Royal commission stability threat a 'worst case outcome'

by Jonathan Shapiro, Dec 6 2017

Fears raised by David Murray that a banking royal commission could undermine the financial system if lenders are unable to enforce terms is a "worst case outcome", say credit experts and bank analysts.

In an opinion piece published in The Australian Financial Review, Mr Murray, who led the 2014 financial systems inquiry said royal commission could have "profound systemic consequences" if banks could not rely on strong contract terms of enforce security.
But Standard & Poor's analyst Sharad Jain said Australia's large banks faced a "balancing act" in lending responsibly and maximising profits.

"Private listed institutions have an obligation to maximise shareholder wealth but they also need to abide by local regulatory guidelines, of which one is responsible lending," Mr Jain said.

Mr Murray argued that foreign creditors and ratings agencies "would be alert to these risks given Australia's very high level of household indebtedness."

Mr Jain said, in theory, additional restrictions imposed on banks would force credit rating agencies to take notice.

"If hypothetically as a consequence of this royal commission, restrictions make it harder for banks to continue their business-as-usual, as such pricing for risk - if that impacts their ability to write profitable business, it is a potential for concern."

Andrew Papageorgiou of Melbourne based credit fund Realm said Mr Murray made important points around the "inherent vulnerability of banks, as highly-leveraged enterprises.

"Ultimately you have $60 billion to $70 billion dollars worth of capital ring fencing a trillion or so worth of assets."

"Those "assets" are ultimately loan contracts. If you start messing with the definition and the quality of the "asset", through the introduction or potential for forbearance, or the voiding or even meaningful weakening of those contracts, frankly those assets aren't worth what they were the day before you made the decision."

One analyst at a Melbourne-based fund said Mr Murray's comments raised the issue of moral hazard, and that bad bank behaviour "cannot be excused for the sake of system stability,"

"If a bank lends badly, or lends too much, where does the accountability fall? The bank has the responsibility to originate a loan with care, due diligence and on the basis that the customer can service and repay from their income."

The analyst said banks and shareholders should wear the consequences of bad credit decisions and the systemic fear promulgated by Murray as "dangerous, self-serving and simply wrong."

"There is a material equity buffer to absorb losses. Share prices simply adjust downwards to reflect the higher required return. New capital will enter and support the bank at a new price," the fund manager said.

Bob Sahota, a former banker and head of fixed income at Challenger who has set up a fund to lend to corporations, said Mr Murray was describing an "absolute worst-case outcome"

"I don't think a royal commission is going to overturn a fundamental thing like security law and if it does, that's bad for everyone. But I can't see that happening."

"Security is a fundamental tenement to loans and I don't think you can challenge that. If you take out valid security, as long as you haven't done predatory lending, security should be enforced."

In Mr Murray's opinion piece, he took aim at the corporate watchdog that he said had "fuelled political attacks on banks and entered commentary on monetary and prudential matters outside its remit." The Australian Securities and Investments Commission declined to provide comment.