Scope of the Inquiry

Terms of Reference

1.1 The Inquiry is charged with:

- considering the impact of deregulation of the Australian financial system since the early 1980s;
- analysing the forces driving further change in the system; and
- making recommendations on regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system:
  - — to underpin stronger economic performance;
  - — consistent with financial stability, prudence, integrity and fairness.

The full Terms of Reference are provided in Appendix A.

Defining the Australian Financial System

1.2 The financial system comprises the institutions, markets, individuals and regulators involved in the financial functions of the economy. At the most general level, the primary function of the system is to match the supply of, and demand for, financial resources. This encompasses both the direct matching of buyers and sellers (or lenders and borrowers) in the market place and the indirect matching of buyers and sellers through intermediaries such as banks. The system also encompasses the information and advisory services which are integral to its operations.

1.3 The Inquiry has not limited itself to an investigation of businesses and markets which have traditionally been identified as constituting the financial system. Increasingly, the economic functions of the financial system are being undertaken by new entities, often in new ways using new technologies. At the same time, the structure of the market place for financial services is changing for example, through an increasing role in origination and distribution of financial services by agents rather than financial system principals.

1.4 The Inquiry will consider the extent to which the Australian financial system is being integrated with the global financial system. Australians increasingly have access to international financial services, particularly in wholesale markets. Conversely, financial services offered in Australia may be used by overseas customers.

1.5 Deregulation of the financial system has affected profoundly the rest of the Australian economy, leading to the pursuit of deregulation in other markets. Globalisation of the financial system will also have consequential effects which will require a global approach in almost all markets and fields of public policy. If the reach of markets exceeds the reach of regulatory jurisdictions, it will be necessary to consider the nature and approach of regulation if it is to remain effective.

1.6 In considering the Australian financial system, the Inquiry has paid careful attention to new means of delivering the economic functions of the financial system and developments in the global economy.

Functions of the Financial System

1.7 Beyond the broad definition of matching the supply of, and demand for, financial assets, it is possible to define the financial system by identifying a number of its more specific economic functions.[1] The three most obvious of these are:

the provision of payments services (including clearance and settlement)

- Payments services involve the transfer of value from one person to another in exchange for goods, services, or assets or for other purposes. Various instruments are used including cash, cheques, direct payments using electronic or other messages, and credit, debit and electronic cash cards.
- The processing of these payments is known as clearing and the final discharge of payments obligations is known as settlement.
- The payments system is critical to the functioning of the whole economy. It provides essential messages which enable practically every facet of economic activity to proceed — paying wages or pensions, purchasing goods and services, buying and selling assets and engaging in new investment projects. A breakdown in this process could cause extreme damage to the economy and hence hardship, even for people who may have had nothing to do with the transactions immediately involved.

the pooling and allocation of financial resources

- Savers pool their resources through investment in financial instruments such as deposits, insurance policies, and securities. These resources are then allocated by the financial system to investors through debt and equity instruments.

1 See Merton, R. C. and Bodie, Z. 1995.

- This function is important for everyone in the community. Among other things, it provides the finance for investment in housing and new businesses, and the assets underpinning insurance, superannuation and other savings schemes.

the allocation and management of risk

- The financial system provides direct and indirect means for allocating risk among different institutions and investors according to their risk preferences. This covers a wide diversity of processes and instruments, including insurance, contractual risk assignment, financial derivatives markets, and risk spreading through pooling of investments.

1.8 There are other economic functions of the financial system which might be seen as ancillary to the three core functions discussed above, including:

- providing price and other information for decision-making (including the provision of financial advice);
- defining, allocating and recording property rights (debt, equity and other financial instruments, in addition to offering differing returns, confer on the holder differing control rights and obligations in relation to underlying assets); and
- providing liquidity.

1.9 These financial functions are critical for the performance of the economy and well-being of the community. Financial contracts, which embody these functions to varying extents, play a key role in facilitating the settlement of trade and channelling resources efficiently across time and space.

1.10 It is fundamental to the integrity and efficiency of the financial system that financial commitments be understood and that the probability of their being honoured be capable of assessment. Regulation has a prime responsibility in these areas.

1.11 Regulation must also deal with market failure in the form of systemic risk and informational asymmetries. The latter failure is a particular concern for consumers because financial complexity and time combine to create an informational imbalance between sophisticated financial institutions and financially unsophisticated consumers that is not always adequately removed by the provision of additional information.

1.12 The challenge facing the Inquiry is to identify a regulatory structure that best meets these objectives, without limiting the ability of financial markets and participants to provide financial services efficiently and creatively. The regulatory structure must be capable of dealing with change flexibly and in a way that does not stifle innovation, competition or competitiveness.[2]

Structure of the Discussion Paper

1.13 A broad description of the existing financial system in Australia is provided in Chapter 2. This chapter is essentially descriptive and does not attempt to meet those Terms of Reference for the Inquiry which require a stocktake of financial deregulation in the 1980s. Such matters will be dealt with in the Final Report of the Inquiry.

1.14 Some preliminary observations on the major factors driving change in the system are outlined in Chapter 3. Again, the Inquiry intends to provide a complete report on these matters in its Final Report.

1.15 The broad approach of the Inquiry to the major regulatory issues is set out in Chapter 4.

1.16 Chapters 5 to 9 provide an outline and discussion of the main elements of the regulatory framework, discussing in turn policies dealing with the regulation of financial markets,[3] industry concentration, prudential regulation, consumer protection, and policies directly affecting

2 In this paper, 'competition' refers to a state of rivalry between firms in a market (see Chapter 6) while 'competitiveness' refers to the ability of a firm (or other entity) to compete successfully (see Chapter 9). The term 'competitive' may be employed in either context.

3 In this paper, 'financial markets' refers to the securities and derivatives markets, and the 'regulation of financial markets' refers to disclosure and conduct rules applied to participants in those markets.

competitiveness. Finally, Chapter 10 discusses the task of regulatory policy co-ordination and review. These regulatory elements are the main focus of this Discussion Paper.

Exclusions under the Terms of Reference

1.17 Consistent with the Terms of Reference, the Inquiry will not make recommendations on the general operation of companies under the *Corporations Law*, the conduct of monetary policy, retirement income policies or taxation policies. The Inquiry is required to take these policies into account in making its recommendations. Particularly in the case of taxation, the Inquiry has interpreted this instruction as requiring it to report on the implications of certain taxation policies for the broader goals of its proposed regulatory framework. Making such observations necessarily falls short of making recommendations, because the latter requires consideration of many other issues, beyond the scope of the Inquiry — issues whose consideration would be essential for a complete judgement to be formed about the appropriate design of taxation laws.

1.18 The Inquiry has considered it inappropriate to investigate the arrangements for the issuance or management of government debt.