with a higher return than the banks (Bendigo Bank may be a partial exception to this).

In Gippsland, GSI has proven that there is a need for local financial institutions that differentiate themselves from the four main trading banks and the second-tier banks.

However, the Trading Banks have little or no appetite to fund GSI – it would be analogous to lending to a competitor. Why do that when allowing GSI to fail would ultimately deliver business their way?

Regional financial institutions tend to have a close connection with their community and a better understanding of the underlying risks. Accordingly, they modify the standard risk matrix. If not properly handled, the opposite can apply: they can become so close they lose their objectivity.

Yet the activities of APRA in relation to risk weighting tend to result in all geographical areas being treated in the same way. The risk in the category is the same and exceptions do not seem to be recognised. Regulation has a one-size-fits-all characteristic, which works against the smaller companies.

There are many examples of situations refused by the trading banks have been banked by the local institutions and turned out to be spectacularly successful.

Regional financial institutions tend to be small in scale, because that is the business available to them. But the lack of scale can be difficult for a small financial institution.

The fixed costs of infrastructure and regulation mean there are not enough transactions or customers to spread and fractionalise the costs.

Like many other small businesses and small financial institutions they have inherent limitations:

- Lack of buying power;
- Higher percentage costs;
- Less specialised staff;
- Less access to infrastructure, innovation and technology.

It should be possible for new entrants to license technology from other banks at a minimum cost. But there are questions about whether the banks would be prepared to do this, because of the competitive implications.

With the huge numbers of staff that have been exited from the banks in recent years, there is an enormous pool of skilled people available to be employed by smaller companies.

If GSI is any guide, there is no reason why good local institutions cannot be profitable.

The Big Four should be shamed into providing wholesale funds for the smaller banks, just as they provide them to the other banks.

The Bank of Melbourne is showing the advantage of establishing a new brand and the appeal this has for people in a limited geographical area. If it makes sense to establish regional banks, then they could form some association with each other to work as a group.

For those seeking to deregulate the banking sector, the studies I have recommended would offer an opportunity to review all regulations, and critically examine the concept that one size should fit all… a concept that, as we have seen above, has been particularly damaging in regional areas.

It would be easy for any one of the existing banks to drive out any new entrant, so competition policy would be an important issue.

With retailing, the players are not allowed to engage in discriminatory pricing which affects a new player. The pricing must be national and not concentrated. Similarly, the retail sector enjoys codes of conduct for certain activities, which have now been adopted by the ACCC, giving them the force of law. This could be a way to proceed for the banks.

Non Bank Financial Institutions (NBFI)

ASIC's handling of the debentures market offers a salutary lesson in the fact that the business of regulating is at odds with the aim of fostering a healthy competitive landscape. In short, regulators wield very blunt instruments.

IN 2007, the debentures sector was rife with bad practices: high-risk products and little genuine concern for the interest of debenture holders. In May of that year, ASIC had appeared before a Senate Committee to explain why three investment vehicles had failed.

By the time the regulator issued a consultation paper in August of that year, a signal to the sector that it would have to lift its game dramatically on disclosure,[21] investment in this asset class was reducing rapidly: between June 2006 and December 2008, the amounts on issue had reduced by 51 per cent from $33 billion to $17 billion. The issuers were down by 21 per cent, with 15 being placed in external administration.

The consultation paper set out proposals for changes as part of a 12 month plan of giving guidance to those in the sector. There were two subsequent papers.[22]

This disclosure requirement forced the sector to make very significant changes in its reporting practices, which would have been at some significant cost.

Since then it is understood debentures on issue are now down to about $2 billion or slightly less. In essence, the market has almost disappeared as the regulatory regime is very difficult and costly for small entities. It is a 'one size fits all' regime, with an 'if not, why not' regime, if you do not meet the regulator's requirements that explain what is causing the problems.

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[21] ASIC, Consultation Paper 89, "Unlisted, Unrated Debentures – improving disclosure for retail investors", August 2007

[22] ASIC, Report 127, "Debentures – Improving disclosure for retail investors", April 2008;
ASIC Report 173, "Debentures: Second review of disclosure to investors", October 2009, reviewing progress made with disclosures;

Many of the disclosure requests were sound. It is the ‘if not, why not’ system that is over the top and with a bias against small entities.

The sector was given plenty of opportunity by ASIC to respond to the proposed regulatory changes — so it is hard for them to complain now.

Although the regulator is only partly responsible for the decline in this sector, the regulations are having a compounding impact.

The pursuit of regulation has not ceased, as the regulator wants to introduce a new initiative which will have a further impact with NBFIs unable to accept call deposits for less than 30 days. This regulation clearly favours the banks.

The disappointing aspect of all this is that a void has been created which has been partly filled by the banks without any understanding or research of alternative models or of the demand for these kinds of products.

Again, bank power and concentration has been increased by these regulations without any consideration of alternatives. It is easier for regulators to deal with larger entities, as these are well resourced. The fewer entities to regulate, the easier it is.

PART 4 - Business Banking Difficulties

Business Banking

The Business of Companies in Difficulties

Instruments for Companies in Difficulties (CID)

Bank Failure - Smaller Business

GSI and the Banks

Business Banking

Beyond the anecdotal, we know very little about how banks behave when business customers run into difficulties. This is partly because banks must keep client information confidential. Moreover, companies, particularly private companies, are disinclined to reveal the issues they face with the banks and the way banks deal with them. An inquiry on this would be very revealing.

In what is starting to resemble an obstacle race, the banks are developing more conditions and obstacles, and even traps, for their loans. Woe betides the customer who misses one of the numerous obstacles.

A fundamental problem with risk metrics is that they do not often take account of time. The time may be short, which includes the position for the bank but not for the borrower. Banks are taking as much risk out of transactions as they can and are imposing tighter loan periods. They are putting borrowers on shorter review dates, effectively rendering some loans are basically at-call loans. The borrower enjoys little choice.

A great deal of gaming goes on by banks when a customer faces difficulty. They know it is not easy for a client to go to another institution because the bank has the power to demand immediate repayment and, in effect, put the company out of business. Thus, they are able to push the customer into tighter covenants or terms. Common tactics include:

- charging more interest or fees;
- requests for more information;
- lowering the Loan to Value Ratio;
- seeking more security;
- seeking repayments of the loan or more equity;
- more reporting;
- threat of investigation by an investigating accountant;
- fees that disproportionate to the value being delivered.

When banks tighten up their loan arrangements, there is no countervailing force to the benefit of consumers. The banks all act in parallel at the same time in the cycle. The cycle is an important view here. The banks all tend to take the same approach to the cycle.

Banks use their market power in times of difficulty to lower the risk to a bank. Lower risk with short terms means more profit and ROE.

One bank does not want to take over a client from another, for instance, when that client might be among its hospital division. Given the parallel behaviour, where does a client go? Our banking community is too small.

Banks believe that their credit process and metrics are part of the essential goodwill of the bank and are jealous of this area.

Recently one bank CEO accused another bank of dropping its credit standards to obtain new business. The bank concerned responded by saying it would release a list of possible clients the other bank had acquired.

This is an appalling statement and indicative of the attitude of the banks. There was no mention of the consumer: they were absolutely irrelevant to this spat.

Clearly there are situations where modifying credit standards are called for. This can go beyond merely making good exceptions, and be a thoroughly new approach to accommodate a sector that is recovering, or rising asset prices, where the sector is ok in the short to medium/ longer term. But still the banks will not lend.

The bank has all the levers, and so customers either conform or fail.

In a recent survey of 982 businesses by research group East & Partners, SMEs rated bank performance on empathy, satisfaction, loyalty and advocacy at a record low of 16.6 (out of a possible score of 100).[23] It was particularly

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[23] East & Partners, Business Banking Index, December 2013 http://east.com.au/publications/banking-news/corporate-sized-businesses-happiest-with-their-bank

bad in NSW and Victoria, with similar levels being recorded for all of the four major banks.

The banks have been declining since 2008. Non-investment grade clients are missing out, as ANZ highlighted in its 2013 Annual Report, ANZ states:

> "More generally our business risk profile improved with the continued shift to investment-grade clients and short-term trade finance".

By contrast, when the banks were in difficulty and could not have faced the demand for the repayment of their borrowings, they were saved by the Government. In a sense during the Global Financial Crisis, the governments saved the banks and as we saw, one trading bank could not be allowed to fail, due to the interconnection with others and the failure of the overall banking system.

The Business of Companies in Difficulties

The instruments for dealing with companies in difficulties are crude and inadequate, although it is acknowledged that the instruments have improved since the 80's. There are many companies that could be saved but for the self-interest of those involved in this area.

Receiverships and liquidation destroy value. Voluntary administrations are also crude and do not deal adequately with the company surviving.

There are huge concerns surrounding liquidators and receivers. There are huge fees earned in time delays by insolvency practitioners, as opposed to quick salvage, where the fees are minimal.

Voluntary administration receiverships and liquidations are extraordinarily profitable for the lawyers and accountants who make more money out of distress than salvage. Many people complain about the fees being charged by those involved with companies in difficulties.

The law and regulation has tried to deal with these issues by forcing professionals to disclose the fees and the scope of the work, but this is not working.

The use of time costing is lazy and costly.

The problem with companies in difficulties is that there is no client who has the power to place the prospective supplier in competition and terminate an arrangement and go to another player. The legislation dealing with these kind of issues are crude and grossly inadequate.

An example of banking power and unconscionable conduct is when banks demand repayment but also demand break fees on certain products. In other words, the bank not only charges higher interest, but penalises the client for meeting its demands. A court would not like this and it is unconscionable, but it happens everywhere.

There is also a lot of parallel behaviour in this area as there is with the interest rates set with mortgages.

One may ask, what are the alternatives? The GSI paper attached gives an alternative which can be developed more fully and applied to many situations where the company can be or should be saved even if creditors do take a minor discount. This is not dissimilar to US-style Chapter 11, but it does have the disadvantage of establishing a new agency. There are ways of achieving this with minimum cost and change, which I shall explore further.

The receivers and lawyers have great capacity to capture all the rent at the expense of creditors. Small boutique firms have been hived off from the major accounting firms and specialised in companies in difficulties. Some individuals in these boutique firms are now multi-millionaires.

Even though the big accounting firms have worldwide brands protected, there is still a lack of transparency in this area.

The big brands will argue that their charge rates are up on their websites and comply with the Australian Restructuring Insolvency & Turnaround Association (ARITA), and creditors have the opportunity of seeing them. However, this does not go anywhere near far enough. Further receivers disclose their costs in cents in the $1 which looks a lot less than $ amount.

The fact is that most receivers remove the staff of the company in receivership and replace them with their own, and are using charge rates which have high profit margins in them for the accounting firm for those employees, they are replacing the charge out cost would greatly exceed the employee cost (plus on costs).

These staff are hired at an amount exceeding that of the cost of an employee.

All firms want to manage staff who are under-utilised. Receiverships give an opportunity to use these people at great profit to the firm.

Clearly, insolvency is a very profitable activity for the accounting firms. More needs to be understood about their activities, including the profitability of the practice and the profit margins they are achieving.

It does not matter to the banks that the receivers and lawyers are doing well in this activity, because it is all paid for by the creditors. While they may put the

jobs out for actual or partial tender, that does not mean that their activities are being conducted efficiently and to the advantage of creditors.

And the lawyers? Lawyers cannot capture the rent as much as the receivers, because they are employed by the receivers and the receivers have plenty of choice in this area. If one firm is not performing during receivership, there are plenty of others that could take their place. Indeed, the receivers can adopt the process of continuous tendering which will keep the legal costs to a minimum. There is no evidence any of the lawyers have made fortunes out of this activity — as they should not.

Instruments for Companies in Difficulties (CID)

The GSI situation once again raises the issue of whether the legislative instruments available for Companies in Difficulty (CIDs) are adequate. I believe it is time for Australia to seriously consider instituting a specialised bankruptcy court system, possibly under Federal Court jurisdiction.

The issues around CID instruments have been canvassed extensively, but I believe the last word has not been written. A 2012 APRA consultation paper recommended expanding APRA's power to appoint a Judicial Manager (JM) and a Statutory Manager (SM).[24] It recommended giving the JM and the SM power to impose a moratorium on debt repayment to create a breathing space to find a permanent solution for a bank in difficulties.

These recommendations had the advantage that there was an appropriate and experienced regulatory agency to handle the situation. It was not necessary to create a new agency. Further, APRA was keen to have the power so it could effectively intervene at an early stage.

With NBFIs, there is no regulatory agency to do this. NBFIs are controlled by ASIC, which does not have the skills, resources or supervisory capacity to undertake this.

For NBFIs there is no corollary in the recommendations or plan to put in place a similar concept.

A 2004 report by the Competition and Markets Advisory Committee, "Rehabilitating Large and Complex Enterprises From Difficulties", recommended against developing a new instrument.[25]

Some argued for Chapter 11 US-style instrument, where companies in difficulties can continue to trade but with creditors frozen so that a longer-term

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[24] "Strengthening APRA Crisis Management Powers", September 2012.

[25] Competition and Markets Advisory Committee, "Rehabilitating Large and Complex Enterprises From Difficulties", 2004. On pp 133-136, there is an excellent table comparing
Voluntary administrators and Chapter 11;
Voluntary administrators / Creditor Schemes of Arrangement; and proposing a Creditors Scheme of Arrangement can be combined with a Shareholder Scheme.

solution can be put in place. It is used extensively in the U.S. During the GFC, a number of Chapter 11 bankruptcies of very large, high-profile US companies involved the Government taking up shares.

The Chapter 11 mechanism offers has the advantage that there is a Bankruptcy Court in the US which is used to supervising these situations.

If a company is not insolvent but is having difficulties, there is no reason why the holder of securities in that company could not apply to the Court for a freeze order putting on hold creditors, enabling a Scheme of Arrangement to be put in place.

Where a freeze order is made, this does not affect an NBFI as it would a trading company, as a trading company would have to cease trading.

If APRA were to assume jurisdiction over NBFIs, the SM or JM concept could be extended to NBFIs.

The Committee's recommendations appear to be influenced by the fact that in Australia there is no suitable bankruptcy court. And clearly, the Committee was concerned about the cost and magnitude of the task of creating another court system.

In my view the case for early intervention — US-style Chapter 11, modified for Australia — has not been made out one way or the other. Yet there could be a lot of economic value in early intervention: salvaging companies that do not need to go to the next stage, or accelerating companies into liquidation when there is no hope. Creditors' money could be saved and disruption minimised.

The current situation is too black and white — in or out, solvent or insolvent, when in fact there is a significant grey area.

In this grey area, the possibility of putting in place, for instance, Schemes of Arrangement, could be extremely helpful. The current regime makes that difficult.

It would be interesting to undertake a study of companies in difficulties, or more importantly those that go into voluntary administration, receivership or

liquidation to form a view as to whether any of them could have been saved by earlier intervention.

A specialised court with specialist administration could readily be put in place under the umbrella of The Federal Court of Australia. The Federal Court has the infrastructure but not the supervisory powers. These could readily be put in place.

Further, much more information needs to be captured from this sector about companies in difficulties for the market to be more informed about the issues.

In the current environment, a Government would not like the cost of establishing another court system. For this reason, I am proposing this fall within the Federal Court system, using the infrastructure of that court system including the Magistrate Division.

The notion of a specialised judiciary is valuable and there are a number of existing court cases that go through the bankruptcy court system that could well be diverted to a bankruptcy division of the Federal Court. For instance, the famous Bell case in Western Australia.

With a specialised judicial division, it is arguable that in the long term, costs would be saved and justice would be administered more efficiently.

Further, it would enable fairer resolution of a number of the injustices occurring in companies in difficulty that people are continually complaining.

Clearly, legislators have good intentions but the legislation has not been able to deal with some of the problems that have arisen, such as overcharging.

No government likes to spend money on justice because there is no apparent return. But the reality is that the rule of law is a very significant competitive advantage for a country and reforms should continue in the judicial sector to make justice efficient, fair and available for everyone. This is sometimes achieved through specialisation.

Of course, fees could be charged based on scale for the Court, although it is recognised that this would only be a small contribution to the cost. In my

view, an economic study would show that the net economic benefits for the community would be significant.

There are many people in the law at the moment who would be well suited to be involved in this area, including people whose task is to make much more information available on what is happening in the sector.

In designing the legislation to facilitate this, much could be learned from the US experience.

Bank Failure — Smaller Business

There is a lot of unsubstantiated information in the market about the failure of banks to serve small and medium businesses — particularly those unable or unwilling to seek equity. Equity is much more complex in a private as opposed to a public listed company.

There are probably a myriad of questions that need to be answered, and a briefing or scoping paper, well within the terms of reference of this inquiry, would be useful to assemble the facts and propose solutions.

A number of questions need to be answered.

What is the extent of unsatisfied demand by:

- Segment (or if appropriate, product);
- Regions, area; or
- type of business.

Larger companies can always seek equity in a crisis. This of course is some comfort for a bank and is a justifiable reason as to why higher risk should be put on non-listed companies. But for SMEs, either the equity is not available or would not be available in the event of a cash flow slow down.

There is evidence that some regions are badly supported by the banks because they have become risky regions — usually because of an industry failing in that area or climate issues.

Bruce Billson's claims in July 2013 about the additional margins being paid by small business are light on.[26] My information is that the rates are materially higher than these stated by him.

Quality information is needed on this to produce quality solutions.

If there is unsatisfied demand, then existing activities could be revamped to serve that market. Alternatively, do we need new entrants or a different regulatory environment to satisfy that market? And is it economic to do so?

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[26] Bruce Billson, *The Australian,* 21 July 2013

Could the existing banks be encouraged to be more active, for example, in changing risk weighting? Does existing risk weighting reflect the loss experience? Are existing margins too high and the covenants too onerous?

What are alternative bank models for new entrants that may, for example, have limited bank powers but nevertheless satisfy certain regions?

Are there any models overseas, for instance, Community Banks? What about crowd funding? (See Appendix).

Is it reality, risk or scale that will provide the necessary economic wellbeing?

Will the banks provide wholesale funding to those entities or will they make it difficult for that sector? Will the banks simply crush a new entrant?

What should be the breadth of products offered by NBFIs?

Is it worthwhile developing some kind of pilot? Should a major study be undertaken by one of the consulting houses to bring some of the facts to the table?

If a new model is to be encouraged, will there be any issues with technology, cards, payment systems, wholesale funding, etc?

There will be many association groups and individuals that will want to contribute and some already might have useful information.

Some agencies, particularly the Productivity Commission, have excellent material on regulation and more is in their reports which could be accessed.

Some research will be required as the issues of information about fulfilled and unfulfilled demand are crucial and respect to fulfilled demand is it satisfied demand?

The above seems to fit the Government’s terms of reference.

GSI and the Banks

Not one bank showed the slightest interest in saving GSI for the benefit of the noteholders and the community of East Gippsland.

At the time, GSI had about $154 million of notes; book value of bank of about $125 million and about $33 million in cash.

The Rescue Group wanted between $30 million and $40 million in funds until the loan book was wound down, whereupon the borrowings would have dramatically reduced.

The loan was to cover redemptions which may or may not have happened.

The security was sound:

- Under the Scheme of arrangement the bank's loan would have first ranking security, and accordingly that ranked ahead of noteholders;
- Note maturity would have been realigned to minimise redemptions, so there would not be much threat on the call of the wholesale funds.

Leaving aside extraordinaries, GSI was making a monthly operating surplus and so was able to meet its interest costs. In other words, its interest income exceeded the interest outgoings.

A deposit of $33 million would have been placed on deposit with a lending bank so that amount borrowed from the bank would have been minimal.

A lending bank would have made a good margin on the difference between the monies lent and the monies put on deposit by GSI.

The receiver was then estimating after costs a return of at least 85 cents, so the 15 cent discount which included the fees would have left ample security to a borrowing bank.

The return has now increased from 87 to 92 cents which includes Receivers costs of 4 cents, all within about six months of the commencement of the Receivership.

The Scheme of Arrangement would have precluded the bank being required to disgorge the loans in the event of insolvency within six months.

The Rescue Group was prepared to put in substantial equity. Noteholders would have been required to convert notes to equity.

Considerably more equity and conversions could have been raised, but for the restrictions on borrowing without a prospectus.

The Scheme of Arrangement and the Prospectus provisions could have been inserted, enabling more equity to be raised and conversion of notes.

The bank could have put conditions on minimum equity and minimum conversion of notes to shares, as well as requiring extensive reporting, require the re-constitution of the Board and minimum exposure to real estate.

No bank would even negotiate. Why fund something when you are going to be the beneficiary from failure, increased deposits and loans?

These are both an example of brutal self interest. It highlights the problems many people have with the banking system. Any bank taking on such a transaction could have gained a great deal of local support.

The consequences of a bank providing a loan of even $25 million would have been that:

- redemptions would have dropped dramatically,
- the Trustee would have continued,
- the yet to be regulated 8% of equity could have been achieved,
- Many noteholders were prepared to convert to equity,
- the company's operations could have been enhanced by the use of local people experienced in banking,
- the bank could have achieved collateral business,
- East Gippsland residents would have seen the bank in a good light, which could have led to more banking business.

It would have been easy for various members of the Rescue Group to direct local business to that bank.

GSI Directors, shareholders and noteholders are justifiably perplexed. If this had of been one of the main four banks, the Government Guarantees would have kicked in and one of the other banks would have taken over.

People are perplexed as to why there should be any difference. It would take politicians at the level of the Treasurer or the Prime Minister to intervene and ask the banks to act in the greater good.

In previous crises between the banks, this has happened and smaller banks have been saved (It would be a breach of confidentiality to disclose that information). Given current attitudes, it is unlikely the Government would have asked other banks to help, and so a thriving NBFI has been removed for the market. This is in contrast to earlier days when the Government, through Treasury, would ask the banks to intervene.

PART 5 - Foreign Debt (Government and Private)

How Much Should Australia Borrow?

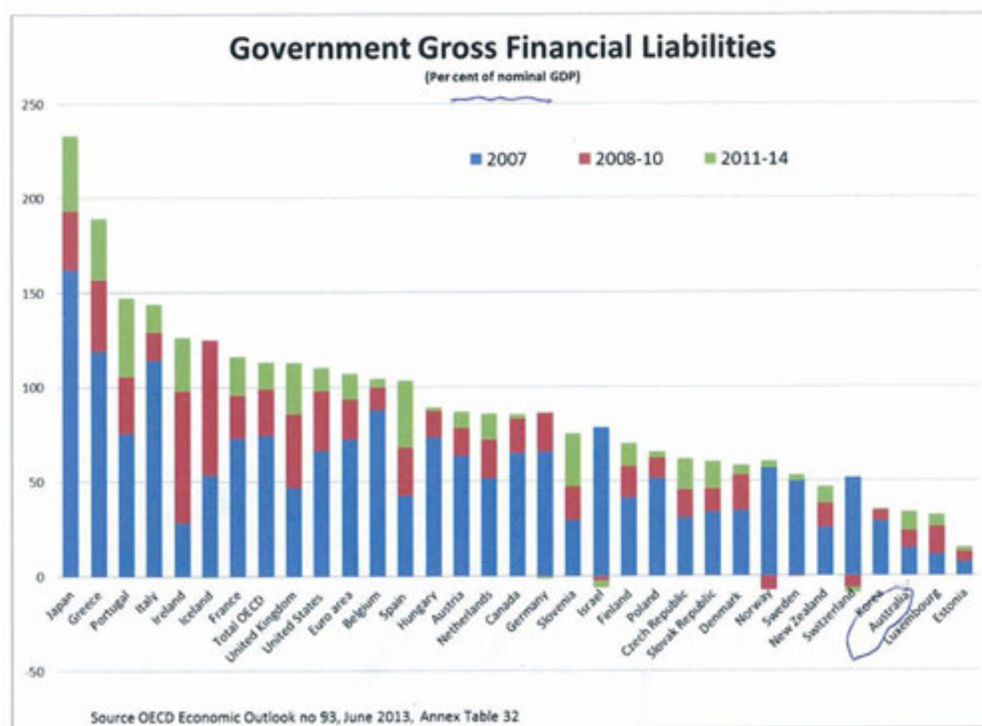
Gross Domestic or National Product

How Much Should Australia Borrow?

As a relatively new country with vast mineral and agricultural resources, Australia has specific needs. It requires massive capital and infrastructure to achieve its full potential. By world standards, it is rich in resources, and boasts well developed platforms in tourism and education. With a relatively small population, it is a multicultural country open to new immigrants. And it has very sound political and financial systems with good sovereign risk.

Other developing countries face greater country or sovereign risk.

Given this need for capital (government and non-government debt), the question arises as to what an appropriate amount of national debt should be.



The chart above indicates that in relation to government debt at least, Australia does not appear to have a problem. The issue for Australia is what that debt is for. Has it been used for productivity or revenue streams or welfare injection? This, plus private debt, would be variable.

Put another way, was the debt for consumption or long-term investment? Does the debt generate a higher rate of return than the rate of interest? A lot of our debt is not for physical and intellectual goods and services with a real return. Someone has to pay tax to service and repay the debt. We will always have welfare debt, but what is the optimum mix of welfare to productivity debt?

Gross Domestic Product (GDP) is used as a measure of the strength of a country and accordingly its capacity to borrow (see next section). But there does not appear to be a consensus on the right amount of debt and the benchmarks. What are the various measures, and the strengths and weaknesses of each measure? We need an accepted measure that is transparent would make it easier for policy makers and politicians.

The debt argument is shrouded in mystery and jargon that, it would seem, only economists understand.

One of the problems is that we do not have a balance sheet. Currently, debt is measured against income, and not against the balance sheet or the country's assets.

For instance, why would there be you be concern about borrowing for an ore mine which has a 50 per cent cash margin and high ROI, and is wholly exported? Clearly, with such a fast pay back, it does not matter how much is borrowed.

The public would understand the benefits in delaying consumption if the alternative was to build productive capacity with such a fast pay back.

A balance sheet would enable you to look long term and distinguish between expense and capital expenditure or future earning capacity.

The writer has taken a similar comparison between Melbourne Business School, which is a corporate entity with a balance sheet and a University. This relationship provides many benefits to the business school in being able to deal with the difference between income and capital.

It is not suggested the inquiry go down this path, but it is interesting to compare this possibility against the existing measures.

It would be possible to scope a plan to establish a balance sheet and profit statement for Australia. The Productivity Commission, drawing on several Government agencies and the academic community, could scope a plan.

Such a paper should examine tangible and non-tangible assets. The obvious problem with a balance sheet – and this is the same for public companies - is the intangibles, such as the environment and technology.

Much improved debate would result from the very process of developing a methodology for:

- The difference between capex and expenditure;
- The life value of capex, its replacement value and appropriate depreciation;
- Placing a value on existing assets and the timing and value of replacement;
- Forecasting capex and cash flow;
- The segmentation of income and expenditure;
- What expenditure is fixed and variable and is maintenance or operating in nature;
- Identifying welfare payments in some meaningful way;
- Allocating debt and its source and type where possible;
- Allocating tax.

This is quite a different endeavour to trying to understand industry dynamics, and profitability and growth prospects. A balance sheet can contribute to this understanding.

The project could commence by focusing on minerals or agriculture, enabling the methodology to be tested before being rolled out.

There are two papers to which I would like to draw the Committee's attention: England and Harris's (1998) excellent United Nations paper[27], which grapples with how to account for intangibles. It would make sense for countries to reach agreement on these intangibles, but this is unlikely. Yet achieving a consensus on a balance sheet would solve a lot of argument. It would be interesting to know if the UN has commissioned further work and what the IMF and other international agencies' views are.

Second, the Coalition's 2030 Vision For Developing Northern Australia, which looks almost like a balance sheet of the kind contemplated here. The paper identifies the critical and social infrastructure needed to support long-term growth to capitalise on Northern Australia's strengths. According to the Coalition, the paper will help establish a clear and well defined and timely policy that forces for the next two, five, 10 and 20 years.

Without a balance sheet, policy development is limited and more likely to respond to vested interests and the deepest and most vocal claimants, or as Ross Gittins calls them, rent seekers.[28] We see this in the current state of infrastructure funding:

> Acutely evident by the $18 billion already pledged is that the majority of the infrastructure spend is ear-marked for marginal seats throughout Western Sydney, Brisbane, Melbourne and Perth. It is an unfortunate reality in Australia that infrastructure policy is typically determined by the electoral cycle rather than the economic and social benefit.[29]

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[27] England, RW and Harris, JM (1998), 'Alternative to Gross National Product: A Critical Survey', reprinted from *Human Wellbeing And Economic Goals* (Island Press, 1998), edited by Frank Ackerman, David Kiron, Neva Goodwin, Jonathan Harris, and Kevin P. Gallagher. http://ase.tufts.edu/gdae/publications/archives/englandpaper.pdf

[28] Gittins, Ross, 'We're now a nation of rent seekers', *Sydney Morning Herald*, 3 March 2014. http://www.smh.com.au/business/were-now-a-nation-of-rentseekers-20140302-33tye.html

[29] Financial Services Institute of Australasia, 'Infrastructure Should Be Based on Policy, not Politics', 3 December 2013, http://www.finsia.com/policy/policy/policy-news/2013/12/02/infrastructure-should-be-based-on-policy-not-politics

Other commentators have expressed frustration in not having a balance sheet as a platform for developing policy and setting out priorities in documents.[30]

What if anything, are other countries doing?

It might improve the public discourse on the allocation of resources and move away from values and often emotive arguments towards a balanced assessment of net community benefit. Net community benefit, of course, includes intangibles as does the balance sheet. Many values-based requests are simply not fundable due to insufficient net community benefit. It might also moderate the misgivings about GDP and GNP, because these are so difficult for people without economics training to understand, in any event, and conceptually flawed and inadequate. It would also assist in ranking one project against another, and lead to better research and evaluation.

[30] Sprague, Julie Anne, *AFR*, pg10, 3 March 2014.

Gross Domestic or National Product

Gross Domestic Product (GDP) and Gross National Product (GNP) are deeply flawed measures. They give information about the size of an economy and how it is performing, but they are not a balance sheet. They do not measure the overall standard of living or whether a country is better or worse off.

GDP is often used to assess the strength of a country. GDP measures all the output generated within a country. It includes goods and services produced for sale and includes some non-market production, such as defense and education services.

GNP includes the above and the output of residents in other countries.

GDP and GNP are often calculated per capita. Neither measure includes unpaid work and wear and tear. Moreover, they are confusing as they include some production and some income. It is also difficult to compare periods because they are not adjusted for inflation.

Journalist Adam Creighton argues that GDP is a fundamentally flawed measure that "ignores a country's stock of financial and physical wealth": [31]

> At best, gross domestic product is a harmless, if increasingly muddled, artifact of a bygone era; at worst it is a ruse underpinning the fallacy that bureaucrats can measure and politicians can control economic activity…GDP considers frivolous debt-fuelled consumption as worthy inclusion in 'economic growth' as considered to long-term investment, public or private.

The move away from manufactured goods and the pace of technological change make it harder to meaningfully compare incomes or outputs at more distant times.

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[31] Creighton, Adam, 'GDP an Indicator of Grossly Distorted Product', *The Australian*, p 28, 7 March 2014. http://www.theaustralian.com.au/business/opinion/gdp-an-indicator-of-grossly-distorted-product/story-fnc2jivw-1226847426904

A further distortion comes with the surge in financial services activity. Financial transactions from the 1990s have been included in the GDP. How can intermediary activity be included in output?

PART 6 - Superannuation Funds and Bonds

Superannuation Funds

Infrastructure Bonds

Superannuation Funds

It is likely that if the status quo remains, the banks' share of financial services will continue to grow and further dominate the ASX. This makes discussion about superannuation funds crucial.

The $1.8 trillion super fund market is growing exponentially and it is a great honey pot for many who would like to plunder. It would take huge changes in legislation and some fundamental tenets to be established for super funds to change the banks in some segments. Should super funds step in where banks have failed, and undertake banking activities themselves? With the growing concentration of the banks and the problems of new entrants, scale, funding and technology, it is tempting to look to super funds to stop the growing concentration.

I welcome the Committee Chairman's recent statements that the Committee will closely examine the ways in which super funds allocate capital.[32]

The governing principles of any super fund are the same, whether it is a huge scale, multi-million dollar fund or a small one-man fund. Members are beneficiaries and the trustees have clear and well tested fiduciary obligations to them. Any investment product should satisfy the Trustees' obligations — not the other way around.

Super funds invest but are rarely in the position where they can manage or run a business. There is inherent conflict with that position. How can they judge their own performance, and how can they change and exit?

The core activity of a bank is credit assessment. Super funds do not have that core capacity.

A bank requires infrastructure and gross income or margin. With low margins, banks need leverage to get income. For instance, a leverage of 10 times and a margin of 2.5 requires a gross of 25% to cover expenses.

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[32] Maley, Karen & Eyers, James, 'Murray Drafts Finance System Blueprint', Australian Financial Review, 20 March 2014, p 29.

Super funds cannot achieve this. Although they could provide the financial leverage, sources of leverage are myriad and forever changing. There are sources that specialise in this form of borrowing or lending.

Super funds are better off investing in bank shares and placing their cash in fixed interest component of their funds in the best and safest place.

Again there is a competitive market for that and so super funds have the power to choose where they, in the interest of their beneficiaries, should invest.

This makes it difficult for a bank to own super fund management rights, unless they accept the proposition that no funds should be placed with them:

- This will not discourage banks for expanding into this market because it is in the interest of the banking sector to do so;
- The bank super fund manager would simply place their monies on deposit with the other banks and expect reciprocal business as this is what happens – parallel behaviour.

If the current structural state of the banking sector if is to continue with no material new entrant, this presents a serious challenge for the inquiry.

Australia needs huge capital for infrastructure and there is no reason why infrastructure bonds (like war bonds) could not be developed to attract super fund money. But the bank must satisfy the super fund — not the reverse.

Tax concessions do not materially help super funds, as they pay very little tax. The attractiveness of the bond would have to be in the yield, the maturity and the risk.

Governments have demonstrated willingness to assist infrastructure funding, for instance by making concessions to the States. There may also be opportunities beyond tax concessions.

Where a State is the lessee of the infrastructure, this improves the risk position.

Some Governments go further and offer some fall-back security, which might help the risk weighting. This, however, brings deep policy implications.

The alternatives to super funds are some kind of intermediation with super funds that is beyond the scope of this paper.

Another problem has emerged for the banks in the ownership of Funds Management entities. Basel III capital rules have increased the deduction against capital from 50% to 100%, dragging down equity returns. While funds management is not capital intensive, this development represents a significant deterrent. It would not be surprising if clever funding and ownership mechanisms emerged to counter this.

Banks may just be left as either a distention of other entities' products or alternatively, the manufacturing of product of others to distribute.

The potential market is so huge that it is inevitable that some form of innovation will emerge.[33]

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[33] Eyer, James, *AFR*, p 34, 3 March 2014.

Infrastructure Bonds

The market should see Infrastructure Bonds as a part of the long-term vision for Australia's vital infrastructure needs. Similar to other countries in our region, abundant household savings have not translated into significant infrastructure investment.[34] I note that legislative changes anticipated for June 2014 will open up bond issues formerly restricted to institutional investors to retail customers, crucially, to Self Managed Super Funds. SMSFs under management are expected to double from current levels to $1 trillion by 2020, so this is an important untapped market segment.[35] However, a recent Infrastructure Australia report sounds a cautionary note on the problems associated with engaging with retail investors:[36]

> According to one industry participant, 'the ability of retail investors to easily make and manage investments in corporate bonds which are issued into and trade in the unlisted (over the counter) wholesale market has been a deterrent to their involvement'. Other industry participants agreed.

This Inquiry is an opportunity to research and understand the segmentation of the market by:

- kind of issuer
  → Issuer model
  → Scale;
- holder of the bonds
  → Retail
  → Wholesale
  → Combined;
- The extent to which liquidity for the investment is required by each segment;

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[34] Ehlers, T; Packer, F & and Remolona, E, 'Infrastructure and Corporate Bond Markets in Asia, Bank for International Settlements, 14 March 2014, http://www.rba.gov.au/publications/confs/2014/pdf/ehlers-packer-remolona.pdf

[35] Drummond, Shaun, 'Legislation set to let retail investors to buy bonds on the ASX', *Australian Financial Review*, 20 March 2014

[36] Infrastructure Australia, 'Review of Infrastructure Debt Capital Market Financing', February 2014, http://www.infrastructureaustralia.gov.au/publications/files/Review_of_Infrastructure_Debt_Capital_Market_Financing.pdf

- The potential role of the ASX;
- The maturity and yields required to create demand;

There are many questions raised by the challenge of creating a vibrant infrastructure bonds market, and I shall attempt to pose some of them here:

- Who should be involved and get the market facts? Presumably not those who might gain from the introduction to the market of the bonds.
- What should the target range of bonds for the Super Fund sector be?
- What are the characteristics of the Superannuation Sector that are important in the design of the bonds?
- What will the demand be outside the Super sector in terms of amounts and bond design?
- What regulations should apply?
- What disclosures are required for the reasonable investor?
- What is the innovation required to minimise regulation and avoid:
    - Over disclosure
    - Irrelevant disclosure
    - Disclosure geared to the audience, not a "one size fits all".

Who should be the Regulator?

- The relevance of Corporation Law, Competition Law and APRA
- How should issuers be structured:
    - Corporation
    - Trust Structure
    - Individuals;
- Any foreign limitations
- What should the target rate of return be with the infrastructure issuer?
- What should be the level of debt by the issuer?
- Are there any particular issues with governance?
- Does it make any difference if the Government is a tenant?

- What will be the role of the Rating Agencies?
- What is the overseas experience?
- What role should the banking sector play?
- Should there be a model or pro forma structure for discussion with analysts?
- What should the risk framework be and what are the chances of avoiding a “tick the box” approach?
- Is there a place for small issuers, for example, local councils with appropriate regulation to suit small transactions?
- Should there be any tax concessions, given the Super Funds can take little advantage of these tax concessions?
- Should there be any tax concessions to encourage foreign investors?

PART 7 - The Market

Adam Smith and The Free Market

The Market Argument

Scale Argument

Adam Smith and The Free Market

Adam Smith was one of the early proponents of the free market and its advantages.[37] Some economists use Adam Smith to justify a position of not interfering in the market at all.

Adam Smith in fact was a moral philosopher and had views beyond pure economics. He could be described as an early exponent of behavioural economics, a sub-discipline that is getting some attention today. As a moral philosopher he would have endorsed the rise of behavioural economics. People's behaviour is an economic force, as is evident in the GFC and the behaviour of monopolies and oligopolies. The difficulty of behavioural economics is its lack of scientific backing and acceptance among Economists in general.

Adam Smith believed that there were some moral constraints on the exercise of market power. He endorsed the need for a legal system to protect liberty and property rights, national defence, public works; as well as regulations which the community accepts as necessary for its own protection without abandoning free market philosophy.

Smith identified prudence and justice as critical to the civil functioning of a free market. He commended the virtue of beneficence and concern and compassion for others. He distinguished between self-interest and selfishness. An individual could be self-interested and still beneficent. Moreover, the self-interest of one person could be in accord with that of another — for example, in the case of a bargain or a mutually beneficial transaction.

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[37] Much of the material in this section has been derived from the excellent publication by my friend and colleague Richard Morgan, a former director of the Victorian Chamber of Commerce and Industry, "Lessons From The Global Financial Crisis. The Relevance of Adam Smith on Morality and Free Markets", (2010), Taylor Trade Publishing)

Smith's schema highlights the problem with the Global Financial Crisis. Self-interested bankers and bank executives were selfish in that they undertook transactions to benefit themselves but to the material disadvantage of others. This has necessitated greater regulation.

Selfishness often occurs in oligopolies and monopolies where the power derived from that status is used to the disadvantage of others.

Adam Smith's articulation of the constraints on market power was general in nature and difficult to apply to the modern economy.

Without doubt, he would endorse the idea of information symmetry. Information imbalance gives one side a distinct disadvantage over the other. To deny, withhold or delay information is self interested and selfish.

In Banking and Retailing we have significant individual and organisational behaviours which together are unfair. The result is one side capturing too much of the rent to the disadvantage of the other.

Some economists refuse to forecast or predict the future. Recent Nobel Prize Winner Robert C Merton, of MIT, says it is wrong for economists to try to predict or forecast the future.

Economists interpret historical data and explain why certain things happen, but the past is only one ingredient in predicting the future. Merton supports his view by quoting how often economists are wrong.

It is into this void into what the behavioural economy has moved. Most behaviours are not likely to change, so this can lead to consistent outcomes.

In all likelihood, he would describe the behaviour of Australian retailers towards their suppliers, and banks towards their retail customers, as morally wrong.

Adam Smith had strong views on regulation:

> *The Man of System.... is apt to be very wise in his own conceit; and is often so enamoured with the supposed beauty of his own ideal plan of government, that he cannot suffer the smallest deviation from any part of it. He goes on to establish it completely, and in all its parts, without any regard either to the great interests, or to imagine that he can*

> *arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. He does not consider that in the great chess-board of human society, every single piece has a principle of its own, altogether different from that which the legitimate might choose to impress upon it.*

It is understandable that Smith's relevance today is under challenge,[38] given the enormous changes wrought by the Industrial Revolution and the evolution of business in general. Others have highlighted the deficiencies in Smith's view that self-interest can easily explain what happens in firms, and that self-interest inevitably leads to the right outcomes:

> In short, any evolutionary model must account for two opposing processes that operate simultaneously: competition between firms and competition between the individuals within them…
> In reality, firms are made up of individual human beings, with various goals and motives but, most importantly, considerable self-interest.[39]

This one-size-fits-all syndrome creates a lot of difficulties and makes it very difficult for small players. In its 2013 report, 'Regulatory Engagement with Small Business', The Productivity Commission highlighted some instances. For example, it is almost the impossible for builders to comply with all the regulations from multiple regulators without some corner cutting.

It was not the function of this report to deal with the issues in any one sector, as each sector has its own set of issues.

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[38] Gittins, Ross, 'Darwinian model of economics flawed for firms', *Sydney Morning Herald*, 28 December 2013. http://www.smh.com.au/business/darwinian-model-of-economics-flawed-for-firms-20131227-2zzns.html

[39] Johnson, D.D.P., et al., Darwin's invisible hand: Market competition, evolution and the firm. J. Econ. Behav. Organ. (2013), http://dx.doi.org/10.1016/j.jebo.2012.12.016

The Market Argument

Economists will argue that the market is working and we should leave it alone. The market argument assumes there is full information available for customers to make appropriate decisions. The reality is that there is very little information, particularly in segments such as small business and mid-size business banking.

The level of information available is greater in some segments than others. For instance, in the mortgage market, one could argue that the market is working because customers are able to make a choice based on the information that is available or is capable of being put together by third parties like brokers.

This does not apply to business banking. There is very little information available because of the different characteristics of each customer. Banks are able to cloak this activity by saying each client is different and therefore there should be different lending arrangements.

This is partly true, but more information could be available which would give the banking consumer more power in choosing a bank. This would also benefit the media, analysts and financial specialists.

A recent trend that is beginning to have some visibility is the way the pendulum has swung from the banks' frontline sales force and relationship managers to the credit departments.

All the power at the moment is with the credit departments and the credit committees. There is a great deal of parallel behaviour between the banks in dealing with clients, based upon similar risk weighting strategies.

In times of difficulty, the herd instinct of the banks is exacerbated. Banks retreat from risk and tighten up all their lending requirements. It is surprising how the banks do this in parallel.

As the taxpayer is funding the deposit guarantee, it is important the trading banks give more information to taxpayers that will also enable customer choice.

The balance between information and market power is currently distorted. Banks have the market power and customers do not have the appropriate information to put the banks into a competitive position.

Scale Argument

Scale is often used to justify a large market share or a high degree of concentration. The argument goes something like this: Australia is a small country in terms of population and it is inevitable that some sectors will have a higher concentration level, as this is needed to match their international peers. Companies need a large market share and / or concentration to compete globally.

If we take the three sectors of Media, Banking and Retailing, different issues apply to each.

By international standards, Australian retail has a high degree of concentration. There is no doubt that the main divisions of Wesfarmers and Woolworths have the capacity to compete in the International Market if there is a market opportunity. The divisions do not need to be any larger and could indeed be smaller to compete internationally.

The reality is that in most of the international markets, there are already dominant players (some local, some international) and it is hard for any foreign aspirant to gain entry. The reason for success or otherwise will not be scale and resources, but other issues, such as foreign investment and the regulatory environment.

The track record of retailers competing in other countries is not good. Many of the success stories have come as a result of buying out a local competitor as a platform as the cheapest form of entry.

To take this further, one would need to analyse Coles and Woolworths division by division and country by country. There is no doubt Woolworths and Coles have looked at this and have been concerned about their ability to successfully enter foreign markets.

With Banks the situation is similar. Any of the Big Four have sufficient scale to enter any market. Their success in gaining entry does not depend on scale, but upon the structure of the market in each country. Banks do not need to get any larger to facilitate entry to other countries.

Media has a high degree of concentration, but if this is broken down into newspapers, television and radio, television and radio are highly regulated whereas newspapers are not. News Ltd proved its ability to enter foreign markets even though its size was very modest indeed.

PART 8 - Information

The Imbalance of Information

Information

Current State of Information Providers

Information Required on Risk

The Imbalance of Information

There is a huge disparity between the information available to the average bank customer and the information available to and accessed by the banks.

Banks can demand all the information the customer has, but not vice versa. For most customers, the bank can access all the information from other customers and use it to make a judgement about that customer.

The banks use the argument that they cannot talk about customers' affairs because it breaches confidentiality. This does not, however, apply in the case of a bank executive who can use information from one customer to help make decisions in respect of another. In others words, he or she is using the information for a collateral purpose. This wall of secrecy is being abused.

By contrast, revealing information of a portfolio of clients where no one client can be identified customers considerably in understanding why their business was rejected by the bank or why certain securities were sought.

The courts are becoming more rigorous over the information an executive can take and use when he or she leaves one company for another. In banking it is difficult to articulate the nature of that information, how it is obtained and how it can be applied. It is not as simple as a piece of technology or a client list, which are unambiguously useful for an executive to take and use in a new organisation.

By the very nature of banking it is difficult for customers to compare banks.

The information disclosed in some situations is good. In the mortgage market, some operators are comparing mortgage rates and terms, enabling consumers to make informed choices. Indeed, these third parties make a living from making that information available. The same has not happened in other bank sectors to anywhere near the same extent.

In retailing, there have been failed attempts to publish information — for example, grocery prices and the Petrol Commissioner. This is not surprising, because of the omniscience of advertising. Yet this does not apply so much to banking.

The issue of disclosure by the bank really requires a separate study to be carefully scoped out. Banking is complex and more difficult to compare. Many products have different characteristics, whereas retail products are more homogenous and comparable.

The scoping would need to look at the different activities of banks and the problems of disclosure. It would need to go beyond product comparisons, to include disclosure of information about risk and the banks' attitude to that risk.

Information

Information could come from a number of sources: Treasury, the Reserve Bank, APRA and the Productivity Commission.

Banks should be forced to disclose more information on some segments not as part of its annual reporting process, but via other disclosure mechanisms. This would be a disclosure regime at a time, in a way and in a form that makes customers better informed.

The need for information that empowers consumers varies significantly from one segment to another. In each segment, it is important to understand the interplay of information and the exercise of market power.

If something is not done, the concentration will increase, thus further eroding consumer power. The market can only be better off through having more information and better understanding of the individual segments.

The mix of competition and regulatory policy needs to change and we need a better understanding of the objectives and the policies of APRA. We need to balance the risk weighting process not only to lower risk but to encourage or discourage activity in the national interest.

Given the power of risk weighting and the terms by which our security is funded, there should be debate about balancing items and what is good for overall economic wellbeing.

The objectives should be clear and transparent and we should be able to debate them and the consequences of risk-weighting policies.

Current State of Information Providers

It would be helpful to understand the market that has arisen to provide research information about bank products to accounting firms:

- Who are the players and where are they getting the information?
- Who is the audience and who is paying for the information?
- Would they like greater access for information?
- Could APRA / RBA provide raw data for them?
- What are the barriers to getting that information?

In other words, with an understanding of the banking information market, it may be possible to develop an enhanced market for information via APRA, the RBA or the banks direct.

Information Required on Risk

There is little understanding in the community of what risk means: the probability and kinds of risk and how it is minimised, mitigated and measured. We do not know the extent of parallel behaviour by banks in their treatment of risk.

We know little about the role of risk weighting in designing bank products, and the allocation of risk between the various products and components of the Bank. Does it fairly reflect the capital required and the consequent interest cost?

Nor do consumers know the role of time in assessing risk, or whether there is much difference between banks when it comes to appetite for risk. Should consumers know this, and would this be fair on the banks? What role can industry associations (eg, agriculture) play by seeking information on behalf of their members?

What information exists in the public arena on risk and who can access it?

Would the market be more efficient as a result of this information being released? Would an open conversation lead to improvement and more competition?

Banks have powerful data warehouses and information that should be capable of being mined very cheaply and easily. Data mining and making that information more widely available would for consumers, enable better understanding of the risks of a transaction, and for banks, a better understanding of consumer behaviour and where opportunities lie.

In contrast to the banks, retailers have sophisticated re-order systems that order stock in the right quantity and in the right market, for stores to satisfy consumer demand. This technology flows right through the distribution chain.

While these systems are automated, the relevance of data mining is that managers can see trends and spot consumer aspirations, which might lead to new products or modifications of existing products.

Data mining can provide massive benefit for the large companies over the small ones because of their ability to extract massive amounts of information, some of which can be paid for by the suppliers.

The banking sector could easily gather and organise this kind of information in such a way that client confidentiality would be maintained and to prevent conflicts of interest.

The very fact the information was being sought on a particular product or might focus on a particular banking activity would stimulate bank competition.

Then there is APRA. Is its mission still appropriate and is there additional information it could be making available?

APRA in effect influences, if not controls, the risk of transaction undertaken, i.e., the supply side, but there is no information available on the demand, i.e., the transactions not undertaken.

It is important information to know the relationship between a transaction undertaken and, in effect, the unsatisfied demand.

If there is significant unsatisfied demand, then this should be known. Financial institutions might want to enter this market or the risk weighting might be too tight.

There is also the grey area of unsatisfied demand as to the amount lent and / or the tightness of the covenants.

If the risk weighting and consequent allocation of capital and the interest rate are meant to reflect the incidence of default and loss, why is it that certain areas, in particular business banking, are starved of lending?

In the risk-reward axis, presumably all loans are fundable. It is just a question of rate. Theoretically, the interest rate could be 100 per cent. This is not the reality because banks will sometimes refuse to lend irrespective of the risk.

There appear to be more complaints about not lending, as opposed to excess interest rates or onerous loan covenants.

APRA claims that risk weighting between banks can vary by as much as 4 per cent. This seems to suggest:

- The analysis or methodology is open to debate,
- The banks are using the risk weighting to suit their own objectives, particularly profit/portfolio objectives.

APRA wants a common methodology as a one-size-fits-all approach. We need to know a great deal more about this. Major decisions and allocation of resources with debt are being made where the public has little information to form a view. These decisions are shrouded in mystery with statistical analysis, and their designs based on assumptions that do not help understanding and transparency.

It has been suggested in some quarters that Government should intervene and provide guarantees to facilitate more bank lending in the business sector. This is fraught with danger.

An alternative to Government guarantee is insurance but would insurance be too costly?

If a package of loans were to be insured, this would spread the risk and the cost.

It would be better if this were done in conjunction with the private sector, with the insurance risk shared so that the private enterprise would drive the initiative.

Government could step further away by just being involved jointly with private enterprise on a several basis (not joint and several) in reinsurance. This is very controversial as Government intervention in this area on the whole has not been successful.

PART 9 - Banking Communications

Bank Power

Banking – Brand / Values

Bank Bashing

Bank Power

Banks are adept at protecting their fiefdoms. Small proposed changes to regulations or anything that affects the banks' power or profitability even marginally, are met with loud cries from the Bankers Association and the banks themselves. We need the evidence for disproportionate bank power, but it is difficult to establish precisely because of the banks' use of privacy laws and their lobbying clout.

Quite apart from the Bankers Association, the banks have vast resources to protect their interests, including a plethora of well paid third-party advisors only too willing to step in and protect the banks. These people are lawyers, accountants, consultants who collect massive fees. In many cases, the banks represent their largest clients. Their knowledge makes it is easy for them to argue on the banks' behalf.

It is interesting that politicians will privately share their concerns about the banks' power and tactics, but will not commit themselves publicly. They recognise that bank fees, penalties and margins are higher here than overseas.

Many members of the public do not want to talk about bank power in fear of being labelled as a disappointed or disaffected bank customer who should not be listened to. There are in fact many such customers with no avenue to effectively deal with their issues.

Banks have vast resources to out-do complainers and frequently spend massive amounts to protect their position and reputation. Individual clients cannot do this.

Media scrutiny tends to relate to the more visible activities like mortgages, where there are many customers involved and where there is greater reader, listener or broadcast interest.

It is difficult to generate any media interest in a single instance of unfair treatment. This is understandable. Many customers have simply given up, and simply accept their lot without complaining.

It is only where groups of customers can come together with similar complaints that leverage can be exercised. Even then, this requires many customers with significant resources (for example, the Bank West/ Commonwealth Bank class action) to be effective.

It is much easier to complain in other sectors, like communications, where it is easier for the reader or listener to understand the issue and the media outlet to elicit sympathy from its audience.

While customers can take their business to another bank, it is difficult and costly to do so. In any event, the other bank will be similar. Regulation has been required to deal with home loans, making it easier to change.

Banks are in an enormously privileged position in that they can simply say that it is inappropriate for them to talk about a customer's activities.

Banking – Brand / Values

There is often a conflict between a bank's brand and its underlying values.

Banks try to put into the marketplace an image that may not reflect the underlying reality but the problems it is trying to overcome.

Often the underlying values and culture are in conflict with the brand that the advertising is presenting. Sometimes an advertising campaign is launched to deal with negative values.

In analysing banking, it is important to not generalise. The dynamics in each banking sector are quite different and the banks' behaviour in each segment can be quite different.

In trying to glean information from the banks it is important to do it by segment as the banks are often quite silo driven. Behaviour in one silo or segment is quite different to another.

I have discussed earlier in this paper the tendency of banks to collude, to the detriment of the consumer, in contrast to the collision we see in retail that benefit the consumer but disadvantages the supplier.

Banks are steeped in history. Changing culture and values is often quite difficult, whereas retailers change more rapidly in response to consumer demand (but they do not change in how they collide with and capture rent from suppliers).

Over time, retailers tend to lower their profit and percentage margin and compensate by getting volume and gross profit dollars.

While banks partly go down the same track, they are nowhere near as aggressive as retailers. Their pricing may not be as sensitive to volume because their products are more complicated and only occasionally acquired.

It is easier for the consumer to compare retail prices than banking prices. Accordingly, banks get away with more undifferentiated pricing, although it is accepted that BBSY benchmarks and other data published, for example in the

AFR, are helping. But this is not the whole story and some banks interpret it differently.

In both cases the small operator suffers many disadvantages not borne by the large-scale institutions. The disadvantages are quite similar: technology, scale, costs and the ability to fractionalise fixed costs, borrowing costs and regulatory disadvantage.

Bank Bashing

Bank bashing emerges from time to time when there has been some bad publicity involving one or more banks. It is a favourite pastime by the tabloids, the guys at the pub, the chardonnay set, the barbeque, frustrated customers and the talkback radio jocks.

Bank bashing is met by the CEO and sometimes by the Chairman with the response:

- You don't understand;
- Banking is complex and a difficult area;
- Banks are good corporate citizens and add a lot of community value.

Both points of view are correct. Why? There is simply a lack of information about risk and how it is used.

The banks shroud themselves in secrecy, hiding behind the so-called need to keep clients' affairs confidential.

Banks are like a utility with monopoly characteristics and generous Government support. Therefore, taxpayers and consumers are entitled to more. A better understanding of how banks work would aid economic progress. More information in the public arena would do away with some of the uninformed exchanges.

PART 10 - The Wallis Inquiry

Son of Wallis

Terms of Reference of The Wallis Inquiry (May 1996)

Silos / Fiefdoms

Son of Wallis

This inquiry has been dubbed the "Son of Wallis" but in reality it will be the "Grandson of Wallis" by the time it is effective.

Consider the usual trajectory of a parliamentary inquiry. First, fundamental research and evidence are sought, and then the public is interviewed by the Committee. A report is written, the Government considers the report, which is then released and opened to debate. Changes are mooted, changes are agreed, legislation is considered and legislation is implemented.

It will be sometime before there is effective legislation to deal with our banking system. Bank reform may be delayed for some time.

In the meantime, requests for change in the banking sector will be stymied as the banks will simply say, 'Let's wait until we have our review'. The government will probably accept this view. Thus it will be difficult to consider any changes pending the outcome of the review.

Banks will continue to take advantage of the time value of money (early setting of rate increase) and the time value of delay (the reverse).

Not surprisingly, they make hay while the sun shines. The banks will put significant resources into the inquiry both at the level of the Bankers Association and the individual banks.

Potentially, they have a lot to lose. They will certainly be monitoring the submissions and where appropriate, moderate their behaviour in case of adverse submissions. A prime example of this is the rise of residential mortgages at the expense of business banking. The banks are likely to be criticised for the fall-off in business banking and the lack of competitiveness. Many will understand this issue and have already made comment that banks are little more than building societies.

One issue will be, can there be less regulation without the Big Four getting bigger or does it mean a re-orientation of regulation?

Analysis by Industry Super Australia (1SA) reports that every $1 allocated to the financial services sector results in $1.50 of capital formation, down from $3.50 in the 1990s. Although inflation explains some of this, it is an interesting analysis of productivity.[40]

Another interesting development is that stockholding and management recording trading has risen more than 3.5 times since 1985, double the growth of the entire financial sector (so has the average salary).

The appointment of David Murray makes the inquiry interesting. As a former CBA chief executive, Mr Murray may well carry the weight of expectations from his former colleagues. His forthright media comments on the progress of the inquiry are encouraging, and suggest he is approaching issues with an open mind.[41] It is unclear however, how influential the other Committee members will be, and the amount of research the Committee is willing and able to undertake.

Clearly there are two levels to the inquiry, external and internal. A fundamental objective has to be to ensure that at a macro level, Australia has the best banking system in the world, so that Australia has competitive advantage over other countries.

A great deal of background information will be required and fundamental questions should be asked:

- What is the best measure of Australian debt and how does it compare with other countries?
- Is Australia in a different position than many other countries?
- Where will that capital come from?

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[40] Patten, Sally, 'Calls for more efficiency in financial sector', *Australian Financial Review,* 28 November 2013, http://www.afr.com/p/business/financial_services/calls_for_more_efficiency_in_financial_kfEk88PE3kse4e22V02UZM

[41] Maley, Karen & Eyers, James, 'Murray drafts Finance System Blueprint', *Australian Financial Review*, 20 March 2014.

- What might an Australia balance sheet look like and what should its debt be?
- Are there elements of foreign banking systems that would be helpful to Australia?
- Who has the best system architecture?
- Will the inquiry issue position papers so the public can see and comment on the proposals ahead of the inquiry reaching conclusions?
- What research is being commenced?
- To what extent will tax and competition policy be considered — after all, they have a dramatic effect on resource allocation?

Terms of Reference of The Wallis Inquiry (1996)

While the mission of the 1996 Wallis Inquiry was to analyse the forces of driving change and what regulatory arrangements would ensure an efficient and responsive, competitive and flexible financial system to ensure financial safety and market integrity.

The specifics required the identification of factors driving change, including:

- International competition;
- Domestic competition in all its forms.

The terms of reference did not go into such things as:

- The competitiveness of companies in Australia in relevant overseas markets;
- The market structure and the trends and the issue of competition;
- The barriers to entry;
- Would technology and regulation aid or hinder barriers to entry.

The implications with a lot of the data, was that foreign banks would drive the competition as well as technology. The reverse has happened. The GFC has seen foreign banks withdraw from the Australian market and the market has concentrated in a way not foreseen by the Inquiry.

There was no articulation of the barriers to entry in the report, and there was no concern that home loans would be much bigger than business lending. Yet since 1996, technology, regulation and supervision have increased the barriers to entry.

The issue of unsatisfied demand in some banking segments was not contemplated. This is not a criticism but a reality of the time and the Inquiry terms of reference.

The Inquiry achieved massive change and efficiency in the architecture of the banking system. There was a realignment of the architecture, which directly addressed the safety of the system. As a result, the Australian banking system is one of the best in the world and did not suffer as much as other countries in the GFC.

Silos / Fiefdoms

The banking sector is subject to a number of regulatory authorities. ASIC, the ACCC and APRA were created as a result of the Wallis Inquiry. These, along with the Reserve Bank and the ATO are all very powerful silos mandated by legislation with a huge influence on the shape and direction of our economy.

Over time, these institutions built up very strong cultures and values that can be difficult to shift. As they are controlled by legislation, they are difficult to change.

Although they have annual reporting requirements and answerable to Parliament (often via Senate inquiries), their accountability leaves much to be desired.

Except for the RBA, and ATO advisory committees, they do not have Boards interposed between the institution and Treasury. In terms of monitoring their activities, there remains a serious governance gap between the entity and Treasury.

These institutions exist in some shape or form in most developed countries in the western world but their mix of activity in each country is quite different.

It is fair to say that in some countries that have achieved fast growth and success, these institutions would not be as powerful as they are in Australia. If these institutions were to be established in nations such as China, Singapore and South Korea, which have all experienced rapid growth, they would have minimal influence.

Countries sometimes run into difficulties with these silos. The fragile equilibrium with the other silos become unbalanced, the decision making becomes distorted and fails to serve the interests of the country. Many would like from time to time to modify the objectives and mandate of these silos but it is difficult because of the legislation surrounding them. In many countries it is easier to change the objectives or mandates than it is in Australia.

A review of the regulatory institutions could include:

- the entity's mandate and objectives,

- the relationship with other entities,
- governance,
- priorities and national interest,
- operational effectiveness and the quality of the output,
- whether the regions and small business are being adequately covered and served,
- budgeting and funding issues, and
- the cost/benefit of their regulations.

What is clear that some entities, for example APRA, are operating with a very narrow mandate. The result is that their power and influence may be used contrary to some of the country's best interests, for example:

- small NBFI lending and lending to the regions,
- cost/benefit of the regulation,
- impact on the consumer,
- impact on competition,
- Does APRA explain and educate the public about the reason and justification for its regulation and actions?
- APRA's relationship with other regulatory agencies.

Some of the other agencies should be asked some of these questions. One major concern is that the agencies can only be reviewed over very long periods such as 20 years when a banking inquiry is instigated. This is not satisfactory.

These agencies will be slow to respond to changes that are occurring rapidly:

- Increased international competition,
- The rise and influence of technology,
- The change of government priorities in response to the need for Australia to compete globally.

It is not in the national interest to be locked into regulation for long periods without an opportunity for review in periods of much less than 20 years. We should be responding faster to international competition and it is to Australia's competitive disadvantage that we are not.

The mode of regulatory, government agencies needs to change. We must be able to change their objective and mandates more frequently and effectively

Ideally, changes in mandates, say every three to five years, could be very helpful and assist the dynamism of our economy.

However, the principal issue is governance. Governance arrangements could clearly be improved to establish a chain of accountability superior to what currently exists. It is possible that the strong, independent and non-conflicting influence of directors with clearly mandated powers could improve the situation. Also, international persons could be appointed and / or there could also be an international advisory board.

While likely to meet with resistance from agencies, interposing a Board of Directors between an agency and Treasury is certainly one way of ensuring fundamentally important questions could be raised promptly and frequently:

- Is the regulatory agent carrying out its mandate and objectives appropriately?
- How is the agency travelling in an operational sense compared with other similar international agencies?
- How is the agency coping with Australia's national priorities and interests?
- How appropriate is the budget and is the agency meeting that budget?
- How is the agency relating to other agencies?

Agencies would probably enjoy greater independence reporting directly to a Board, and there would be anxieties in the community about this kind of model, but presumably the devil is in the detail.

If the architecture were designed properly, the community could be satisfied our agencies were much more dynamic and able to move with the times. This is not the case of trying to minimise but to increase their relevance and effectiveness in the community.

It is recognised that there are significant legislative issues surrounding a number of these suggestions, and that they may provoke anxiety in some sections of the community.

Clearly there will be great interest in the people appointed on these Boards. There are outstanding people in Australia who would not be conflicted, would make a major contribution to the effectiveness of the agency and add value to their activities in the interest of the nation.

I hope my comments and proposals – which are but a brief introduction to what is a huge subject in its own right — stimulate discussion on the future of our regulatory bodies.

PART 11 - Conclusion

Concluding Comments

CV of John Christian Dahlsen

Concluding Comments

The Wallis Committee did an excellent job in reshaping the architecture of supervision, with the consequence that Australia has one of the best financial systems in the world.

However, the Committee did not ultimately achieve more competition or greater power for the consumers, particularly in regional and small business banking. Instead, the banks have become much stronger and concentrated since the Wallis Inquiry and this will continue unless there is some change.

The situation between the banks — APRA and the Reserve Bank on one hand and the Consumer on the other — in many banking segments is out of balance. Basel and APRA's influence has increased significantly because of the GFC. Combined with the growing power of credit committees, they dominate the banking landscape.

The challenge of re-establishing a balanced system without compromising one of the best supervised systems in the world is not easy. Growing bank concentration and profitability will only serve to increase public anger over the lack of competitiveness and inferior service.

Clearly we need more information on:

- unsatisfied demand by segment;
- pricing and behaviour (query Parallel Behaviour);
- understanding of Risk and Risk Weighting and the role of the Regulator; and
- the extent to which Australia should adopt more risk weighting that is more favourable to the consumer than that recommended by Basel, what criteria this would use, how it would be tested and national priorities.

Providing relevant and timely information need not be inconsistent with overregulation.

Generic competition policies are difficult to apply in all sectors of the economy. The tools of the current regulator, the ACCC, need to be updated, especially in the complex area of banking.

The Banking Ombudsman has failed through no fault of his office. Should codes of conduct or ethics be developed and endorsed by ASIC, and given legal weight?

If a great deal more information were available to consumers and if the banks truly served the customer and dealt with unsatisfied demand, new entrants would not be so vital for competition.

The IMF Paper on Banking Competition endorses the desirability of comparing with other sectors. In retailing, with Coles and Woolworths vigorously pursuing the interests of consumers and competing against each other, the sector does not need new entrants to better serve the customer. One can of course argue that the suppliers are worse off because of the domination of the two.

The four major players in banking would be sufficient to service the interests of consumers if they were in genuine competition with each other. If the competitive climate does not change it is possible that a new entrant, far from injecting competition, might simply join the oligopoly and enjoy the benefits.

Should the information providers in the market be assisted.

To what extent should consumers' interests and power be modified by system safety and where should the balance lie?

Competition for business in small business banking and in regional areas is weak. It is clear fees in this area have escalated in recent years. The banks have developed new forms of income from business banking, some of which border on penalties, as breaches do not affect risk or cost in any shape or form.

The GSI case has highlighted the void in regional banking and small business, as well as the crudity of the tools available to deal with companies

in difficulties. It would be a shame if this were not studied further and instead shunted to law reform, where economic studies are limited.

Unlike any other sector, banks are in a very privileged position granted by the Government on behalf of taxpayers. There should be some quid pro quo for these privileges, eg., accept greater risks and lend to business and regional Australia. This would likely result in fewer complaints and more service. In the past, Governments have attempted to solve some of these problems by setting up specialised banks, but on the whole this has failed.

On debt and deficit, is it possible to reduce fruitless controversy by better understanding of where Australia is at, where we expect it to be, and its infrastructure needs? The public needs benchmarks and explanations, in the absence of information on productive capacity and the ideal of a balance sheet.

Should Super funds be a market for bonds? Australia has well documented infrastructure shortfalls and the process for allocating government funding is invariably and hopelessly politicised. The entry of super funds, in particular SMSFs, by way of bonds, could revitalise Australia's capacity to build for its future.

It must be acknowledged that the dynamics are very different in the various sectors of banking and this is an overriding comment on much of this material and highlights its complexity.

The bodies that make up the banking system's regulatory framework — ASIC, APRA, ACCC and the RBA — are all very powerful silos with clear mandates, charters and objectives. All report to Treasury, but only one, the RBA has a Board comprising a majority of independent directors appointed by Treasury.

The Committee could foster greater responsiveness in the policy and architecture of these entities by developing a model like the RBA, where independent and non-conflicted Directors are appointed by Treasury. These entities could have a dual reporting line to Treasury and the Boards.

In the case of APRA, policy and architecture change could be achieved by changing its charter, mandate or objectives to require it:

- to take into account the interests of the consumers in making its decisions;
- to articulate more clearly the objectives of regulatory change and why it is in the interests of the country for it to be introduced given the competition between sovereign nations;
- to move away from a 'one size fits all' approach and develop regulation which does not disadvantage the smaller financial institutions;
- to circulate in the market place material that offers a better understanding of its activities.

This would require a cost-benefit analysis to be undertaken on any new material regulation, and a review of existing regulations to ensure they are effective in meeting the above objectives.

CV of John Christian Dahlsen

Company Director and Solicitor

Qualifications

Bachelor of Laws, University of Melbourne (1958)
Master of Business Administration, University of Melbourne (1969)
(John Clemenger Prize Winner as top student)

Career in Summary

Family Company	JC Dahlsen Pty Ltd Group (Chairman and Sole Owner)
Previous Charitable Activities	The Smith Family National Drugs Partnership Non Profit Australia Institute of Public Affairs Ltd (Councillor) Melbourne Business School Ltd (Chairman) Centre for Journalism University of Melbourne Little St Margarets Ltd (Chairman) (with others, acquired the school on its imminent closure)
Some Former Directorships	**Public Companies:** Woolworths Limited (Chairman) Melbourne Business School Limited (Chairman) Sothern Cross Broadcasting (Aust) Ltd (Chairman and Co Founder) Herald and Weekly Times Limited (Chairman) and Director of Associated Companies: - Advertiser Newspaper Limited - Herald Sun TV Pty Limited - Television Broadcasters Pty Limited - Queensland Press Limited Myer Emporium Limited (Deputy Chairman) ANZ Banking Group Limited OVS Investment Corporation Limited Bell Group Ltd Bell Resources Ltd **Private Companies:** Myer Family Investment Companies WJM Pty Ltd Mining Project Investors Pty Ltd John Holland Group Pty Ltd Sandridge City Development Co Pty Ltd Penrice Ltd G S Private Equity Pty Ltd Byvest Management Buyout Group LEK (Member Advisory Group)

Banking Experience	Director of ANZ Banking Group for approximately 15 years Many years as a member of the ANZ Credit Committee Many years as the Chairman of the ANZ Audit Committee
Nature of Legal Practice	Commercial Solicitor for over 45 years having practised in all aspects of commercial law including takeovers, reconstructions, tax and trade practices related issues. Preparing extensive submissions to Tribunals. For a number of years operated a large practice in Public Company Takeovers. Advising Boards on strategic issues and as to the duties of directors and on relationships with shareholders and shareholder interest. Advising in relation to directors duties generally. Member of the three-man Panel that reviewed The Audit Act 1994 in Victoria. Completed a study for the Prime Minister's Community Business Partnership on the desirability or otherwise of establishing a Not-for-Profit Council of Australia. On the Committee to interview Candidates for the I.A.C.
Family	Married to Gillian Hamilton York Syme on 21/09/1962 Children, Sarah, Geoffrey and Mary

Attachment 1

GSI / the Trust Company / Rescue Group Court Decision and Comments

GSI / the Trust Company / Rescue Group

Court Decision and Comments

Decision:

Federal Court of Australia

Farrell J

Decision 18th December 2013

The Trust Company of Australia (Nominees) Ltd

(referred to as the “Trust Company” or “Trustee”)

V

Gippsland Secured Investments Ltd (GSI)

John Dahlsen LLB, MBA

25th March 2014

Postscript 1

25th February 2014

On Sunday 9th February 2014, the Receiver by auction at Metung, sold most of the unsold property owned by Riviera Properties Ltd (RPL) which was mortgaged to GSI.

The sale was very successful and is likely that the RPL loan will be repaid to GSI. This should result in over 90cents in the dollar being returned to noteholders but query the substantial fees and costs being incurred by the Receivers and their solicitors, Ashurst. These fees need to be reviewed. The comment has been made by several people that there appears to be over manning and lack of cost concern. It is interesting that no Gippsland entities have been involved in a material way in the process other than real estate sub agencies.

The RPL auction vindicates the position taken by the Rescue Group that it could achieve 100cents in the dollar of value for noteholders. The difference between the Receivership and the Rescue Group return to noteholders is the massive brand and goodwill damage done to GSI by the Trustee with the close down of the business and the forced sales and the damage to the people and the economics of Gippsland.

Postscript 2

18th March 2014

The receiver announced on the 18th of March 2014 the sale of the GSI loan book enabling the receiver to forecast a return of between 87-92 cents. The cost of up to 4 cents which amounts to $5.72M, does not include legal costs. In time we should be informed of the breakup of all costs between the Trust Company, Receiver, Lawyers and other Professionals.

- In other words without the Receivership adding back the Receiver costs of say 4 cents would mean a return of between 91 and 96 cents;
- Further the Receiver's property auction at Metung was a distress sale. With more orderly and timely process, proceeds could have been higher achieving possibly close; to 100 cents;
- Even though it was a distress sale, it is understood Riviera Properties Ltd will be repaying all its debt and interest to GSI;

- This discounted return for Noteholders comes at a huge cost to the community of Gippsland. Gippsland has lost an institution that has produced great value;
- Great damage has also been done to regional NBFI market;
- It is unusual and disturbing that a company should be put into receivership to achieve such a attractive return to Noteholders in a relatively short space of time;
- Events have vindicated the Rescue Group attempts to save GSI and it is a tragedy that Group could not act earlier;
- It is hoped that the new owner of the Trust Company, Perpetual, will have a better attitude and relationship with Noteholders.

Disclaimer

John Dahlsen's opinions in this material are entirely his own and he accepts complete responsibility for them.

Observations and Comments on the GSI Judgement and Regulatory Policy

GSI was a small non-bank financial institution. It had a loan book of about $125 million funded by about $154 million of notes with about 250 loans, with a head office in Bairnsdale. It has a limited number of other offices in East Gippsland and Warragul. It had cash of about $27 million and 15 loans comprise about 50 per cent of the loan book. It had few staff.

Generally

Gippsland has lost a second tier non-banking financial institution (NBFI) that had done great deal of good for the local community. There is now a void, which, like in other areas of regional Australia, is unlikely to be filled.

With the closure of GSI, the Gippsland community has lost:

- An entity which provided a deposit facility with a range of maturities and interest rates more attractive than the banks;
- Lent monies to companies that were refused lending by the main banks but have become significant and successful companies;
- Provided funds to get subdivisions off the ground;
- Played huge role in the community by donating and supporting numerous local institutions;
- Retained the noteholder's money for investment into the local community;
- Entirely run by local people who gave GSI a face and a feeling of local involvement;
- Understood the local community and recognised when/where it was safe to lend when banks remote from the area would not understand.

It is because of the above that this paper is being written with the hope of some reform.

The regulator's "one size fits all" approach to the NBFI will make it difficult for them to survive. The regulator has more regulation in mind that will further depress this sector. A NBFI will only be able to accept deposits of 30 days plus. The banks will gain greater advantages of stopping the NBFI in the short-term deposit market.

The regulation requirement for equity and disclosure is over the top for small entities and as a consequence will leave a void in the structure of the banking market with lack of smaller banks or NBFI's to serve regional Australia.

This is typical of what is happening in banking. The regulators, by their actions (both ASIC and APRA), is making it more and more difficult for the

small institution. The effect on the small players and consumer choice is simply not being considered.

The Financial Services Inquiry is meant to be addressing these issues. We now have a degree of concentration unparalleled in the western banking world.

The amount of money being earned by trust companies and receivers in situations of companies in difficulties is appalling. There are several specialist accounting firms whose partners have become multi millionaires as a result of the money earned.

While legislation attempts to deal with this issue by disclosure, this is nowhere near enough. There is no client with a choice to drive efficiency and innovation. It is mainly lazy time costing. It is an area that needs reform.

In the case of GSI's receivership, the fee payable to the Trust Company for its "additional duties and responsibilities" in the receivership have been approved by the receiver appointed to GSI by the Trust Company (see the Trust Company's letter dated 3 September 2013).

<u>More detail on this follows.</u>

Realities

Too often the parties involved with GSI assumed that they were dealing with a large non-bank financial corporation with unlimited resources. This is a problem which small companies often face, particularly with litigation.

The Trust has in effect unlimited resources. Expenses are met by noteholders. There is a considerable pool of cash to pursue their position and there is no incentive for them to minimise or reduce costs. The pool can be used to reduce their own risk and protect themselves from challenge and litigation. The same applies to the receiver.

The Trust could employ any advisors and pay the rates even though those rates may have been too high for such a small transaction. Is this fair to noteholders? Is this sensitive to the interests of noteholders?

Also the Trust Company issued the Federal Court in Sydney, which was remote from the parties. It suited the Trust Company but not the other parties. Don't worry about the travel costs we won't be paying them, the Noteholders will.

It is also generally accepted that legal fees in Sydney are at least 10 per cent higher than those in Melbourne.

The recapitalisation proposal was put together quickly with limited resources. The Trust Company, the receiver and their advisors did not appreciate the efficiency and timing of the formation of the Rescue Group, how much they had achieved in such a short time and the time spent on raising money and gathering information given they were starting off from scratch.

The Rescue Group was bound by passion for East Gippsland and the welfare of the noteholders. There was no alternative commercial or other agenda.

The team funded the initiative at a personal cost ($300,000 between them) and put in a huge amount of time pro bono with a value of way more than the $300,000 cash contributed. It was only Duncan Johnston who would receive limited fees for his time. With the exception of Duncan Johnston, each Rescue Group member has lost $50,000.

Duncan Johnston's links had been earlier disclosed and it is regrettable that we did not inform the court of this in the principal affidavit, although query whether this may have been in the exhibits.

Courts tend not to understand logistical problems that people have in situations like this for instance being in the country.

The Court's criticism around the edges of the recapitalisation proposal being complex was justified, but subsequent re-runs of the proposal significantly simplified and improved the proposal. The Court was not to know that the proposal matured rapidly. The Court was dealing with a snapshot in time. In other words, the situation was frozen which in fact it was changing and maturing every day. Courts found it difficult to cope with this kind of situation.

The Trust Company's initial actions caused massive brand damage to GSI, which could have been avoided. Even after the Rescue Group emerged, damage could have easily been mitigated.

The Trust Company's Behaviour

The Trust Company's behaviour was appalling. Large resources were used to create difficulties and roadblocks for the Rescue Group.

There was no genuine desire to negotiate. In a normal negotiation environment many issues could have been easily solved particularly the early problems that emerged. But the environment was hostile. It is very difficult to understand this hostility when the Rescue Group had very little to do with GSI and were simply doing their best for noteholders and East Gippsland.

The lawyers had far too much to say in the transaction with the Trust Company losing sight of the underlying commercial reality, the cost and the interest of noteholders.

The Trust Company should have embraced the Rescue Group and negotiated to strengthen the proposal for instance by seeking more equity. This could have been achieved given the information the Rescue Group had about others who were prepared to contribute capital but could not do so as we were restricted by prospectus issues.

The Court was concerned about the progress and detail of the Rescue Group's proposals. The Rescue Group was diverted by the action of the Trust Company in the courts. This may have been a tactic but it had the effect of diverting resources away from developing the proposal, both in terms of time,

cost, energy and emotion. Without that diversion, the proposal would have been much more mature. Soon after the Court hearing, a more developed proposal was tabled for noteholders, which answered many of the Court's concerns. We wanted Duncan Johnston to be examined by the Court so many issues could be explained and give greater confidence for further deliberations.

Unfortunately the judgement is made in a snapshot of time and this often unsatisfactory. A Court is not a good forum for a transaction of this nature. Rules of evidence and Court protocols and barrister tactics make it difficult to get a total understanding. This is no criticism of the judge. The judge, in 128 pages, did an excellent and workman-like job with the data she had.

The judge could have written a brief judgement simply denying the delay of the adjournment but has instead went to great lengths to interpret the evidence and try and understand the behaviour of the Trust Company. Why wouldn't it negotiate?

It is interesting that the judge commented that the Trust Company's written submissions and oral submission about the Recapitalisation Proposal were misconceived in important respects. This is an incredible indictment given the all of the time and expenses incurred by them.

Further, the Trust Company has gained confidentiality on a number of Court documents on dubious grounds. This is, in the circumstances, very curious.

GSI

There was no fraud or wrong doing discovered by the receivers on GSI to date. It is most unlikely they will do so.

Why did GSI allow the relationship with the Trust to become toxic?

The Trust Company's has record of placing many similar companies in receivership. This was well known and gossiped by the other NBFI's in the regional sector. Subsequent conversations have confirmed this. It probably put GSI Directors on the defensive, GSI realised they had an antagonistic party and had to accordingly adjust their style.

However GSI:

- May have been slow in addressing the reality of their equity deficiency but this is questionable and an open issue;
- Lacked some experience in financial management and would have been better governed with a couple of non-executive directors on the Board who were so experienced;
- Been better managed generally;
- Over staffed and could have made better use of technology and systems to cut costs.

The above comments should be interpreted in light of the following:

- Until the Banksia disaster GSI was operating successfully and its relationship with the Trust Company was benign. GSI did not know who the Trustee executives, Smoker and Gribin were. There was little contact between the entities;
- It was the Banksia failure that changed the Trust Company behaviour from inactivity to over activity;
- The Trust Company progressive demands for so called independent valuations in haste from Melbourne valuers with no local knowledge and the questionable results made it difficult for GSI to establish how much capital was required. The GSI balance sheet was forever changing;
- GSI concern about those valuations and process has subsequently been validated;
- Had there been better valuations and so the quantum of write downs, a recapitalisation proposal with entities such as the rescue Group would have been relatively straight forward;
- This was not helped by the Trust Company legalistic, unco-operative and uncommercial approach to GSI;
- It is not easy for Directors to deal with all the issues at the time given the changing legislative environment and the undue haste by the Trustee;
- More generally, the situation was not helped by GFC;
- It was not possible to get the above flavour into the Court proceedings.

Schemes of Arrangement

- Schemes of Arrangement (SoA) are useful but not often used as an instrument for dealing with companies in difficulties;
- Subject to the approval of members or creditors by a 75 per cent vote in value and 50 per cent in number of those present in person or by proxy at a genuine meeting use a SoA for:
    - Reorganise the assets and shareholders of a company;
    - Abandon unnecessary companies;
    - Compromise creditors by paying less than 100 cents in the dollar over an extended period with or without interest;
    - Convert creditors to shareholders.
- The judge almost has a magic wand which can be used in effect to start again and control all the elements for the future;
- SoA are nearly always is done free of stamp duty with minimal tax constraints;

- Why isn't it not used more often particularly by smaller companies?
- SoA are expensive. The documentation and processes are extensive, time consuming and expensive;
- Over the years ASIC has developed several regulatory guides to help practitioners and which set out the steps that ASIC requires to be followed;
- What has resulted is a "tick the box" and "a one size fits all" regime which takes little account of small transactions and business;
- There is no reason why this instrument should not be available to all;
- While the guides have attempted to focus on important issues and grade the information accordingly with minor information being relegated to lower print and appended, the fact is a significant amount of information still has to be disclosed which results in the public scheme document being anywhere from 100 to 600 pages (as was the case in the Centro restructure);
- ASIC copes with the disclosure by an "if not, why not" regime. In other words, you have to explain why the information is not being disclosed;
- While the guides are excellent checklists, the result is that most SoA are huge documents with incredible amount of disclosures and relatively unimportant information;
- Despite valiant attempts by ASIC there is still a tendency for the key topics to become a laundry list accompanied by a mass of trivial, irrelevant and immaterial information probably read by few;
- The disclosure requirements and regime leaves little to the imagination of the preparers;
- The documents lack dynamism and focus;
- While there are third parties such as analysts, regulators, agencies and competitors that are interested in this detail, few others are and there are other ways of dealing with this;
- The consequences of this massive disclosure regime is that it has become a picnic for lawyers, accountants and consultants;
- Every fact has to be checked so a massive due diligence program is put in place;
- These programs suffer because they are rarely weighted to the important or high risk areas. Again, a "one size fits all" approach;
- Rarely does one sit back and do a risk analysis of a transaction:
  - Identifying the key risks;
  - Gradating the risk in terms of magnitude;
  - The probability of that risk occurring;

- How many risks could occur;
- The cost of the risk if it eventuates;

- By multiplying out the risk, the cost and the probability of it occurring then the risk would be more meaningful given there is rarely any sensible ranking it just becomes a list;
- More importantly if agreement could be reached by all participants and the advisors as to where the real key risks are and to concentrate on them that would produce a more useful result. Time and cost would be saved and readers would be more informed;
- Further the due diligence could be skewed and concentrate on the relevant areas avoiding the word by word verification of documents that can be hundreds of pages;
- The risk analysis itself should be disclosed;
- The very process of all parties reaching agreement on this is healthy particularly between client and advisor;
- A great deal of information disclosed is in reality designed to de-risk the transaction and protect advisors from litigation;
- In the current environment, advisors are becoming even more risk adverse and the professional indemnity insurers are playing a role to eliminate as much risk as possible, so distorting the transactions;
- These transactions are great fee earners for the professionals and the profit margins in this area are high with limited fixed fee quoting because of unexpected issues that might arise;
- The big law firms put teams of lawyers on these transactions and make great use of their capacity at all levels. Where there is under capacity, that under capacity is used;
- Each time another SoA is underway, the last few SoA filed with ASIC are followed but with a difference in that more information is being added so the SoA becomes longer and longer;
- It has become a game and the advisors like it because it increases their fees and lowers their risk;
- Who is going to break the game and produce SoA which is:
    - Concise
    - Relevant
    - Helpful in decision making
    - Readable;
- In the meantime it is pathetic as to who will run the risk with some minor disclosure not being made;
- ASIC is not helping

- It is not surprising that under this background that the judge and the Trust Company's lawyers (Ashurst) all doubted that the Rescue Group could undertake the restructure for the amount quoted and believed the cost would be as much as four times that estimated by the Rescue Group. This was used to imply a lack of sophistication and knowledge by the Rescue Group;
- The reality is quite different;
  - We (the Rescue Group) studied the regulatory regime carefully, identifying areas of relevance. We went through this material carefully with Gadens and analysed ways of cutting down costs, including the investigating accountants report;
  - We were assisted by many who were offering pro bono help and we were quite confident that with the pro bono help and the discounted fees offered by Gadens we would achieve close to the lower figure;
  - We were going to try and investigate and push ASIC into being sensible and reasonable about the level of disclosure and granting relief where appropriate. ASIC showed signs of being helpful and constructive. Clearly this would be a useful exercise for everyone.

What are the lessons for small business?

- SoA should, where possible, be available for the smaller companies. Why should it be only the big companies that can undertake the work on SoA as an instrument?;
- Nowhere are the regulatory agencies, including ASIC, asked to consider these issues as far as the smaller companies are concerned;
- There is a clear issue for small business and why should the "one size fits all" be imposed upon them;
- This is an on-going issue. There is no silver bullet but it certainly needs a greater sensitivity by the regulatory agencies;
- The regulators should engage with the small business community to have a better understanding of the issues that they face.

GSI Committee

- The receiver has appointed a committee to take an interest in the receivership on behalf of the noteholders;
- The receiver is under no statutory obligation to do so but it is the practice of receivers in accordance with the best practice as recommended by the Australian Restructure Insolvency and Turn Around Association (ARITA);

- This is commendable but there are limitations;
- The committee has no powers;
- Members are subject to confidentiality agreements;
- The committee cannot effectively monitor the receiver's fees;
- Can the committee influence the timing and information going to noteholders and the amount and timing of repayments?;
- What about discussions on:
  - Litigation against the Trust Company;
  - Complaints about receivership;
  - Concern about fees;
  - The regularity of meetings and the information disclosed to noteholders and members of that committee.

Banks and the Regional Markets

- GSI will leave a serious gap in the East Gippsland and the Warragul area;
- It is well documented that in the 44 years of operation there were a number of high-profile transactions refused by the banks but funded by GSI to the great advantage of all parties including the local community;
- The situation is the same in other parts of Australia where NBFI have closed, or put into receivership as a result of their appointed Trustee requiring strict compliance with regulatory requirements which have most likely adopted a view that they will be found to have breached their fiduciary duties if they do anything less;
- The situation has not been helped by ASIC, which has been tightening the regulations of NBFI with the consequence that the sector has shrunk in size from several billion to about $1.33 in 2013;
- ASIC is happy to disclose these figures as if it has been a clear objective on their part to regulate out and downsize this sector;
- There has been no policy development to find an alternative model in regional markets. There has been no evidence to suggest any concern for consumer choice in regard to the rural market;
- There is no evidence to suggest that the banks have been deliberately targeting reduced lending in regional areas but there is a void as a result of their inactivity;
- The growth in regulation and sophistication in risk management metrics and processes has affected the lending into regional markets generally;

- The old fashioned bank manager who knew the local areas intimately and has some power to contribute to lending decisions has been abandoned;
- In the centrally controlled decision making and processes, control has lead to deterioration in the understanding of regional markets;
- GSI has proved that the banks are weary of NBFI markets and did not want to lend into that market and accordingly to GSI;
- Why would they, as the more the NBFI market shrinks, the more banks pick up the business. There is a fundamental conflict;
- GSI could not raise funds despite the fact that the Scheme of Arrangement may have given the bank first ranking security ahead of noteholders with very significant loan to value ratios and interest covers;
- With the current state of the banking market and regulation, it is unlikely any institution will emerge in any way that resembles GSI; and
- This must be investigated in the banking enquiry.

Companies in Difficulties (CID)

- The instruments available for companies in difficulties are:
  - Voluntary administration (DOCA);
  - Receivership;
  - Liquidation;
  - Schemes of Arrangement and reconstruction;
- None of these instruments are very good for the early stage of companies in difficulties;
- Banks recognise this and attempt where possible to have de facto receiverships where the investigating accountant plays a key role;
- Clearly de facto receiverships are usually in all parties' best interests. There is a better chance of the company surviving and being able to meet its obligations;
- The problem arises if the company needs more funds and the company fails within six months then these funds are at risk of being disgorged by a liquidator. This is a grey area and there are some solutions but there is risk for banks so banks are wary;
- The answer might be to develop a model more around a Scheme of Arrangement and a freeze order;

- Legislation could be designed around a freeze order where under certain circumstances a freeze order would be made to protect the parties, so a Scheme of Arrangement could be prepared;
- Some of the judge's comments in the GSI case would be helpful to a draftsman;
- While it is not the plan to develop the concept further here, it is something that deserves attention;
- The GSI situation specifically raises issues about instruments available for CID's;
- These issues have been canvassed extensively but I believe the last word has not been written;
- For APRA Regulated Entities a consultation paper was prepared in September 2012 called, "Strengthening APRA Crisis Management Powers". This paper recommended expanding the power of APRA to appoint a Judicial Manager (JM) and a Statutory Manager (SM). It recommended giving the JM and the SM power to impose a moratorium on debt repayment to create a breathing space to find a permanent solution for a bank in difficulties;
- These recommendations have the advantage that there was an appropriate and experienced regulatory agency to handle the situation. It was not necessary to create a new agency. Further APRA was keen to have the power so it could effectively intervene at an early stage and hopefully solve any problems;
- With the NBFI's there is no regulatory agency to do this. NBFI's are controlled by ASIC and ASIC would not have the skills and resources to undertake this. ASIC is not used to supervising;
- For NBFI's there is no corollary in the recommendations or plan to put in place a similar concept;
- The Competition and Markets Advisory Committee Report in 2004. "Rehabilitating Large and Complex Enterprises From Difficulties" recommended against developing a new instrument;
- Some argued for Chapter 11, U.S. Style Instrument, where companies in difficulties can continue to trade but with creditors frozen so that a longer term solution can be put in place. It is used extensively in the U.S. With the GFC there was a number of very large high profile companies in the U.S. in Chapter 11, some involving the Government taking up shares;
- The Chapter 11 situation in the U.S. has the advantage that there is a Bankruptcy Court in the U.S. which is used to supervising these situations;
- In the above report, page 133-136, there is an excellent comparative table between:

- Voluntary administrators and Chapter 11 and
- Voluntary administrators / Creditor Schemes of Arrangement;

- A Creditors Scheme of Arrangement can be combined with a Shareholder Scheme;
- If a company is not insolvent but is having difficulties there is no reason why the holder of securities in that company can not apply to the Court for a freeze order putting on hold creditors enabling a Scheme of Arrangement to be put in place;
- Where a freeze order is made this does not affect a NBFI as it would a trading company, as a trading company would have to cease trading;
- If APRA were to take over the NBFI. The same recommended concept as a SM or JM could be put in place for NBFI's;
- In my view the case for early intervention (U.S. Style, Chapter 11, Modified for Australia) has not been made out one way or the other in Australia;
- The Committee's recommendations appear to be influenced by the fact that in Australia there is no suitable bankruptcy court;
- The Australia Bankruptcy Court deals with individuals and appoints suitable persons to be the Trustee in Bankruptcy;
- Clearly the Committee was concerned about the cost and magnitude of the task of creating another court system;
- There could be a lot of economic value in early intervention:
  - Salvaging companies that do not need to go to the next stage
  - Accelerating companies into liquidation when there is no hope,

  In both cases, Creditor's money can be saved and disruption minimized;
- The current situation is too black and white, in or out, solvent or insolvent, when in fact there is a significant grey area;
- In this grey area, the possibility of putting in place, for instance, Schemes of Arrangement, could be very helpful;
- The current regime makes that difficult;
- Whilst with voluntary administration, a company can come out of administration and into a Deed of Company Arrangements (DOCA) whereby:
  - The earlier status is resumed,
  - Trade on indefinitely,
  - Assets are sold, or
  - A combination.

And whilst a DOCA is a form of simplified SoA without the comprehensive and time consuming processes unfortunately

- With a voluntary administration, the Directors lose control and it is placed in the hands of an Administrator,
- Subject to a secured creditor not exercising its rights to appoint a Receiver or Liquidator within a defined period;

- The better option is for a freeze order as with GSI followed a simultaneously with a SoA so that the Directors stay in control and no outside person is appointed, and although the company cannot trade, no creditor can take any action;
- Unfortunately with the above scenario, a SoA and its processes are nowhere near as simple as a DOCA. There is less damage and approbation with a freeze order than with a voluntary administration. The reasons for the freeze order and what will then happen can be explained to those concerned;
- A voluntary administrator has responsibilities to creditors that override those of Shareholders and Directors and so considerable control is lost;
- With a freeze order there is however a void but with control whereas with voluntary administration the control passes to the Administrator;
- Clearly if it is well planned, the period of the void with a freeze order could be minimised on the basis that the Scheme is already prepared and the process commences in a timely and efficient way;
- It would be interesting to undertake a study of companies in difficulties, or more importantly those who go into voluntary administration, receivership or liquidation to form a view as to whether any of them could have been saved by earlier intervention with say a freeze order;
- Dedicated Judges and Magistrates with modest, specialist administration could be put in place under the umbrella of The Federal Court of Australia. The Federal Court has the infrastructure but not the supervisory powers;
- In the current environment a Government would not like the cost of establishing another court system and it is for this reason that it is being suggested it comes within the Federal Court System so that the infrastructure of that court system including the Magistrate Division is used;
- The notion of a specialised judiciary is valuable and there are a number of existing court cases that go through the bankruptcy court system that could be well diverted to the bankruptcy division of the Federal Court. For instance the famous Bell case in Western Australia;
- With a specialised judicial division it is arguable that in the long term, costs would be saved and justice would be administered more efficiently;

- The Federal Court was a poor and inadequate forum to deal with the GSI case. The Court protocol and rules of evidence made it difficult to get to the key issues and weigh them up properly. As John Grisham the U.S. author in ex main street lawyer often writes that the scope of evidence often works against justice. His novels frequently write about this issue;
- Further it enables a number of the injustices that are occurring that people are continually complaining about that could be better dealt with;
- Clearly legislators have had good intentions but the legislation has not been able to deal with some of the problems that have arisen, eg overcharging and other abuses. The redress is cumbersome and almost impossible;
- No Government likes to spend money on justice because there is no apparent return but the reality is that the rule of law is a very significant competitive advantage for a country and reforms should continue in the judicial sector to make justice efficient, fair and available for everyone and this is sometimes done by specialisation;
- Of course fees could be charged based on scale for the Court although it is recognised that this would only be a small contribution to the cost. In my view an economic study would show that the net economic benefits for the community would be significant;
- There are many people in the law at the moment who would be well suited to be involved in this area, including people whose task is to make much more information available as to what is happening in the sector;
- In designing the legislation to facilitate this, much can be learnt from the U.S. Chapter 11 experience.

Conflicts of Interest

- The important point is that conflicts are disclosed to all parties as soon as they become known and there should be reasonable articulation of that conflict so that the parties in the insolvency are armed with sufficient information to take a position;
- At the outset of the formation of the Rescue Group, our conflicts were put on the table and set out in our communications. There was more or less detail depending upon the audience;
- East Gippsland is a small community and it was important everyone knew the extent Rescue Group member’s individual interests, particularly with GSI and the interrelationships;

- The early disclosures included Duncan Johnston's relationship with Riviera Properties but, over time, this disclosure was lost.
- The most important disclosure is to the Court and it was not made known to the Court, however it was probably felt at the time that one of the incidental documents would have had the material in it.
- Given that so many documents were exhibited, we were entitled to believe the disclosures had been made.
- Given our care and interest in this issue, it is a shame that the Judge had to make one of her few negative comments about the Rescue Group. The other issues raised about the Rescue Group were all about degree and timing, which could have been relatively easily answered.
- Of more importance was the conflict of the Trust Company.
- The Trust Company appeared hell bent on putting GSI into receivership no matter what.
- The Trust Company would not seriously negotiate with the Rescue Group and with the help of their lawyers (some with litigation background) continued road-blocking the Rescue Group.
- We believe this is why the Judge, made a number of seriously adverse findings in this area, and this should be of concern to the Trust Company.
- Our suspicion was that the Trust Company wanted to minimise their risk. Gippsland was remote from their concerns. We argued that they had no interest or care about our proposal on Gippsland.
- If it is not a legal conflict it is certainly an ethical one, particularly given that several other companies similar to GSI, have been treated the same way.
- Clearly the judge was as curious as we were. It did not make sense for the Trust Company to fight the Rescue Group in the way it did.
- It is interesting the judge requested the parties meet to try and find a solution; this was a sensible suggestion and the Rescue Group went into this negotiation with the best of intentions.
- With what we know now about the Trust Company roadblocking, we would never have entertained the transaction. The Rescue Group set out their then plans carefully and raised money.
- A video meeting was called and chaired by Ashurst lawyers (formerly Blake Dawson Waldron), with a galaxy of participants, hardly the way to negotiate and explore a proposal.
- The meeting was carefully choreographed to try and show the Court that the Trust Company was trying to be helpful. This did not succeed;

the Trust Company barrister gave it away through his performance in Court.

- The lawyers questioned every aspect of the plan, trying to find weaknesses and reasons for its failure. It was both pathetic and frustrating.
- It is interesting that the judge found that a number of the Trust Company's submissions in respect of the Rescue Group's proposal were wrong and were apt to a mind closed to the proposal.
- That is an indictment on the Trust Company's behaviour and presumably the Trust Company will consider carefully the fees being sought and the fees charged by its advisors.
- The lawyers were an integral part of the road-blocking and it is surprising that there was not a senior, experienced commercial lawyer on behalf of the Trust Company to exercise some leadership.
- The alternative position by the Trust Company could have one of helping the Rescue Group to produce a good result for noteholders.
- The Trust Company's negotiation should have been to persuade the Rescue Group to contribute the maximum amount of equity attainable in the circumstances (including the conversion of notes to equity) and to assist in the design and implementation of a Scheme of Arrangement. As opposed to focusing on the fund raising restrictions applicable to the Rescue Group's efforts to recapitalise GSI.
- The Trustee indicated it did not want to be the Trustee for the new Scheme of Arrangement, but under the Corporation Act they cannot resign until a replacement is appointed.
- There is one important caveat to the above; during an early meeting without the lawyers, one of the Trust Company's employees (Mr David Gribin, Group Executive General Manager, Corporate Client Services) stopped the discussion and the road-blocking to accept that the Rescue Group had a credible proposal and that the parties should pursue it.
- This position was corrected several hours later when the Rescue Group was told by email from Mr Smoker that the Trust Company would not be supporting the Rescue Group and would return to Court. We did not understand the reason for the change and the role of the lawyers.
- <u>The second conflict is that of the investigating accountant was to become the receiver</u>.
- The investigating accountant's report (IAR) was one of the reasons why the Trust Company appointed a receiver.
- The Investigating Accountants Report was a vital document yet there were several flaws, some minor, some serious.

- The receiver did not give a draft report to GSI for checking before the report was tabled with the Trust Company despite indicating earlier they were prepared to do so.
- The consequence is that there were inaccuracies that could have been easily corrected.
- Subsequent events in particular the auction at Metung has proved that there were flaws in the valuations done by the Receivers valuers;
- The valuers knew little about the local market;
- GSI requested for another independent Valuer to be appointed but was in effect refused;
- Is it appropriate for a receiver to be appointed in these circumstances as the one who did the IAR?
- You could understand the trustee's position; the receiver's knowledge of the business meant that the receiver could get on with the receivership quickly and maybe at lower cost.
- The alternative is that the receiver is a different role to that of the investigating accountant and that the Trust Company should have gone out to the market to get the best receiver available for the job in the interests of noteholders.
- A smaller, possibly Gippsland-based firm with local knowledge could have been appointed at significantly lower cost. This could have been more sympathetic to the interests of noteholders and the Gippsland community.
- Noteholders would have wanted a local Gippsland firm but were not canvassed, nor was GSI or the Rescue Group. This was typical of the many decisions made in Sydney without local knowledge or consideration.
- This is an open issue.

Fees

- It is well know that receiverships are very profitable for the accounting profession. Several boutique insolvency firm partners are now multi-millionaires;
- With one exception, the fees paid to the advisors were excessive;
- Give the Rescue Group were acting pro bono they were able to negotiate lower fees, particularly with Gadens (Jeremy Smith and Michael Kenny) with whom I had no prior contact and whose fees were well below the normal rates;

- The Rescue Group's barrister was asked to reduce his fees but declined to do so, asking "why should I?";
- There was no incentive for the Trust Company, their receivers or advisors to reduce their fees. Why should they?;
- In the light of the judge's observations about the Trust Company's behaviour, the noteholders should consider whether the Trustee acted in the best interests of the noteholders in performing its role as trustee, and if it did not, they may wish to consider getting relief from the Trustee's fees;
- Litigation would be extremely damaging to the Trust Company. The judge's comments open huge areas of discovery and cross examination and without that process it is difficult to comprehend their behaviour;
- GSI directors must consider their obligations to their noteholders as to what they should do and what information about the Court decision should be made available to them.

Conclusion

- Noteholders are entitled to be disappointed that the GSI directors did not act earlier. Hindsight is easy. When companies are experiencing difficulties people are not always rational. It is in a close regional community and not subject to the rigours of Melbourne or Sydney;
- As for the Trust Company's behaviour, noteholders are entitled to be disappointed, if not angry;
- It was difficult to understand the Trust Company's attitude and behaviour. The Trust Company has a huge responsibility to noteholders (the beneficiaries) so why not consult them? What have they got to lose?;
- Even a person without any legal training would understand the essential nature of the Trustee/beneficiary relationship and as such seek out the beneficiaries' views;
- It was extraordinary road-blocking for the Rescue Group and at a huge costs when, by negotiation, substantial fees could be saved;
- It is clear the judge had difficulty understanding the Trust Company's position and so went to a lot of trouble setting out the facts and the various submissions made by the parties. It could have been easy for the judge to make a simple, short and quick decision as the legal principles were not difficult. The judge has considered the Trust Company's behaviour in a way that will not please. It was as if the judge was concerned that the Trust Company did not facilitate the Rescue Group's proposal;

- The judge was previously an experienced commercial solicitor and understood the nuances of the situation and made a number of careful and helpful observations facing a transaction of this nature;
- The Rescue Group failed and this paper has been written to try and explain the situation to those that unequivocally and generously backed them with money, pro bono help or moral support. No one likes failure but the Rescue Group hoped that, with the litigation, the Trustee might take a different approach;
- We went to the Court with a difficult case. The Trust Company had all the cards and GSI's position was fragile. We were seeking and hoping for justice. We believed that we had a strong commercial justification for a good outcome with a good plan for noteholders and the Gippsland community;
- But we failed. The judge sensed that but was confined by the facts and the legal principles. But in our search for justice the judge has made a number of observations on the facts that may be helpful in subsequent negotiation or litigation. This litigation of a different kind will go to the core of the fiduciary obligations;
- While the judge has not made a decision on any of these issues, questions could be asked about the gaps that frankly need to be filled;
- Even if this is a grey area and may be difficult to prove, there would be huge reputation damage in trying to get to the bottom of their behaviour with GSI;
- Some consideration should also be given to the Rescue Group who contributed a massive amount of pro bono time and $300,000 toward the costs out of their own pockets;
- It was only following a survey of noteholders which showed their overwhelming support for the Rescue Group proposal that the Trust Company's behaviour changed. This was backed by the Rescue Group's more mature plan completed after the court proceedings, which was published in a local newspaper, and which was summarised at a meeting of noteholders;
- <u>At the moment noteholders don't understand what happened and why</u>;
- It is to the credit of the receiver (presumably with the consent of the Trust Company) that the meeting of noteholders was called. The receiver was under no statutory obligation to do so though it is customary for the receiver to do that under ARITA recommendations. The receiver gave the Rescue Group a reasonable say at the meeting but they were not able to lodge material with the noteholders ahead of the meeting. The material appeared in a local newspaper and was summarised at the meeting;

- The Rescue Group received overwhelming support for its proposal from the Gippsland community and owes it to GSI and the people of Gippsland to explain what went wrong;
- Many people offered money, more than the amount disclosed. Many offered free services such as legal, accounting and commercial advice pro bono. Some offered to work free and many suppliers offered free goods such as printing;
- Gippsland is a special community. When ravaged by fires and floods, the people rally around generously;
- For the first time, a financial transaction has damaged the community and the community has responded in the same way;
- <u>What should happen now?;</u>
- The GSI directors and the Trust Company should inform noteholders about the details of the decision. This would not be easy for either of them to do;
- The Rescue Group is capable of taking more of an objective view and this paper could be made available to them;
- We are entering difficult times and there is a danger of an eruption of litigation. This would be a shame as raw emotions only work to the benefit of the lawyers;
- Should the Trust Company waive some of their fees? Whether the Trust Company should seek a contribution from their parties is a matter for them;
- Clearly the judge was very concerned about the transaction and believes that noteholders have not been properly treated;
- Noteholders are entitled to be disappointed and angry;
- By schemes of arrangement the Trust Company has been taken over by Perpetual Trustees Ltd (Perpetual);
- The executives formerly involved in the transaction and who had the toxic relationship with GSI are no longer directly involved;
- Perpetual has no baggage and is a highly regarded and successful trust company. One would expect Perpetual to be rational and recognise litigation all over the place is not the answer. The parties should sit down and negotiate a sensible commercial outcome for all;
- A sensible commercial outcome should heal many of the wounds and be good for Perpetuals reputation even though Gippsland has lost GSI.

Summary of Judgement

1. **Introduction**

- It was common ground that the Court had power to make an order protecting noteholders' interest;
- GSI position was that the Trust Company was paying insufficient regard to the merits of the recapitalisation proposal and so the Court should be mindful of the damage to GSI and noteholders;
- The Rescue Group was not formally a party.

2. **Without the Recapitalisation Proposal an order would be made**

- GSI capacity to repay the notes was doubtful;
- As Trustee would not consent to be named in a replacement prospectus which effectively prevented GSI from issuing additional Notes.

3. **Approach to be applied**

- The Court was faced with the issue of whether to enforce the trust security leading to the appointment of a receiver;
- Would the then recapitalisation proposal address the issues?;
- Would it be beneficial to defer the Trust Company's application to allow the Implementation Agreement to be prepared, negotiated and signed on the basis that the recapitalisation might address the relevant circumstances?.

4. **Jeopardy to Payment of Notes**

- The Court did not need to resolve the issue of solvency. Clearly GSI position was perilous and there is serious jeopardy to repay capital and interest;
- Satisfied that GSI's incapacity to repay all notes and interest when they fall due as no new capital has been raised and a prospectus cannot be issued.

5. **When are Notes Due and Payable**

- Court accepted Rupert Smoker's (the Trust Company) argument that the likelihood of Court freezing orders would cause a floodgate of redemptions;
- An issue of unequal treatment of noteholders would arise if GSI sought to choose between "at call" and "term note" for repayment out of available liquid funds;
- Unless GSI financial position can be immediately addressed it is not appropriate to continue the freeze order and allow control to pass to an external administrator.

6. **Interest of GSI Shareholders and Creditors**

- As GSI accepted that its Net Tangible assets are in deficit there is reasonable doubt as to the repayment of notes when they become due, the Court determined that in the absence of the Recapitalisation Proposal, it would be appropriate for the Court to make the order (see paragraph 242 of the judgement).

7. **The Trust Company Loss of Confidence in GSI Management**

- Unless the recapitalisation is imminent the company should move to external administration especially if Trust has lost confidence in GSI management;
- Trust only needs to show that it had reasonable grounds for losing confidence in GSI management. The Trust Company does not have to prove this definitively;
- No evidence suggests the GSI Board and management had been dishonest or there was a conflict of interest;
- A net asset deficiency is not per se evidence of failure of proper and efficient management, although it may be a reason for concern;
- GSI response to the EY equity improvement report was not cursory or wrong. Understandably against a background of 40 years of successful experience;
- There were genuine differences of opinion between the Trust Company and GSI on the valuation methodology;
- The Trust Company urgency about GSI's 8 per cent so-called equity requirement was overblown. The four year transition had not yet commenced;
- GSI Board and management failed to understand or demonstrate the gravity of GSI equity position particularly with the delivery of lower revaluations and the lodging of quarterly report on the last day;
- GSI technical approach did not demonstrate an understanding or urgency about ensuring that it had adequate equity capital;
- GSI failed to act promptly or adequately in relation to EY Equity Improvement Report;
- GSI only appointed FTI consulting after the redemption of notes had been suspended;
- With the loss of confidence of the Trust in GSI and doubtful solvency, this weighs heavily for the Court making an order.

8. **What is the Impact of the Recapitalisation Proposal**

- Described.

9. **Certainty of Commitment of the Local Investment Group**

- Accepted the Trust Company argument about the uncertainty by the commitment of the Rescue Group (referred to in the judgement as the "investor Group") and the legal status of the pledge.

10. **Impact of Converting Notes to Equity**

- The Court agreed that notes converted to shares is equity, and that the Trust Company argument on this was misplaced.

11. **Unequal Treatment of Noteholders in Converting to Shares**

- The conversion of notes to equity would not result in an unequal treatment of noteholders.

12. **Likelihood that Scheme would avoid investigation by external administration of GSI**

- The Court was not troubled by this. Noteholders are the best people placed to decide whether it is in their best interest for GSI to move into receivership which may or may not have the result of stopping an investigation into the conduct of GSI directors. This is the essence of reconstructions;
- These issues can be put to noteholders;
- Noteholders are the best to decide upon receivership thus exposing GSI directors to investigation.

13. **Trustee's Powers and Consultation with Noteholders**

- The Trustees view that only the Trust Company is competent to make a judgement about the recapitalisation is misplaced, the role of noteholders to make decisions should not be displaced;
- It is difficult to maintain a position that a Trustee is better placed than a legally competent, properly informed beneficiary to make decisions that affect that beneficiary. It is the noteholder who would bear the consequences;
- It is highly desirable that noteholders be consulted and given the choice. This is especially so because the external administrator notoriously affects the prices at which assets can be realised;
- Further the Trust Company acts in a "<u>fiduciary capacity</u>" it's powers are conferred for a fiduciary purpose and are <u>not rights</u>. Submissions of this kind about rights were concerning;
- When the Court is called upon to exercise discretion, its primary concern is the interests of noteholders, not validating the rights and powers of the Trustee. Many of the Trust Company's submissions reflected the latter.

14. How much capital is enough?

- Agreed with the Trust Company that it is not just a balance sheet test;
- The cost of the implementation proposal was open to contention. The Rescue Group and the Trustee had different views;
- The ability of the Rescue Group to undertake the transaction at a low or reduced cost assumes the Rescue Group will have a significant role in the process. This may not eventuate as GSI is the scheme company (in other words the receiver) and the Trust Company as Trustees are in control and have the carriage of the transaction and this might affect the cost;
- The Trust Company signalled that the ASIC requirement of 4 per cent and later 8 per cent of capital would be required is wrong. ASIC has not yet announced a start date for this regime. The Trust Company insistence of that level of capital is either unduly inflexible or addressing an irrelevancy;
- It is possible that if a run occurred neither 4 per cent or 8 per cent would be sufficient;
- Whether or not the noteholders would agree on limiting the rights to redemption is unknown;
- The unknown factors about solvency and capital requirements weighted against the conclusion that the recapitalisation proposal would address the issues in favour of making on order.

15. Time to elapse before a Scheme can be put to noteholders.

- GSI current financial position need not have been determinative in favour of the appointment of a receiver. Maybe even more appropriate for noteholders to be given a choice where that path ahead and amount to be repaid and the level of discount is not clear;
- In any event, under the proposed recapitalisation, noteholders would have the benefit of an independent expert report under a scheme and noteholders would be able to consider all alternatives which might or might not include the impact of GSI's failure in the Gippsland area balanced against their own interests;
- Court not in a position to assess that the return would be better under either regime. Why:
  - Johnston assessment is not disinterested;
  - Execution risk as the recapitalisation proposal is not finalised;
  - Impact of market factors on GSI loan book over the years;
  - The cost of receivership;
  - Adverse impact of receivership on the market value of GSI's assets and security.

16. Recapitalisation Proposal

- The Rescue Group was not trying to hold the Trust Company hostage for their own commercial interests;
- It is open to noteholders to approve a scheme where notes would be exchanged for shares;
- Open to the Court to allow noteholders to consider such a scheme;
- The Trustee does not have a right but a fiduciary duty and it would be open to the Trustee for a scheme to be presented to the noteholders even if less than 100 cents in the dollar might be delivered;
- The Trust Company's "rights" under the Trust Deed was misconceived.

17. Impact on the Gippsland Community

- Primary consideration is the protection of the interests of noteholders;
- The regional impact on GSI might have reasonably led the Trust Company to consult with noteholders particularly after the emergence of the Rescue Group;
- The Court acknowledged it might have been difficult to consult in a meaningful way.

18. Hardship Regime

- Not necessary to discuss.

19. Conclusion

- Not satisfied that the then recapitalisation proposal did adequately address all the circumstances in favour of the order, although it might have been if GSI was in a position to put a proposal immediately.

20. Adjournment Application

- The Trust Company's written and oral submissions had not demonstrated the full appreciation of the recapitalisation proposal. A number of submissions were surprisingly technically wrong, for example:
  - The conversion of notes to equity did, according to the Trust Company not address the tangible assets. This is plainly wrong, the notes could become equity;
  - Wrong statement about the adequacy of the cash injection to address the balance sheet deficiency;
  - Failure to appreciate the potentially different regulatory treatment of debentures and interest in the MIS and where ASIC benchmarks were not relevant and when a run can be avoided.
- Many submissions appeared overly committed to achieving compliance with regulation and ASIC benchmarks which are not yet mandated and for which the four year implementation period for transition has not yet

started. It was open to the Trustee to be more open and communicative, than appeared in its consideration of the recapitalisation proposal;

- The Trust Company had a closed mind on the recapitalisation (despite subsequent meetings) and was only concerned with the Trust Company's rights or punishing GSI. Expressions of criticism of management to investigate any breaches by GSI and the directors, is not necessary in terms of looking after the noteholders interests. <u>This is not an end in itself</u>. There was no evidence to suggest that any inquiry would be fruitful;
- Although the recapitalisation proposal is complex and has substantial execution risk and issues to be addressed it had persons of considerable commercial reputation and apparent wealth as its proponent;
- The willingness of the Rescue Group to put up over $2,000,000 and $300,000 was important even after allowing for the Trust Company loss of confidence in GSI management may have been reasonably based it is difficult to understand why the matter has not been approached with greater willingness for commercial negotiation designed to shape the proposal with less complexity and execution risk;
- The Trust Company comment that informal receivership is a bad thing, the Trust could not be held hostage was inappropriate. This comment was curious since and informal work outs you can avoid the bad odour of a receivership and the value destruction with an external administrator when a proposal without receivership might well be efficient and achieve the best result for noteholders;
- Further the Trust Company public announcement, which had the effect of discouraging alternatives, was not helpful;
- If an informal workout has a prospect of being a better option, the Trust Company should have had an open mind;
- Where a borrower's solvency is problematic but an informal workout has a proposal of success, the Trustee is in a better position than the Court is to supervise;
- It is open to the Trust Company to conclude that it was complex with too much execution risk, but not give a realistic chance of success in the near term. This was clouded by the Trust Company unwillingness to negotiate.
- Had GSI negotiated earlier it may have been different.

Seven factors against the continuation of the freeze

1 Execution risk and the time involved in the recapitalisation proposal:

- The Recapitalisation Proposal was still evolving. Pledges were not legally enforceable;
- No authorised licensed entity was available to be Trustee;
- There were to be new board members of GSI;
- How redemptions were to be managed;
- Despite having indicated that it would provide circa $2 million to fund the implementation proposal, the Rescue Group had not estimated the cost adequately;
- The underlying purpose and documentation had yet to be agreed;
- Rescue Group only carrying some of the cost;
- Might be enough time to address regulatory issue;
- How would a run be managed?.

2 The Trust Company has not supported the proposals so without their commitment it was difficult for the proposal to be implemented. Though the Rescue Group put up money at risk this was insufficient for the Trust Company;

3 The trustee company must explain the proposal to noteholders. The Trust Company has not been sensitive to this and the Trust Company had not shown a full appreciation of the terms sheet;

4 The need for ongoing court supervision. It was anticipated the court would receive further applications and is not appropriate for a court to be placed in this position. The Rescue Group should have been in a position to propose solutions rather than deal with emerging issues. It is not enough that it is a well intentioned group of local investors. The proposal needed momentum and demonstrated appreciation of the issues.

Mr Johnston conflict position should have been declared to the Court upfront;

5 Inappropriate for GSI to bear the cost of the contested hearing. A lack of appreciation of the legal costs associated with the Scheme of Arrangement. Had the Trust Company been more open to the recapitalisation proposal and the Scheme of Arrangement and for the local Rescue Group to bear some of the abnormal cost it may have been appropriate to adjourn the application.

Not appropriate for a Court to support a regime where there would be expenditure on contested court applications;

6 The Trust Company does not support the proposal and the receivers will be more efficient and effective in the conduct of the negotiations with the Rescue Group;

7 There might be further contest between the Trust Company and GSI so making an adjournment futile.

21. Conclusion

- If the recapitalisation proposal was more advanced and this could have been put to noteholders immediately it would have been appropriate to grant an adjournment to allow the noteholders to consider the proposal. This is so even if the noteholders would not get 100 cents in the dollar.
- The Trust Company wanted 100 cents refund, yet it was not clear whether either proposal would achieve that. However that is not a reason for not giving noteholders the choice;
- GSI did too little too late.

Attachment 2

Crowdfunding: How a radical new finance model is changing product development, research and the arts

THE UNIVERSITY OF MELBOURNE

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#284: Crowdfunding: How a radical new finance model is changing product development, research and the arts

VOICEOVER

This is Up Close, the research talk show from the University of Melbourne, Australia.

ELISABETH LOPEZ

I'm Elisabeth Lopez. Thanks for joining us. Every person with a great idea faces two fundamental hurdles in taking it to the world; money and markets. For entrepreneurs, emerging businesses and creative professionals, the Global Financial Crisis choked off traditional sources of finance. Getting past the banks and the venture capitalists was never harder. Since 2008, there's been a spectacular growth in crowdfunding where businesses, projects and products are financed by small donations or investments. Crowdfunding isn't a new idea. Since time began, businesses have got their start through family and friends financing. What is new is the power and global reach of social media to engage groups of people passionate about a cause, an art form or a niche product.By 2012, crowdfunding raised US$2.7 billion for projects and businesses globally. Many of these projects have been fun, frivolous or the stuff of dreams. But crowdfunding is now moving beyond its donation-based origins to be an important source of finance for small businesses and research institutes, for example. In the developing world, crowdfunding holds the promise of bringing small producers and marginalised groups to new markets.So how seriously should economies, large and small, view crowdfunding? In what unexpected areas are we beginning to see crowdfunding initiatives crop up? And how must crowdfunding and the laws that restrict it adapt and evolve to stay ahead of often volatile market conditions? Our guest on Up Close this episode, Dr Richard Swart, has worked with startup companies to large corporations on their digital strategies and crowd-funding initiatives. Richard heads the Crowdfunding Research Program at the University of California, Berkeley. He's the co-author of a World Bank Report called Crowdfunding's Potential for the Developing World. He's also co-author of a new UK report, The Rise of Future Finance, which is the first country-level study of an alternative finance market anywhere in the world. Richard joins us by Skype from Berkley.Richard, welcome to Up Close.

RICHARD SWART

Thank you.

ELISABETH LOPEZ

Richard, crowdfunding is often seen to be part and parcel of the United States entrepreneurial culture. And it's been said that it has the potential to create silicone valleys everywhere. Where did it actually emerge?

RICHARD SWART

Well, crowdfunded investing actually started there in Australia about 2006/2007. If you go back in history, the first crowdfunding campaign which actually existed was about 20 years ago when a group of fans crowd-funded a British rock band to come on tour. In the United

States back before we even had social media sites, there was fundraising through bulletin boards in the old 1990s version of the internet. Crowdfunding for equity has been experimented with in Europe off and on for several years. But honestly the award for first equity crowd-funding market does have to be there in Australia.

ELISABETH LOPEZ

Let's take crowd donation funding, which is probably the simplest model, the one that's had the most media exposure. How does it work? And what sort of incentives are there for people to start investing?

RICHARD SWART

Well, donation crowed funding is specifically not for investing in. The most commonly known platform is Kickstarter, although there are hundreds of other platforms in the world, some very specific to one region of the world or one type of crowdfunding activity. It's essentially solicitations through websites done over social media where people are asked to contribute small amounts of money towards a project or a cause. Sometimes an entrepreneur will actually come up with a product idea and basically pre-sell their products. So please give me $50 or $100 and I will send you one of these once I manufacture it. Typically campaigns will have multiple levels of rewards. Some people call that perks-based crowdfunding, similar to a public radio station, or a public television station or a charitable foundation where they'll ask for contributions from listeners or donors. Depending on what your donation is, you may get different sorts of rewards, such as t-shirts, hats, access to events, signed autographed copies of album covers, early admission to a play. There's even crowd-funding for movies. Based on higher donations, you could fund your own cameo appearance in a movie.

ELISABETH LOPEZ

We're not talking amateurish efforts, are we? We're also talking about the kind of niche products put out by major studios but where the proposals to extend, say, a popular series have just not got past the in-house accountants.

RICHARD SWART

Yes, the most commonly used example of that is the Veronica Mars television series that went for five years, had an extremely loyal fan base, was cancelled by the studio. And the producer went to crowdfunding sites to actually crowndfund the Veronica Mars movie, which successfully launched. I believe one of the movies that received an Oscar last year, a documentary category, had been crowd-funded. I know that two of the movies at the Sundance Film Festival which just wrapped in the United States a couple of days ago received crowndfund backing. So crowdfunding is not just for small arts. In fact, there's data in the United States that crowdfunding contributes more to the arts than our national endowment for the arts. That's been true for the last two-and-a-half years. Looking at science and technology, there's been a crowd-funded satellite. The first human-powered helicopter was crowd-funded. There's also been crowdfunding for medical research as well as crowdfunding for medical interventions. So it's not just a kids' game anymore. It's become much more of a serious tool being used by the entrepreneurs, scientists and the film producers to get backing for their projects without having to go through intermediaries.

ELISABETH LOPEZ

Can you tell me a little bit more about crowdfunding for medical research? I notice that there's an interesting website that was founded by a woman who survived breast cancer. She seems to be having some success in rallying other people who were passionate about finding the next cure for whatever ailment they're affected by.

RICHARD SWART

It's very early still but I believe, and this is going to be my crystal ball moment of the show, that you'll see a much larger penetration of crowdfunding for both medical cures and also funding research. One of the magic elements of crowdfunding is that you're organising a community that shares an interest or an affiliation. That may already be communicating through Facebook groups or following certain bloggers. But if you can channel the passion of

the group through the financing mechanism of crowdfunding you can sometimes raise significant amounts of money. There have also been examples of medical crowdfunding sites that highlight the medical needs of specific individuals, sometimes first world, sometimes third world. Third world example oftentimes are done sort of like a UNESCO or Save the Children model where they'll highlight a particular cause or a particular child. And they'll explain how, for example, this young girl doesn't get her arm set, which will cost approximately $200, she won't be able to use her arm, and she'll be ostracised from society and probably not find a husband. So the long-term ramifications of lack of access to medical care in some third world countries are significant. And there are some sites that are highlighting that.There are also some sites in the United States where due to the challenge of receiving continual funding for some of the research projects, scientists and medical doctors have been attempting to use crowdfunding to get continual support for their research, with mixed results but it's an interesting experiment. I think you'll see more of that in the future.

ELISABETH LOPEZ

I suppose, especially as government budgets wind back for things like the arts and research?

RICHARD SWART

It's hard to say what the governments intend to do. But I believe that it's a fair assumption of the majority of governments in the world are going to start curtailing their research, especially if you're looking at what we call an orphan disease or something that doesn't have a lot of opportunity for commercialisation. It's difficult to find large organisations willing to fund some of that research. There's also a very well-known effect in a lot of science where, if you're outside of the mainstream literature, it's hard to get your work noticed. And so crowdfunding can be a mechanism to get some of that research funded and to build a community around what you're trying to create or the researcher's trying to accomplish.

ELISABETH LOPEZ

It's easy to see the benefits of rewards-based crowdfunding to a community of fans, for instance, or people who want the next cure for a particular disease. What are some of the benefits for the people who are actually producing the product or the research? What is it that they get from crowdfunding that goes beyond just money?

RICHARD SWART

That's a great question. First of all, you connect to a community of people that care about what you're trying to accomplish, whether that's a new video game, a new type of consumer electronics device, craftsmen, wood products, artisanal food. And whatever your niche industry is, you typically find that crowdfunding mobilises and energises a community around what you're trying to create. And a community will give you extensive feedback about your business idea or model. It's not a one-way communication mechanism where you're pushing out advertising. It literally starts a conversation with your intended customers about what you would like to produce or what you are producing. And we found extensive evidence where the community comes back and gives detailed feedback to that entrepreneur, sometimes several pages of very specific and accurate feedback on product features or desired features. The most famous example of which is the Pebble watch, the most successful crowdfunding campaign ever, which was a Bluetooth-enabled watch that connected to your iPhone. They launched the campaign. And very quickly the community said, this has to be waterproof. What good is this watch if it's not waterproof? So they were able to, within the time of the crowdfunding campaign, redesign the watch to make it waterproof and tell the crowd, we've listened and we now have a waterproof watch. So think about the difficulty, complexity and cost it would take for a corporation to change design features and to modify a marketing budget and to retool production. That would have been either impossible or prohibitively expensive. Given the presale model where manufacturing, in fact, had not started yet, they were able to make that change and produce something that their customers wanted before you had made your first unit.

ELISABETH LOPEZ

And large corporations and companies in heavy industry are also getting into this, aren't they? I think you've documented a carmaker that is using crowdfunding to pretty much design new cars to customer specifications. Or is that overstating it?

RICHARD SWART

That may be overstating it. Dodge had a very successful experiment using crowdfunding for their Dodge Dart, one of their less expensive cars. I think it appeals more to college students. What they did is they had a campaign where you would produce a video about why you wanted a Dodge Dart and you would share this video with your friends. And what they found, which was amazing, was that in the first quarter following their crowdfunding campaign which was done extremely inexpensively, they sold more Dodge Darts than they had in the previous year. So think about essentially quadrupling sales in a very short period of time with a very small amount of money. It's obviously successes like that have attracted the interest of major brands. Some brands have gone public, like Conde Nast, Proctor and Gamble have initiatives around crowdfunding right now. There's a few others that I'm aware of that have not yet gone public but there will be in 2014 a significant, I call them series of experiments as corporations and major brands start to figure out how they can use crowdfunding to better connect to their customers and also receive feedback from those customers.

ELISABETH LOPEZ

Do they tend to get hamstrung, these large corporations by their own inertia, the bigger the firm is, the more bureaucratised it is and the more closed to innovation it often is, they don't necessarily have the agility of an emerging firm?

RICHARD SWART

You're absolutely correct. There's two types of crowdfunding that your comment implies. The first is sort of crowdfunding innovation or crowd sourcing innovation whereby putting out product or product features in a crowdfunding campaign, the real initiative of the corporation is to get very fast and rapid feedback from either intended customers or, in some cases, even suppliers and distributors will give feedback. There's documented literature around crowd sourcing innovation and crowdfunding. crowdfunding platforms has become a much more public and fast way of doing this crowd source innovation which is sometimes is only done inside of companies. But there's also crowdfunding where you have a particular project. What you're noticing is that some of these corporations are attaching their crowdfunding campaign to a charitable cause or to highlight the passion of a particular entrepreneur. So they're not just taking well-known branded product which is already in production and saying, let's crowndfund Tide laundry detergent or something like that. They'll come up with a specific product or a new issue, if you will, a new type of tennis shoe or a branded tennis racket using sport examples. Or they might come up with a limited production run of a food item. And sometimes they'll tie the production of that item to a donation to a charitable cause. So it's a bit of a hybrid between social giving, public good and philanthropic giving of the organisations with a marketing campaign blended in.

ELISABETH LOPEZ

So, in terms of crowdfunding platforms, Kickstarter is probably the one that's best known in the world and that most of its projects are creative projects. But who are some of the major players that are emerging? What trends are you seeing in terms of, I guess, specialisation of platforms and the differences in the openness and the accountability that they offer investors or donors?

RICHARD SWART

There are several types of platforms. The first that you're referring to are the pledger donation platforms where there's no equity. There's no debt. It's not an investment activity. It's simply a company is using those platforms to ask for small donations or presale inventory. The big three in the world are Kickstarter, Indiegogo and RocketHub. Kickstarter's very narrow in what they allow. They only allow 11 types of projects, of which two or three of them counts for the vast majority of all projects on the site. Indiegogo basically allows anything that's legal. They intentionally want crowdfunding to not be bounded. They want

anyone to be able to figure out how to use crowdfunding to fuel their passion and their dreams. RocketHub is similar to Indiegogo; they're much more liberal in what they'll allow on their sites. RocketHub has also shown the most momentum in marrying their crowdfunding platform to these major brands. I think you'll start to see RocketHub quickly emerge as the dominant platform for corporations to use, as opposed to Kickstarter which is not so open to corporations. You will also see crowndfund equity sites where people are able to invest in companies using crowdfunding. The most well-known example here in the United States is one called AngelList. Angel AngelList has started when our laws passed to allow equity crowdfunding. It's been growing relatively fast in numbers of individuals posting deals, the number of investors looking at deals. But the total volume has only been about $30 million in the last four months. So it's getting a slow start. And some of that's due to regulation.

ELISABETH LOPEZ

I'm Elisabeth Lopez. On Up Close this episode we're speaking with Dr Richard Swart from the University of California Berkeley about the extraordinary global growth of crowdfunding. Richard, it seems a paradox that crowdfunding relies so much on trust and community. Yet your research has shown that fraud, at least for now, has been minimal. Why is this?

RICHARD SWART

There are several things that we think explain it. There's no definitive research that absolutely answers that question. We started off with the most simple example of to what extent has there been any documented fraud on any of these platforms? And we're looking worldwide. There's a strong market in Europe. There's a very strong market in the United Kingdom and, of course, there in Australia. There are two or three things that we think account for it. First of all, most equity transactions, whether it's ASSOB (Australian Small Scale Offerings Board) there in Australia or the British Market, require a fairly comprehensive disclosure, background checks, identity verification before a deal can even be put up there. So if a criminal intends to defraud people, there's much more efficient, fast and less risky ways of defrauding individuals in crowdfunding. In terms of the actual Kickstarter or Indiegogo pledge and donation model, Ethan Mollick at Wharton Business School did some research. He found that less than 1/100th of one per cent of sites appear to be fraudulent. That's one of 10,000 campaigns that would be potentially fraudulent. And what we find is it's the actual interaction of the community around the product. So you say, here's what my product is. Here's its features. Here's what it can do. You put that out there in the world and you share it through social media. You have no idea who will get that information. What we find is, interestingly, many times experts in an area will find that posting and will say that's physically impossible, that can't be done or the laws don't allow that. There's a very rapid, we find, 24 to 48 hours these projects are called out by the crowd. And so there's something wrong. We find oftentimes the company seeking funding simply drops the campaign when they're called out.

ELISABETH LOPEZ

What influence does a crowding platform's policies on all or nothing funding, for instance, have on the potential for fraudsters to get involved in crowdfunding?

RICHARD SWART

I believe it actually is a bit of a protective mechanism in that you have to believe you have the ability to go out there, reach a crowd of people and solicit donations. Typically, if you're going to commit financial fraud, given the outsized risk you're taking, you're going to want to raise a substantial amount of money. So I think requiring people to raise all the money that you ask for and then there's no benefit to you unless you raise that amount, which is the Kickstarter model, the all or nothing model, it does have something of a preventative effect. We also know that the platforms themselves do an extensive amount of work trying to weed out the fraud. They all have artificial intelligence, natural language processing and other software technologies running in the background looking at the nature of the offerings and the nature of the individuals. And the platforms, unbeknownst to most individuals, actually do weed out a lot of potentially questionable offerings or campaigns.

ELISABETH LOPEZ

Yes, and as we're seeing venture capital firms get into this space, I suppose they're starting to vet projects before they even see the light of day online.

RICHARD SWART

Almost without exception, all crowdfunding platforms do some sort of screening or vetting, which it's for legal compliance or identity verification. Those platforms that are dealing with cross board or money flows also have a fairly extensive compliance burden in that they're not doing equity. Think about a situation where you're collecting money from individuals in dozens of countries, there's a lot of law and regulation about tracking where that money comes from and how it's being used. These sites have a burden on them to do a lot of accounting and a lot of compliance work on the back. They're doing a good job of that.The interest of venture capitalists really hasn't affected the dynamics of how the sites are posting deals. What it has done is sort of give credibility to the industry. We know that Google Ventures back on the large peer-to-peer lending platforms. We know of private equity firms and hedge funds that are pushing money through peer-to-peer lending platforms. It seems like Wall Street and major financial institutions around the world are starting to pay attention to crowdfunding. They're going to start deploying capital through their mechanisms. I think because of that, the leading sites are recognising that there's an investment opportunity there and there's a chance to partner with these larger firms. They are, if you will, becoming even more professional at what they're doing in order to attract more interest from these venture capital firms.

ELISABETH LOPEZ

So if Wall Street and private equity in the hedge funds are getting involved, it sounds like the original reasons why crowdfunding really took off a few years, because the banks were starving lending to households and businesses, it does sound that once banks get to normal, crowdfunding is not going to go and die a quiet death?

RICHARD SWART

No, crowdfunding will always be here. In fact, I fully expect it to continue to grow exponentially for a number of years, even with the entrance of the major players. The major players don't want to move small amounts of money. They want to deploy tens or hundreds of millions of dollars through platforms. So their interest is on two sides of the market. On the peer-to-peer lending space or the peer-to-business lending space such as they have in the United Kingdom, they want to deploy 50/hundred/200 dollar million loan portfolios because they can generate very good returns for these loan products that they cannot get through money market accounts or banking. So there are hedge funds that are using peer-to-peer lending platforms and with leverage are getting 12 to 18 per cent returns, which is a pretty healthy return. It's actually a good thing because it means there's money available to lend to entrepreneurs and people with dreams. And these hedge funds are basically using crowdfunding platforms as a way of deploying that lending capital.Small banks are so constrained around the world in their credit-worthiness requirements and their collateral requirements that in many times crowndfunded companies are companies that have approached banks and have been told, no, you don't have enough revenue. You don't have enough time in business. You don't have enough collateral. We can't lend to you. They then approach crowdfunding as an alternative to that. In fact, there's data suggesting that crowdfunding is now the first choice of lending companies, not bank lending. They raise money through crowdfunding. And then our research shows that fairly quickly they then approach institutional investors or bankers. And their success in crowdfunding oftentimes makes it much easier for them to subsequently acquire a loan or an investor.

ELISABETH LOPEZ

Can you tell us what's been happening in the UK with small to medium enterprises? Lending there to businesses has tanked and it's not recovered to pre-GFC levels. To what extent is crowdfunding filling that void? Who are the players in this new, I guess, ecosystem that's starting up?

RICHARD SWART

You know, the UK is a very interesting case study. The banking regulations are very different there. And there's only actually five major banks in all the United Kingdom. It's very different than here in the United States where we've thousands and thousands of banks. It's a very tightly-controlled, essentially monopolised banking model with very tight central regulation. And because of multiple economic and political factors, the banks really are constrained in their lending. That does not appear to be getting better any time soon. So the peer-to-peer lending and peer-to-business lending space has exploded in the United Kingdom, growing well over 100 per cent a year for the past three or four years and continues to grow in velocity. Major venture capital firms are now backing those platforms and investing money through those platforms. It's been seen as a very disruptive influence. That being said, the total volume of alternative finance in the United Kingdome was roughly £1 billion last year which, in terms of a major financial market, is still a very small amount. The bad news is that, despite significant growth and well over 100 per cent increase in loan volume and over a 600 per cent increase in crowndfund equity activity in the United Kingdom, that entire pool of activity is still very small and not able to fill the gap yet.

ELISABETH LOPEZ

How important is the role of government in developed economy? What's its main value?

RICHARD SWART

On two things, and I don't want to come across as an anti-government radical. But the research clearly shows that limited regulation is better for crowdfunding, both empirical research and also we built in a econometric model study in the emergence of crowdfunding around the world. We found that the countries where crowdfunding seems to be doing best are those that have what we call light-touch or limited regulation. If governments see crowdfunding as an equivalent or alternative to a full security offering and layer on extensive costs, financial auditing, paperwork and difficulty, they sort of miss the fact that this is not a large institution with lawyers, accountants and security brokers that they're already working with that can produce those sorts of documents. Those compliance costs and documentation preparation costs can be a prohibitive barrier for these small companies. We did a study, for example, of the average company utilising crowdfunding in the last year. Again, this is a self-reported study so there's some variation in the actual outcome here. Approximately two to three employee companies are those going out there using crowdfunding. The interesting thing is, after they have success, these companies very quickly hire about two more employees. The average number was 2.2. So if governments intend to utilise some sort of financial market intervention to create jobs, I don't know of any data which suggests a more effective and fast way of doing so than putting through crowdfunding.

ELISABETH LOPEZ

Which brings us to the legislative responses to crowdfunding. The US and the UK have both passed laws to enable it. In the US we saw the JOBS Act passed last year, legalising equity crowdfunding. What sort of opportunities has this opened up? Are the regulations up to speed yet? Can they follow such a fast-moving phenomenon adequately?

RICHARD SWART

They're not following adequately. And I feel sorry for the SEC, the Securities and Exchange Commission. They're basically being exposed to a new world and a new set of conditions that they're not comfortable with or familiar with. Now, security regulations are based on basically phone calls, boilers rooms and paper transactions. That model has been around for dozens of years. They're being sort of forced to deal with a new paradigm. There's no regulatory guidance for them. In enacting the provisions of the JOBS Act here in the United States, there's essentially two pieces that matter. And I won't bore your audience with a lot of technical detail. Basically there's crowdfunding for the wealthy, so crowdfunding for what we call an accredited investor, someone who makes over $200,000 a year or has $1 million of net worth, not including their house. And that's what's legal today in the United States. And there's AngelList, CrowdFunder, WeFunder and a few other sites out there that have got the what we call Title II crowdfunding operating. It's going fairly slowly. One of the things that happened was our securities commission said in the past you had to know the people you

were soliciting to. Now you're able to do what's called general solicitation, utilise social media marketing, Twitter, any sort of messaging that you want. So the burden has now shifted to the platforms or the issuer of the security instrument to verify that the potential investor's actually qualified and can legally make that investment here in the United States. The laws are a little bit unclear as to exactly how that verification should be done. Until the SEC comes out with very specific guidance in the minds of their intended customers makes that clear you're not going to see a lot of growth.Now, Title III is what you think of as crowdfunding, what the average citizen can buy part of a company, the mum and pop who wants to invest in a local business or who wants to utilise crowdfunding. Those laws will not go into effect for several months. We don't know exactly when. So we're probably still four to six months away in the United States, from seeing equity crowdfunding emerge. A structure of the rules unfortunately imposes a fairly high degree of cost on the companies. It's going to be one of the more expensive ways for a company to raise funds which sort of goes counter to the intent of the legislation.

ELISABETH LOPEZ

And I guess counter to the whole spirit in which crowdfunding has evolved?

RICHARD SWART

Oh, absolutely. I think it's overregulated based on what was frankly a political compromise to push the bill through Congress very fast in our last election cycle. There is a strong voice in the United States from consumer product lobbies and some other organisations that are afraid of rampant fraud. And they make these arguments very loudly and successful despite the lack of empirical evidence to justify them. And those arguments in many ways have carried the day and our laws have been structured in a way to protect the investor from the perceived outsized risk of fraud. Whereas in reality the empirical evidence shows it's going to be one of the safest markets that an early stage investor could get into. That being said, it is going to be a higher risk. Any time you're going to invest in an early stage company, there is a lot of risk there. But the risk of fraud is relatively miniscule.

ELISABETH LOPEZ

This is Up Close. We're joined this episode by crowdfunding expert Dr Richard Swart. I'm Elisabeth Lopez. Richard, what are the hallmarks of a successful crowdfunding campaign?

RICHARD SWART

Several things. The first hallmark is that the campaign effectively highlights the reason why the founder or the entrepreneur wants to produce the product or produce the campaign. It's all about the idea and the passion of the individual. And a lot of the psychological motivations for donation are very similar to charitable giving. Many entrepreneurs especially suffer from what I call shiny ball syndrome, where they fall in love with their technology or what they've invented. All they do is talk about the what and not the why. The why is what motivates people to back your project.Secondly, there's the fallacy that all crowdfunding requires is launching a video, putting it up there and money will magically pour in. A successful crowdfunding campaign starts about three or four months after the entrepreneur has started thinking about crowdfunding. They prepare a content library. And they prepare and engage their social media communities. And they build up followings. They build up Twitter followings. They engage relationships with bloggers and thought-leaders in their space. It's essentially a product launch. So you have to prepare for that and think about how you're going to have your message amplified through other channels and influential people that already have followers. You can't simultaneously build a following and do a crowdfunding campaign. Then they also do high-quality videos and audio quality, which is interesting that most people are so focused on the visual aspects of video that they forget about the audio. The audio oftentimes is so poor that it kills the crowdfunding campaign. Successful campaigns have good audio.

ELISABETH LOPEZ

All this communication sounds incredibly labour-intensive. Are a lot of start-ups or people coming into this space really aware of how much time it takes to have that very authentic relationship with donors or investors?

RICHARD SWART

I don't believe the vast majority of people who start a crowdfunding campaign know what they're getting into. My research shows that the average crowdfunding campaign which successfully raised $100,000 requires 136 hours of work once you start the campaign, that's on the average, some well over 200, 300 hours. That's done over a typically 45 day period. If you're investing 150 to 200 hours over four to six weeks, that's a part-time job. It's a significant component of your work day. It has to be on a daily basis and actually throughout the day because you have to engage with people through social media. This is essentially a social media phenomenon. So the entrepreneur or the founder has to be ready, willing and able to commit a good chunk of energy and time to that crowdfunding company once they start. It's not a set it and forget it model which unfortunately many entrepreneurs think that it is.

ELISABETH LOPEZ

You've pointed out that one of the big risks in crowdfunding is fulfilment risk where the enterprise just has a lot of demand for what it's offering but it just can't quite get there. It's not anticipated the demand correctly or it just doesn't have the nous or the wherewithal to get it all happening in time.

RICHARD SWART

It's sort of ironic. There's a direct linear relationship between the amount of money raised, the length of delays and getting a product out the door. So it shows that people that are more successful than they expected to be, oftentimes are not prepared for that success. As you pointed out, it's typically a logistical challenge or a production challenge. Many of those companies have spent so much time focused on the product, they forgot about things like tax registration and issues about international taxation, international shipping and accounting systems and all the complexities of running a business many times they're not prepared for. It does not mean they've fraudulent intent. It just means they didn't get their act together. Now, what we found is that if these companies communicate those challenges back to their community, they provide frequent updates and they show good faith in fulfilling it, the crowd's pretty forgiving. They understand they're backing an early stage person with a dream. I don't know if that will be true with major corporations. I suspect it will not be true of the bigger companies as they experiment with crowdfunding. But there's very little evidence to show that people crowndfund without any intention of fulfilling the project. The vast majority of the time they do eventually fulfil their obligations.

ELISABETH LOPEZ

Richard, you've observed that there's a perception that companies who resort to crowdfunding just can't get funding from any other source. What's your response to that?

RICHARD SWART

The data shows that that's pretty much not the case. We did a major study and we, in this case, is crowndfund Capital Advisors, one of the consulting groups that I work with, looking on follow-on activity after crowdfunding. And what we found was that in six months 28 per cent of firms had already close a deal with an investor. And 43 per cent of firms were still in talks with a potential investor. Oftentimes there's a several month process to arrive at terms. We've also been tracing activity of several angel networks around the world. I've personally been contacted by more than one venture firm and have been asked to consult with them on strategy but how to best utilise crowdfunding. And it seems that's what's happening is these Angel Networks are waking up to the fact that there's a pretty strong correlation between crowdfunding success, the interest in the community and buying a product. So they're now, what we call, sourcing deals through crowdfunding. There's investor networks that are now explicitly requiring companies they intend to invest in to go demonstrate their ability to crowdfund. Go show us people want your product. Go crowdfund $100,000 and then we'll

match that investment with $200,000 of our own. There are crowdfunding platforms emerging in Asia which are literally hybrids of Angel Networks. All the investors are in Angel Network and they're just using a crowdfunding platform to make it easier to select deals. There are also platforms here in the United States that will allow a company to list an equity transaction but they won't due a full due diligence and all the background checks, which is really expensive, until it looks like there's crowd momentum behind that company. Then once they reach a certain threshold they then sort of tip over into a full documentation, full background check, full due diligence process. So they're basically allowing the crowd to let them know when it's worth their time and money to actually go through the process of screening these companies using crowdfunding.

ELISABETH LOPEZ

The process of gaining angel investment or venture capital investment seems to be quite labour-intensive, involving lots of meetings and to'ing and fro'ing. I suppose crowdfunding potentially eliminates a lot of that?

RICHARD SWART

Yes, I mean, the odds of receiving investment from a venture capitalist are lower than the odds of a child being accepted to Harvard University, extremely rare, in other words. The amount of time necessary to pitch to a group of investors for the average company is dozens or sometimes hundreds of pitches with require manpower, travel, time away from your office. Think about the man costs and the labour costs of that. It's extremely expensive. It's very time-consuming. crowdfunding is not always successful. I mean, only a small percentage of firms are going to raise the amounts of money they want. It's statistically much more successful than going out on a venture pitch or an Angel round pitch. Having had success in crowdfunding changes the nature of the conversation. Many firms that have been turned down or not even allowed to present to the Angel Networks go out and crowdfund and then they get a call from the very same Angel Network saying, please come in next month, we want to talk to you. It's a great way of gaining attention from them quickly and accelerating that process of getting funding.

ELISABETH LOPEZ

Richard, the World Bank believes that the developing world could leapfrog developed countries in crowdfunding. What sort of conditions are necessary for crowdfunding to take off, especially where internet access might be precarious and there are cultural attitudes that discourage entrepreneurship?

RICHARD SWART

There are several factors that come into play. You asked about leapfrogging. That's a fascinating concept and we're already seeing some evidence of that emerging. For example, we know that, while ICT penetration, meaning hardwire computer cables Cat5, fibre optic, things like that, are relatively rare in developing countries, there are still extensive networks of cellular technology, so SMS messaging, cell phones, smart phones. And even though some of the phones in the developing world might not be equivalent to a smart phone you'd buy there in Australia, they still have extensive functionality. So we're finding very innovative entrepreneurs that are utilising different models of crowdfunding. There's one that utilises basically cell phone to cell phone with no website. It's essentially an app. We're seeing other crowdfunding emerge that targets what I'd sort of call the next generation of microenterprise lending where people are talking about very specific need in a village for an entrepreneur to raise a relatively small amount of money but maybe larger than they could get through a microenterprise loan. So we're going to see the emergence of some very interesting hybridised combined loan and donation models in the third-world countries that are going to facilitate these entrepreneurs from accessing capital because in most of the developing world you either go and get a microenterprised loan or you have to have several million dollars in revenue and then you can access institutional capital. So what we call a valley of death in finance is so wide in the developing world, you literally have a gap of sometimes $1000 to several million dollars whereas in most of the first world, there's different stages of financial investing from seed, to angel, to early stage venture capital to private equity. That system

simply does not exist in the rest of the world. So crowdfunding is going to start filling that gap, especially the earlier parts of that spectrum.

ELISABETH LOPEZ

Well, one of the really interesting crowdfunding platforms in Africa is Homestrings funded by Guinea National who was born in New York, a guy called Eric Guichard. Can you tell me a bit about how Homestrings has been working?

RICHARD SWART

I don't have the numbers off the top of my head but I know it's extremely successful and growing very rapidly. It allows essentially diaspora, people that have cultural ties that have left Africa to invest back in Africa. They can select their country or they select the type of project they want to back. I know that in the African American community in the United States and in several other parts of the world, it's gaining a lot of attention and traction as a beautiful example of what community organising around itself and trying to funnel capital back to Africa. The World Bank would call that north-south capital flows. We're also seeing a different example of that where there's a site called OurCrowd, which is a US-based company which primarily solicits for investments and is really technology startup companies. And they are soliciting essentially from Jewish diaspora around the world. They are actually the number two equity crowdfunding site in America right now and growing rapidly. They may emerge as the most successful equity crowdfunding site in America based on the volume of transactions that they're pulling off. So when you can touch an emotional connection or a cultural affinity to a country and crowdfunding becomes the mechanism providing investment money or stabilisation money to that country, you're going to see crowdfunding emerge very rapidly.

ELISABETH LOPEZ

And the World Bank is really moving into this space with climate innovation centres which focus on encouraging clean technology projects. Can you tell us a bit about those?

RICHARD SWART

Yes, they had their first centre operating in Kenya. I believe they're going to open five or six more in the next couple of years. It's basically local entrepreneurs embedded in an area, can identity and innovate around climate technologies and energy technologies. Some of them are very simple. They don't necessarily have to be solar technology. Sometimes they can be a stove. They can be a water project. But the World Bank has recognised that oftentimes you have to provide training to people that understand all those nuances of a local community and enable them to succeed. These climate innovation centres have an accelerator co-working space. Many of them are going to have fabrication facilities or prototyping facilities where people can actually build prototype some products. They typically have ties to universities where they can get expert consulting, engineering and the science behind their ideas. Many times they have ties to venture capital or institutional investors to help them, if not [unnecessarily fund them but help them get ready for future funding. It's a great idea if executed well. And I believe the team at the World Bank is very much on top of crowdfunding and wants to utilise crowdfunding because they see that it will be a way for the World Bank to leverage their money in that country and then allow them to, if you will, follow the British model. So the World Bank will either co-invest with the community or will put some seed money in and then ready them for crowdfunding.

ELISABETH LOPEZ

China, on paper at least, is potentially the biggest market in the world for crowdfunding but it also has incredibly strict controls on social media. What's the future looking like there?

RICHARD SWART

Anyone's guess. Looking at the economic variables, China should comprise about half of the world's crowdfunding market within 10 years. There's no reason that, given the amount of capital, the growth in the middle class, the technology penetration, that China can't become the World's dominant player in all forms of crowdfunding. I fully expect there's entrepreneurs in China that have that explicit goal. But our research showed that the number one most

predictive factor in crowdfunding success is Facebook utilisation. Facebook is the most common social media platform in all but five countries of the world, China being one of them. You have to have free transmission of information for crowdfunding to succeed. So if there's heavily censored social media use or people are afraid to basically exchange information openly and transparently, it's going to be very difficult for crowdfunding to emerge as it exists now.Now, peer-to-peer lending platforms where there's certain companies looking for a loan, they'll give you a certain percentage rate and individuals can loan $500 to that company. That's a lower risk involved and it's probably going to attract less creative or innovative ideas just by the nature of the requirements for a consistent revenue stream to pay back those loans. So we already are seeing some growth in the peer-to-business lending space in China but crowdfunding as we see it in the western world is far less likely to succeed unless there's a major cultural shift and a government shift that allows transparent and open communication.

ELISABETH LOPEZ

Richard, thanks very much for joining us on Up Close.

RICHARD SWART

It's been my pleasure. Thank you for having me.

ELISABETH LOPEZ

That was Dr Richard Swart, director of research on the Program for Innovation in Entrepreneurial and Social Finance at the University of California, Berkeley. Richard Swart consults to leading US financial services companies. He's an active advisor or board member to several start-ups. You can find relevant links and a full transcript of this episode on our website. Up Close is a production of the University of Melbourne, Australia. This episode was recorded on 28 January 2014 and produced by Kelvin Param and Eric van Bemmel, audio engineering by Gavin Nebauer. Up Close is created by Eric van Bemmel and Kelvin Param. I'm Elisabeth Lopez. Thanks for joining us. Until next time, goodbye.

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