

## SUBMISSION ON POLICY ISSUES IDENTIFIED IN THE INTERIM REPORT

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**Submission for:** My Self

**Name of other person, business or organisation:**

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**Your submission:**

**ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY.**

**PERSONAL SUBMISSION OF DR. COLIN BEARDSLEY, EMERITUS ADJUNCT PROFESSOR, INTERNATIONAL CAPITAL MARKETS ASSOCIATION CENTRE, UK; RETIRED MEMBER OF THE AUSTRALIAN STOCK EXCHANGE (ASX); FOUNDER AND FIRST CHAIRMAN OF AUSTRACLEAR LIMITED.**

1. I make this submission both as a retired academic who wrote a PhD on a behavioural analysis of lending decisions by banks and as a market practitioner in the banking and securities industries in Australia from the early-1970s until the mid-1990s.

2. My thesis was entitled "Financing the 1980's commercial property boom: A behavioural analysis of lending decisions by British banks." (1996) Department of Land Management and Development, Faculty of Urban and Regional Studies, University of Reading, UK.

3. It may be useful for the Royal Commission to consider the parallels between banks' behaviour in the UK in the 1980s and extant behaviour in Australia. To this end I offer an abstract of my findings. The most relevant findings to the Australian experience are **underlined in bold**.

4. I have also set down below a selected list both of the academic and other references I used. I can provide further information on these as well as a soft or hard copy of the final thesis (350 pages!) should this be useful

5. From the abstract:

"Britain has experienced two major commercial property cycles since the early 1970s. One of the more evident features in each boom was the extent to which both domestic and overseas banks were prepared to provide large scale finance for development and investment properties

"This thesis offers a behavioural analysis of commercial property lending decisions made by British banks focusing on the commercial property boom of the late 1980s. Where applicable, experience from the Secondary Banking Crisis in 1974 is also included. **The thesis draws from extant theories on managerial ambitions under competition; contestable markets; bank portfolio maximisation; adverse selection and moral hazard; expected utility; prospect theory; adaptive and herd behaviour; principal agent behaviour; group decision making processes; and institutional memory.**

"The 1980s commercial property lending boom is analysed in terms of three basic questions which require explanation to understand the behaviour of banks *vis-à-vis* the commercial property market.

"The questions and conclusions are as follows:

***"Do rational explanations exist which explain apparent bank preferences towards property as an asset class?"***

"Commercial property has a high volatility of returns which makes it an attractive asset for banks seeking to increase earnings and to maximise implicit put options against the regulator. Commercial property also minimises adverse selection and moral hazard risk for bankers. With a rational lending approach, commercial property is an outstanding asset class for risk minimisation with potentially high returns

***"Are there rational explanations which explain sudden large increases in bank lending to property?"***

"Property booms occur in times of rising economic activity with increases in rentals feeding rapidly into increases in collateral value. Both adaptive behaviour and herd behaviour are powerful behavioural forces at work as bankers anticipate further rental increases, and further increases in property values. In addition, there is safety in following the herd in adding assets. Bankers can increase property assets quickly as transactions tend to be large and banking officers are motivated to market aggressively by means of incentive payments which are based not on revenues or fees but on the amount of loan business achieved.

**"The existence of group incentives reinforces further the possibility of increased lending risk as senior banking officers have a conflict of interests between earnings targets and credit quality. 'Groupthink' and risk shift in committees may not provide the necessary quality filter as the managerial desire to add assets quickly may take precedence over prudent lending criteria. Personal greed [What's In It For Me] is a major contributing force.**

***"In view of experience which could have been gleaned from the events of 1974 and from modern lending techniques, why do banks appear consistently to violate prudent lending practices?"***

**"Each generation of new bankers will not have the direct experience of its predecessors. Bankers choose rationally to abandon hard-won, well-known knowledge in which all have been trained to pursue increased earnings in rising asset markets.**

**“When threatened by competition which may erode client relationships, bankers may abandon prudent lending practice to preserve market share. Support from the stock market for a strategy of pursuing market share can encourage further risk taking.**

**“Empirical evidence from a face to face survey of 20 bankers suggests the industry as a whole will not learn from past mistakes.”**

6. Key words: Commercial property banking; rational lending; property booms; banking competition; managerial ambitions; prospect theory; principal agent relationships; adaptive behaviour; herd behaviour; organizational behaviour; group decision making under risk; institutional memory.

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