FROM THE
Managing Editor

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At a time of increased uncertainty in financial markets, some seven years after the onset of the global financial crisis, this issue of *JASSA* includes several papers on the issue of financial stability. These papers focus on the implications of the international linkages of Australian banks, the fast-growing global shadow banking system, and the need to balance safety, stability, efficiency and competition. Other papers address a range of themes on market regulation, outperformance and infrastructure.

This issue of the journal also contains a special section which includes a number of papers presented at the 20th Melbourne Money and Finance Conference — The Australian Financial Sector and Global Integration — held in July 2015. The conference was organised by the Australian Centre for Financial Studies. It was sponsored by APRA, Finsia and the Reserve Bank of Australia. While not subject to the usual double-blind process, each of these papers was reviewed by a member of the Editorial Board and by me prior to inclusion.

First, a timely paper by Nobel laureate Robert Engle, Fariborz Moshirian and Christopher S Wong examines the key factors driving the rapid growth in the shadow banking system and the implications for global risk. The paper highlights the increasing importance of the shadow banking industry in Asia and the factors that will contribute to its expansion in the immediate future. It also discusses the risks associated with shadow banking including leverage risk, maturity and liquidity mismatch, and regulatory arbitrage. With China's shadow banking system one of the fastest growing in the world, the authors indicate that stronger regulation of this system is crucial for the maintenance of financial stability and the prosperity of China and the world at large.

Next Bart Frijns F Fin examines the difficulty of generating positive alpha and the claim by many mutual funds that they are able to generate outperformance. Frijns notes that this claim is at odds with much of the academic literature on fund performance and he presents three academic arguments on the difficulty of generating outperformance by mutual funds. Frijns indicates that a fund manager who mistakes their ability for talent (and charges a high fee), but in reality is doing nothing more than taking exposures to known risk sources (which can be achieved at a much lower fee), will not only be overcharging customers for a skill that they do not possess but also exposing customers to risks that are not communicated to them, and are probably not well understood.

The paper by Neil Hartnett F Fin and Adrian Melia underlines the challenge for financial planners in understanding and suitably modelling an individual's attitude to financial risk. Harnett and Melia suggest that although there appears to be a reasonable volume of guidance regarding the nature of financial risk, there is only limited direction on how best to model a client's attitude towards such risk and that the available guidance is characterised by disparate terminology and confounded interpretation. They indicate that adviser understanding and expertise would be enhanced and the chance of unethical behaviour reduced by a stricter 'prescriptive' framework that precludes the type of error or abuse which currently occurs due to limited guidance.

Bob Li, Paul Lajbcygier and Cindy Chen reassess the relationship between default risk, return and the book-to-market ratio by incorporating negative book equity (BE) stocks into their study. The authors note that a paradox is created by the common practice in stock evaluation models of excluding stocks with a negative BE. They say this suggests that in interpreting the book-to-market ratio as a proxy for distress risk, it makes no sense to exclude these negative BE stocks since they are, prima facie, most prone to distress risk. They find that negative BE stocks carry higher default risks than their positive BE counterparts and that these risks are not totally offset by higher returns, suggesting that a default risk filter can be used in the investment universe selection process through which the portfolio return can be enhanced.

Turning to the special section of this issue of *JASSA*, the first paper by Grant Turner and James Nugent examines the international linkages of the Australian banking system and the implications for financial stability. Turner and Nugent note that the large Australian-owned banks maintain significant international assets, including a large exposure to New Zealand and that exposures within the Asian region have grown rapidly over recent years. The authors also indicate that while Australian banks fund a portion of their domestic activities offshore, the post-crisis balance sheet adjustments should enhance banks' resilience to potential future global funding market disruptions. They welcome further research on these issues, particularly on how inward transmission of shocks through Australian-located banks might arise from post-crisis changes in international markets, including the growing use of central clearing for over-the-counter derivatives, new prudential rules and instruments and altered resolution regimes.

The paper by Charles Littrell focuses on the important need to find a balance between safety, stability, efficiency and competition within Australia's banking system. It provides insight into the way APRA thinks about capital requirements for Australia's major banks in the context of its prudential mission. The paper concludes that there are good reasons to think that the Australian economy would be better served by major banks that are unquestionably strong, to borrow a phrase from the Financial System Inquiry. Littrell argues that any increase in capital would make the major banks, and therefore the banking system, appreciably better positioned to deal with unexpected shocks. Furthermore, because the major banks are currently profitable, competitive, and efficient, increasing their capital requirements would be unlikely to unduly impair, and might marginally improve, the financial system's competitiveness.

Finally, Oliver Harvey, Calissa Aldridge and Ben Cohn-Urbach indicate that the rapidly changing dynamics in global financial markets are being acutely felt in the Australian marketplace and that in order to deliver most effectively for those they are designed to serve, markets need to reliably and effectively provide the infrastructure for companies to raise capital and for investors to invest and allocate risk. Using the example of recent developments in the over-the-counter (OTC) derivatives market, the paper highlights the challenges and opportunities in ensuring Australian financial markets continue to deliver these enduring benefits. The authors indicate that a great deal of work will be needed in the next few years to implement requirements for counterparties to exchange margin for non-centrally cleared trades, on the back of internationally agreed principles agreed by IOSCO (International Organization of Securities Commissions) and the Basel Committee. They expect these requirements to bring in the need for margining across a range of firms that previously had limited or no need to margin, in particular corporates, superannuation funds and asset managers.

I would like to thank all of our contributors to this very broad ranging and topical issue of *JASSA* and encourage anyone interested in contributing to the journal to contact us at membership@finsia.com